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## **Ukraine: 'market economy' at last**

On 1 December 2005, the European Commission finally announced its decision to grant Ukraine the 'market economy' status. This long overdue move will ease the burden of anti-dumping investigations launched against the imports from Ukraine (notably metals and chemicals) to the EU markets. Also, it may be regarded as the first tangible result of political rapprochement between the EU and Ukraine since the 'orange revolution' at the end of 2004. However, the decision itself (though politically motivated) is rather 'technical' and should not be interpreted as a step on the path of Ukraine's integration into the EU,<sup>1</sup> while a similar decision from the United States is still pending. Otherwise, integration with the EU has not progressed very much either: while EU citizens have been entitled since mid-2005 to visa-free entry into Ukraine, the EU's visa regime for Ukrainians remains highly restrictive, and a re-admission agreement has not been concluded yet (although, as exemplified by Russia's recent experience, even the conclusion of such an agreement may not necessarily ease the EU visa regime for the country in question). Ukraine's WTO accession, initially planned for December 2005, has been postponed, but it may be realistically expected to take place in the course of this year.

Ukraine's EU integration prospects are hardly helped by the country's political instability and the mounting economic problems. The record-high 12.1% GDP growth observed in 2004 was persistently declining in the course of 2005 and stood at a mere 2.4% for the year as a whole, reflecting first of all a slowdown in the dynamics of gross industrial output of a similar magnitude: from 12.5% in 2004 to 3.1% in 2005. The 2005 grain harvest reached about the same (high) level as in the year before, thus gross agricultural output was flat, which had a dampening effect on GDP growth as well. Viewed from the demand side of GDP, the growth slowdown has been primarily due to the weak investment activity and the disappointing foreign trade performance. As a result of the political instability, fixed investments were up by just 3.4% in the first three quarters of 2005 (compared to 34.5% over the same period of 2004). In turn, the trade balance in goods turned negative (USD -1.3 billion in January-November, according to the customs statistics) – largely due to the collapse in the world steel prices and partly also to the revaluation of the hryvnia in April. However, thanks to the high services exports (representing largely transit fees for the Russian energy carriers shipped to Europe) and the inflows of remittances, the current account in 2005 was once again in surplus, probably reaching some 3% of GDP.

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<sup>1</sup> For instance, Russia – which does not have ambitions of EU membership – has had a 'market economy' status from the EU since 2002.

A pleasant side effect of the economic slowdown has been disinflation. The *end-year* consumer price inflation last year stood at 10.3% – somewhat lower than in 2004 (12.3%), even though the *average* inflation figure turned out to be higher (13.5% vs. 9%), largely resulting from the ‘overheating’ which accompanied the country’s economic boom throughout most of 2004. The slowdown of producer price inflation has been much more pronounced (from 24.1% in 2004 to 9.5% in 2005 on an end-year basis) and will have a mitigating effect on consumer inflation as well.

After several failed attempts, on 20 December 2005 the Verkhovna Rada (the Ukrainian parliament) finally adopted the central budget for 2006. The budget envisages a deficit of UAH 12.9 billion (or 2.5% of GDP), of which UAH 1.5 billion is to be covered by borrowing and another UAH 2.1 billion by privatization receipts. The latter target is far below both the 2005 privatization target (UAH 7 billion) and the actual privatization proceeds of the government last year, well in excess of UAH 20 billion – primarily due to the highly successful re-privatization of Ukraine’s biggest steel mill Kryvorizhstal’ to Mittal Steel in October. Also, the opposition-minded Rada has put a ban on the forthcoming privatization of some big industrial enterprises, probably in an attempt to prevent the transfer of big assets to commercial structures close to President Yushchenko. However, the government’s earlier UAH 24.2 billion receipts from the Kryvorizhstal’ deal should be sufficient to cover the bulk of the 2006 budget deficit – even after subtracting the UAH 4.2 billion compensation to the former Kryvorizhstal’ owners, the sum allocated to bridge the gap of the Pension Fund, and money used to finance the 2005 budget deficit. Besides, the Kryvorizhstal’ deal alone was responsible for a 30% surge in the foreign exchange reserves of the National Bank, which reached some EUR 16.2 billion by the end of the year.

