Ukraine: Macroeconomic Developments and Structural Change with a Special Focus on the Energy Sector

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Major traits of Ukraine's macroeconomic and structural development since the turn of the millennium constitute the focus of this study. Following a brief look back at the decade-long recession of the 1990s, the authors identify positive terms-of-trade shocks, the cumulative effect of structural reforms and the strong recovery of domestic demand as the underpinnings of the country's robust economic recovery of 2000–2004, while a halt, respectively reversal, of terms-of-trade gains and a deterioration of the investment climate are regarded as the driving forces of the sharp slowdown of 2005 and early 2006. Fiscal policy and tax reforms, monetary and exchange rate policies, and the evolution of external accounts are analyzed in more detail. Given Ukraine's extremely energy-intensive economic and export structure and concomitant vulnerability, energy and gas sector developments are given prominence on the structural front. A near-term economic outlook wraps up the study.

1 Introduction

This study gives an overview over the eventful evolution of the Ukrainian economy since the turn of the millennium with a focus on macroeconomic developments and on structural change. To better clarify the point of departure, i.e. the country's economic situation at the turn of the millennium, section 2 briefly sketches the economic developments of the 1990s and also contains some references to the overall political and external environment. Since 2000, Ukraine has (so far) experienced two major economic episodes: The turnaround at the beginning of the decade, followed by years of strong recovery (2000–2004), and the sharp slowdown of 2005. Section 3 concentrates on these two consecutive periods and discusses the driving forces behind the respective adjustments. It deals with macroeconomic developments and policies, in particular GDP developments, fiscal policy and tax reforms, monetary policy, inflation and exchange rate developments, the balance of payments and external debt. Moreover, it further analyzes structural changes and policies in a key sector that weighs heavily with the Ukrainian economy's competitiveness, namely energy. Section 4 gives a short and medium-term economic outlook for the country. The study is deliberately selective. In particular, it hardly deals with the labor market and unemployment, farming, demographic developments and the social situation.

2 Economic and Political Framework and a Look Back at Developments of the 1990s[2]

Measured by territory (603,700 square kilometers), Ukraine is the second-largest country in Europe, following Russia; measured by population (2005:

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[2] *For more information on developments in Ukraine in the 1990s, see Barisitz (1999 and 2000).*

46.9 million), it ranks sixth after Russia, Germany, France, Britain and Italy. However, owing to strong emigration and low birth rates, Ukraine's population has shrunk by about 9% since the country gained independence in 1991. The Ukrainian GDP per capita amounted to EUR 6,210 in purchasing power parity (PPP) terms in 2005, which corresponds to only about one-quarter of the euro area or Western European level. Equipped with important iron ore and coal deposits in or near the Donetsk basin (Donbass) in the east of the country, Ukraine has been a major exporter of steel and heavy industrial equipment since Soviet times. Origins of this activity can even be traced back to the Russian Empire.

Ukraine's heavy industry is very energy-intensive and consumes large amounts of natural gas and oil, which the country itself does not possess in sufficient quantities and which are therefore supplied in pipelines from neighboring Russia and Central Asia. Most of this energy is supplied at prices that are far below world market levels, and Ukraine's energy consumption per unit of output remains one of the highest in the world. The country processes the major part of the imported oil in refineries and resells petroleum products at world market prices. Furthermore, Ukraine is an important transit country for energy deliveries: Oil and gas pipelines built by the Soviets in the 1970s and 1980s run from Russia across the country to Central and Western Europe, assuring the bulk of Russian oil and gas exports outside the CIS.

The industrialized Eastern part of the country has a larger Russian population and features higher levels of income; it contrasts with the more farming-dominated and poorer Western part of Ukraine. Before 1917, Ukraine was called the "granary of Europe" for the rich harvests its extremely fertile "chernozyom" (black soil) belt provided. In 2004, by contrast, Ukraine's most important export items were metals (40%), machinery (17%), fuel and energy products (12%) and food. The country mainly imports fuel and energy products (36%), machinery (28%) and chemicals (14%). Most of Ukraine's exports, particularly metals, petroleum products and food, constitute staples with a rather low value-added which are subject to the volatility and cyclicality of world market price fluctuations.

Since the collapse of the Soviet Union, the political framework in Ukraine has been marred by discord and power struggles between the executive branch, i.e. president and government, on the one hand and the legislative branch, i.e. parliament (Verkhovna rada, the Supreme Soviet) on the other. It has repeatedly been extremely difficult to find a consensus among the major political forces on economic policy and the direction of reforms. This situation has made the country's transition to a market economy slow and hesitant and has contributed to numerous setbacks in the implementation of structural changes and modernization. Altogether, the first decade of Ukraine's independence was characterized by uninterrupted economic contraction. According to the European Bank for Reconstruction and Development (EBRD), by 1999 Ukraine's GDP had descended to less than 40% of what it had been ten years earlier (EBRD, 2000, p. 65).

Recurrent budget and current account disequilibria (twin deficits) produced a trend of rising public and external debt, pushing Ukraine to the brink of insolvency at the end of the decade. Generally weak payment discipline, inadequate protection of property rights, insufficient rule of law and widespread corruption promoted capital flight and held foreign strategic investors at bay. Monetization was modest and barter and other types of nonmonetary transactions dominated in many areas, particularly in the energy sector. Accordingly, the shadow economy was large; in the second half of the 1990s it was estimated by the Ministry of Economy to have peaked at more than half the size of the formal economy (IMF, 2005, p. 19).

The 1990s can be seen to comprise three phases of Ukrainian economic development and policies: First, the initial era of unambitious reform (1992–1994), when the newly established Ukrainian leadership presided over the effects of the disintegration of the former USSR without pursuing any major reform efforts. This stage featured hyperinflation (inter alia), which reached 10,155% in 1993. In the fall of 1994, a new administration adopted a macro-stabilization and structural reform program which, however, soon lost momentum and ushered in the second phase, one of stop-and-go policies. Enterprise privatization was largely effected through management and employee buy-outs and voucher schemes, which hardly brought any new capital and know-how and which strengthened insider control. Restructuring and consolidation was sluggish. This phase was interrupted by the repercussions of the Russian crisis of 1998, which struck a fragile Ukraine and triggered the third phase, a period of extended crisis management. The country showed some similarities (weak tax system, dominance of treasure bills in budget deficit finance, strong crisis-induced devaluation of the currency) and some differences to Russia (more prudent reaction of the authorities in Kyiv, avoidance of outright default).

