



# Monthly Economic Monitor Ukraine

- The People's Union "Nasha Ukraina" and the Block of Yulia Tymoshenko signed an agreement on joint opposition activity.
- In January 2007 real GDP grew by 9.3% yoy.
- The government lifted export quotas for barley and corn.
- Parliament prohibited privatization of the gas transportation system or transferring it into concession.
- In 2006 the annual current account balance was negative at USD 1.6 bn or 1.5% of GDP.
- The central fiscal surplus reached 3.6% of GDP due to underexecution of expenditures.
- In February consumer prices inflation decelerated to 9.5%.

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March  
2007

Population: 47 m  
Industry/GDP: 27%  
Agriculture/GDP: 10%  
Investment/GDP: 19%  
Exports to: Russia 18%, EU 29%  
Imports from: Russia 40%, EU 32%

## Politics: The opposition factions united their forces

Two factions in the Parliament, the People's Union "Nasha Ukraina" and the Block of Yulia Tymoshenko, signed an agreement on joint opposition activity. Besides, they agreed to unite both factions in local councils. These agreements partially restored the coalition established during the Orange Revolution, and may help to change disposition of political forces in the country.

In February the Verkhovna Rada appointed Mykola Tomenko from the Block of Yulia Tymoshenko as the Vice-Speaker and re-elected Nina Karpachova, the representative of the Party of Regions of Ukraine, as the Ombudsman. At the same time, the Parliament did not support the candidatures proposed by the President for the positions of the Foreign Minister, Vladimir Ogrzyzko, and the Head of the Security Service, Viktor Korol. The President resubmitted these candidatures to the Parliament. The continued conflict over power distribution caused hot debates on the necessity of further changes to the Constitution. As a result, a parliamentary commission was established and requested to develop possible amendments.

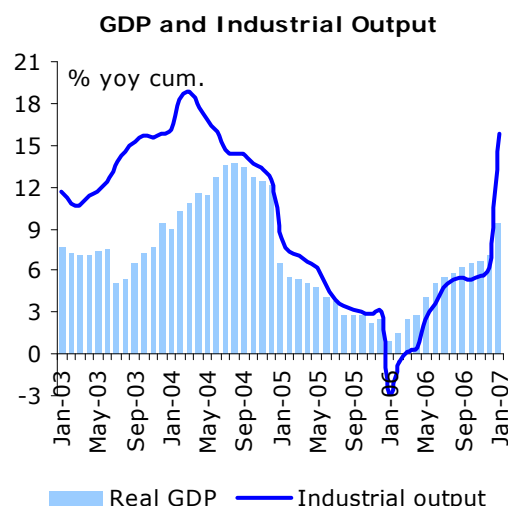
## Real sector: 9.3

According to Derzhkomstat, in January 2007 real GDP grew by 9.3% yoy against 0.9% yoy growth a year before. High growth is primarily explained by rise of value added in trade and industry, as well as continued recovery of construction. Also, the situation in agriculture improved backed by the growth in livestock production. In January the industrial output increased by 15.8% yoy against 2.2% yoy reduction in the same period of 2006. The upward trend in industrial production that started in the middle of the previous year has prevailed thanks to growth in extracting and manufacturing industries. In particular, extraction of non-energy materials, especially ores, increased backed by development of metal production. Continued boom of residential housing stimulated growth of construction materials production and woodworking production.

## Sectoral trends: The export quotas for barley and corn are lifted

**Agriculture.** A half-year existence of grain export quotas significantly harmed investment climate and the reputation of Ukraine as a reliable supplier of agricultural products. In February, the Government finally lifted export quotas for barley and corn, but left wheat and rye export quotas untouched. This decision makes likely that farmers will not decrease seeded area under the spring grain. The eventual lifting of export quotas shows how the WTO accession may limit discretionary steps of the government.

**Energy.** In February the President signed the law that bans any possible form of privatization of the gas transportation system (GTS). The law explicitly forbids the restructuring of companies that run major pipelines; the alienation of the property of such companies and of the national oil and gas company "Naftogaz Ukrainy", its subsidiaries and gas storages; or any transfer, rent, lease or



Source: Derzhkomstat

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concession of their property. Bankruptcy proceedings against those enterprises are also forbidden. The unanimous approval of the ban demonstrated the high political importance of this issue. However, this decision will make it more difficult to attract private investors for financing the necessary maintenance and expansion of the GTS.

