Ukraine
Macroeconomic Situation

June 2005

Iryna Piontkivska, Edilberto L. Segura

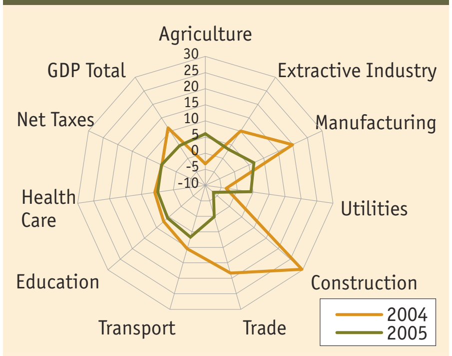
Summary

- Real GDP growth kept decelerating in May, reaching 4.7% yoy of cumulative growth. Accelerating agricultural production is expected to improve the overall growth performance in the summer months.
- Consolidated budget execution indicates improvements in tax compliance and the administrative capability of fiscal authorities as the surplus reached 2.1% of GDP in January-April.
- Ukraine's prospects for foreign investment inflow crucially depend on successful resolution of the Kryvorizhstal issue.
- Hryvnia appreciation and stabilization of gasoline prices contributed to non-accelerating consumer price dynamics in April-May.
- In January-April, the merchandise trade surplus narrowed to $800 million, less than half as over the same period last year.
- Fitch revised the outlook of sovereign Ukrainian ratings from BB- stable to BB-positive in early June.

Economic Growth

In January-May, broad-based economic growth in Ukraine continued, but its pace decelerated considerably. Over the period, real GDP growth made up 4.7% yoy compared with 5% in January-April. Lower rates of growth were registered in all sectors except for agriculture and utilities. Value added in agriculture increased by 6% yoy in January-May compared to a 3.3% yoy decline over the same period in 2004. The Ministry of Agriculture indicates that current weather conditions support expectations of a fairly good harvest this year. At the same time, construction continued to stagnate, posting a 6.7% yoy decline after almost 30% yoy growth demonstrated during the same period last year.

GDP Growth by Sector in January-May, % yoy



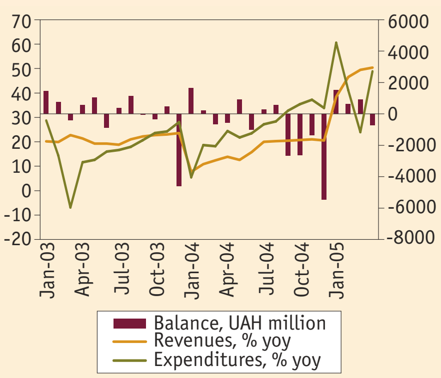
Source: State Statistics Committee

In May, industrial growth slowed to 4.3% yoy compared to 5.1% yoy growth a month before. This brought the cumulative growth rate to 6.2% yoy at the end of May. Machine building, chemicals and food processing were the major contributors to the expansion of industrial output. Machine building performance remained solid despite the deceleration of production to 8.4% yoy in May. During the month, food processing demonstrated robust growth of 11% yoy, encouraged by an increase in spending power of population. Enjoying strong external demand, chemicals producers expanded their production by 12% yoy in May. Export-oriented metallurgy showed a slight decline of 0.3% yoy in January-May, reflecting weakening external demand for metals. Oil-refineries improved their performance in May as compared to previous months, but in annual terms production volume declined 2% yoy. The latter figure looks considerably better than the 12% yoy decline in April, thus indicating stabilization of the situation on the domestic gasoline market. At the beginning of May, the country experienced a gasoline crisis -- after the government tried to intervene to prevent an abrupt increase of petroleum prices in April (provoked by higher world oil prices) the market experienced a shortage of gasoline.

Rising income and propensity to consume stimulated by loose fiscal policy and relatively low interest rates are expected to boost GDP growth in the short-run. However, it seems unlikely that economic growth will reach 8.2% as the government expects. Taking into account recent economic developments, GDP growth of 6-7% forecasted by international organizations and independent analysts looks more realistic.