Given its history and dual geopolitical orientation (eastern Ukraine traditionally gravitating toward Russia, western Ukraine assertive and looking to the West), the country's leaders have been performing a balancing act, but in recent years have more and more favored the "European choice" and tilted Ukraine toward the West. The European Union and Ukraine signed a Partnership and Cooperation Agreement in 1995, which entered into force in 1998. In 1997, Ukraine and Russia concluded a Treaty for Friendship, Cooperation and Partnership. In the same year, a Charter of Special Partnership started to govern Ukrainian relations with NATO. In December 1999, the European Council adopted a Common EU Strategy on Ukraine, one of the nonbinding goals of which is to negotiate a free trade zone with Ukraine once the country has joined the World Trade Organization (WTO).

In 2002, Ukraine declared its goal of joining the EU and Euro-Atlantic structures such as NATO. In September 2003, the presidents of the Russian Federation, Ukraine, Belarus and Kazakhstan signed an agreement to create a Common Economic Space (CES), which Ukraine identifies with the goal of establishing a free trade area between the four countries as long as this does not jeopardize its aspirations to integrate with the EU. With the EU's latest round of enlargement in May 2004, the European Union and Ukraine have become direct neighbors. Ukraine is considered a priority partner country within the European Neighborhood Policy (ENP), and in February 2005, a joint EU-Ukraine Action Plan was endorsed, which focuses on helping Ukraine consolidate its "European choice" by harnessing further reforms. However, the European Union has not accepted Ukraine's request for becoming a candidate for EU membership. In December 2005 the EU, and in February 2006 the United States, acknowledged Ukraine as a market economy, which should strengthen the country's position in antidumping cases. WTO accession appears probable in late 2006.

Assistance from the International Monetary Fund (IMF) used to be of major importance for Ukraine, especially during the difficult period following the 1998 crisis, when the country's solvency was severely stretched. However, respective programs were often interrupted owing to nonobservance of performance criteria or failure to fully implement agreed-upon reforms. Most recently, a 12-month Stand-by Arrangement that was treated as precautionary by the authorities veered off track in the summer of 2004 and formally expired in March 2005.

3 Macroeconomic Developments and Structural Adjustment since 2000

3.1 Driving Forces behind the Turnaround and Recovery of 2000–2004 and the Slowdown of 2005

By the end of the 1990s, the steep and persistent economic decline in Ukraine had entailed a substantial drop in real wages and had left sizeable industrial capacities idle. In this situation, the strong depreciation of the Ukrainian hryvnia triggered by the 1998 crisis and the strong recovery that took hold of Ukraine's largest trading partner, Russia, in 1999 may have been two factors that started to change the overall economic environment for Ukraine. Successful macrostabilization measures in the wake of the crisis contributed to calming the situation. After a decline in 1998, Ukrainian GDP remained almost flat in 1999 (table 1).

The weakening of the hryvnia was not abrupt and sharp, but spread out over late 1998 and most of 1999. From September 1998 through end-1999, the Ukrainian currency's real effective exchange rate fell by about one-quarter. Not unlike developments in Russia, the depreciation triggered growth in some industrial sectors via import substitution (food processing, light industry) as well as in others via export expansion (metals, chemicals). Export expansion initially focused on products in demand in Russia (subject to the inherited division of labor between the two republics), but then spread to other markets, as growth there picked up and world market prices started to rise (Halushka, 2003, pp. 131–132). The industrial rebound produced a sharp turnaround of the previously negative current account balance in 1999; the surplus increased in the following year.

In 2000, world market prices of ferrous and nonferrous metals as well as of oil, refined petroleum products and chemicals started to grow strongly, contributing to a substantial improvement in Ukraine's terms of trade since energy (particularly gas) inputs coming from Russia and other CIS countries stayed relatively cheap despite recurrent nonpayment problems. Cumulative effects of past structural change as well as some important reform efforts of the administration that came to power in early 2000 and held office until early 2001 under then Prime Minister Yushchenko contributed to the breakthrough to positive GDP growth in 2000 and to the continuation of high levels of expansion in the following years. Traditional industries "learned by doing," i.e. by adjusting production to market requirements; managers also quickly reacted to antidumping problems in Western markets by reorienting sales to Asian countries (Berengaut et al., 2002, pp. 34–38). Thus, with limited actual downsizing and modernization, Ukraine's Soviet era industries achieved a remarkable degree of competitiveness. The land reform of 2000 (dissolution of former kolkhozes) and the reduction of government interference in agriculture contributed to a long-awaited agricultural rebound at the beginning of the new decade. The authorities also stepped up privatization activities and enacted a new banking law in early 2001.

Overall prudent fiscal and monetary policies, the simplification of tax rules and their enforcement as well as the administration's insistence on increasing cash collections in the energy sector served to strengthen payments discipline and boost confidence in the economy. Growing confidence was also reflected in rapid remonetization tendencies and the reduction of nonmonetary transactions. Accordingly, expanding demand for money facilitated monetary accommodation measures by the Ukrainian central bank (National Bank of Ukraine – NBU) through unsterilized interventions on the foreign exchange markets (starting in 2000) to fend off appreciation pressures on the hryvnia and support the newly found competitiveness of Ukraine's industries. As of early 2000, the external value of the national currency was de facto pegged to the U.S. dollar. In this situation, monetary accommodation appeared to provide room for production expansion without rekindling inflation as long as there were sufficient idle capacities.

Another important factor underpinning the upswing was swiftly rising private consumption, which started out from a very low level and then boomed on the back of strong wage and pension increases in 2001 and the following years.[3] Later on, notably in 2003 and 2004 and driven by exporters' and consumer industries' profits, private investment, including foreign direct investment (FDI), joined the factors propelling growth. Yet FDI inflows per capita remained far below those observed in most transition countries, including CIS neighbors, given the quite challenging Ukrainian investment climate. Economic expansion was further supported by a surge in private sector credit in recent years. In 2004, most of the above-mentioned factors were at work simultaneously, accounting for the growth spurt that year (table 1), while at the same time capacity bottlenecks started to show.