The state company "Gaz Ukrainy" created the daughter enterprise "Ukrgazmerezha" for maintenance and operation of state gas-distribution networks as the alternative to local gas distribution companies (oblgazy). It is planned to transfer to "Ukrgazmerezha" gas-distribution networks from those oblgazy, which have large arrears for fuel payments and do not meet requirements regarding investments and maintenance of infrastructure. However, the principle cause for poor oblgazy performance lies in the centrally determined tariffs for household consumers, set below full costs of services. Accordingly, transferring distribution networks to the control of Naftogaz might allow for a short-term rehabilitation of the existing system, but it does not help to overcome the fundamental problem of the sector.

**Utilities.** The sharp growth of utility tariffs in 2006 provoked discussion on their economic justification. Special Governmental commission, the Main Department of Control and Audit and the Office of Public Prosecutor combined their forces in examining the utility tariffs setting. As a result, tariffs were decreased in some local areas. Furthermore, the Government decided to make locally-set utility tariffs changes subject to approval by the State Price Control Inspection, which is to develop economically justified methodology of tariffs setting. The latter measure is intended to make tariffs more transparent. However, the centralized approval of tariffs may lead to further administrative interventions in tariff settings making them even more political-cycle dependant. Also, if further tariff increases are significantly restrained, it will extend the ongoing process of asset deterioration in the sector.

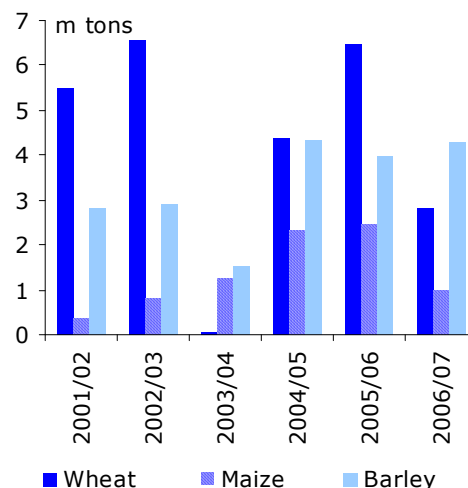
**Privatization.** The State Property Fund (SPF) won a suit on the retrieval of 50% plus one shares of the Nikopol Ferroalloy Plant (NFP) to the state property. The Supreme Economic Court obliged the custodian of the shares to transfer them to the SPF. The NFP was privatised in 2003 by a consortium "Pridneprovie". The disputes around the *bona fide* buyer of the plant were investigated several times during 2005-2006 after the rightfulness and transparency of the privatization of the NFP was questioned. After receiving shares, the SPF could start the process of plant re-privatisation.

### External sector: Current account balance was negative at 1.5% of GDP in 2006

According to the NBU preliminary information, in 2006 the annual current account balance was negative at USD 1.6 bn or 1.5% of GDP for the first time since 1998. It is explained by commodity trade deficit and, to a lesser extent, increased outflow of incomes. While exports gradually accelerated during the year and its growth reached 10.9% yoy in dollar terms, commodity imports growth was 20.9% yoy. Resulting commodity trade deficit reached USD 4.9 bn compared to USD 1.1 bn a year before.

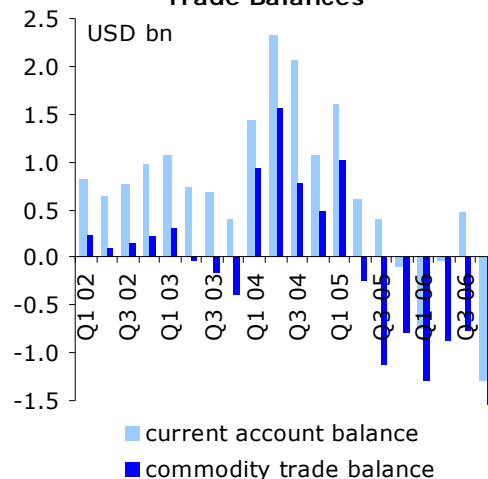
The key feature of 2006 balance of payment was a sharp increase in long-term financing inflows, in particular foreign direct investment (FDI), allowing adequate financing of current account deficit. According to preliminary estimates, in 2006 the FDI inflow reached USD 5.3 bn that is twice more than a year before, if the receipts from sale of metallurgical giant Kryvorizhstal are excluded. The foreign capital was primarily directed into financial intermediation, real estate transactions, business services, and trade. Despite growth, the FDI per capita at around USD 490 remained three times lower than the average for transition economies, emphasising the potential for attracting more FDI in future if the investment climate is improved. Also, the medium- and long-term credits reached USD 5.5 bn thanks to banks borrowings abroad.

