



Monthly Economic Monitor Ukraine

- The Cabinet of Ministers and the Secretariat of the President engaged in procedural squabbles.
- In the first eight months of 2006 real GDP increased by 5.7% yoy.
- Import gas price remains unchanged in last quarter of 2006.
- Current account deficit improved to 1.9% of GDP in the first half of the year.
- The draft State Budget 2007 foresees central fiscal deficit at 2.6% of GDP.
- In September inflation jumped to 9.1% yoy.
- The NBU continued policies aimed at boosting national currency deposits.

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October
2006**

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: Cabinet of Ministers and the Secretariat of the President engaged in procedural squabbles

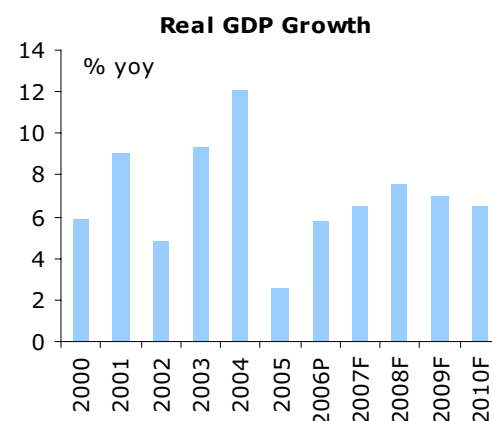
The Cabinet of Ministers (CMU) and the Secretariat of the President engaged in the procedural dispute over the schedule of coming to force of some presidential decrees that concern such topics as defence and foreign policy. In September the CMU returned to the Secretariat decrees on appointments and dismissals of Ambassadors, changes in the court staff, and liquidation of one military court, although these decrees were already published. According to the Constitution, the Prime Minister and minister responsible for execution should sign such decrees. The CMU claims that this provision means that the Decree could not be officially published before they were countersigned. Countersign is a part of the system of checks and balances, which envisages the assumption of the execution responsibility by the respective minister. The question of the countersign power and its implementation will be settled in the Constitutional Court. This dispute reflects tense relations between the President and the Prime Minister, as well as procedural gaps in the system of relations between two centres of power established by the Constitution.

While the creation of wide coalition between the Block 'Our Ukraine', the Party of Regions, the Socialist and the Communist Parties remains questionable, on September 22 Yulia Tymoshenko, the leader of the BYUT, and Yosyp Vinsky, breakaway member of the Socialist Party, signed the Agreement on establishment of the opposition in the Verkhovna Rada that regulates activity of opposition in the parliament.

Real economy: Real GDP increased by 5.7% yoy

In the first eight months of the year the real GDP increased by 5.7% yoy compared to the 2.8% yoy rise in the same period of 2005. The growth was registered in all major sectors of the economy except agriculture. Here, the value added declined by 2.3% yoy due to lower grain harvest vis-à-vis the previous year figure. It is expected that real GDP growth rate will remain around 6% till the end of the year against the background of stable development of service sectors and acceleration of industrial production. Between January and August industrial output grew by 5.4% yoy, continuing upward trend after the slow growth rates in 2005 – beginning 2006. The acceleration is caused by higher growth of metallurgy and machine building thanks to growth of both external and internal demand.

The Cabinet of Ministers released the forecast of real GDP growth in 2007-2010. It is expected that the average annual growth rate will be 6.9%. Growth in domestic demand is expected to be backed by strong exports growth (12.7% average growth in dollar terms) that will exceed the growth rates of imports (9.5% on average), ensuring positive trade balance. Whether this forecast is realized will depend on several factors. Domestically, it will be determined by the capacity of the economy to cope with next gas price increases, and ability of



Source: Derzhkomstat
P - official estimate; F - official forecast

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the government to conduct necessary structural reforms to stimulate investments. Externally, developments on key export markets will be crucial for supporting stable pace of growth of the economy.