Likewise, the abrupt slowdown of growth in 2005 was triggered by the confluence of unfavorable factors. The temporary political turmoil surrounding the tumultuous elections and change of government of late 2004 triggered a near-banking crisis which temporarily cut credit expansion (see also subsection 3.2.3). This had knock-on effects on capital formation, which also suffered from economic uncertainty emanating from the new government's confusing review of the earlier privatization process and related disputes. However, the second half of the year was punctuated by some important FDI deals

[3] *Thus, to some degree, the "timing" of wage developments may have been fortunate for the unfolding of the Ukrainian recovery: The strong contraction of real wages in the 1990s reduced the costs of – hardly restructured – Ukrainian heavy industries. Once further advances in competitiveness had been achieved by currency devaluation and rising external demand, there was room for a beneficial effect of strong wage and pension adjustments on growth, given that there continued to be ample idle capacities.*

Table 1

Overview: Ukrainian Macroeconomic Indicators 1995–2005

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005[1]
GDP growth (real annual change in %)	−12.2	−10.0	−3.0	−1.9	−0.2	5.9	9.2	5.2	9.4	12.1	2.6
Gross industrial production (real annual change in %)	−12.0	−5.1	−0.3	−1.0	4.0	13.2	14.3	7.0	15.8	12.5	3.1
Gross agricultural production (real annual change in %)	−3.6	−9.5	−1.8	−9.6	−6.9	9.8	10.2	1.2	−11.0	19.9	0.0
Consumer price inflation (year-end, %)	181.7	39.7	10.1	20.0	19.2	25.8	6.1	−0.6	8.2	12.3	10.3
Unemployment rate (year-end, ILO definition, %)	×	×	9.7	11.5	12.4	12.2	11.2	11.1	9.0	8.7	8.2
Consolidated government budget balance (% of GDP)[2]	−4.9	−3.2	−5.4	−2.8	−2.4	−1.3	−1.6	0.5	−0.9	−4.4	−2.5
Merchandise trade balance (% of GDP)	−7.3	−9.8	−8.5	−6.2	0.8	2.5	0.5	1.7	−0.5	5.8	−1.1
Current account balance (% of GDP)	−3.1	−2.7	−2.7	−3.1	5.2	4.7	3.7	7.5	5.8	10.5	3.0
Exchange rate UAH/EUR (annual average)[3]	×	×	2.1	2.8	4.4	5.0	4.8	5.0	6.0	6.6	6.4
Exchange rate UAH/USD (annual average)[3]	1.5	1.8	1.9	2.5	4.1	5.4	5.4	5.3	5.3	5.3	5.1
External debt (end-year, % of GDP)	21.4	19.8	19.2	28.6	42.8	37.8	31.8	30.1	29.4	31.1	31.8

Source: Derzhkomstat, NBU, EBRD, wiiw.

[1] *Preliminary data or estimates.*
[2] *Consolidated government comprises the central government, local authorities, and social funds.*
[3] *The Ukraine hryvnia replaced the Ukraine karbovanets in September 1996, but the average annual rates prior to 1997 are shown in Ukraine hryvnia for convenience.*

Given the slowing global economy, demand for – and prices of – Ukrainian export staples (metals, chemicals, refined petroleum products) declined again or leveled off, halting the country's terms-of-trade gains and curbing its current account surplus. Ukraine's industries lost some of their competitiveness due to real appreciation tendencies of the currency, mainly on the back of rising inflation driven by the fiscal relaxation around the 2004 elections and by some capacity constraints that took effect (Shiells, 2006). Pushed by further salary and pension hikes, consumer demand was the only factor continuing to fully support growth in 2005.

3.2 Macroeconomic Developments and Policies

3.2.1 GDP Developments

Looking at GDP development from the supply side, industry, transportation and particularly trade were the drivers of growth in the period from 2000 to 2004. While it was punctuated by bouts of expansion (notably from 2000 to 2001), agriculture behaved more like a roller coaster and on the whole has been somewhat losing importance. Although final supply-side data for 2005 were not yet available at the time of writing, industry and agriculture can be assumed to have contributed to the sharp economic slowdown observed in that year. The evolution of demand components (table 2) clearly shows that Ukraine's foreign trade orientation increased over the years until 2004, before suffering a setback in 2005: The shares of exports and imports in GDP steadily expanded and then suddenly shrank. This expansion and the subsequent contraction can be explained by pronounced terms-of-trade developments and adjustments to changing demand (see section 2). They also show the risks of an economy heavily dependent on staple prices. Household – but not government – consumption constitutes one of the demand-side driving forces behind the Ukrainian economic expansion in the period from 2001 to 2005. Gross fixed capital formation gained momentum in 2003 and 2004, but then, facing a tougher economic and investment climate, lost steam in 2005.

Table 2

GDP and Its Components – Demand Side

	Growth (real annual change in %)					Structure (share in total GDP in %)				
	1999	2001	2003	2004	2005[1]	1999	2001	2003	2004	2005[1]
Total GDP	−0.2	9.2	9.4	12.1	2.6	100	100	100	100	100
of which:										
Final consumption	*−5.5*	*11.1*	*9.6*	*9.0*	*12.7*	*77.1*	*76.5*	*75.4*	*73.3*	*77.7*
households	*−3.9*	*10.4*	*8.6*	*10.3*	*15.9*	*54.7*	*54.9*	*54.7*	*53.8*	*56.9*
government	*−7.6*	*15.1*	*13.2*	*6.8*	*4.1*	*19.9*	*19.6*	*19.0*	*18.1*	*19.5*
Gross accumulation of fixed assets	−2.2	9.8	17.6	9.9	−4.0	19.2	19.7	20.6	20.2	. .
Change in inventories	×	×	53	×	. .	−1.8	2.1	1.4	−1.0	. .
Exports of goods and services	29.6	−2.9	15.0	18.9	−13.6	54.4	55.5	57.8	61.3	51.9
Imports of goods and services	10.2	2.4	19.3	9.1	−0.8	−48.8	−53.8	−55.2	−53.7	−51.4

Source: Derzhkomstat, IMF, wiiw, authors' calculations.

[1] *Preliminary data or estimates.*

3.2.2 Fiscal Policy and Tax Reforms

Buoyed by swift economic growth, which started in 2000 after a period of economic contraction that had been observed up to 1999, the government's fiscal results improved considerably compared to what their level had been in the second half of the 1990s (table 1). At the turn of the millennium, high consolidated budget deficits turned into near-balanced budgets or even small surpluses – a trend that continued up to 2003. Debt service payments exceeded 2% of GDP in the time from 1999 to 2001 and therefore necessitated primary surpluses in this period (table 3). However, the Ukrainian tax system has traditionally been overly complex and has suffered from serious distortions, noncompliance and inefficiencies. The new administration that came to power in 2000 made an important effort to streamline the system, cancel some discretionary tax exemptions, enhance tax administration, improve cash management and clear public spending arrears. It was successful in raising payments discipline. The new administration also attempted to rein in the practice of offsetting or netting overdue tax obligations against public expenditure arrears.