Fiscal Policy

Consolidated Budget Dynamics, 2003-05

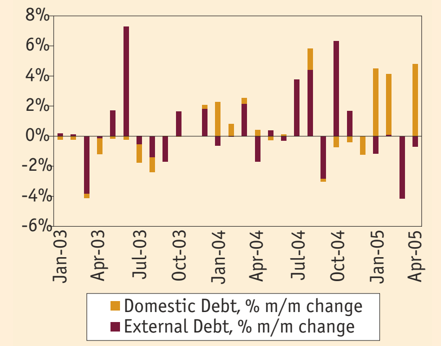


Source: Ministry of Finance

In January-April, the consolidated budget surplus reached almost UAH 2.33 billion ($461 million), which is equivalent to 2.1% of period GDP. Budget execution indicates improvements in tax compliance and administration by fiscal authorities. In real terms, consolidated budget revenues went up 32% yoy to reach UAH 35.8 billion ($7.1 billion), while expenditures grew by 26.3% yoy to UAH 33.5 billion ($6.64 billion). Tax revenue collection has been successful so far, as corporate tax proceeds increased 47.2% yoy in real terms. Although value added tax receipts increased 62% yoy to UAH 9.4 billion, the government failed to fully execute its VAT refund targets. Despite successful implementation of budget targets, further fiscal performance crucially depends on the ability of fiscal authorities to collect revenue because the ability to cut budget spending is limited. If budget revenues fall short of targeted levels, the government will have to look for extra resources to cover a larger fiscal deficit. In terms of budget gap financing, the government relies heavily on new debt issues and also privatization receipts.

In the first five months of the year, the government demonstrated poor privatization performance due to the ban on the privatization of strategic enterprises imposed in February 2005 and the change of the State Property Fund (SPF) management. Soon after the appointment of the new Head of the SPF (Socialist party representative Valentyna Semeniuk) the ban was lifted. However, acceleration of the privatization process is expected only after successful resolution of the disputed Kryvorizhstal deal. Allegedly, there are some 30 more enterprises whose privatization may be reconsidered. However, the list of those enterprises has not been published yet. On June 11, Prime Minister Yulia Timoshenko ordered the SPF to initiate the Kryvorizhstal re-sale procedure, after the commercial court declared that the privatization of Kryvorizhstal was carried out illegally and ordered the sold shares to be returned to the state. It is expected that the new tender will be held within a month. According to the 2005 Budget Law, the government expects to receive UAH 4.5 billion ($890 million) from the sale of state property in 2005. However, the target may appear ambitious taking into account that privatization receipts made up only UAH 633 million in January-May and there is no clear privatization plan for the remainder of the year.

Change in Public Debt Structure, 2003-2005

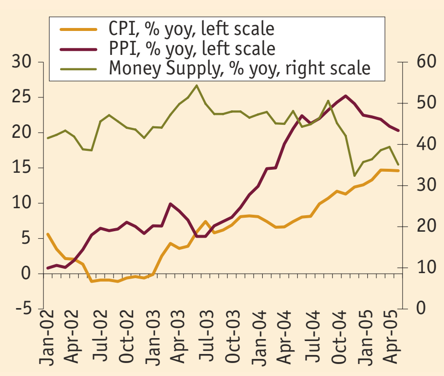


Source: Ministry of Finance

In January-April, total public debt shrunk by 1% year-to-date (ytd) to $15.9 billion as the government reduced the share of external debt, while issuing domestic debt instruments. Over the period, external public debt fell 5.8% ytd to $11.5 billion, while domestic debt increased by almost 14% ytd to $4.5 billion. Domestic T-bills issued in 2005 turned out to be attractive debt instruments to non-residents and this allowed the government to substantially reduce the cost of its borrowings. This appears to be quite prudent debt management policy to issue cheap medium-term paper while paying out more expensive earlier external obligations. According to Ministry of Finance estimates, about 40% of domestic T-bills are held by non-residents, which makes the local money market vulnerable to the changes in foreign investors' sentiment towards Ukraine. In order to prevent swings in speculative capital flows, the NBU and the Ministry of Finance decided to limit the amount and the maturity of T-bills that non-residents may hold. There will be a special committee to decide on the amount and maturity of internal government papers that non-residents may buy.

Monetary Policy

Prices and Money Supply Dynamics, 2001–05



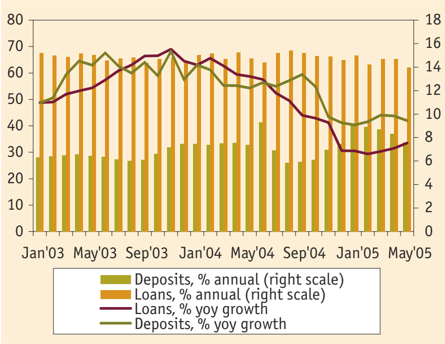
Source: State Statistics Committee, National Bank of Ukraine

