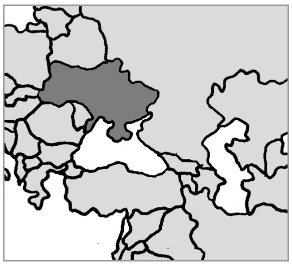

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Ukraine:
Exports to the rescue

The second round of the presidential elections on 7 February 2010 resulted in a narrow victory of the leader of the pro-Russian opposition Party of Regions Viktor Yanukovych. This victory was followed by the break-up of the previous parliamentary coalition around Yulia Tymoshenko and the formation of a new coalition centred around Yanukovych's Party of Regions (and including two smaller parties: the Communist Party and the centrist Lytvyn Block, as well as a number of defectors from the two 'orange' factions) and of a new government headed by Mykola Azarov, a close ally of Mr. Yanukovych. Although the legal aspects of the coalition build-up appear questionable,[1] a speedy government formation was seen to be crucial in bringing the badly needed political stability. Indeed, the fact that the president and the prime-minister now represent the same political force has put an end to the stalemate which persisted in Ukraine over the years of the 'orange' rule, and the policy efficiency of the authorities has increased. However, the newly gained stability seems to have come at the expense of reduced political freedoms, including a tougher scrutiny of mass media.

One of the declared priorities of the new government is to resume cooperation with the IMF. The latter was suspended in November 2009 because of Ukraine's non-compliance with the IMF conditionalities attached to the USD 16.5 billion 'stand-by' loan (of which USD 10.5 billion had already been disbursed). Currently, the government is hoping for a new 2.5-year IMF package of up to USD 19 billion. However, for that, the fiscal deficit will have to be cut from 8-9% of GDP recorded last year to 6% in 2010 (the 2010 budget law adopted by the new government envisages a deficit of 5.3% of GDP). On the one hand, the fiscal situation should be helped by the ongoing economic recovery. Also, the newly granted price discount for Russian gas should reduce the losses of the state-owned Naftohaz and ultimately the burden on the state budget. However, the targeted surge in budget revenues by 28% (in nominal terms) underlying the current budget is highly questionable and relies partly on tax hikes (excise tax) and improved tax administration (e.g. of banks), which have not been legislatively enacted yet. In the first five months of

1 Ukraine's constitution envisages that the parliamentary coalition is formed by factions rather than individual MPs, but the constitutional court has confirmed the legitimacy of the new coalition.

2010, the collection of tax revenues fell 8% short of the target, and the situation is unlikely to change dramatically, implying that the budget deficit for the year as a whole will probably reach at least 7% of GDP. The relatively high fiscal deficits also imply that it will not be easy for the new authorities to implement their ambitious tax reforms promised during the presidential election campaign, but seemingly postponed at least until 2011. These include, inter alia, a reduction of profit tax from 25% to 20-22% and of VAT from 20% to 17%, whereas excise taxes are to be raised further (bringing them closer to EU levels), and a 'luxury' tax is on the agenda. In addition, export subsidies of up to 3% of GDP are envisaged for next year.

Meanwhile, the need for IMF funding seems less acute given the recent turnaround in external balances. Since March 2010, Ukraine – for the first time since the crisis began – has become a net importer of capital, helped by increased political stability and the reversal of depreciation expectations, which resulted in flight *from* foreign cash by households. Overall, in January-April 2010, Ukraine recorded net capital inflows of USD 500 million – compared to *outflows* of USD 5.3 billion in the same period of last year. In addition, the current account improved further, to a surplus of around USD 100 million in January-April 2010 (from a deficit of USD 900 million in the same period of 2009), and is expected to be close to zero for the year as a whole. To contain the appreciation pressure, the National Bank has been replenishing its foreign exchange reserves, so that the hryvnia has appreciated against the US dollar only slightly, to about 7.9 UAH/USD (the appreciation against the euro, which fell against the US dollar in April-May 2010, was of course more pronounced).

In addition, the prospects for the government to raise funding elsewhere rather than from the IMF have improved. Following the speedy government formation, the yields on government (hryvnia-denominated) bonds plunged markedly: from over 20% p.a. at the end of 2009 to 10-13% p.a. currently. Given the current (CPI) inflation rate of 10-11%, this corresponds to real yields close to zero.[2] The CDS spreads also declined from around 10% at the start of the year to a mere 5% in mid-April, although they increased subsequently to around 7% due to the turbulence in the eurozone and the related increase in risk aversion. The 2010 budget law envisages domestic borrowings of UAH 36 billion (excluding bond issues for the purposes of bank recapitalization) and foreign borrowings of USD 4.1 billion, including the anticipated USD 2 billion from the IMF to be used for fiscal purposes.[3] In addition, privatization – which almost stalled in the past few years due to the

2 Of course, the latter applies only to domestic investors; for foreign investors, the yields are very high given the stable exchange rate outlook.