However, these efforts were interrupted and in some cases weakened by the granting of a tax amnesty in April 2001 and the ad-hoc extension of new tax loopholes to various industries (including metals, chemicals and engineering, i.e. major exporting sectors) as well as the rapid accumulation of new arrears, mainly reflecting noncompliance in the energy sector.[4] In July 2001 a new budget code was enacted, which modernized inherited Soviet tax collection methods (the kartoteka approach). A single treasury account became operational in mid-2002. After attaining high levels as a ratio of GDP at the turn of the millennium, public debt declined in the following years, reaching about 25% in 2004. Yet tax breaks continued to flourish.[5]

[4] *One could argue that these new instances of nonpayment were implicitly encouraged by the tax amnesty.*

[5] *For the central government budget, the cost of tax preferences (nonstandard exemptions and privileges) in 2003 came to 17% of tax revenue (IMF, 2003a, p. 16).*

Table 3

Consolidated Government Budget[1] and Public Debt 1999–2005 (% of GDP)

	1999	2000	2001	2002	2003	2004	2005[2]
Revenue	33.8	33.4	33.5	36.0	35.9	35.0	42.3
Expenditures	36.1	34.7	35.1	35.5	36.8	39.4	44.8
of which: interest payments	*2.6*	*3.1*	*2.0*	*1.3*	*1.0*	*0.9*	*0.8*
Cash balance	−2.4	−1.3	−1.6	0.5	−0.9	−4.4	−2.5
Commitments balance[3]	−1.4	2.1	−1.5	0.2	−0.1	−3.6	. .
Privatization proceeds	0.6	1.3	1.3	0.5	1.1	3.1	5.2
Net foreign financing	0.2	−0.3	0.4	−0.7	1.0	1.5	0.7
Public debt and arrears[4]	66.7	47.7	38.6	35.7	27.7	25.1	19.7
Memorandum item: GDP growth (real change in %)	*−0.2*	*5.9*	*9.2*	*5.2*	*9.6*	*12.1*	*2.6*

Source: Ministry of finance, IMF.

[1] Consolidated government includes the central government, local authorities and social funds.
[2] Preliminary data or estimates.
[3] Cash balance adjusted for net change in arrears (e.g. with respect to VAT refunds) and for noncash property income.
[4] Government and government-guaranteed liabilities and arrears, plus NBU debt. Excludes debt of state-owned enterprises.

A new tax reform initiative was launched in 2004, when corporate and personal income taxes were radically simplified: In both cases, tax rates were reduced to uniform single rates of 25% (corporate tax) and 13% (income tax). In return, respective tax bases were broadened and preferences and benefits were eliminated.[6] In the environment of the accelerating economic expansion of 2004 the change to flat taxes had a positive effect on revenues (Duchêne and Dubien, 2005, pp. 48, 52). On the other hand and for other reasons, 2004 signaled the end –or at least an interruption –of the period of prudent fiscal policies. In view of the presidential elections of late 2004, the authorities pushed up public spending. They raised pensions and stepped up clearing wage arrears and distributing tax privileges. Despite record GDP growth that year, the budget cash deficit grew to 4.4% of GDP. The new government of 2005, which was itself under pressure to prepare for the parliamentary elections of early 2006, largely continued the previous administration's expansionary social policies, but matched them with tax increases in other areas, some closures of loopholes and a tightening of fiscal administration. However, given the sharp economic slowdown in 2005, the budget shortfall remained relatively high at 2.5% (table 3). Covering the deficits was not a problem in 2004 and 2005, owing to strongly expanding privatization receipts.[7]

3.2.3 Monetary and Exchange Rate Policy

Following successful macrostabilization efforts in the wake of the 1998 financial collapse, Ukrainian monetary and exchange rate strategies seem to have been well orchestrated and may also have had a lucky touch in guiding remonetization and setting the stage for the financial deepening of the still fragile economy. After some impressive results achieved in the first years of the new millennium, inflationary pressures resurfaced, however, in 2004 and 2005.

[6] The income tax reform followed the example of Russia, which had adopted a flat personal income tax of 13% two years earlier.
[7] The reprivatization of the steel plant Kryvorizhstal in November 2005 alone produced net receipts (after refunding the plant's previous owners) of around 5% of GDP.

In the post-crisis situation of 1999 and against the backdrop of the country's delicate financial situation, monetary policy was still burdened by the government's heavy reliance on NBU financing. The Ukrainian hryvnia continued to weaken steadily throughout the year. Yet the breakthrough to economic growth in 2000, major improvements in fiscal and budgetary policies and practices as well as the positive swing in the country's external accounts supported decisive changes in monetary policymaking. Since January 2000, the NBU has defended a de facto peg of the hryvnia to the U.S. dollar at the exchange rate level of end-1999 within the formal framework of a managed float. Thus the U.S. dollar has served as a highly visible external nominal anchor, which managed to calm inflation expectations. Given Ukraine's newly found exchange rate-driven competitiveness, which was soon enhanced by world market price gains for the country's main export staples, rising current account surpluses produced upward pressures on the currency, which the NBU countered by expanding foreign exchange purchases. These interventions have served to gradually build up the NBU's modest external reserve position, but have largely been unsterilized, thus raising the money supply (table 4).

However, rising confidence and the continuing robust economic recovery contributed to boosting money demand, thus enabling a swift process of remonetization. Thanks also to the fact that government policies insisted on promoting cash payments, the weight of barter transactions and enterprise arrears was reduced. Velocity of money declined and inflation remained relatively low for some years. Thus, monetary expansion effectively accommodated an increase in money demand. The rise in CPI inflation to 26% at end-2000 was strongly influenced by adjustments in administered prices (notably communal tariffs) which had been put off until after the elections of the fall of 1999. While the monetary authority at times hiked mandatory reserve requirements, the only substantial sterilization measures were undertaken by the government, which generally conducted prudent fiscal policies up to 2003 and which temporarily accumulated deposits with the NBU.