Ukraine's export of barley, maize and wheat



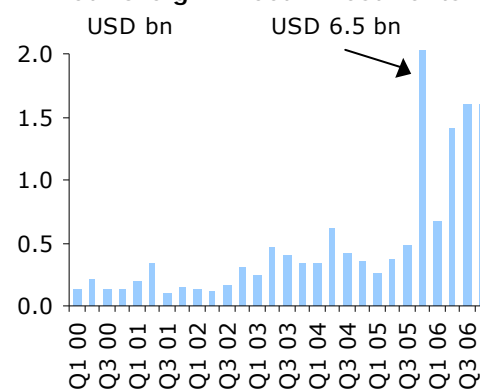
Source: Derzhkomstat

Current Account and Commodity Trade Balances



Source: NBU

Net Foreign Direct Investments



Source: NBU

### Fiscal policy: Central fiscal surplus reached 3.4% of GDP in January due to under-execution of expenditures

In January 2007 central fiscal revenues were executed at 111.8% of the target thanks to high tax revenues. In particular, the VAT and enterprise profit tax (EPT) were over-executed by 17.7% and 8.4% of plan respectively thanks to high economic growth rates. At the same time, the central fiscal expenditures were 30% below the planned figure, being traditionally explained by the technical difficulties in adopting necessary by-laws. The social payments were executed at the highest rate of 93.4%, while central fiscal expenditures on the utility sector were below 30% of the target. As a result, the central fiscal surplus reached UAH 1.6 bn or 3.6% of GDP.

In February the Government approved the Concept of Tax System Reform for 2007-2015. The Concept foresees the simplification of tax administration and tax rates reduction. Also, it envisages the adjustment of Ukrainian tax legislation to the EU standards by 2015. The Concept is only a starting point of long-awaited tax reform. The tax system will be regulated by the Tax Code, which is planned to be approved by mid-2007. The tax reform has been under the discussion for many years, and is expected to ease up taxation procedures, thus contributing to improvement of investment climate.

### Social policy: The pensions will further grow in 2007

In 2007 the State Budget Law envisages zero deficit of the Pension Fund budget compared to UAH 7.3 bn deficit in a previous year. The total central fiscal transfer planned at UAH 22.3 bn is to finance state pension programs, payment of pensions to military pensioners and retired judges, and compensation of losses caused by reduced contribution rate for agricultural producers. During the year minimum pension was planned to be gradually increased from UAH 380 in January to UAH 395 in October. However, the government plans steeper pension growth that may result in the Pension Fund deficit, thus creating an additional burden to the central budget.

### Monetary policy: CPI decelerated to 9.5%

In February consumer prices inflation decelerated to 9.5% mainly due to lower food prices. Also, some local governments partly retracted their decisions on utility tariffs increases after the government started examining economic justification of tariff levels. In February government officials stepped up with rhetoric against price increases. However, longer-term disinflation could not be achieved through short-term administrative actions, while such actions are likely to misbalance markets.

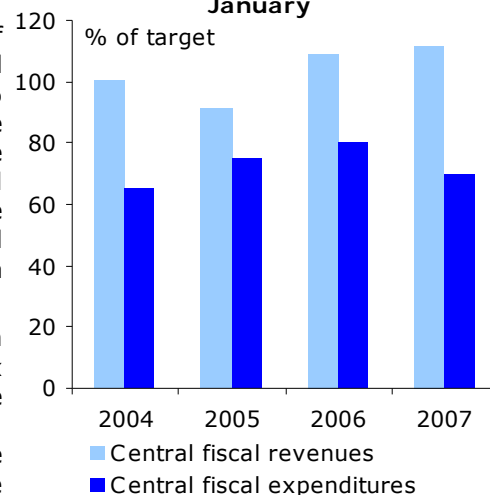
Money supply grew by 37.2% and monetary base grew by 21.7% in February. Great volumes of free liquidity accumulated by commercial banks allowed the NBU to offer deposit certificates and withdraw some of excess liquidity at the minimum interest cost.

The Parliament approved amendments to the law on the NBU. Key changes include extension of the NBU chairman term from 5 to 7 years, shortened lists of reasons for the NBU council members' dismissal. Such measures could help to increase stability of monetary policy as the members of the board become less vulnerable to the political cycle in the country. At the same time, the amendments envisage dilution of education requirements for the NBU council members.