Hryvnia appreciation and stabilization of gasoline prices helped to contain further acceleration of consumer prices. In May, the consumer price index (CPI) stood at 14.6% yoy, virtually unchanged from the previous month's figure. Although food prices continued to grow at almost the same pace as a month before, growth of non-food prices decelerated. Over May, food prices grew by 18.9% yoy, while non-food price growth slowed to 5% yoy, down from 6.3% yoy in April. Over the month, gasoline price growth dropped to 27% yoy from 67% yoy in April. The latter decline occurred after the government managed to reach an agreement on the growth of gasoline prices with the major gasoline market players. However, the agreed level of gasoline prices is conditional on the dynamics of world oil prices. Also, the parliament cancelled import duties for different types of gasoline and diesel as an additional measure to ease tensions on the gasoline market and facilitate price reduction for the final consumer. At the same time, service tariffs growth accelerated to 7.2% yoy as a lagged effect of the gasoline price increase on transportation tariffs. The producer price index (PPI) continued to decelerate, reaching 20.3% yoy in May.

Monetary aggregates growth slowed down in May following the hryvnia revaluation and the NBU's measures restricting the excess liquidity of the banking sector. In May, money supply (M3) growth fell to 35% yoy. Despite the increase in the required reserves ratio, commercial bank lending continued to accelerate reaching 34% yoy growth in May, while the average cost of loans fell to 13.6% annually from 14.7% in April. At the same time, growth of deposits dropped to 42% yoy, while average deposit rates declined to 7.3% annually.

After a sharp revaluation in April, the official hryvnia rate remained frozen at 5.05 UAH/USD, with only small

Loans and Deposits Growth and Interest Rate Dynamics

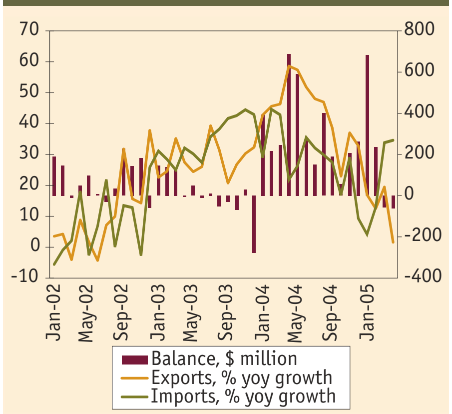


Source: National Bank of Ukraine

fluctuations in the cash exchange rate. Further fluctuations of the exchange rate will depend on consumer prices dynamics and the dollar supply on the domestic forex market. With the narrowing trade surplus, further appreciation of the national currency is unlikely. In May, gross international reserves increased by 1.4% month-over-month reaching $13.2 billion.

International Trade and Capital

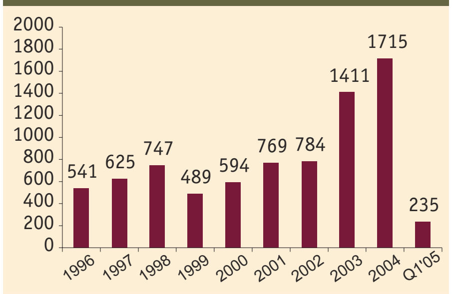
Merchandise Trade Performance, % yoy growth



Source: State Statistics Committee

In January-April, the surplus in the trade of goods account declined to $800 million, almost half of the level achieved in the same period last year. Since the beginning of 2005, imports growth has been accelerating, eventually exceeding the rate of export expansion in March-April. Over the period, exports grew by a robust 12.4% yoy to $11.39 billion in the first four months of 2005, while goods imports increased by 22.9% yoy to $10.59 billion. In April alone, the merchandise trade balance turned into a deficit of $61 million. Cross border metals sales remained among the largest contributors to the overall growth of goods exports, though the pace of metals export expansion dropped from 60% yoy to slightly above 40% yoy. Some deceleration of export growth is associated with weakening of external demand for Ukrainian metals products. At the same time, a sharp increase in household incomes and recent hryvnia appreciation will further boost growth of imports. The positive effect of cheaper imports is that it is likely to stimulate investment goods purchases abroad to renovate obsolete production capacities. The factors mentioned above will eventually result in a narrower current account surplus as compared with the previous year, but they are very unlikely to be strong enough to erode the surplus altogether by the end of the year.

