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 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.

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

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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 fulfillment of certain criteria (such as compliance with the Basle prudential regulations and cooperation with FATF) and will need a National Bank permission.
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**

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<thead>
<tr>
<th>Year</th>
<th>Population, th pers., end of period</th>
<th>GDP/capita (UAH at exchange rate)</th>
<th>GDP/capita (UAH at PPP - wiiw)</th>
<th>Gross industrial production</th>
<th>Gross agricultural production</th>
<th>Consumption of households, UAH mn, nom.</th>
<th>GDP/capita (EUR at exchange rate)</th>
<th>GDP/capita (EUR at PPP - wiiw)</th>
<th>General government budget, nat.def., % GDP</th>
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*Note: The term 'industry' refers to NACE classification C+D+E.*


Source: wiiw Database incorporating national statistics; wiiw forecasts.