Vasily Astrov

Ukraine: riding on the wave of high steel prices

The country's recent economic performance has been very encouraging. Growth accelerated markedly, while macroeconomic imbalances were largely avoided and the 'gas price shock' reasonably well digested. According to preliminary data, in 2006 the economy grew at a solid 7%, up from 2.7% in 2005. This acceleration largely reflected a pick-up in metals production (+8.9% in output terms) and construction (+9.8%), both these branches having contracted in 2005. (Still, it was retail and wholesale trade and transport which recorded the highest value-added increase in 2006, while agricultural output stayed nearly flat.) The impressive turnaround in construction activity was due to the recovery in fixed capital formation (+11.4% in the first nine months of 2006), resulting partly from under-investment under the first 'orange' government back in 2005 and reflecting the generally improved business climate. Also, there is evidence that the rising investment is partly motivated by energy-saving considerations following the 'gas price shock' in January 2006. In turn, the expanding metals production translated into exports performing unexpectedly well. At the same time, the growth of imports, though impressive, was somewhat contained by a decline in oil prices in the second half of the year. (Unlike for gas, Ukraine is paying the 'world market price' for its oil imports from Russia). As a result, the 2006 current account must have been largely in balance.

Judging by these indicators, the country's current growth path is increasingly resembling that observed in 2000-2004, i.e. prior to the 'orange revolution'. Its salient features were the high overall dynamics, the pivotal role of the industrial sector as the growth locomotive, and the generally high saving ratios mirrored in both thriving domestic investment and strong external surpluses. The role of industry reflected not least the favourable developments in the world steel markets, while the high propensity to save was related to the prevailing weak social protection and unequal income distribution. With both these factors seemingly at work again (a marked recovery of steel prices to the 2004 levels after a major dip in 2005 and the arguably pro-'oligarchic' government of Prime Minister Viktor Yanukovych in place), it is little surprise that current developments present certain resemblance to the 'pre-orange' period. The important difference, however, is that in 2006 the contribution of consumption to growth was very high. In the first nine months, private consumption was up by a record-high 19% year-on-year, backed by impressive real wage growth (18.6% for the year as a whole) – the legacy of the 'orange' governments. However, the average figure disguises marked changes in the monthly dynamics. In fact, wage restraint has been increasingly visible since the Yanukovych government took office in August, and by December 2006, the growth in real wages plunged to just 11.7% year-on-year.

In 2006 the consolidated government budget recorded a 0.7% deficit which, in the absence of sizeable privatization revenues, was covered largely by external borrowing. At the same time, domestic public debt fell by some 13%. As a result, three quarters of the country's public debt are now denominated in foreign currency. The government strategy to borrow in foreign rather than domestic currency makes sense given the lower interest rates on foreign currency-denominated bonds[1] and the stable exchange rate outlook (if anything, rather an appreciation of the hryvnia could be expected). While *public* foreign debt increased by 12.6% in dollar terms in 2006, *overall* debt expanded, according to some estimates, by 24% and reached 47% of GDP by the end of the year. The main driving force behind has been the banking sector's rapidly growing external borrowing, possibly associated with the growing presence of foreign banks. The rising overall level of external debt and the substitution of public debt by private are well in line with the earlier experience of other transition countries and is in itself a welcome development reflecting lower risk perceptions on the part of foreign creditors.

Another manifestation of lower risk perceptions has been the growing inflow of FDI. In January-September 2006 alone, Ukraine received nearly EUR 2.9 billion in FDI – much more than the EUR 2.2 billion (net of the revenues from the Kryvorizhstal privatization which was in many ways exceptional) received in 2005 as a whole. The principal target of FDI has been the banking sector. As a result, 13 of the 30 biggest banks are now majority foreign-owned, and the share is set to grow further, not least due to the newly adopted law which allows foreign banks to open branches in Ukraine following the country's WTO accession.[2]

While the impact of the January 2006 'gas price shock' on the real economy was negligible, inflation picked up somewhat. In 2006, consumer prices of 'electricity, gas and water' increased by 85.7% on an end-year basis. However, food prices – dominating the CPI basket – were flat; thus, the end-year consumer inflation stood at a 'mere' 11.6% (up from 10.3% the year before). The inflationary pressure is likely to stay stubbornly high, particularly as a result of further ongoing and forthcoming energy price hikes. Following the renewed hike in the border price of imported gas from USD 95 to USD 130 per th cm as of 1 January 2007, the price for industrial consumers has been raised accordingly, to some USD 143 per th cm (without VAT and transport costs). By contrast, gas tariffs charged to households are still much lower, starting from USD 62 per th cm and depending on the volumes consumed. However, further upward adjustments will be unavoidable, thus fuelling overall inflation. Also, consumer inflation will be increasingly affected by the spillovers from the recent surge in producer prices (+14.1% on an end-year basis). In the medium term, the border price of gas will rise further – given Gazprom's current strategy of