3 Pending the outcome of negotiations with the IMF, the government has secured a USD 2 billion loan from Russia.

persistent political stalemate – is likely to receive a boost, with stakes in Ukrtelecom and the Odessa Port plant (the second-biggest fertilizer producer) featuring on the privatization list. The 2010 budget law reckons with privatization revenues of UAH 10 billion.

In the area of foreign policy, the marked improvement of relations with Russia – manifested most visibly in the new contract granting a 30% price discount on imported Russian gas in exchange for extending the lease of the Russian naval base in Sevastopol at least until 2042 – is an encouraging development, which also reduces drastically the probability of future ‘gas wars’ between the two countries (a major concern for Europe, which receives the bulk of its gas imports from Russia via Ukraine). However, the scope of Ukraine’s advances towards Russia is potentially constrained by domestic politics and the powerful Tymoshenko-led ‘orange’ opposition, which is eager to earn political points in the run-up to the next parliamentary elections scheduled for autumn 2011. Therefore, it is unlikely that the most radical Russian advances – such as merging Ukraine’s energy monopolist Naftohaz with Russia’s Gazprom or Ukraine acceding the Russia-Belarus-Kazakhstan customs union[4] – will materialize in the near future, although increased cooperation in a number of areas including aviation and nuclear energy is almost certain.

These developments are to be viewed against the background of the economic recovery underway. Real GDP was up by 4.8% in the first quarter of 2010 (year-on-year), while industrial production increased by 12.6% in January-April. Metals industry and machine-building have been leading this growth (+22% and +28% in gross output terms, respectively) and are strongly export-oriented. Steel exports soared over the same period by 37% and those of machinery by 39% (in US dollar terms). Overall, exports of goods and services increased by 25%, while imports by only 20%. As a result, the trade deficit in goods and services in January-April 2010 halved compared to the same period of last year. This was entirely due to trade in services, whereas the trade deficit in goods actually widened. However, the latter reflected the abnormally high growth in energy imports in January-April 2010 (particularly in the *value* of oil imports), given the very low oil price in the first months of 2009 and hence the very low statistical base. In the coming months, import growth will almost certainly fall short of the growth in exports, partly due to the subsiding statistical effect, but also thanks to the 30% discount on Russian gas starting from the second quarter of 2010 onwards. The observed improvement in external competitiveness is hardly surprising given the 60% nominal depreciation of the hryvnia during the crisis which brought the real exchange rate back to levels observed in 2005-2006, when Ukraine’s external accounts were largely balanced.

4 Unlike the latter three countries, Ukraine is a WTO member.

At the same time, domestic market-oriented sectors continue to be a drag on growth. The performance of the food-processing industry was anaemic (+1.2% in January-April 2010), while retail trade turnover – a proxy for private consumption – fell by 1.2%, albeit picking up gradually on a monthly basis. Investment activity proved to be an even bigger disappointment: in the first quarter of 2010, investments in fixed assets plunged by 12.5% and construction output by 21% year-on-year – and that starting from an already very low base (in the first quarter of 2009, they had fallen by 40% and 57% respectively). The weakness of domestic demand reflects the combination of rising unemployment, falling wages, cautious spending behaviour, still under-utilized capacities and the ongoing credit crunch in both corporate and consumer segments. Interest rates charged on loans (16-17% p.a. in hryvnia terms) remain prohibitively high and reflect the high risk perceptions of banks.

For 2010, we expect (largely export-driven) economic growth of close to 4%, with gradual acceleration in the years to come. However, even with this relatively high growth (given the circumstances), Ukraine's GDP will still be nearly 12% below the pre-crisis level. Also, domestic demand, though picking up somewhat, is likely to remain subdued at least until the end of the year. Unemployment is unlikely to recede fast, while bank lending is unlikely to recover before the re-capitalization of the banking sector has been completed. One positive consequence of the weak domestic demand is however further disinflation. In both April and May 2010, the country recorded CPI deflation (on a monthly basis), which is likely to continue over the summer months. (In Ukraine, deflation is often observed in summer due to the declining prices of food, which account for more than half of the consumer basket.) In annual average terms, consumer price inflation should not exceed 11% this year, particularly if the government opts not to raise gas tariffs for households and heating companies. Lower inflation should lead to lower nominal interest rates and reduce incentives for speculative capital inflows, thus preventing excessive currency appreciation and safeguarding external competitiveness.