Liquidity inflows and the favorable environment allowed banks to expand their (hitherto modest) lending to the private sector at a very rapid pace, bringing about a credit boom. From end-1999 to mid-2005, the average annual growth of commercial bank lending to the economy came to about one-third in real terms. Real credit expansion accelerated until 2003, when it reached 55%, but then some momentum was lost in 2004 (see below).[8] The decline of inflation to near-zero levels in 2002 was largely connected to temporary factors, namely the good harvests in 2001 and 2002 and the resulting sharp drop in food prices as well as renewed delays in adjusting administered prices and spillover effects of flat producer prices in 2001. However, the bad harvest of 2003 contributed to ratcheting up the price level that year.[9] In the same year, producer price inflation gathered momentum, and it further accelerated in 2004 owing to rising prices of oil and metals. After interest rates had fallen to

[8] *For more information on Ukrainian banking developments since the turn of the millennium, see Barisitz (2004).*

[9] *The rather erratic development of agricultural production seems to constitute something of a "swing factor" for Ukrainian economic and foreign trade activities and price dynamics.*

negative real levels by 2003, the NBU responded to the resurgence of retail price inflation by hiking its policy rates back up again in 2004 and early 2005 and by raising reserve requirements.

The fiscal loosening of 2004, which was only partially reined in the following year, augmented aggregate demand in a situation when production appeared to be nearing capacity bottlenecks, and some sectors, like housing construction and metallurgy, seemed to be overheating (IMF, 2004, p. 16). Rising inflationary pressures and a near-banking crisis triggered by the political instability and change of government in late 2004 (see below) halted or reversed money demand growth and interrupted remonetization tendencies. After it had continually fallen since 1999, the dollarization of the Ukrainian economy started to grow again in the fall of 2004 (Duchêne and Dubien, 2005, p. 51). These factors came on top of a record external surplus that produced further major liquidity inflows in 2004. The result was double-digit inflation at end-2004 (12.3%), as shown in table 4.

The near-banking crisis evolved in the following manner: The political turmoil of late 2004 combined with fragile confidence in the banking sector put the hryvnia under pressure. Depositors – mostly in Eastern Ukraine – stepped up withdrawals from bank accounts (which attained 17% of total Ukrainian household deposits) and changed their money into foreign currencies. Capital flight gained momentum. The NBU reined in the impact of these runs with a package of measures combining administrative restrictions, the granting of stabilization loans to some banks and foreign exchange interventions. By February 2005, calm had largely returned; restrictions were lifted and bank accounts and reserves were filling up again (Astrov, 2005, p. 105). After sharply decelerating to 18% in 2004, real credit growth regained some momentum in 2005 (+25% in the period from January to September 2005, year on year).

Despite the intermittent slowdown, the Ukrainian loans-to-GDP ratio more than tripled from 9% at end-1999 to almost 31% in June 2005, which corresponds to one of the most rapid expansions so far experienced in transition economies (table 4).[10] Given existing structural weaknesses, the speed of credit growth has raised financial and macroeconomic concerns. Owing to the stability of the exchange rate in recent years, to nominal hryvnia appreciation pressures and to lower interest rates on foreign currency-denominated loans, taking up foreign exchange loans has been quite popular, if risky: Almost 40% of all credits taken up in Ukraine are denominated in foreign exchange – in a situation characterized by a high number of unhedged borrowers.

In April 2005, the NBU slightly revalued (+3%) the national currency, but then continued to defend the new stable exchange rate. Despite this revaluation and notwithstanding the sharp drop of economic growth and of the external surplus in 2005, further increases in social spending as well as new post-election hikes in administrative prices contributed to keeping inflation in double digits that year. Although the real effective exchange rate of the hryvnia, which had slightly depreciated since 2000, reappreciated again in

[10] *However, this expansion proceeded from a very low point of departure, and levels attained are still quite modest compared to developed market economies.*

Table 4

Monetary Indicators

	1999	2000	2001	2002	2003	2004	2005[1]
Consumer prices (year-end, change in %)	19.2	25.8	6.1	–0.6	8.2	12.3	10.3
Producer prices (year-end, change in %)	15.7	20.6	0.9	5.7	11.1	24.1	9.5
Base money (M1, year-end, change in %)	39.2	40.1	37.4	33.6	30.1	34.1	46.9
Broad money (M2, year-end, change in %)	40.4	45.5	41.9	41.8	46.5	32.3	54.3
Refinancing rate (year-end, %)	45.0	27.0	12.5	7.0	7.0	9.0	9.5
Credit (credit volume to GDP, %)	9.0	12.4	14.5	19.4	26.6	27.1	30.7[2]
Credit growth (real, %)	24.2	36.0	34.5	48.1	54.5	18.5	20.0[2]
Deposit rate (average, year-end, % p.a.)	20.7	13.7	11.0	7.9	7.0	7.8	10.0
Lending rate (average, year-end, % p.a.)	55.0	41.5	32.3	25.4	17.9	17.4	16.5
Exchange rate UAH/EUR (annual average)	4.4	5.0	4.8	5.0	6.0	6.6	6.4
Exchange rate UAH/USD (annual average)	4.1	5.4	5.4	5.3	5.3	5.3	5.13
Real effective exchange rate (annual average, change in %)[3]	–16.3	–4.4	+6.0	–4.1	–6.3	–0.9	+12.0

Source: Derzhkomstat, NBU, IMF, EBRD, wiiw, authors' estimates.

[1] *Preliminary data or estimates.*
[2] *Mid-2005.*
[3] *(+) corresponds to real appreciation; based on CPI and average trade weights for 1996–2002.*

2005, competitiveness has been broadly maintained, judging from Ukrainian wage and price levels that stood at only about half of the comparable Russian levels in September 2005.

3.2.4 Balance of Payments and External Debt

Ukraine is a quite open economy for its size. As noted above, the shares of exports and imports in GDP have been increasing and have reached levels of around 55% to 60%. While the 1998 crisis had brought Ukraine in a serious financial situation, putting the country at the brink of bankruptcy for two years, the brightening of the external environment at the turn of the millennium and the ensuing strong current account surpluses dispelled solvency problems. The external deterioration in 2005 met a country equipped with a fair amount of foreign exchange reserves (table 5).

Ukraine's payment difficulties triggered by the financial collapse of 1998 and the following large-scale devaluation pushed up external liabilities as a share of GDP. Yet at the same time, the devaluation coupled with fortunate price gains on international markets and significant idle capacities sharply improved Ukraine's cost and price competitiveness and reversed the country's terms-of-trade and external position, creating a chain of sizeable current account surpluses and entailing years of respectable growth. In addition, Ukraine reached debt rescheduling agreements with the creditors of the London Club (April 2000) and the Paris Club (July 2001), which eased the debt service burden. Payment arrears of the Ukrainian monopoly gas supplier Naftogaz Ukraini to Gazprom (Russia) amounting to about USD 1.4 billion were rescheduled in October 2001 (Bon and Duchêne, 2001, p. 181). Foreign public debt declined to one-fifth of GDP by end-2004.