On 10 January 2006, the government of Yuri Yekhanurov, in office only since September 2005, was sacked by the Verkhovna Rada in the aftermath of the widely criticized gas agreement with Russia. In particular, the opposition claimed that the terms of the agreement signed on 4 January ran against the country’s national interests by envisaging a rise in the price of imported natural gas. Meanwhile, the agreement as it stands will hardly pose a big shock to the country’s economy: the price of USD 95 per thousand cubic metres of gas agreed for the first half of 2006 is only 30% higher than the effective price paid by Ukraine to Russia before (taking into account the simultaneous upward revision of the transit fees for Russian gas destined for Europe), and stands at less than half of the ‘world market’ price. At the same time, many of the contract provisions are confusing: the above price seems to apply to only a limited import volume, the price for the second half of 2006 (and thereafter) has not been set, and the envisaged role of RosUkrEnergo – a Swiss-based offshore company – as the sole importer of natural gas into Ukraine is controversial.<sup>2</sup>

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<sup>2</sup> For details of the gas agreement, see V. Astrov, ‘The Ukrainian-Russian ‘gas deal’: a question mark’, *The Vienna Institute Monthly Report*, No. 2, February 2006, pp. 2-3.

The gas agreement with Russia has been a pretext rather than the real reason behind the Rada's decision to sack the government. More generally, the move reflects the rising self-confidence of Viktor Yanukovich – whose 'Party of Regions' had supported the nomination of Mr Yekhanurov as prime-minister in September 2005, but whose popular rating has grown markedly in the meantime – but also the broad disillusionment of Ukrainian society with the new power elite, not least as a result of the earlier split between Mr Yushchenko and Ms Tymoshenko. It is also to be viewed against the background of the upcoming parliamentary elections scheduled for 26 March 2006, and the constitutional amendments taking effect this year. According to these amendments, Ukraine is converted from a presidential-parliamentary into a parliamentary-presidential republic, whereby the government is essentially formed by a parliamentary coalition – however, not until the March elections. Therefore, the current (Yekhanurov) government will most likely remain in office until the elections. However, in political terms, the Rada's decision has been a setback for Mr Yushchenko and his 'Our Ukraine' party, and will make it more difficult for them to find political allies in the newly elected parliament. Therefore, both the future parliament and the future government will be more powerful and will probably find themselves in opposition to the current president – prompting the latter to try to revert the constitutional reform, e.g. by holding a nation-wide referendum. However, in the present circumstances, such a referendum appears hardly realistic.

