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Ukraine: economy withstanding the gas price shock

The dramatic deceleration of economic growth in Ukraine observed throughout 2005 and in early 2006 appears to have reversed. The hike in the price of imported natural gas at the beginning of the year has not had any sizeable impact on growth or inflation, at least so far. According to preliminary data, in January-May the GDP grew by 4% year-on-year – faster than in 2005 (2.6%, according to revised figures). The growth was mainly driven by agriculture and services, particularly construction (+8.2% in value-added terms), whereas industrial output stayed flat for most of the period. However, in May industry picked up by an impressive 10%, largely due to the strong expansion of metals production. Still, on *average* in January-May 2006, metals were up only by 1.7%, and the production of chemicals – another major export industry – even marginally declined. Both metals and chemicals are highly energy-intensive branches and it is little surprise they were hit hardest by the gas price shock (more on that, see below). At the same time, some of the less energy-intensive industries performed well, and machine-building even grew by 11.5%.

Viewed from the demand side, there appears to be a shift in the sources of growth, with domestic demand increasingly making up for deteriorating net exports. In particular, fixed capital investments (+15.9% year-on-year in the first quarter) performed much better than last year, and the already booming consumption gained momentum once again. In January-April, retail trade turnover – a proxy for private consumption – was up 27.4% in real terms. Similarly to 2005, the booming consumption is backed by the strong growth of wages (especially in the public sector), pensions and other social payments enacted by the first 'orange' government, but also by the strong expansion of consumer credit. At the same time, the contribution of net exports to growth must have been strongly negative: in the first four months of 2006, exports of goods fell by nearly 4% in dollar terms, whereas imports jumped by 23%.

The growing trade deficit (USD 2.1 billion in January-April, according to the customs statistics) will inevitably translate into a worsening current account, which we expect to turn negative this year – after a 3.1% surplus in 2005. However, it is being easily financed by the FDI inflows increasingly targeting the biggest banks such as Ukrsibbank acquired by BNP Paribas of France and Ukrsotsbank by Banca Intesa of Italy. These two deals alone are of a magnitude comparable to the current account deficit expected for the year as a whole. Besides, the inflows of FDI are expected to accelerate following Ukraine's accession to the WTO. (The main remaining stumbling block in the WTO accession process – a bilateral agreement on market access with the United States – has been

settled,¹ even though accession may be delayed somewhat and synchronized for political reasons with that of Russia.) Therefore, while the short-run dynamics of foreign exchange reserves may stay volatile,² in the medium term the National Bank should have no difficulties in maintaining the current 5.05 UAH per USD exchange rate peg. A weakening of the US dollar against other major currencies will make this task even easier.

Since January 2006, Ukraine has been formally paying a new border price of USD 95 per thousand cubic metres (th cm) for its natural gas imports – instead of USD 50 it used to pay previously for Russian gas under a barter arrangement. However, given the monopoly position of the state-owned energy company Naftohaz and the administrative price-setting in the domestic market, the price increase has been passed on to the final consumers only partly. As a result, Naftohaz has accumulated debt arrears to its supplier RosUkrEnergo of some USD 700 million, which are to be financed largely by external borrowing.

Starting from 2006, the gas price for industrial consumers was capped at USD 110 per th cm (excluding VAT and transportation costs). However, industrial producer prices rose only moderately (by 4.3% in May against December), as the most energy-consuming export industries facing international competition were unable to pass the rising cost of the energy inputs on to customers (given the stable exchange rate) and were forced to reduce their production volumes instead. In turn, the gas and electricity tariff hikes for households were postponed until after the March parliamentary elections; both were eventually raised by 25% on 1 May 2006. As a result of the move, the prices of services jumped by 3.6% in May, but the surge was mitigated by the continuous deflation of foodstuffs making up some 60% of the consumer basket. Thus, between December 2005 and May 2006, consumer prices rose by a mere 2.8%. However, in the second half of the year consumer price inflation will almost certainly pick up, given the 85% gas tariff hike scheduled for 1 July (one more, albeit a smaller, tariff hike is planned for 1 January 2007). In addition, the border price paid by Ukraine for imported gas may well rise further, for instance, to USD 130 per th cm, as suggested recently by the RosUkrEnergo officials, although the negotiations are still going on. Against the background of the planned hikes of gas, but also other regulated tariffs such as telecommunications and railways, the consumer price inflation in 2006 will be almost certainly double-digit once again.

Last but not least, economic prospects may be hampered by the policies of the renewed 'orange' coalition formed after the parliamentary elections held in March. The elections resulted in a triumph of the opposition parties, weakening the position of the pro-president

¹ Almost simultaneously, the United States granted Ukraine 'market economy' status and abolished the trade discriminating so-called 'Jackson-Vanik amendment'.

² As demonstrated by the recent developments, this volatility typically results from the sequence of one-time FDI-related foreign exchange inflows followed by current-account-related outflows.

'Our Ukraine' and potentially forcing it to accept difficult compromises. Given the renewed nomination of Ms Tymoshenko for the post of prime minister and the participation of the Socialist Party in the newly formed coalition, a liberal and reform-oriented economic policy course may be problematic. Nevertheless, the coalition is unlikely to be stable and we expect a gradual acceleration of economic growth in 2006-2007, while both the budget and the external deficits will be generally kept in check.