Other factors that added to Ukraine's favorable current account position were expanding service receipts for Russian oil and gas transit to Central and Western Europe and rising current transfers consisting of remittances (mostly from Ukrainians working in Russia) and compensation payments for forced labor in World War II, which the country has received since 2001. After being confronted with a mounting number of antidumping actions and threats pertaining to Ukrainian products like steel, rubber and fertilizer and coming from their main trading partners (notably the EU, Russia and the U.S.A.), Ukrainian manufacturers successfully ventured into other markets especially in Asia and Africa. The particularly large current account surplus of 2004 was caused by a continued positive terms-of-trade shock, which reflected exceptionally high staple prices,[11] as well as by strong demand from the booming Russian and Chinese economies. The abrupt halt and partial reversal of the favorable terms-of-trade dynamics in 2005, the rising inflation-induced real appreciation of the exchange rate, the slowing of global demand (including demand for metals) as well as buoyant domestic household spending pushed the trade balance into the red and produced a strong contraction of the current account surplus that year (table 5).

Given limited restructuring, including weak or insufficient FDI, the content of Ukraine's exports has not evolved much since the turn of the millennium. Traditional, low value-added products continue to dominate the market: Metals, chemicals and energy products made up 62% of total exports in 1999, and continued to do so in 2004, although relative price increases for these staples masked a degree of real contraction. While the share of fuel and energy in total imports declined in this period from 46% to 36%, it is still predominant. The latter percentages are downward biased because a considerable part of energy, particularly natural gas, is imported at prices that are far below world market levels. The share of machinery grew from less than one-fifth to over one-quarter of imports. Chart 1 reveals that Russia is still Ukraine's largest trading partner as a country, although the enlarged EU overtook Russia and the CIS as an export destination in 2004. Given the continuing long-term effects of Soviet disintegration and the global economic reintegration of Ukraine, Russia's and the CIS' share in Ukrainian foreign trade decreased further in recent years, but this decrease has been slowing down in the light of Russia's and its neighbors' robust growth.

On the import side, Ukraine's strong dependence on energy reflects Russia's undisputed dominance (chart 1): Over 40% of Ukraine's imports came from its big northern and eastern neighbor in 2004; more than half of the country's imports are purchased from CIS members, with Turkmenistan as the second-largest energy supplier. These shares would be even higher if world market energy prices were applied. Still, the EU-25 are clearly the second-most important trading area for Ukraine and enlarged their share in Ukraine's imports to over one-third in recent years. In view of this specific trade pattern and record, one may wonder about the viability and sustainability of what might be called a "Ukrainian growth model," i.e. a model which is characterized by the production and export of low-tech and price-sensitive heavy industrial goods on the world market, which in turn are based inter alia on imports of cheap Russian and CIS energy. This question appears relevant in connection with the latest Russian-Ukrainian gas agreement, which was con-

[11] *Altogether, according to IMF estimates, Ukraine accumulated terms-of-trade gains during the period from 2000 to 2004 that amounted to about 24%, thus corresponding to a positive current account impact of 12% of GDP (Davis et al. 2005, p. 18).*

Table 5

Balance of Payments and External Debt 1999–2005 (% of GDP)

	1999	2000	2001	2002	2003	2004	2005[1]
Merchandise exports	41.4	50.3	44.9	44.0	47.3	51.4	44.3
Merchandise imports	–40.6	–47.8	–44.4	–42.3	–47.8	–45.6	–45.5
Services receipts	12.1	12.2	10.5	11.0	10.4	9.7	7.4
Services payments	–7.2	–9.6	–9.4	–8.3	–7.3	–7.9	–6.1
Income (net)	–2.7	–3.0	–1.8	–1.4	–1.2	–1.0	. .
Current transfers (net)	2.2	2.7	3.8	4.5	4.4	4.0	. .
Current account	5.2	4.7	3.7	7.5	5.8	10.5	3.0
Direct investments (net)	1.5	1.9	2.0	1.6	2.8	2.6	9.2
Portfolio equity	0.4	–0.6	–1.9	–4.6	–3.4	–2.0	. .
Bonds and medium- and long-term loans (net)	–0.5	–0.3	–0.3	0.9	2.6	6.3	. .
Short-term capital (including net payables)[2]	–0.3	–3.2	0.5	–0.4	–1.3	–13.5	. .
Capital and financial account	–1.6	–2.2	0.3	–2.5	0.6	–6.5	9.8
Gross international reserves (change)[3]	–0.9	–1.3	–4.2	–2.5	–4.1	–3.4	. .
Total external debt	42.8	37.8	31.8	30.1	29.4	31.1	31.8
Gross international reserves (year-end)	3.4	4.8	8.1	10.4	13.8	14.6	24.6
Debt service (% of exports of goods and services)	16.6	10.4	6.7	5.4	6.2	4.8	4.9
Terms of trade (change in %)	9.2	–8.2	1.3	1.6	8.6	16.4	0
Memorandum item: GDP in billion euro (current prices)	26.7	33.8	42.4	44.9	44.40	52.2	65.4

Source: Derzhkomstat, NBU, IMF, authors' estimates.

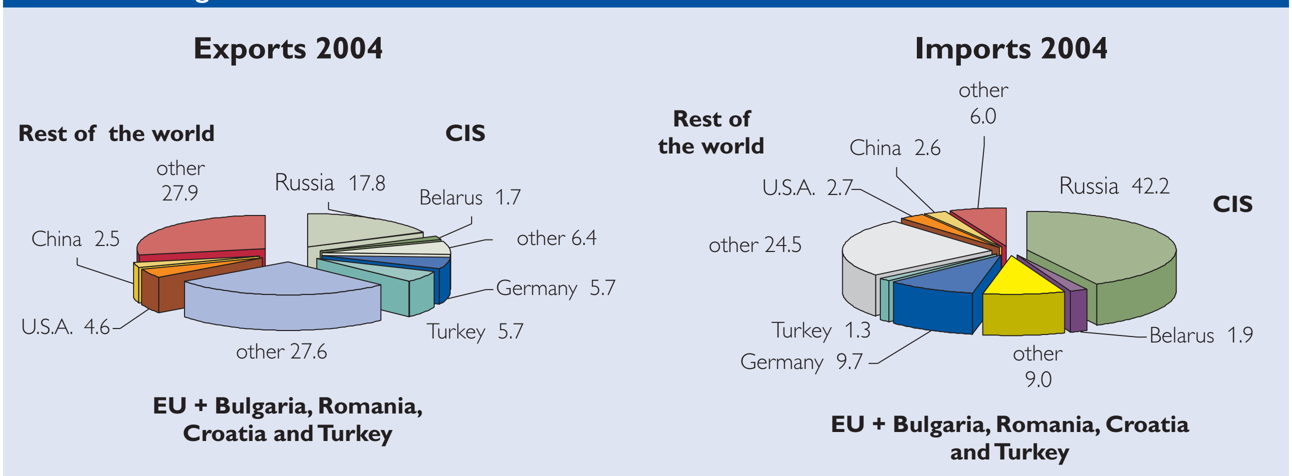
[1] *Preliminary data or estimates.*
[2] *Including barter settlements to clear outstanding arrears to Russia.*
[3] *(-) corresponds to an increase in percentage points of GDP.*

