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Ukraine: fiscal expansion at a time of boom

Economic boom continues

Available data reveal a picture of fast and generally balanced growth, albeit accompanied by strong and primarily 'cost-push' inflationary pressures. According to preliminary figures, in 2007 real GDP growth stood at 7.3% – about the same pace as in 2006, and slightly exceeding our earlier expectations. Most importantly, domestic demand kept its momentum, with household consumption and fixed capital investments growing by an estimated 14% and 20%, respectively. However, the main reason for the economy performing better than expected has been the good export dynamics – partly due to high international prices of metals and food, but also because of the booming exports of machinery and equipment, particularly to Russia.[1] Although the growth of imports exceeded that of exports once again (+34.2% vs. +27.9% in January-November in US dollar terms), the current account deficit must have been reasonably low, most probably below 3% of GDP. In addition, Ukraine attracted an estimated record-high FDI inflows – more than twice the current account deficit, persistent political instability notwithstanding. On the supply side, agriculture recorded a 5.6% decline due to poor grain harvests, but both manufacturing and services performed strongly, with machine building leading the growth (+29% in gross output terms, reflecting particularly the strongly expanding car production).

Following the pre-term parliamentary elections held in September 2007, a new coalition government was formed in December, with economic policy-making assigned almost exclusively to the Block of Yulia Tymoshenko (BYuT), and Ms Tymoshenko herself becoming prime-minister for the second time.[2] Although this time, her premiership is likely to be less controversial than the first one in 2005,[3] the present coalition – possessing only a thin majority in the parliament – appears to be rather fragile. Also, it is split over several key issues. In the area of foreign policy, the new 'orange' government is predictably drifting away from Russia, and the efforts to bring the country closer to NATO have received a new impetus. At the same time, the authorities have generally agreed to the opposition's demand for a referendum on this not very popular issue. However, the timing of such a referendum remains uncertain, given the generally sceptical public attitude towards NATO membership.

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1 According to the customs statistics, in January-November 2007 merchandize exports to Russia soared by 50% in US dollar terms, thus raising Russia's share in Ukraine's exports still further, to 25.9% of the total.

2 The other coalition partner is Our Ukraine-People's Self-defence (OUPS) of President Viktor Yushchenko.

3 For instance, she has largely distanced herself from the idea of large-scale re-privatizations – the policy move she was strongly advocating back in 2005.

Fiscal policy becomes more expansionary

In the area of the economy, a laxer fiscal policy is on the agenda after two years of a nearly balanced budget. A sizeable fiscal relaxation is envisaged in the central budget for 2008 adopted after the new government took office, although part of this relaxation was found already in the budget draft prepared by the previous government. The current budget version[4] envisages a deficit of 2.1% of GDP, which is to be covered by both borrowings (1.1% of GDP) and privatization receipts (1% of GDP). The minimum monthly wage (affecting wages in the public sector) was raised to UAH 515 as of January 2008 and will be adjusted further, to UAH 605 by December. Pensions were raised as well, as were childbirth grants in an attempt to counteract the dramatic demographic decline (simultaneously, they were differentiated according to the number of children in the family). Last but not least – and in line with Ms Tymoshenko's earlier electoral promises – the government has started the reimbursement of household savings in the state-owned Oschadbank, which lost their value in the wake of hyperinflation in the early 1990s after the collapse of the Soviet Union, with a generally flat compensation of UAH 1000 per depositor. For these purposes, the government has earmarked UAH 20 billion (corresponding to 2.2% of GDP) for 2008.[5] However, of this sum, only UAH 6 billion will come from the budget, whereas the rest is to be financed from privatization revenues in excess of the planned target.

Taking into account the full scale of the planned deposit compensations, the central budget deficit in 2008 should de facto reach some 3.6% of GDP. Given the very low level of public debt (12.6% of GDP) and the reasonably low yields offered on government bonds, there is little doubt that the planned deficit will be easily financed – even if the de facto privatization target appears to be overly ambitious. Besides, the social generosity should benefit the government of Ms Tymoshenko politically and improve her chances in the next presidential elections due at the end of 2009. Irrespective of whether her government will hold until then, she is widely seen as one of the two main contenders for the post, along with the opposition leader and former prime-minister Viktor Yanukovych (with the incumbent president Yushchenko seen as an outsider, at least at the moment). However, from the macroeconomic point of view, the fiscal expansion envisaged by the budget will work rather 'pro-cyclically': it will further fuel the already booming private consumption, adding to both rising imports and inflationary pressures.