Sectoral trends: Import gas price remains unchanged in the fourth quarter

Energy. In the last quarter of 2006 the price of imported gas remains unchanged at USD 95 per thousand cubic meters. Such agreement was achieved during the meeting of the Minister of Fuel and Energy of Ukraine with the president of Gazprom. Moreover, it was agreed that Ukraine would import 55 bn cubic meters of gas per year till 2010. The price for the imported gas in 2007 will be agreed in October 2006. The preservation of gas price gives additional time for the enterprises to make energy-saving improvements to alleviate effects of anticipated gas price increase in 2007.

Privatization. The execution level of privatization receipts remained below 20% of annual target in the first nine months of the year. The sale of the machinery plant Luhanskteplovoz might change the situation, as the expected price for enterprise is around UAH 3 bn, which is sufficient to accomplish the privatization plan of UAH 2.12 bn in 2006. Four bids have been already submitted for the privatization tender. However, in early October court decision led to suspension of this privatisation tender.

For 2007 privatization proceeds are planned at UAH 10 bn. The list of enterprises announced for privatisation consists of around 500 objects. However, unless some 'blue chips' like Ukrtelecom will be put on tender next year, the privatisation target may be unfulfilled.

Agriculture. The draft of State Budget 2007 envisages UAH 8.9 bn for agricultural programs, which is UAH 1.6 bn more than in 2006. While the 'green' box expenditures – state support measures not restricted by the WTO rules – decreased by 4.5% to UAH 4.5 bn UAH, the spending on 'amber' box measures are to increase by 71% to UAH 4.4 bn. Although Ukraine stays in the limits of its possible aggregate measures of support ceiling, the increase in the 'amber' box shows that reforms of agricultural support mechanisms are still postponed.

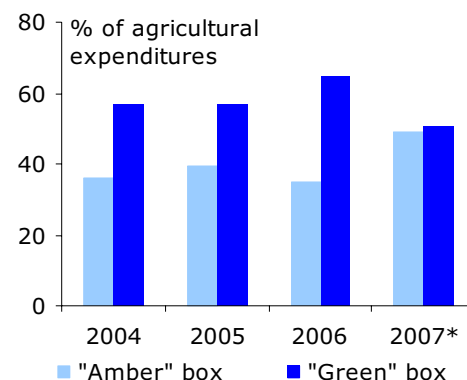
The important innovation of the draft of State Budget for 2007 is the change in the VAT regime for agricultural producers. It is planned to introduce 12% VAT rate in this sector since 2007. It is a positive step in terms of raising overall fiscal revenues, and balancing spending on the agriculture and revenues from the sector. However, this step will limit cash flows for farms.

Infrastructure. The Parliament overrode the presidential veto imposed on the Law on Moratorium on Increase of Tariffs for Public Utilities, Housing, Electricity, Gas, and Public Transport. This voting created a lot of problems. First, the Law contradicts the Constitution and other laws. Second, economic results of its implementation could be very negative, including unexpected financial pressure on local budgets, financial failure of the enterprises, drop in the quality and supply of services, and increased probability of technical breakdowns. The decision demonstrates inclination of Ukrainian parliamentarians to populist decisions disregarding their economic consequences. Expected negative consequences forced some deputies seek ways to cancel this decision. On October 5, the Parliament cancelled its decision by approving respective resolution.

External sector: Current account balance improved

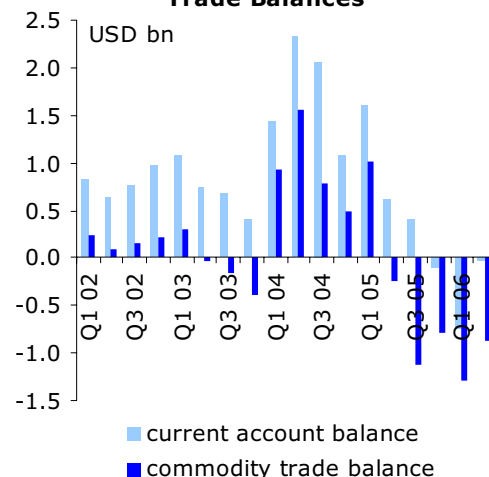
According to the NBU, in the first half of 2006 the deficit of the current account was USD 0.78 bn (1.9% of GDP), thus remaining almost unchanged compared to the first quarter of the year. That is explained by the recovery of commodity exports due to increased external demand on metal products and machinery. In financial account, foreign direct investments (FDI) significantly accelerated. The FDI inflow was USD 2.1 bn in the first half of 2006 compared to USD 0.6 bn a year before. Such increase is attributed to purchases of several banks by foreigners, as well as accelerated investments in