cluded in January 2006 and which provides for an immediate near-doubling of Naftogaz Ukraini's gas purchase price right at the Russian border.[12]

Notwithstanding a political situation that continues to be less than stable, one should note that in recent months inward FDI turned into a substantial item in the Ukrainian balance of payments. The first major deal was Raiffeisen's purchase in October 2005 of a 93.5% stake in the country's second-largest credit institution (measured by assets), Avalbank, for about EUR 850 million. This move was followed by the successful reauction (reprivatization)

Chart 1

Ukraine: Foreign Trade Structure – Partner Countries



Source: Derzhkomstat, NBU, IMF.

[12] *For more details on the energy sector, see section 3.3. For possible implications of the gas price increase, see section 4.*

in November of the giant steel company Kryvorizhstal, which was sold for almost EUR 4 billion to the British-Indian Mittal corporation. Another important deal was BNP Paribas' takeover in December of a 51% stake in the fifth-largest bank, Ukrsibbank, for EUR 420 million, followed in February 2006 by Banca Intesa's acquisition of 85% of Ukrsotsbank, the fourth-largest bank, for EUR 900 million. These transactions have contributed to boosting the country's foreign exchange reserves, which topped EUR 16 billion at end-2005.

3.3 Energy Sector Developments and Reforms

Energy plays a pivotal role for production, import dependence, export revenues and consumption activities in Ukraine. Energy intensity (energy use per unit of GDP) is extremely high in Ukraine and, according to the EBRD, was the highest of any European country in 1999 and a multiple of the Western average (EBRD, 2001, pp. 91–92). This is largely connected with inefficient and aging industrial technologies. About a quarter of Ukraine's gross industrial production and a third of the country's imports consist of energy products. The main components of the energy sector are coal, oil and natural gas; accounting for around half of energy imports, use and consumption, natural gas is the most important energy source.

Coal

Coal accounts for a quarter of Ukraine's primary energy supply. Most of it is mined domestically and used in industries such as the steel industry (Davis, 2005, p. 5). As of 2002, prices set for coal produced in Ukraine amounted to about half the level of world prices, which implies that substantial implicit subsidies have been passed on to enterprises in other sectors. The coal industry consists of over 200 mines. Given low prices, chronic underinvestment and outdated equipment, most coal mines are loss-making, and the budget transfers annual subsidies to the industry that amount to about 5% of central government expenditure or 1% of GDP. Ukraine's coal mines are among the world's most accident-prone. After repeated delays, bankruptcy proceedings have been opened against around 100 mines.

Oil

Crude oil makes up about one-fifth of Ukraine's primary energy supply; about 90% of this oil is imported. Oil purchased abroad originates almost exclusively in Russia, with minor quantities being imported from Kazakhstan. Until recently, Ukraine's oil prices had been well below world prices (in this case, Urals grade crude) – a reflection of preferential contracts with Russia. Since the partial liberalization of the oil trade in 2002, however, Ukraine's oil import prices have converged substantially, and the differential to the world price level may currently only be a few percentage points. In this context, it has been estimated that full adjustment to world prices would subtract some quarter of a percentage point of GDP from Ukraine's current account balance (Halikias, 2005, p. 36).

After the recent privatization sale of some of the country's six oil refineries to Russian investors, their capacity utilization, which previously had been very low, has increased markedly. Ukraine is a key transit country for Russian oil exports, hosting part of the Southern Druzhba oil pipeline, Russia's main overland export route, as well as the Prydniprovsky pipeline. The steep oil price hikes of recent years have had substantial effects on the Ukrainian economy, which, however, have been largely offset by strengthening economic activity and thus higher import demand in Russia, a key destination of Ukraine's exports[13], and by increasing revenues from Russian oil transit.

Gas

Ukraine enjoys a key strategic location on the European East-West gas transportation corridor. 80% to 90% of Russia's natural gas exports to Central and Western Europe transit through Ukraine (mainly through the Soyuz and Progress pipelines). For this transit of about 115 billion cubic meters annually, Ukraine receives around 25 billion cubic meters worth of gas as in-kind payment. Ukraine further consumes 29 billion cubic meters of gas a year from Turkmenistan (delivered through Russian territory). Ukraine's own production for domestic consumption comes to about 18 billion cubic meters. The country's gas sector is dominated by the state-owned holding company Naftogaz Ukraini (founded in 1998), which is in charge of gas production, import, distribution and transit.

In contrast to external oil prices, external gas prices are not market-dominated, but continue to depend on political factors and leverage. Given that Ukraine is a near-monopolist for Russian gas exports to Central and Western Europe, and that Turkmenistan and other Central Asian countries have limited options for export outlets, Ukraine has considerable leverage in price negotiations with Russia and other CIS members. Since the breakup of the Soviet Union, there have been repeated occasions of payment delays, supply cutoffs, debt restructuring negotiations, barter arrangements, new arrears, etc.[14] Until most recently, no moves toward convergence with world gas prices could be detected. As of end-2005, the European parity price was above USD 200 per 1,000 cubic meters (Davis et al., 2005, p. 9). For several years, Russia has continued to provide gas to Ukraine at a rate of USD 50 per 1,000 cubic meters. Earlier in 2005, Ukraine and Turkmenistan negotiated a gas price of USD 44 per 1000 cubic meters, which means USD 60 at Ukraine's border after Russian transport costs are added.[15]