### Financial markets: Role of foreign currency in financial system continues to grow

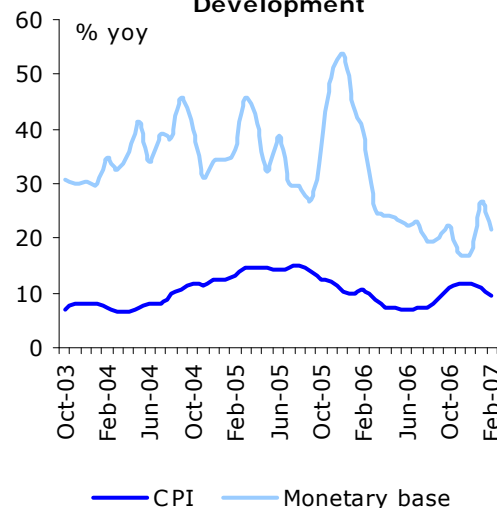
**Dollarization.** Role of foreign currency in financial system continues to grow. Dollarization is especially pronounced in bank lending, where share of foreign currency credits outstanding grew from 41.3% in September 2005 to 50.7% in February 2007. Main reason behind such shift is explosive growth of consumer-oriented lending offered mainly in foreign currency. Such trend exposes the economy to exchange rate risk as significant share of borrowers do not have stable cash flows in foreign currency to offset credit payments.

Central fiscal execution in January



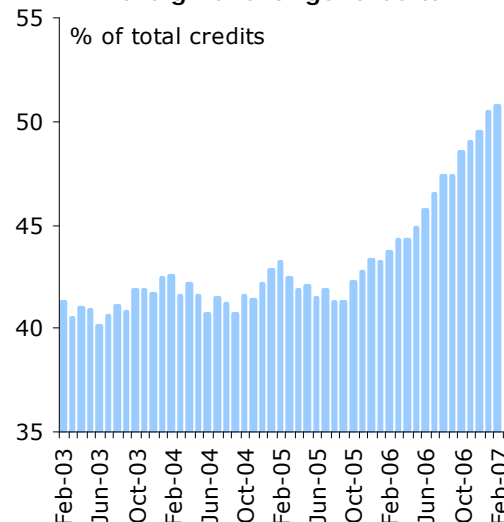
Source: State Treasury reports

CPI and Monetary Base Development



Source: Derzhcomstat, NBU

Foreign exchange credits



Source: NBU



Economic Trends		Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Oct	Nov	Dec	Jan	Feb
GDP growth (real)	% yoy	1.7	3.2	7.3	8.0	...	9.0	8.2	...	9.3	...
GDP growth (real)	% yoy cum.	2.6	3.2	5.4	6.5	7.0	6.5*	6.7*	7.0*	9.3	...
Industrial production (real)	% yoy cum.	3.1	0.2	3.6	5.5	6.2	5.3	5.6	6.2	15.8	...
Agricultural production (real)	% yoy cum.	0.0	4.0	3.2	-2.8	0.4	-1.1	-0.9	0.4	6.9	...
CPI	% yoy eop	10.3	8.6	6.8	9.1	11.6	11.0	11.6	11.6	10.9	9.5
PPI	% yoy eop	9.6	6.5	6.3	10.7	14.4	13.1	14.0	14.4	15.6	16.5
Exports (USD)***	% yoy cum.	7.5	-0.3	4.7	10.7	...	11.2"	11.4"	12.1"	...	...
Imports (USD)***	% yoy cum.	20.4	24.9	19.7	19.8	...	22.6"	22.4"	24.6"	...	...
Merchandise trade balance	USD bn cum.	-1.14	-1.29	-2.16	-2.93	-4.9 <sup>e</sup>	-4.64"	-5.22"	-6.67"	...	...
Current account	USD bn cum.	2.53	-0.74	-0.78	-0.32	-1.6 <sup>e</sup>	x	x	x	x	x
Current account	% GDP, cum.	3.0	-3.7	-1.8	-0.4	-1.5 <sup>e</sup>	x	x	x	x	x
Gross international reserves	USD bn eop	19.39	17.3	17.7	19.1	22.3	19.5	21.2	22.3	22.4	22.4
Monetary Base	% yoy eop	53.9	25.2	22.4	20.3	17.5	22.5	17.2	17.5	26.7	21.7
Lending rate on UAH credits **	% pa, aop	16.4	15.8	15.5	14.6	15.1	14.3	14.4	15.1	14.2	13.9
Exchange rate (official)	USD aop	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05
Exchange rate (official)	EUR aop	6.00	6.07	6.34	6.43	6.51	6.37	6.49	6.67	6.57	6.60