Table UA

## Ukraine: Selected Economic Indicators

|  | 1999    | 2000    | 2001    | 2002    | 2003    | 2004    | 2005 <sup>1)</sup>     | 2006<br>forecast   | 2007<br>forecast |
|--|---------|---------|---------|---------|---------|---------|------------------------|--------------------|------------------|
| Population, th pers., end of period                      | 49429.8 | 48923.2 | 48457.1 | 48003.5 | 47622.4 | 47280.8 | 46930.6                | 46600              | 46400            |
| Gross domestic product, UAH mn, nom.                     | 130442  | 170070  | 204190  | 225810  | 267344  | 344822  | 400800                 | 463000             | 535000           |
| annual change in % (real)                                | -0.2    | 5.9     | 9.2     | 5.2     | 9.6     | 12.1    | 2.4                    | 5                  | 6                |
| GDP/capita (EUR at exchange rate)                        | 595     | 688     | 872     | 931     | 928     | 1099    | 1330                   | .                  | .                |
| GDP/capita (EUR at PPP - wiiw)                           | 3420    | 3770    | 4240    | 4620    | 5120    | 5910    | 6210                   | .                  | .                |
| Gross industrial production                              |         |         |         |         |         |         |                        |                    |                  |
| annual change in % (real)                                | 4.0     | 13.2    | 14.3    | 7.0     | 15.8    | 12.5    | 3.1                    | 6                  | 7                |
| Gross agricultural production                            |         |         |         |         |         |         |                        |                    |                  |
| annual change in % (real)                                | -6.9    | 9.8     | 10.2    | 1.2     | -11.0   | 19.9    | 0.0                    | .                  | .                |
| Construction output total                                |         |         |         |         |         |         |                        |                    |                  |
| annual change in % (real)                                | -11.0   | 0.4     | 3.5     | -5.8    | 26.5    | 17.2    | -6.6                   | .                  | .                |
| Consumption of households, UAH mn, nom.                  | 71310   | 92406   | 112260  | 124560  | 146301  | 185533  | .                      | .                  | .                |
| annual change in % (real)                                | -1.9    | 2.5     | 9.6     | 9.5     | 12.4    | 15.1    | .                      | .                  | .                |
| Gross fixed investment, UAH mn, nom.                     | 17552   | 23629   | 32573   | 37178   | 51011   | 75714   | 51552 <sup>I-X</sup>   | .                  | .                |
| annual change in % (real)                                | 0.4     | 14.4    | 20.8    | 8.9     | 31.3    | 28.0    | 3.4 <sup>I-X</sup>     | 7                  | 10               |
| LFS - employed persons, th, avg. <sup>2)</sup>           | 20048.2 | 20175.0 | 19971.5 | 20091.2 | 20163.3 | 20295.7 | 20748.2 <sup>I-X</sup> | .                  | .                |
| annual change in % <sup>3)</sup>                         | -12.8   | 0.6     | -1.0    | 0.6     | 0.8     | 0.7     | 1.9 <sup>I-X</sup>     | .                  | .                |
| Reg. employees in industry, th pers., avg. <sup>4)</sup> | 3932.0  | 3445.0  | 3811.0  | 3578.1  | 3416.0  | 3408.3  | 3411.7                 | .                  | .                |
| annual change in %                                       | -5.1    | -12.4   | -6.2    | -6.1    | -4.5    | -0.2    | 0.1                    | .                  | .                |
| LFS - unemployed, th pers., average <sup>2)</sup>        | 2698.8  | 2655.8  | 2455.0  | 2140.7  | 2008.0  | 1906.7  | 1780                   | .                  | .                |
| LFS - unemployment rate in %, average <sup>2)</sup>      | 11.9    | 11.6    | 10.9    | 9.6     | 9.1     | 8.6     | 8                      | 8                  | 8                |
| Reg. unemployment rate in %, end of period               | 4.3     | 4.2     | 3.7     | 3.8     | 3.6     | 3.5     | 3.1                    | 3                  | 3                |
| Average gross monthly wages, UAH <sup>4)</sup>           | 177.5   | 230.1   | 311.1   | 376.4   | 462.3   | 589.6   | 806.2                  | .                  | .                |
| annual change in % (real, gross)                         | -5.4    | 1.1     | 20.7    | 20.0    | 16.7    | 17.0    | 20.4                   | .                  | .                |
| Consumer prices, % p.a.                                  | 22.7    | 28.2    | 12.0    | 0.8     | 5.2     | 9.0     | 13.5                   | 10                 | 9                |