Agricultural expenditures of the central budget according to WTO framework



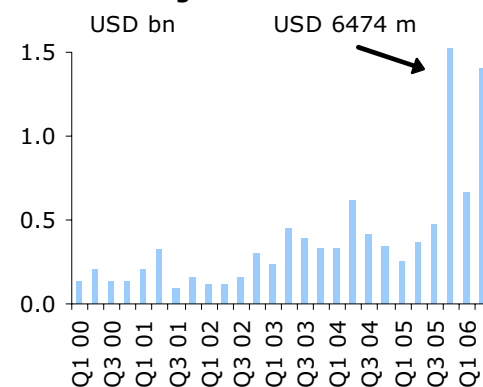
* Draft budget figures
Source: IER estimations

Current Account and Commodity Trade Balances



Source: NBU

Net Foreign Direct Investments



Source: NBU

other service sectors. As a result, the FDI inward stock reached USD 19.7 bn, or USD 422 per capita. Despite considerable improvement, stock of FDI in Ukraine is still lagging behind whose other emerging market countries indicating potential for further acceleration of FDI inflow.

According to the Derzhkomstat, between January and July exports of goods increased by 4.8% yoy in dollar terms, while imports grew by 21.3% yoy. The trade balance was negative at USD 3.26 bn.

Fiscal policy: Central fiscal deficit dropped to 1.4% GDP

Continuous over-execution of the VAT, which was 16% above the target figure, ensured execution of central fiscal revenues at 101.3% of the plan between January and August. At the same time, the revenues from enterprise profit tax, trade duties, and profits of state owned enterprises due to the state coffers remained below the target. The central fiscal expenditures were 4% below the projected figure. The highest level of execution was in transfers to population, health care and education. The central fiscal deficit dropped to UAH 4.1 bn or 1.4% of GDP.

The Government submitted to the Parliament the draft of State Budget 2007. The central fiscal revenues will be at UAH 140.3 bn (23.6% of GDP), while expenditures are foreseen at UAH 153.5 bn (25.8% of GDP). The resulting budget deficit is 2.6% of GDP. One of the positive features of the draft is planned increase in investment expenditures. At the same time, the government plans to reintroduce some privileges to free economic zones, thus reducing the tax base and creating further rent-seeking incentives in the economy.

Social policy: Further increase in pensions expected

The draft of State Budget 2007 foresees further increase in social standards, although this growth will be lower than in 2004-2006. In particular, the increase in subsistence minimum to UAH 492 will cause growth in minimum pension, which is linked to it. Besides, other social assistance payments, like assistance to low-income households, are to be increased. The minimum wage will grow from UAH 400 in December 2006 to UAH 450 in December 2007, although remaining lower than subsistence minimum. The positive feature of the draft Budget is an introduction of targeting principle in provision of social assistance payments and privileges, allowing better efficiency of social support programs of the state.