Table UA

Ukraine: Selected Economic Indicators

	2006	2007	2008	2009 [1]	2009	2010	2010	2011	2012
					1st quarter			Forecast	
Population, th pers., average	46788	46509	46258	46053	46112	45934	45800	45600	45400
Gross domestic product, UAH mn, nom.	544153	720731	948056	914720	188037	218125	1049200	1195100	1368200
annual change in % (real)	7.3	7.9	2.3	-15.1	-20.2	4.9	3.8	4.5	6
GDP/capita (EUR at exchange rate)	1800	2200	2700	1800	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5200	5800	6000	5100	.	.	.	.	.
Consumption of households, UAH mn, nom.	319383	423174	582482	590196	131905	148068	.	.	.
annual change in % (real)	15.9	17.2	11.8	-14.2	-15.1	0.5	2	4	6
Gross fixed capital form., UAH mn, nom.	133874	198348	250158	164522	32189	33631	.	.	.
annual change in % (real)	21.2	23.9	1.9	-46.2	-53.9	-2.2	5	10	10
Gross industrial production									
annual change in % (real)	6.2	7.6	-5.2	-21.9	-31.8	10.8	6.5	7	8
Gross agricultural production									
annual change in % (real)	2.5	-6.5	17.1	-1.8	1.7	5.3	.	.	.
Construction industry									
annual change in % (real)	9.9	15.6	-15.8	-48.2	-56.5	-21.4	.	.	.
Employed persons - LFS, th, average	20730.4	20904.7	20972.3	20191.5	20005.1	20088.4	20200	20250	20300
annual change in %	0.2	0.8	0.3	-3.7	-3.4	0.4	0	0.2	0.2
Unemployed persons - LFS, th, average	1515.0	1417.6	1425.1	1958.8	2096.9	1983.8	.	.	.
Unemployment rate - LFS, in %, average	6.8	6.4	6.4	8.8	9.5	9.0	8.7	8.2	7.8
Reg. unemployment rate, in %, end of period	2.7	2.3	3.0	1.9	3.1	1.8	.	.	.
Average gross monthly wages, UAH [2]	1041.4	1351.0	1806.0	1906.0	1736.0	1993.0	.	.	.
annual change in % (real, gross)	18.4	15.0	6.8	-8.9	-11.0	3.3	.	.	.
Consumer prices, % p.a.	9.1	12.8	25.2	15.9	20.4	11.2	10.5	9	8
Producer prices in industry, % p.a. [3]	9.6	19.5	35.5	6.5	17.4	17.2	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	31.6	30.5	31.4	29.8	34.9	.	.	.	.
Expenditures	32.3	31.6	32.8	33.9	35.0	.	.	.	.
Deficit (-) / surplus (+)	-0.7	-1.1	-1.5	-4.1	-0.04	.	-7	-4.5	-3
Public debt, nat.def., in % of GDP	14.8	12.3	20.0	33.0	19.1	.	37	37	35
Discount rate of NB, % p.a., end of period	8.5	8.0	12.0	10.3	12.0	10.3	.	.	.
Current account, EUR mn [4]	-1289	-3849	-8721	-1291	-500	-50	500	0	-500
Current account in % of GDP	-1.5	-3.7	-7.1	-1.5	-2.7	-0.3	0.5	0.0	-0.4
Exports of goods, BOP, EUR mn [4]	31048	36383	46274	28958	6468	7577	33300	36600	40300
annual growth rate in %	10.5	17.2	27.2	-37.4	-30.7	17.2	15	10	10
Imports of goods, BOP, EUR mn [4]	35188	44100	57270	32296	7200	8565	35500	39100	43000
annual growth rate in %	21.3	25.3	29.9	-43.6	-41.6	19.0	10	10	10
Exports of services, BOP, EUR mn [4]	9000	10337	12228	9936	2176	2371	10900	12000	13200
annual growth rate in %	19.9	14.9	18.3	-18.8	-8.7	9.0	10	10	10
Imports of services, BOP, EUR mn [4]	7305	8571	11039	8048	2040	1764	8000	8800	9700
annual growth rate in %	20.7	17.3	28.8	-27.1	-12.5	-13.6	0	10	10
FDI inflow, EUR mn [4]	4467	7220	7457	3453	697	705 [5]	4000	.	.
FDI outflow, EUR mn [4]	-106	491	690	116	21	.	.	.	.
Gross reserves of NB excl. gold, EUR mn	16587	21634	21847	17824	18647	17934	.	.	.
Gross external debt, EUR mn	41391	54421	72109	72516	75437	76275	.	.	.
Gross external debt in % of GDP	50.6	56.0	82.6	90.8	94.4	72.7	.	.	.
Average exchange rate UAH/EUR	6.335	6.918	7.708	10.868	10.065	11.068	10	10.5	10
Purchasing power parity UAH/EUR, wiiw [6]	2.227	2.656	3.402	3.921	.	.	.	.	.

1) Preliminary. - 2) Excluding small enterprises. - 3) Domestic output prices. - 4) Converted from USD with the average exchange rate. - 5) FDI net.
6) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.