



THE WORLD BANK

UKRAINE Economic Update

April, 2007

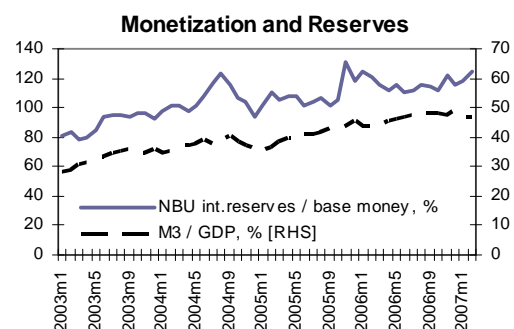
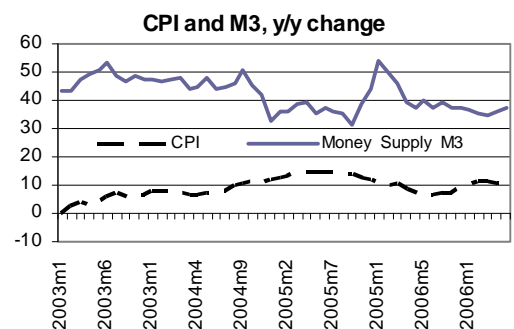
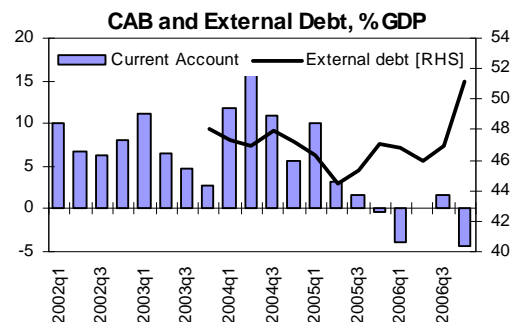
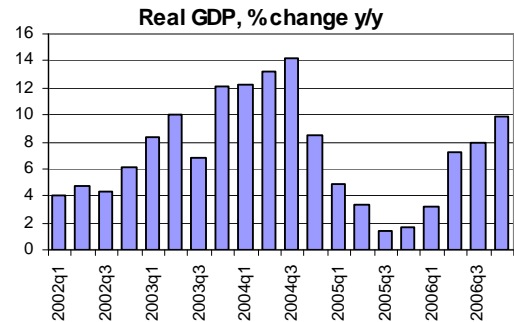
- **While Ukraine remains vulnerable to a number of shocks, the economy is now better balanced than it has been for several years.**
- **In the short run, the primary challenge is to maintain a sufficiently tight fiscal framework to dampen domestic demand and to be able to counteract negative external shocks.**
- **Ukraine will need to lay the basis for a shift towards greater exchange rate flexibility which would allow for a larger role for monetary policy to maintain economic balance.**

Recent Economic Developments

Strong growth reveals the considerable resilience of Ukraine's economy. In 2006, real GDP growth reached 7.1% driven by decelerating but still strong private consumption and accelerating fixed investments. Nominal GDP for 2005 has been revised upward by 4% leading to a higher than expected nominal outcome for 2006. To date in Jan-Feb 2007, real GDP posted an 8.6% y/y growth on the back of a combination of strong recent momentum in manufacturing, a one-time boost associated with unusually mild weather in Jan, and low base of 2006Q1. The shift from export to domestic demand led growth has led to a change in external balances from current account surplus to a small deficit of USD1.6 billion (1.5%) in 2006, as import growth was twice as high as that of exports. FDI inflows posted USD5.2 billion (5% GDP), reflecting improved perceptions of Ukraine as an investment location. CPI inflation is around 10%, as local governments passed through gas prices into higher tariffs for communal and heating services.

The Parliament amended 2007 Budget by introducing faster phase-in of minimum wage and pension increases. The cost for the budget is estimated at US\$ 7.6 billion (1.2% GDP). Average nominal minimum wage is now set to grow by 20% this year (5 p.p. up). Our analysis suggests that higher revenues from better than earlier projected nominal GDP would be enough to keep the deficit under 3% GDP. NBU continues to maintain the official exchange rate at 5.05 UAH/USD. External debt increased by a record US\$ 8 billion in 2006Q4 due to private borrowings, helping the international reserves to reach new highs of US\$ 23 billion.

