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UKRAINE Economic Update

November, 2006

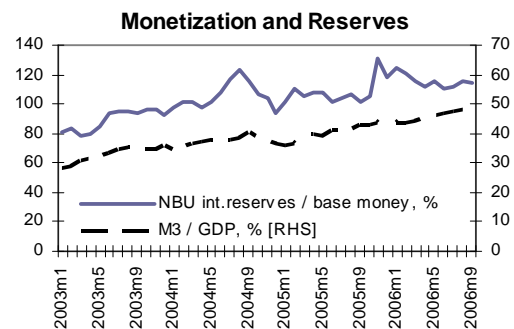
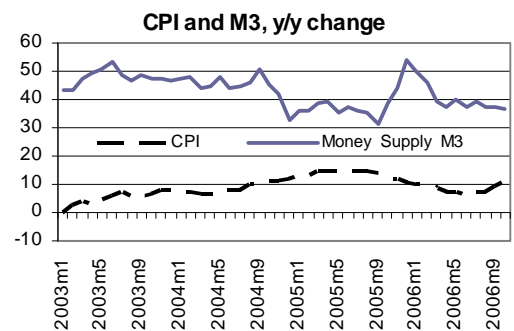
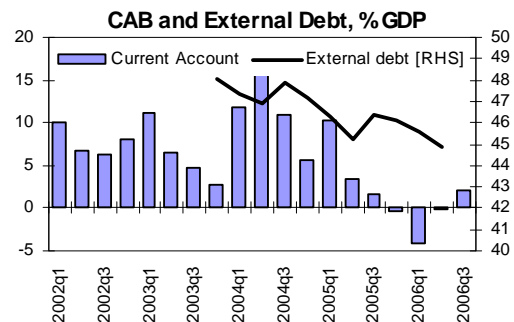
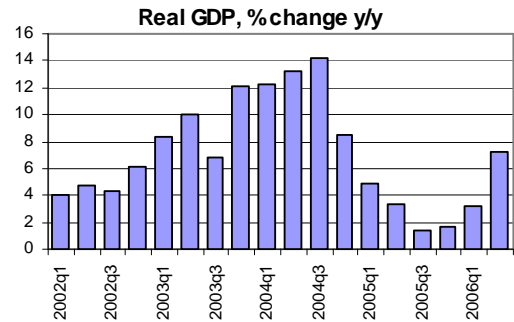
- **Ukraine's economic performance has exceeded expectations during 2006 so far. While to some extent fortuitous, the outturn also reveals greater resilience to energy price increases than originally thought.**
- **The 2007 draft budget makes a welcome correction to excessive public consumption spending – but disappointingly seems to do little to cut wasteful subsidies and reintroduces some tax expenditures (such as the Free Economic Zones) that have proven ineffective in the past.**
- **A negative terms of trade shock remains the key short term risk to the outlook, with modest concern over an inadequate fiscal response. However, overall, the macroeconomic situation leaves enough room for a focus on structural reforms – on which government plans so far remain somewhat unclear.**

Recent Economic Developments

Accelerating output growth driven by metals exports' revival. In Jan-Oct, real GDP growth accelerated to 6.5% y/y and is now on target for closing the year at the same rate. Metal prices in Q3 exceeded the record highs of end 2004, fuelling export growth of over 20% y/y since May. Despite higher import prices for energy, significantly lower gas import volumes and decelerating domestic wage growth have brought import growth to under 20% over recent months. The current account moved into surplus of 2% GDP in 3Q. CPI inflation is on the rise, as local governments started to pass-through gas prices into higher tariffs for communal and heating services. In October, the CPI picked up to 11% y/y, driven by a 43% y/y growth of the services sub-component, while food and non-food goods inflation remains moderate under 5% y/y.

The draft 2007 state budget, with a target deficit of 2.55% of GDP, was approved in its first reading. The draft budget sharply decelerates wage and pension spending, while shifting resources into subsidies with vague allocation procedures. NBU continues to maintain the official exchange rate at 5.05 UAH/USD, while allowing the interbank market to fluctuate in an informal band of 5–5.06 UAH/USD. International reserves in October increased by USD 0.3 billion to USD 19.4 billion, thus returning to the previous peak of Nov 2005.