Table UA

Ukraine: Selected economic indicators

	2001	2002	2003	2004	2005 ¹⁾	2005 1st quarter	2006	2006 forecast	2007
Population, th pers., end of period	48457.1	48003.5	47622.4	47280.8	46929.5	47166.2	46831.7	46600	46300
Gross domestic product, UAH mn, nom.	204190	225810	267344	345113	418529	79356	93086	480900	547800
annual change in % (real)	9.2	5.2	9.6	12.1	2.6	5.4	2.4	3.5	4.5
GDP/capita (EUR at exchange rate)	872	931	928	1100	1391	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	4240	4620	5120	5920	6250	.	.	.	.
Gross industrial production									
annual change in % (real)	14.3	7.0	15.8	12.5	3.1	7.1	0.2	3	4
Construction output total									
annual change in % (real)	3.5	-5.8	26.5	17.2	-6.6	-5.9	5.0	.	.
Consumption of households, UAH mn, nom.	112260	124560	146301	180956	238040	.	.	.	.
annual change in % (real)	9.6	9.5	12.4	15.1	15.9	.	.	.	.
Gross fixed investment, UAH mn, nom.	32573	37178	51011	75714	93096	12638	16486	.	.
annual change in % (real)	20.8	8.9	31.3	28.0	1.9	4.5	15.9	7	10
LFS - employed persons, th, avg.	19971.5	20091.2	20163.3	20295.7	20748.2	20027.1	.	.	.
annual change in %	-1.0	0.6	0.8	0.7	2.2	3.0	.	.	.
Reg. employees in industry, th pers., avg. ²⁾	3811.0	3578.1	3416.0	3408.3	3406.6	3414.0	3378.2	.	.
annual change in %	-6.2	-6.1	-4.5	-0.2	0.0	0.5	-1.0	.	.
LFS - unemployed, th pers., average	2455.0	2140.7	2008.0	1906.7	1557.0	1912.1	.	.	.
LFS - unemployment rate in %, average	10.9	9.6	9.1	8.6	7.0	8.7	.	6.8	6.6
Reg. unemployment rate in %, end of period	3.7	3.8	3.6	3.5	3.1	3.6	3.2	3	3
Average gross monthly wages, UAH	311.1	376.4	462.3	589.6	806.2	676.6	918.3	.	.
annual change in % (real, gross)	20.7	20.0	16.7	17.0	20.4	15.2	23.8	.	.
Consumer prices, % p.a.	12.0	0.8	5.2	9.0	13.5	13.5	9.7	11	9
Producer prices in industry, % p.a.	8.6	3.1	7.8	20.4	16.8	22.3	8.4	10	8
General governm.budget, nat.def., % GDP									
Revenues	26.9	27.4	28.2	26.5	32.0	30.2	35.3	.	.
Expenditures ³⁾	27.2	26.7	28.4	29.7	33.9	26.6	34.9	.	.
Deficit (-) / surplus (+), % GDP	-0.3	0.7	-0.2	-3.2	-1.9	3.5	0.4	-2.5 ⁴⁾	.
Public debt in % of GDP	36.5	33.5	29.0	24.7	18.7	.	.	.	.
Refinancing rate of NB % p.a., end of period	12.5	7.0	7.0	9.0	9.5	9.0	9.5	.	.
Current account, EUR mn ⁵⁾	1565	3360	2559	5560	2030	1221	-618	-1500	-2500
Current account in % of GDP	3.7	7.5	5.8	10.6	3.1	10.7	-4.0	-1.9	-2.7
Gross reserves of NB excl. gold, EUR mn ⁶⁾	3353	4088	5386	6838	16165	9068	13921	.	.
Gross external debt, EUR mn ⁷⁾	13785	12247	19055	22528	32824	24643	33045	.	.
FDI inflow, EUR mn ⁵⁾	884	734	1261	1380	6263	202	553	.	.
FDI outflow, EUR mn ⁵⁾	26	-5	12	3	221	14	3	.	.
Exports of goods, BOP, EUR mn ⁵⁾	19074	19770	21013	26906	28093	6499	6824	28000	29500
annual growth rate in %	12.1	3.6	6.3	28.0	4.4	9.0	5.0	0	5
Imports of goods, BOP, EUR mn ⁵⁾	18853	19018	20555	23895	29004	5722	7896	33000	36300
annual growth rate in %	16.6	0.9	8.1	16.3	21.4	10.0	38.0	14	10
Exports of services, BOP, EUR mn ⁵⁾	4459	4958	4615	6325	7503	1428	1809	8500	9000
annual growth rate in %	8.5	11.2	-6.9	37.0	18.6	10.5	26.7	13	6
Imports of services, BOP, EUR mn ⁵⁾	3995	3743	3934	5329	6054	1285	1663	7000	7500
annual growth rate in %	16.4	-6.3	5.1	35.5	13.6	8.5	29.4	16	7
Average exchange rate UAH/USD	5.372	5.327	5.333	5.319	5.125	5.299	5.050	5	5
Average exchange rate UAH/EUR (ECU)	4.814	5.030	6.024	6.609	6.389	6.956	6.067	6	6
Purchasing power parity UAH/USD, wiiw	0.912	0.943	0.998	1.120	1.288	.	.	.	.
Purchasing power parity UAH/EUR, wiiw	0.988	1.014	1.092	1.229	1.423	.	.	.	.

Notes: 1) Preliminary. - 2) Excluding small enterprises. - 3) From 2004 including lending minus repayments. - 4) Central budget deficit passed by Parliament end December 2005. - 5) Converted from USD. - 6) Useable. - 7) Up to 2002 long-term debt only.

Source: wiiw Database incorporating national statistics; wiiw forecasts.