[1] For instance, the government placed a CHF 384 million worth of 12-year 3.5% bonds in September 2006, followed by a USD 1 billion issue of 10-year 6.58% bonds in November. This is to be compared to the 9% p.a. yield on domestic 2-year bonds placed in October.

[2] Generally, unlike subsidiaries, bank branches operate subject to regulations of the 'home' country. However, foreign banks will be only allowed to open branches in Ukraine after the fulfilment of certain criteria (such as compliance with the Basle prudential regulations and cooperation with FATF) and will need a National Bank permission.

bringing its export prices in line with the West European levels, and notwithstanding the marked improvement in Russia-Ukraine relations over the past few months (and the associated restraint from the EU).

Inflation apart, the country's short-term economic prospects are good. In 2007-2008, we expect economic growth ranging between 5.5% and 6% – barred any major downturn in the world metals markets. Exports and particularly investments are likely to perform well. However, the growth of private consumption is likely to slow down somewhat due to greater wage restraint, and despite booming consumer credit. Although the slowdown of consumption will have a dampening effect on imports, the latter will be inflated by the higher gas prices, so that a further deterioration of the country's external position can be hardly avoided. Still, the current account deficit this year should remain relatively modest at some 2% of GDP. After a dip last year, large-scale privatization in 2007 is likely to receive a new boost, with Ukrtelekom and the Odessa Port Plant (the leading fertilizer producer) featuring on the list. In fact, privatization revenues are expected to cover two-thirds of the planned 2.6% central budget deficit. At the same time, the moratorium on the free sale of agricultural land has been prolonged until 2008.

Political developments appear to have only a minor impact on the economy these days. Despite the persistent stand-off between the president and the prime minister, the country is now living through a period of its greatest political stability since the 'orange revolution'. Prime Minister Yanukovych has been generally successful in consolidating his power grip, while President Yushchenko looks increasingly weak and isolated. He has been outmanoeuvred by both Mr Yanukovych and Ms Tymoshenko and has largely lost control even over his own party. Also, he has been often facing a constitutional, i.e. a two-thirds, parliamentary majority against him, as the faction of Ms Tymoshenko – though formally in opposition – has opted to cooperate with the ruling coalition on several occasions. At the moment, the chances of President Yushchenko to be re-elected in 2009 appear slim, although the three years left represent still a long time to go, particularly by Ukrainian standards.