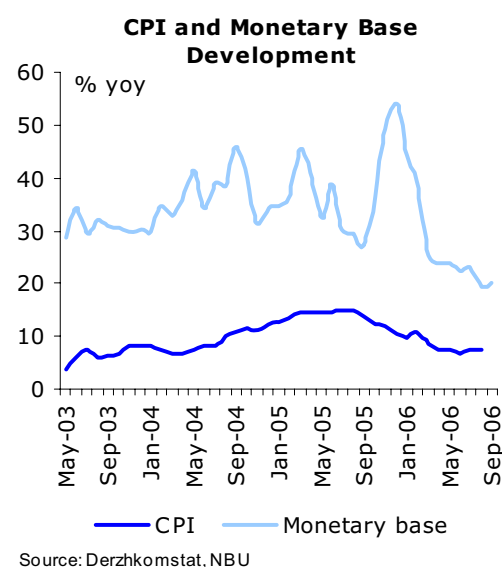
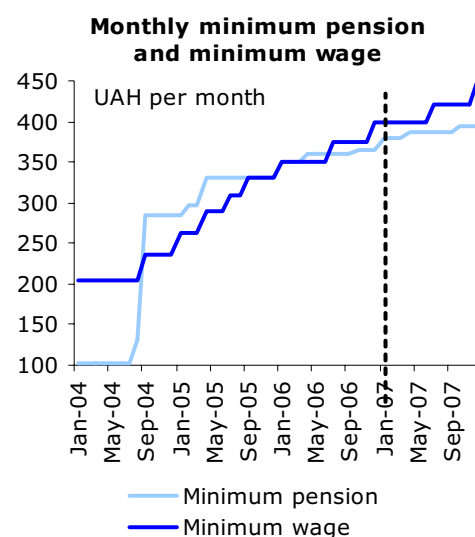
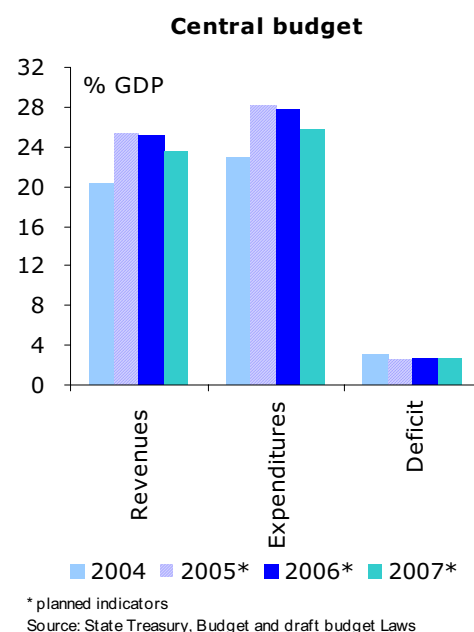
Monetary policy: Inflation accelerated to 9.1 % yoy

In September consumer inflation moved upwards to 9.1 % yoy after 7.4% yoy in August. Increases in utility tariffs, in particular rise of electricity tariffs for households by 25%, and stronger than seasonal average increase in food prices contributed to consumer prices growth acceleration, constrained by moderate growth of monetary aggregates and continued ban on export of dairy and meat products to Russia. Possible lift of aforementioned export restrictions and government policy concerning regulated prices will shape changes in inflation over next several months.

The NBU approved the Principles of Monetary Policy for 2007. According to the Principles, money supply will grow by 28-33% in 2007, decelerating compared to 2006 figure. The exchange rate is expected to stay in UAH/USD 4.95-5.25 range. In September money supply grew 20.3% yoy and monetary base increased by 37.4% yoy.

Financial markets: The NBU favours national currency deposits

Banking. In September the NBU continued policies aimed at boosting national currency deposits. The NBU decreased reserve requirements for national currency deposits from 2-3% requirements introduced in August to 0.5-1.0% since October. At the same time, it increased reserve requirements for time foreign currency deposits to pre-August level of 4% and increased daily reserve maintenance requirement to 100% of monthly level.