Structural reform agenda remains unclear. The arrival of a new government in early August has so far not found reflection in a concerted effort to re-launch structural reforms. Pronouncements of senior government officials have indicated that attention has been focused on "stabilization measures", aiming to reduce imbalances in the budget and obtaining a new gas deal with Russia.



Short Term Outlook

Growth is likely to slow to 4-5% in 2007. Ukraine's resilience in 2006 has surprised observers. It is due to three factors, all of which are unlikely to be present to the same extent in 2007. First, terms of trade developments taking metal prices into account were positive on the whole whereas the forecast is for a clear deterioration in 2007 (we assume around 5%). Second, consumption growth continued to be resilient, as the energy price pass through to consumers was delayed to mid-year and public sector wage growth remained buoyant. The public sector will no longer lead wage settlements in 2007. We assume consumption growth will slow from double digits to around 3-4% over the next 2-3 years. Third, and most difficult to predict, enterprises seem to have been able to absorb the energy price shock much more easily than anticipated. To what extent this can continue with gas prices rising to US\$130 is not clear. We do assume, however, that industry will continue to have good access to financing and will choose to invest in energy efficiency. Our forecast is thus based on sustained investment demand, declining consumption momentum, and on the back of slower real import growth an overall neutral net exports contribution.

Inflation increase is a concern, although fiscal and external imbalances are likely to be contained. Both fiscal and external imbalances are forecast to grow in 2007 while energy price increases will keep inflation in low double digits. The risks to the government's fiscal deficit target are on the upside, although lower growth and higher inflation should partially compensate each other. Quasi-fiscal deficits in the energy sector should be contained if the government passes through the price increase to industrial tariffs and maintains payment discipline (even without further utility price adjustments for households). The current account deficit is likely to exceed 3% of GDP due to declining terms of trade, but this should be easily funded by FDI and private borrowing barring a sharp downturn in global emerging market sentiment.

The key risk is a much larger terms of trade shock, combined with a global downturn and inadequate domestic policy response. Should metal prices and external demand fall sharply, there would be the need to a sharper fiscal adjustment, accompanied by some exchange rate adjustment. Tightening external liquidity would hurt investment demand and may cause difficulties in the banking sector, where recent credit growth has been very fast. An inadequate fiscal and monetary response, with rising fiscal deficits and a delayed but sharp exchange rate adjustment would exacerbate these risks. The appropriate policy response would therefore be a gradual shift towards greater exchange rate flexibility from the present position of external strength to force private agents to adequately account and price foreign exchange risk.

Table 1: Key Macroeconomic Indicators

	2002	2003	2004	2005	2006F	2007F	2008F	2009F
Nominal GDP, <i>UAH billion</i>	225.8	267.3	345.1	424.7	522.0	606.1	697.6	789.6
Real GDP, % change	5.2	9.6	12.1	2.6	6.5	4.5	5.5	5.0
Consumption, % change	5	12.9	12.2	12.9	14.2	3.4	3.5	4.1
Investment, % change	-1.5	11.9	20.5	-0.3	10.9	10.4	11.5	5.5
Export, % change	7.4	10.4	13.8	-11.2	-4.2	5.9	6.2	6.0
Import, % change	3.3	16.5	8.6	2.1	8.7	6.6	5.8	4.8
GDP deflator, % change	5.1	8.3	15.2	20.0	15.4	11.1	9.1	7.8
CPI, % change eop	-0.6	8.2	12.3	10.3	11.6	10.7	9.4	8.2
Current Account Balance, % GDP	7.5	5.8	10.7	3.1	-0.9	-4.1	-4.8	-4.7
Terms of Trade, % change	1.4	1.7	3.9	2.5	7.0	-5.3	-2.2	-1.0
Budget revenues, % GDP	35.7	35.9	35.1	41.3	40.4	39.8	39.2	37.9
Budget expenditures, % GDP	35.5	36.8	39.5	43.6	43.3	42.9	41.8	40.9
Fiscal balance, % GDP	0.2	-0.9	-4.4	-2.3	-2.9	-3.1	-2.6	-3.0
External debt, % GDP		47.5	47.2	46.1	41.9	41.7	41.6	40.7
Public and Guaranteed Debt, % GDP	36.5	29.0	24.7	18.4	16.6	17.6	18.1	19.1

Source: Ukrainian Authorities, WB projections

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