Inflationary pressures mounting further

In 2007, consumer price inflation soared to 16.6% on an end-year basis, largely due to galloping food prices (+22.9%). One 'cost-push' factor behind the rising inflation were the growing bottlenecks in some segments of the labour market. Official nominal wages rose

4 The current budget version is preliminary, as further amendments are to be introduced until 1 March 2008.

5 Still, this is only a fraction of the officially acknowledged UAH 125 billion worth deposits to be repaid.

on average by nearly 30% – far ahead of labour productivity (+7%), implying an increase in unit labour costs by 20%. At the same time, the surge in food prices has little to do with domestic 'overheating' but rather reflects the global trends: the growing world demand for food, particularly in developing countries, and the increased use of crops for biofuels production (although a poor grain harvest in Ukraine played a role as well). In Ukraine's case, food price inflation will probably persist also in 2008,[6] but it might be supplemented by rising energy tariffs. It remains to be seen how long the government will be able to ignore the long-standing necessity to adjust domestic tariffs to the ever growing energy import bill. Last year, tariff hikes for households were largely avoided in the run-up to parliamentary elections, and notwithstanding a 37% price hike for imported natural gas in January 2007. This policy has already brought the state-owned energy company Naftohaz on the verge of insolvency, whereas a renewed 38% hike in the border gas price (to USD 179.5 per thousand cubic metres) in January 2008 and the reportedly increased tax burden on Naftohaz will complicate the situation still further.

While the fiscal policy is going to be anything but restrictive, the inflation problem might be at least partly tackled by the monetary and exchange rate policies. One possible option is a re-valuation of the hryvnia, e.g. to UAH 4.9 per US dollar as mentioned by Ms Tymoshenko (from 5.05 now). Alternatively, in the medium term the authorities might switch from the current de facto exchange rate peg to the US dollar to inflation targeting, thereby letting the hryvnia float and almost inevitably appreciate – given the strong capital-related foreign exchange inflows. A stronger hryvnia appears justified against the background of the ever weakening US dollar, and given the modest role of the dollar-based countries in Ukraine's foreign trade. However, the wisdom of a shift to inflation targeting is questionable, at least at the moment. In particular, attempts to contain inflation, which is currently driven primarily by supply-side factors and tends to be highly volatile, might harm the real economy.

US crisis unlikely to have strong impact

The short- and medium-term economic prospects depend on the quality of domestic policy-making and partly also on the possible spillovers of the recent subprime crisis in the United States. However, the impact of possibly more restrictive lending policies by (especially foreign-owned) banks on private consumption and investments should not be overrated. While lending rates have indeed been on the rise recently, this reflects to a large extent a pick-up in inflation and higher inflationary expectations. Besides, business investments – unlike consumer expenditures – have so far been predominantly financed out of profits rather than by taking loans, although this is gradually changing. Still, we expect fixed capital investment in 2008 to cool down somewhat, given the risk of erratic policy moves on the part of the new government. At the same time, the government's

[6] In January 2008 alone, consumer prices jumped by 2.9% (against December 2007), reflecting particularly the 4.3% rise in food prices.

generous social and incomes policy should offset any adverse effects of possible household credit tightening on private consumption. Also, prospects for exports are favourable given that world steel prices are expected to remain high, and Russia – Ukraine's biggest export destination – should prove highly resilient to the US crisis. Therefore, we forecast only a minor GDP growth slowdown to 6.5% this year, followed by another moderate slowdown in 2009-2010, after the effects of the fiscal impulse have died down and with household indebtedness possibly approaching levels that would require a restrictive policy response by the National Bank.[7]

Nevertheless, the country's still high dependence on steel exports remains a factor of risk, and attracting more FDI should prove instrumental in diversifying Ukraine's economic structure. So far, FDI inflows have been largely targeting services (wholesale and retail trade, financial sector, real estate) rather than industry. Judging by the earlier experience of other countries, this may change following Ukraine's expected WTO accession this year.[8] Ukraine is offering a lucrative combination of a highly qualified and still cheap workforce, proximity to the EU markets and good market prospects both at home and in Russia, so that the overall prospects for FDI inflows into industry are good.[9] However, as exemplified by other countries' experience, the less pleasant side of such a development may be massive labour shedding as an initial result of the restructuring programmes. Unless the redundant labour force is absorbed by the expanding services sector, the situation in the labour market may temporarily deteriorate, bringing about a reversal of the earlier trend.

7 During 2007, outstanding credit to households nearly doubled, albeit starting from a fairly low level.

8 Ukraine's WTO accession agreement was signed on 5 February 2008, but it still has to be ratified by the Ukrainian parliament.

9 For instance, for 2008 we expect net FDI inflows in the tune of EUR 6-7 billion, of which at least EUR 2 billion should come from the planned takeover of five metallurgical assets of *Privat* by Russia's *Evraz Group*.