Net FDI Flows, $ million



Source: State Statistics Committee

The positive macroeconomic outlook for Ukraine's future development seemed to lessen political risks associated with the drastic changes in the management of the country in the beginning of 2005. As a result of the peaceful transfer of power, the overall country risk decreased considerably in foreign investors' assessments. This is evident in the robust inflow of foreign direct investment in the first quarter of 2005. Over the period, net FDI inflows made up $235 million. Although this figure is somewhat lower than over the first quarter of 2004, it is a quite promising start taking into account the political turbulence of the first months of 2005. At the end of March, the cumulative FDI stock that Ukraine managed to attract since independence had increased to $8.8 billion, which is equivalent to $186 per capita. The largest amount of FDI originated from the USA (13.7% of the total), Cyprus (13%), and the UK (10.7%). The amount of FDI attracted by Ukraine is considerably lower than in other transition economies and is far below the country's investment potential. For a long time, foreign investors have not considered Ukraine to be an attractive investment location because of its poor international image and business environment. The new government acknowledges that Ukraine urgently needs foreign capital in order to replace worn-out capital stock, which is necessary for sustainable economic development. With this motivation in mind, the new government has launched an extensive country promotion campaign in order to improve the country's image. On June 16-17, Ukraine hosted an international investment forum, called "Mini-Davos". The invitation to visit the forum was accepted by nearly 150 international companies, and the event attracted significant attention from potential investors, which may eventually result in a considerable increase in foreign

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
21, Pushkinska Street, Suite 40
Kyiv 01004, Ukraine
Tel: (380-44) 244-9487 Fax: (380-44) 244-9488
E-mail: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (380-57) 714 1180 Fax: (380-57) 714 1188
E-mail: kharkov.office@sigmableyzer.com.ua

investment inflows to the country. For the time being, the international investment community is awaiting the resolution of the re-privatization issue, which negatively affects the investment climate in the country.

International Programs

On June 1-7, a regular IMF staff mission visited Kyiv to assess the key macroeconomic challenges facing Ukraine today. The mission concluded that accelerating inflation is the most important problem that the government needs to address immediately. To bring inflation back down to single digits, the IMF recommends the following actions:

(1) tighten monetary policy by allowing more flexibility to the exchange rate;

(2) assure strong fiscal discipline in order to achieve optimistic fiscal targets in 2005. In addition, fiscal policy tightening is expected in 2006, which will improve Ukraine's medium-term growth outlook.

(3) accelerate implementation of market-friendly structural reforms, including quick resolution of the re-privatization issue.

(4) demonstrate a more unified and coherent macroeconomic strategy (cooperation between the NBU and the government should be more effective in order not to send contradictory signals to market participants.)

Later this summer, a follow-up IMF mission is expected to arrive in Kyiv to focus on fiscal policy issues and the 2006 State Budget. Currently, cooperation between Ukraine and the IMF is limited to technical assistance support and there is no active lending program.

At the beginning of July, the government expects to receive a $175 million tranche under the Second Programmatic Adjustment Loan (PAL-2) from the World Bank. The disbursement of this financing is conditional on the adoption of the package of laws facilitating energy sector reform. Also, the World Bank and the government are working closely on a new lending program, the Development Policy Loan (DPL), which envisages up to $500 million of development assistance financing. However, this has yet to be approved by the World Bank Board of Directors.

Other Developments and Reforms Affecting Investment Climate

On June 9, Fitch revised its outlook for sovereign Ukrainian ratings from BB- stable to BB-positive. According to the agency, the peaceful change of government in Ukraine should bring medium-term economic and political stability to the country. The agency expects the government will accelerate implementation of structural reforms in the medium-term. Among positive trends, Fitch also pointed out the positive pro-reformist steps of the new government such as anti-corruption measures, cancellation of a wide range of special tax privileges and re-orientation in external policy toward the EU. At the same time, Fitch hopes that the government will make greater effort to reduce the fiscal deficit and to contain inflation in 2006.

Ukraine again failed to obtain market economy status from the EU. During the meeting of the Ukraine-EU Cooperation Council, the EU postponed its positive decision on granting functioning market economy status to Ukraine emphasizing concerns over the government's efforts to intervene in price setting via non-market mechanisms. The recent crisis on the gasoline market as well as earlier attempts by the government to reduce meat prices were the likely reasons preventing the EU from granting market economy status. Obtaining market economy status from the EU is an important step towards signing a free-trade agreement with the EU and joining the World Trade Organization. The government expects that the outstanding issues will be resolved in the coming months, thus enabling Ukraine to achieve market economy status in the fall of this year.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
21, Pushkinska Street, Suite 40
Kyiv 01004, Ukraine
Tel: (380-44) 244-9487 Fax: (380-44) 244-9488
E-mail: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (380-57) 714 1180 Fax: (380-57) 714 1188
E-mail: kharkov.office@sigmableyzer.com.ua