Economic Trends		Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Jun	Jul	Aug	Sep
GDP growth (real)	% yoy	3.4	1.4	1.7	3.2	...	9.3	7.7	7.1	...
GDP growth (real)	% yoy cum.	4.1	3.0	2.6	3.2	...	5.0*	5.5*	5.7*	...
Industrial production (real)	% yoy cum.	5.0	3.2	3.1	0.2	3.6	3.6	4.8	5.4	...
Agricultural production (real)	% yoy cum.	6.4	3.4	0.0	4.0	3.2	3.2	-1.9	-2.8	...
CPI	% yoy eop	14.4	13.9	10.3	8.6	6.8	6.8	7.4	7.4	9.1
PPI	% yoy eop	17.7	14.7	9.6	6.5	6.3	6.3	9.4	10.9	10.7
Exports (USD)***	% yoy cum.	10.9	9.0	7.5	-0.3	4.7	2.1"	4.8"
Imports (USD)***	% yoy cum.	21.5	22.3	20.4	24.9	19.7	22.1"	21.3"
Merchandise trade balance	USD bn cum.	0.78	-0.35	-1.14	-1.29	-2.16	-2.92"	-3.26"
Current account	USD bn cum.	2.22	2.63	2.53	-0.74	-0.78	x	x	x	x
Current account	% GDP, cum.	6.3	4.5	3.0	-4.0	-1.9	x	x	x	x
Gross international reserves	USD bn eop	13.07	14.26	19.39	17.3	17.7	17.7	18.0	18.6	19.1
Monetary Base	% yoy eop	38.7	27.2	53.9	25.2	22.4	22.4	23.8	19.5	20.3
Lending rate on UAH credits **	% pa, aop	15.4	15.4	16.4	15.8	15.5	15.5	15.0	14.6	14.6
Exchange rate (official)	USD aop	5.10	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05
Exchange rate (official)	EUR aop	6.43	6.19	6.00	6.07	6.34	6.40	6.40	6.47	6.43

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

Key Economic Indicators		1998	1999	2000	2001	2002	2003	2004	2005
Nominal GDP	UAH bn	102.6	130.4	170.1	204.2	225.8	264.2	345.9	424.7
Nominal GDP	USD bn	41.9	31.6	31.2	37.8	42.6	49.5	65.1	83.1
GDP growth (real)	% yoy	-1.9	-0.2	5.9	9.2	5.2	9.4	12.1	2.6
Industrial production	% yoy	-1.0	4.0	13.2	14.2	7.0	15.8	12.5	3.1
Agricultural production	% yoy	-9.6	-6.9	9.8	10.2	1.2	-11.0	19.1	0.0
CPI	% yoy aop	10.6	22.7	28.2	12.0	0.8	5.2	9.0	13.5
CPI	% yoy eop	20.0	19.2	25.8	6.1	-0.6	8.2	12.3	10.3
PPI	% yoy aop	13.2	31.5	20.9	8.6	3.1	7.8	20.4	16.8
PPI	% yoy eop	35.4	15.7	20.8	0.9	5.7	11.2	24.1	9.6
Exports (gs, USD)	% yoy	-13.4	-7.9	17.9	9.5	10.7	24.0	42.6	7.5
Imports (gs, USD)	% yoy	-14.0	-19.1	18.9	14.1	4.9	28.7	31.3	20.4
Current account	USD bn	-1.3	0.9 °	1.2 °°	1.4	3.1	2.9	6.9	2.5
Current account	% GDP	-3.1	2.9 °	3.8 °°	3.7	7.6	5.9	10.6	3.0
FDI (net)	USD bn	0.7	0.5	0.6	0.8	0.7	1.4	1.7	6.5
International reserves	USD bn	0.79	1.09	1.48	3.09	4.42	6.94	9.52	19.39
Fiscal balance'''	% GDP	-2.7	-2.1	-0.7	-1.9	0.8	-0.2	-3.4	-1.82
Total state debt	% GDP eop	49.4	61.4	45.2	36.3	34.3	29.5	24.7	18.40
External debt (total)	% GDP eop	38.4	49.9	33.0	26.0	24.6	17.3	18.6	10.35
Monetary base	% yoy eop	21.9	39.3	39.9	37.4	33.6	30.1	34.1	53.9
Exchange rate	USD aop	2.45	4.13	5.44	5.37	5.33	5.33	5.31	5.12
Exchange rate	USD eop	3.43	5.07	5.44	5.30	5.33	5.33	5.31	5.05
Exchange rate	EUR aop	2.77	4.39	5.03	4.81	5.03	6.02	6.62	6.40
Exchange rate	EUR eop	4.02	5.20	5.10	4.67	5.53	6.66	7.22	5.97

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

''' "Minus" denotes a consolidated fiscal deficit

° 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

°° 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.

° Preliminary estimate of the Derzhkomstat

Notes:

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