Table UA

Ukraine: Selected Economic Indicators

	2002	2003	2004	2005	2006	2007 [1]	2008	2009	2010
								Forecast	
Population, th pers., end of period	48,004	47,622	47,281	46,930	46,646	46,373	46,000	45,800	45,600
Gross domestic product, UAH bn, nom.	225.8	267.3	345.1	441.5	537.7	689	840	997	1,163
annual change in % (real)	5.2	9.6	12.1	2.7	7.1	7.3	6.5	6	6
GDP/capita (EUR at exchange rate)	931	928	1,100	1,467	1,814	2,140	.	.	.
GDP/capita (EUR at PPP - wiiw)	3,480	3,860	4,460	4,720	5,210	5,760	.	.	.
Gross industrial production									
annual change in % (real)	7.0	15.8	12.5	3.1	6.2	10.2	8	8	8
Construction output total									
annual change in % (real)	-5.8	26.5	17.2	-6.6	9.9	15.8	.	.	.
Consumption of households, UAH bn, nom.	124.6	146.3	181.0	252.6	315.3	.	.	.	.
annual change in % (real)	9.5	11.5	13.5	16.6	14.4	14	14	12	12
Gross fixed capital form., UAH bn, nom.	43.3	55.1	77.8	97.0	129.0	.	.		
annual change in % (real)	3.4	22.5	20.5	-0.3	18.7	20	15	15	15
LFS - employed persons, th, avg.	20,091	20,163	20,296	20,680	20,730	20,800	.	.	.
annual change in %	0.6	0.4	0.7	1.9	0.2	0.3	.	.	.
Reg. employees in industry, th pers., avg. [2]	3,578	3,416	3,408	3,416	3,362	3,279	.	.	.
annual change in %	-6.1	-4.5	-0.2	0.2	-1.6	-2.5	.	.	.
LFS - unemployed, th pers., average	2,141	2,008	1,907	1,601	1,515	1,420	.	.	.
LFS - unemployment rate in %, average	9.6	9.1	8.6	7.2	6.8	6.4	6.4	6.6	6.8
Reg. unemployment rate in %, end of period	3.8	3.6	3.5	3.1	2.7	2.3	.	.	.
Average gross monthly wages, UAH [2]	376.4	462.3	589.6	806.2	1,041.4	1,351.0	.	.	.
annual change in % (real, gross)	20.0	16.7	17.0	20.4	18.4	15.0	.	.	.
Consumer prices, % p.a.	0.8	5.2	9.0	13.5	9.1	12.8	14.5	12	10
Producer prices in industry, % p.a.	3.0	7.6	20.5	16.7	9.6	19.5	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	27.4	28.2	26.5	30.4	32.0	31.9	.	.	.
Expenditures [3]	26.7	28.4	29.7	32.2	32.6	33.0	.	.	.
Deficit (-) / surplus (+), % GDP	0.7	-0.2	-3.2	-1.8	-0.7	-1.1	.	.	.
Public debt in % of GDP	33.5	29.0	24.7	17.7	15.0	12.9	.	.	.
Refinancing rate of NB % p.a., end of period	7.0	7.0	9.0	9.5	8.5	8.0	.	.	.
Current account, EUR mn [4]	3,360	2,559	5,560	2,030	-1,289	-2,500	-4,500	-6,500	-9,000
Current account in % of GDP	7.5	5.8	10.6	2.9	-1.5	-2.5	-4.3	-4.8	-5.2
Gross reserves of NB excl. gold, EUR mn	4,088	5,348	6,977	16,058	16,587	21,634	.	.	.
Gross external debt, EUR mn	12,247	19,055	22,528	33,504	41,418	52,421 IX	.	.	.
Gross external debt in % of GDP	30.0	47.5	47.1	45.3	51.2	57.7 IX	.	.	.
FDI inflow, EUR mn [4]	734	1,261	1,380	6,263	4,148	7,000	7,000	.	.
FDI outflow, EUR mn [4]	-5	12	3	221	-106	700	500	.	.
Exports of goods, BOP, EUR mn [4]	19,770	21,013	26,906	28,093	31,048	36,300	40,000	44,000	48,000
annual growth rate in %	3.6	6.3	28.0	4.4	10.5	17	10	10	9
Imports of goods, BOP, EUR mn [4]	19,018	20,555	23,895	29,004	35,188	42,900	50,000	56,000	62,000
annual growth rate in %	0.9	8.1	16.3	21.4	21.3	22	17	12	11
Exports of services, BOP, EUR mn [4]	4,958	4,615	6,325	7,503	9,000	10,400	11,000	12,500	14,000
annual growth rate in %	11.2	-6.9	37.0	18.6	19.9	16	6	14	12
Imports of services, BOP, EUR mn [4]	3,743	3,934	5,329	6,054	7,305	8,400	10,000	11,500	12,500
annual growth rate in %	-6.3	5.1	35.5	13.6	20.7	15	19	15	9
Average exchange rate UAH/USD	5.327	5.333	5.319	5.125	5.050	5.050	5	4.9	4.8
Average exchange rate UAH/EUR (ECU)	5.030	6.024	6.609	6.389	6.335	6.918	8	7.4	6.7
Purchasing power parity UAH/USD, wiiw [5]	1.176	1.244	1.392	1.680	1.851	2.159	.	.	.
Purchasing power parity UAH/EUR, wiiw [5]	1.347	1.451	1.631	1.986	2.207	2.572	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) Excluding small enterprises. - 3) From 2004 including lending minus repayments. - 4) Converted from USD. - 5) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics; wiiw forecasts.