About one-third of this cheap gas helps subsidize energy-intensive industries, notably export-oriented branches (like fertilizer, chemicals and steel production), one-sixth is consumed by commercial and public services, another third is delivered to the residential (household) sector on the basis of regulated below-cost prices (implying additional budgetary or cross-subsidization). Implicit gas subsidies to the economy are estimated to reach about 2% to 3% of GDP per year. Therefore, transition to less energy-intensive technologies

[13] *However, the establishment of the Russian oil stabilization fund in 2004 introduced a stability factor which, in the immediate future, will tend to moderate the potential growth of export demand from Russia.*

[14] *Some reports claim that Ukraine resorted to unauthorized siphoning of Russian transit gas (Saprykin, 2003, p. 189; Clement, 2002, p. 56). The flaring-up of Ukrainian-Russian gas disputes have at times also had repercussions (brief supply disruptions) on Central and Western European countries further down the supply line.*

[15] *However, Ukraine may lose some of its market power in the medium to long term, as Russian energy export projects circumvent Ukraine (and other transit countries), inter alia by constructing the Northern European Pipeline which directly links Russia and Western Europe (Germany) through the Baltic Sea.*

may have been hindered by understated energy prices. The government of 2000–2001 – particularly former deputy prime minister Timoshenko, who was in charge of reforming the energy sector – proved to be quite successful in bringing about a dramatic increase in cash collection rates and enhancing domestic payment discipline in the sector (particularly gas and electricity). Successor governments continued these efforts. Rapid economic growth provided many energy consumers with higher revenues, which contributed to improving the situation.

Despite these advances, tariffs have remained insufficient to cover the gas sector's costs and investment needs. Coupled with inefficient management, weak maintenance and poor transparency, the long-term sustainability of the transit infrastructure may be in jeopardy. The new gas treaty with Russia (of early January 2006), which almost doubles external gas prices for Ukraine, constitutes a serious challenge for the financial integrity of Naftogaz and for large parts of the Ukrainian economy. While in the first months of 2006 budgetary intervention has helped to reduce the burden for the energy sector, painful price adjustments for industry and consumers can be expected for the near future.

4 Outlook

After five impressive years of strong growth and rapid catching-up, the sharp slowdown in 2005 recalled the fragility and volatility of Ukrainian economic developments and their foundations. It seems that in the coming years, Ukraine's economic prospects will be strongly influenced by two factors: the country's terms of trade and its political stability. The new Ukrainian-Russian gas deal, which almost doubles gas import prices at the Russian border, reportedly also pertains to gas deliveries from Turkmenistan and Kazakhstan that are sent to Ukraine via Russian territory or purchased by Russia and resold to Ukraine. While Gazprom claims to be able to earn the full USD 230 per 1,000 cubic meters it demanded in the negotiations, the lower overall price of USD 95 paid by Naftogaz is apparently reached by generously mixing cheaper central Asian gas into the quantities purchased. Transit tariffs for Russian gas deliveries through Ukraine will also increase, but only by about 45%, and they will not offset the gas price hike. While there appears to be conflicting information on the stipulated duration of the treaty, the nature of the deal described above would make it difficult to imagine Turkmenistan and Kazakhstan putting up with their relatively modest prices for long. Therefore, pressures for further adjustments toward world price levels can be expected.

Most experts believe that the new gas deal will have substantial repercussions for the Ukrainian economy, its external accounts, growth, and probably, longer-term structural development. Estimates of IMF, World Bank, Deutsche Bank and Raiffeisenbank (some of them hypothetical on the basis of simulations from the time before the gas deal was concluded) seem to converge around a negative impact on the current account amounting to 2 to 3 percentage points of GDP (mainly by deepening the trade deficit) and a negative impact on GDP growth coming to 1 to 2 percentage points in the first year (2006), followed by a declining impact in subsequent years.[16] Given uncertainty as to the durability of the agreement, this result may bear a downside risk. Another issue in question is the price of steel, the major Ukrainian export staple. As a result of an overall profit squeeze, the financial situation of some export-oriented enterprises could seriously deteriorate. On a more positive note, the price shock could trigger energy saving investments which might contribute to finally weaning the country off its excessive energy dependence in the longer run.

Political instability may persist even after the parliamentary elections of March 2006, as the legislative branch will probably continue to reflect a fractured political landscape. In any case, notwithstanding the rada's increased powers according to the constitutional changes that came into force at the beginning of 2006, it may not be easy for the future government to muster the necessary political support to push ahead with a bold reform agenda. Banking is set to continue its fragile expansion, and new financial instability does not appear imminent, but could potentially be triggered by a new political crisis or sharp economic downturn, especially if one takes into account the recent credit boom.

While acknowledging that with all these uncertainties the margin of error is high, one might conclude that in 2006 the current account will probably be more or less in balance or slightly in the red, while GDP growth may remain around the (rather weak) level of 2005 (+2.6%) or perhaps slightly lower. Pushed by rising energy and utility prices, inflation is bound to stay above 10%. Real incomes are likely to expand at a somewhat slower rate in 2006 than in 2005, but should remain the main pillar of economic activity. Modest economic growth and increased budgetary energy subsidies are liable to widen the fiscal gap in 2006.

Equipped with sizable foreign exchange reserves, the NBU will probably continue to aim at keeping the exchange rate stable vis-à-vis the U.S. dollar. Yet, conditions for monetary policy have already adjusted somewhat. Since early 2006, large trade-connected foreign exchange inflows seem to have dried up, although FDI inflows may at least partially take their place.[17] Unless the country is in for a further energy and/or terms-of-trade shock in the short term – which cannot be excluded – recovery from the slow growth trough could start in 2007. But recovery will remain precarious until the energy-related retooling of industry, and the economy itself, has made appreciable progress. Competitive wages, growing FDI, the strengthening global economic integration of Ukraine, prospective WTO membership and increasing adherence to European standards should help stabilize economic expansion and facilitate restructuring in the coming years.

Editorial close: April 5, 2006.

[16] *See i.a. Halikias 2005, pp. 35–38; Davis et al., 2005; Paruk and Nystedt, 2006; Lechner, 2006; Budnyk and Zinovyev, 2006. In January to Febuary 2006, Ukrainian GDP grew by 1.5% in real terms (year on year).*

[17] *In the first quarter of 2006, the NBU was reported to have spent over EUR 1.5 billion defending the hryvnia. In this period foreign exchange reserves declined by about 10% to EUR 14.4 billion. However, in the same time span, transactions committing new inward FDI of approximately EUR 1 billion were concluded.*

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