The progress in structural reform agenda is uneven. On the one hand, one of the biggest steps in structural reform in Ukraine was taken at the end of 2006 with the enactment of 21 pieces of legislation laying the foundations for the accession to the WTO. Despite higher imported gas prices, the quasi-fiscal deficit in the energy sector actually fell as a percent of GDP in 2006, as a result of strong domestic price adjustment. On the other hand, un-transparent and uncompetitive privatization of *Luganskteplovoz*, introduction of grain quotas and delays with VAT refunds are examples of the back-tracking.



Short Term Outlook

While Ukraine remains vulnerable to a number of shocks, the economy is now better balanced than it has been for several years. Bank Staff expect solid, but not spectacular, economic performance going forward. Growth is expected at an average of 5.5 percent per year in the medium-term. This forecast builds on the assumption that structural reforms will advance gradually, but recognizes that Ukraine's growth over the short term may continue to receive an additional fillip from the forces of recovery and convergence. The key factors underlying these projections are as follows: (i) the current account is expected to move into larger deficits due to a forecast deterioration in Ukraine's terms of trade, increased imports of goods and services associated with growing investment demand and rising disposable incomes, and increased availability of international financing; (ii) private consumption growth is expected to decelerate to below the rate of GDP growth after 2008 following a decline in the growth rate of public sector wages and pensions. Rising energy prices and growing investment spending are also likely to put pressure on wage growth in the private sector; (iii) the growth rate of gross fixed investments is projected to exceed GDP growth, as the political situation remain stable and Ukrainian companies use the improved access to finance to modernize production facilities in the context of energy price increases; (iv) the government will maintain fiscal prudence and keep the budget deficit below 3 percent. Public consumption and transfers growth will decelerate to provide more room for capital spending and reduction of the tax burden.

Despite genuine progress in economic transition and institutional development, the rapid pace of growth is still supported by external factors that are either temporary or inherently unpredictable. This includes strong world prices for Ukrainian exports, most notably of iron and steel, a still moderately undervalued national currency, internal excess capacity, and extremely rapid growth in credit. As these conditions weaken, the challenges to economic policy will become greater. In the short run, the primary challenge will be to maintain a sufficiently tight fiscal framework to dampen domestic demand and to be able to counteract negative external shocks. Moreover, Ukraine will need to lay the basis for a gradual shift towards greater exchange rate flexibility which would allow for a larger role for monetary policy to maintain economic balance in the future.

The key economic risk is a much larger terms of trade shock, combined with a global downturn and inadequate domestic policy response. While political uncertainty and prolonged political crisis may pose downside risks to the outlook, a better than currently projected external environment and genuine progress in investment climate would call for an upside revision.

Table 1: Key Macroeconomic Indicators

	2002	2003	2004	2005	2006F	2007F	2008F	2009F
Nominal GDP, UAH billion	225.8	267.3	345.1	441.5	535.9	632.1	727.5	823.5
Real GDP, % change	5.2	9.6	12.1	2.7	7.1	5.5	5.5	5.0
Consumption, % change	5	12.9	12.2	15.7	11.2	6.1	5.0	4.2
Fixed Investment, % change	-1.5	11.9	20.5	3.9	14.7	11.1	10.4	5.9
Export, % change	7.4	10.4	13.8	-12.2	-3.1	5.3	5.6	5.6
Import, % change	3.3	16.5	8.6	6.4	6.3	8.4	7.1	4.8
GDP deflator, % change	5.1	8.3	15.2	24.6	13.3	11.8	9.1	7.8
CPI, % change eop	-0.6	8.2	12.3	10.3	11.6	10.9	9.4	8.2
Current Account Balance, % GDP	7.5	5.8	10.6	2.9	-1.5	-3.9	-5.3	-5.6
Terms of Trade, % change	1.4	1.7	3.9	8.1	1.2	-1.8	-2.1	-1.0
Budget revenues, % GDP	35.7	35.9	35.1	41.3	40.4	39.8	39.2	38.0
Budget expenditures, % GDP	35.5	36.8	39.5	43.6	43.3	42.8	41.7	40.9
Fiscal balance, % GDP	0.2	-0.9	-4.4	-2.3	-1.3	-3.0	-2.6	-2.9
External debt, % GDP		47.5	47.1	45.3	51.2	49.8	51.5	52.7
Public and Guaranteed Debt, % GDP	36.5	29.0	24.7	17.7	15.0	14.9	15.5	16.7

Source: Ukrainian Authorities, WB projections

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