| Producer prices in industry, % p.a.                      | 31.1    | 20.9    | 8.6     | 3.1     | 7.8     | 20.4    | 16.8                   | 8                  | 7                |
| General governm. budget, nat. def., % GDP                |         |         |         |         |         |         |                        |                    |                  |
| Revenues   | 25.2    | 28.9    | 26.9    | 27.4    | 28.2    | 26.5    | 33.4                   | .                  | .                |
| Expenditures <sup>5)</sup>                               | 26.7    | 28.3    | 27.2    | 26.7    | 28.4    | 29.7    | 35.4                   | .                  | .                |
| Deficit (-) / surplus (+), % GDP                         | -1.5    | 0.6     | -0.3    | 0.7     | -0.2    | -3.2    | -1.9                   | -2.5 <sup>6)</sup> | .                |
| Public debt in % of GDP                                  | 61.0    | 45.3    | 36.5    | 33.5    | 29.0    | 24.7    | 19.5                   | .                  | .                |
| Refinancing rate of NB % p.a., end of period             | 45.0    | 27.0    | 12.5    | 7.0     | 7.0     | 9.0     | 9.5                    | .                  | .                |
| Current account, EUR mn <sup>7)</sup>                    | 1559    | 1602    | 1565    | 3360    | 2559    | 5476    | 2000                   | 500                | -500             |
| Current account in % of GDP                              | 5.2     | 4.7     | 3.7     | 7.5     | 5.8     | 10.5    | 3.2                    | 0.6                | -0.6             |
| Gross reserves of NB excl. gold, EUR mn <sup>8)</sup>    | 1042    | 1453    | 3353    | 4088    | 5386    | 6838    | 16168                  | .                  | .                |
| Gross external debt, EUR mn <sup>9)</sup>                | 13456   | 12759   | 13785   | 12247   | 19055   | 22529   | 30557 <sup>I-X</sup>   | .                  | .                |
| FDI inflow, EUR mn <sup>7)</sup>                         | 466     | 644     | 884     | 734     | 1261    | 1380    | 6000                   | .                  | .                |
| FDI outflow, EUR mn <sup>7)</sup>                        | 7       | 1       | 26      | -5      | 12      | 3       | 195 <sup>I-X</sup>     | .                  | .                |
| Exports of goods, BOP, EUR mn <sup>7)</sup>              | 12400   | 17008   | 19074   | 19770   | 21013   | 26906   | 28500                  | 29900              | 31400            |
| annual growth rate in %                                  | 2.3     | 37.2    | 12.1    | 3.6     | 6.3     | 28.0    | 6                      | 5                  | 5                |
| Imports of goods, BOP, EUR mn <sup>7)</sup>              | 12170   | 16165   | 18853   | 19018   | 20555   | 23895   | 29500                  | 34000              | 37400            |
| annual growth rate in %                                  | -15.6   | 32.8    | 16.6    | 0.9     | 8.1     | 16.3    | 23                     | 15                 | 10               |
| Exports of services, BOP, EUR mn <sup>7)</sup>           | 3637    | 4111    | 4459    | 4958    | 4615    | 5060    | 5300                   | 6500               | 7000             |
| annual growth rate in %                                  | 4.8     | 13.0    | 8.5     | 11.2    | -6.9    | 9.6     | 5                      | 23                 | 8                |
| Imports of services, BOP, EUR mn <sup>7)</sup>           | 2155    | 3433    | 3995    | 3743    | 3934    | 4149    | 4400                   | 4500               | 4700             |
| annual growth rate in %                                  | -4.3    | 59.3    | 16.4    | -6.3    | 5.1     | 5.5     | 6                      | 2                  | 4                |
| Average exchange rate UAH/USD                            | 4.130   | 5.440   | 5.372   | 5.327   | 5.333   | 5.319   | 5.125                  | 5                  | 5                |
| Average exchange rate UAH/EUR (ECU)                      | 4.393   | 5.029   | 4.814   | 5.030   | 6.024   | 6.609   | 6.389                  | 6                  | 6                |
| Purchasing power parity UAH/USD, wiiw                    | 0.705   | 0.849   | 0.912   | 0.943   | 1.000   | 1.127   | 1.246                  | .                  | .                |
| Purchasing power parity UAH/EUR, wiiw                    | 0.768   | 0.917   | 0.988   | 1.014   | 1.093   | 1.230   | 1.371                  | .                  | .                |

Notes: 1) Preliminary. - 2) From 2000 revised data according to census 2001. - 3) In 2000 unrevised data. - 4) Excluding small enterprises. - 5) From 2004 including lending minus repayments. - 6) Central budget deficit passed by Parliament end December 2005. - 7) Converted from USD. - 8) Useable. - 9) Up to 2002 long-term debt only.

Source: wiiw Database incorporating national statistics; wiiw forecasts.