SOURCES: Derzhkomstat, Ministry of Finance, NBU, IFS, own calculations

" Monthly figures are only for merchandise exports and imports (source: Derzhkomstat)

Quarterly figures are for trade in goods and services (source: NBU)

\* Monthly figures do not include the regular quarterly revision of the GDP series

\*\*Weighted average for different maturities (source: NBU)

\*\*\* Growth rate in dollar terms

<sup>e</sup> Preliminary estimate provided by the NBU

Key Economic Indicators		1999	2000	2001	2002	2003	2004	2005	2006
Nominal GDP	UAH bn	130.4	170.1	204.2	225.8	264.2	345.9	424.7	527.4 <sup>e</sup>
Nominal GDP	USD bn	31.6	31.2	37.8	42.6	49.5	65.1	83.1	104.4 <sup>e</sup>
GDP growth (real)	% yoy	-0.2	5.9	9.2	5.2	9.4	12.1	2.6	7.0 <sup>e</sup>
Industrial production	% yoy	4.0	13.2	14.2	7.0	15.8	12.5	3.1	6.2
Agricultural production	% yoy	-6.9	9.8	10.2	1.2	-11.0	19.1	0.0	0.4
CPI	% yoy aop	22.7	28.2	12.0	0.8	5.2	9.0	13.5	9.1
CPI	% yoy eop	19.2	25.8	6.1	-0.6	8.2	12.3	10.3	11.6
PPI	% yoy aop	31.5	20.9	8.6	3.1	7.8	20.4	16.8	9.5
PPI	% yoy eop	15.7	20.8	0.9	5.7	11.2	24.1	9.6	14.2
Exports (gs, USD)	% yoy	-7.9	17.9	9.5	10.7	24.0	42.6	7.5	...
Imports (gs, USD)	% yoy	-19.1	18.9	14.1	4.9	28.7	31.3	20.4	...
Current account	USD bn	0.9 <sup>o</sup>	1.2 <sup>oo</sup>	1.4	3.1	2.9	6.9	2.5	...
Current account	% GDP	2.9 <sup>o</sup>	3.8 <sup>oo</sup>	3.7	7.6	5.9	10.6	3.0	...
FDI (net)	USD bn	0.5	0.6	0.8	0.7	1.4	1.7	6.5	...
International reserves	USD bn	1.09	1.48	3.09	4.42	6.94	9.52	19.39	22.26
Fiscal balance <sup>'''</sup>	% GDP	-2.1	-0.7	-1.9	0.8	-0.2	-3.4	-1.82	-0.94 <sup>e</sup>
Total state debt	% GDP eop	61.0	45.3	36.5	33.5	29.0	24.7	17.7	15.3
External debt (total)	% GDP eop	49.9	33.1	26.3	24.1	21.3	18.7	13.4	12.1
Monetary base	% yoy eop	39.3	39.9	37.4	33.6	30.1	34.1	53.9	17.5
Exchange rate	USD aop	4.13	5.44	5.37	5.33	5.33	5.31	5.12	5.05
Exchange rate	USD eop	5.07	5.44	5.30	5.33	5.33	5.31	5.05	5.05
Exchange rate	EUR aop	4.39	5.03	4.81	5.03	6.02	6.62	6.40	6.32
Exchange rate	EUR eop	5.20	5.10	4.67	5.53	6.66	7.22	5.97	6.65

SOURCES: Derzhkomstat, NBU, IFS, Ministry of Finance, own calculations

<sup>'''</sup> "Minus" denotes a consolidated fiscal deficit

<sup>o</sup> The value of goods transferred to Russia according to the inter-governmental agreement reached in May 1997 on the Black Sea Fleet division totaling USD 726 m is not included

<sup>oo</sup> The value of the aircraft complexes transferred to Russia as repayment of a gas debts according to the inter-governmental agreement reached in October 1999 totaling USD 274 m is not included.

<sup>e</sup> Preliminary estimate

#### Notes:

<b>avg</b>	average	<b>ytd</b>	year-to-date
<b>cum.</b>	cumulative	<b>p.a.</b>	per annum
<b>mom</b>	month on month change	<b>eop</b>	end of the period
<b>qoq</b>	quarter on quarter change	<b>aop</b>	average of the period
<b>yoy</b>	year on year change	<b>gs</b>	goods and services