Table UA

Ukraine: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	2006 1)	2007	2008
								forecast	
Population, th pers., end of period	48923.2	48457.1	48003.5	47622.4	47280.8	46929.5	46638.7	46300	46000
Gross domestic product, UAH mn, nom.	170070	204190	225810	267344	345113	424741	496000	578300	658900
annual change in % (real)	5.9	9.2	5.2	9.6	12.1	2.6	7	6	5.5
GDP/capita (EUR at exchange rate)	688	872	931	928	1100	1411	1670	.	.
GDP/capita (EUR at PPP - wiiw)	3770	4250	4630	5130	5930	6260	6870	.	.
Gross industrial production									
annual change in % (real)	13.2	14.3	7.0	15.8	12.5	3.1	6.2	5	4.5
Gross agricultural production									
annual change in % (real)	9.8	10.2	1.2	-11.0	19.7	-0.1	0.4	.	.
Construction output total									
annual change in % (real)	0.4	3.5	-5.8	26.5	17.2	-6.6	9.8	.	.
Consumption of households, UAH mn, nom.	92406	112260	124560	146301	180956	238961	221919 I-IX	.	.
annual change in % (real)	2.5	9.6	9.5	11.5	13.5	16.6	19.0 I-IX	.	.
Gross fixed capital form., UAH mn, nom.	33427	40211	43289	55075	77820	93357	80854 I-IX	.	.
annual change in % (real)	12.4	6.2	3.4	22.5	20.5	-0.3	11.4 I-IX	15	15
LFS - employed persons, th, avg. 2)	20175.0	19971.5	20091.2	20163.3	20295.7	20680.0	20880.8 I-IX	.	.
annual change in %	1.1	-1.0	0.6	0.4	0.7	1.9	0.6 I-IX	.	.
Reg. employees in industry, th pers., avg. 3)	3445.0	3811.0	3578.1	3416.0	3408.3	3415.8	3350.4	.	.
annual change in %	-12.4	-6.2	-6.1	-4.5	-0.2	0.2	-1.6	.	.
LFS - unemployed, th pers., average 2)	2655.8	2455.0	2140.7	2008.0	1906.7	1600.8	1460	.	.
LFS - unemployment rate in %, average 2)	11.6	10.9	9.6	9.1	8.6	7.2	6.6	6.5	6.4
Reg. unemployment rate in %, end of period	4.2	3.7	3.8	3.6	3.5	3.1	2.5	2.4	2.3
Average gross monthly wages, UAH 3)	230.1	311.1	376.4	462.3	589.6	806.2	1042.9	.	.
annual change in % (real, gross)	1.1	20.7	20.0	16.7	17.0	20.4	18.6	.	.
Consumer prices, % p.a.	28.2	12.0	0.8	5.2	9.0	13.5	9.1	10	8
Producer prices in industry, % p.a.	20.8	8.7	3.0	7.6	20.5	16.7	9.5	11	8
General governm. budget, nat.def., % GDP									
Revenues	28.9	26.9	27.4	28.2	26.5	31.6	34.6	.	.
Expenditures 4)	28.3	27.2	26.7	28.4	29.7	33.4	35.4	.	.
Deficit (-) / surplus (+), % GDP	0.6	-0.3	0.7	-0.2	-3.2	-1.8	-0.7	-2.6 5)	.
Public debt in % of GDP	45.3	36.5	33.5	29.0	24.7	18.4	17.2 XI	.	.
Refinancing rate of NB % p.a., end of period	27.0	12.5	7.0	7.0	9.0	9.5	8.5	.	.
Current account, EUR mn 6)	1602	1565	3360	2559	5560	2030	0	-2000	-3000
Current account in % of GDP	4.7	3.7	7.5	5.8	10.6	3.1	0	-2.1	-2.7
Gross reserves of NB excl. gold, EUR mn 7)	1453	3353	4088	5386	6838	16165	16587	.	.
Gross external debt, EUR mn 8)	12759	13785	12247	19055	22528	32671	35295 IX	.	.
Gross external debt in % of GDP	37.7	32.5	27.3	42.9	43.1	49.1	.	.	.
FDI inflow, EUR mn 6)	644	884	734	1261	1380	6263	4000	.	.
FDI outflow, EUR mn 6)	1	26	-5	12	3	221	0	.	.
Exports of goods, BOP, EUR mn 6)	17008	19074	19770	21013	26906	28093	31500	34700	36400
annual growth rate in %	37.2	12.1	3.6	6.3	28.0	4.4	12	10	5
Imports of goods, BOP, EUR mn 6)	16165	18853	19018	20555	23895	29004	34800	40000	44000
annual growth rate in %	32.8	16.6	0.9	8.1	16.3	21.4	20	15	10
Exports of services, BOP, EUR mn 6)	4111	4459	4958	4615	6325	7503	9000	10350	11400
annual growth rate in %	13.0	8.5	11.2	-6.9	37.0	18.6	20	15	10
Imports of services, BOP, EUR mn 6)	3433	3995	3743	3934	5329	6054	7500	9000	10800
annual growth rate in %	59.3	16.4	-6.3	5.1	35.5	13.6	24	20	20
Average exchange rate UAH/USD	5.440	5.372	5.327	5.333	5.319	5.125	5.050	5	5
Average exchange rate UAH/EUR (ECU)	5.029	4.814	5.030	6.024	6.609	6.389	6.335	6	6
Purchasing power parity UAH/USD, wiiw	0.849	0.912	0.943	0.997	1.117	1.301	1.378	.	.
Purchasing power parity UAH/EUR, wiiw	0.917	0.987	1.013	1.091	1.227	1.442	1.542	.	.

Note: The term ‘industry’ refers to NACE classification C+D+E.

1) Preliminary. - 2) From 2000 revised data according to census 2001. - 3) Excluding small enterprises. - 4) From 2004 including lending minus repayments. - 5) Central budget deficit passed by Parliament in December 2006. - 6) Converted from USD. - 7) Useable. - 8) Up to 2002 long-term debt only.

Source: wiiw Database incorporating national statistics; wiiw forecasts.