Ukraine Macroeconomic Situation

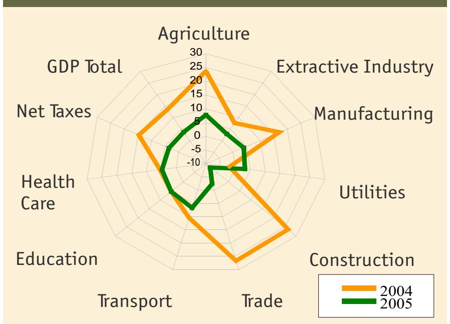
Olga Pogarska, Edilberto L. Segura

Summary

- During January-July 2005, economic growth slowed down to 3.7% year-over-year (yoy); growth is expected to reach about 5% yoy for the whole year thanks to good agricultural performance.
- In the first half (1H) of 2005, the consolidated budget registered a surplus of 0.9% of GDP on the back of improved tax enforcement and tax administration, despite further increases in social payments.
- Following the re-sale of Kryvorizhstal scheduled for October, the stalled privatization process should revive, provided that it is followed to other business improvement measures. Recommencement of privatization should stimulate FDI, which slid 14.4% yoy in the first half of 2005.
- To secure enough financing for the expected fiscal deficit, the government increased its reliance on new borrowings; following an almost one year interval, Ukraine is going to enter the external markets, issuing 10-year Eurobonds of EUR 600 million.
- Containing rapid inflation growth remains the primary macroeconomic challenge for the government; the National bank of Ukraine (NBU) made several steps to reduce inflation, although they were insufficient.
- The merchandise foreign trade balance continued to worsen on the back of deteriorating export growth and accelerating imports.
- Ukraine still has a good chance of joining the WTO before the end of this year, while the prospects for its participation in the Common Economic Area (CEA) are unclear.

Economic Growth

GDP Growth by Sector in January-July, % yoy



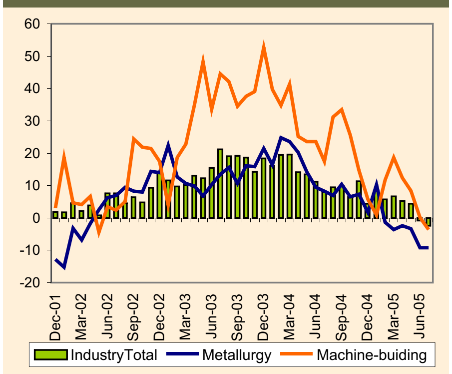
Source: State Statistics Committee

The steep downward trend of economic growth in Ukraine, observed since the beginning of 2005, came to a breaking point in June, when real GDP advanced by a negligible 1.1% yoy. In July, GDP growth accelerated slightly to 2.4% yoy. However, cumulative real GDP growth continued to decelerate to a modest 3.7% yoy over January-July, three times lower than in the corresponding period last year. Deceleration was reported in all sectors except for agriculture. Despite a high base effect caused by the outstanding crop last year, value added in agriculture increased by an encouraging 7.8% yoy over the period. Considering expectations of a fairly good harvest this year, good agricultural performance may help increase the pace of economic growth in the second half of the year. Transport, lower growth rates of which should also be attributed to a high base effect, advanced by a solid 6.6% yoy over January-July, benefiting from increasing transportation tariffs (up by almost 15% since the beginning of the year). Utilities continued expanding at 3.1% yoy compared with the 2.1% yoy decline in the corresponding period last year. At the same time, favorable performance in agriculture, transport and utilities (the combined value added of which amounts to around 30% of total Ukrainian GDP) could not compensate for the slowdown in the extractive industry and manufacturing and the stagnation in construction and domestic trade (the combined value added of which is estimated at about 40% of total GDP.) Since the beginning of the year, value added in construction kept declining in contrast to the booming growth in the sector last year. Over January-July, it shrunk by more than 8% yoy. Value added in wholesale and retail trade decreased by a cumulative 2.4% yoy over the period. Considering fairly poor domestic industry performance, buoyant domestic demand stimulates the growth of imports, thus contributing to the worsening of the country's external trade balance.

Industrial output declined for the second month in a row, shrinking by 2.4% yoy in July. As a result, cumulative growth slowed to below 4% yoy compared to 14.7% yoy in the corresponding period last year. The deceleration should be primarily attributed to unfavorable market conditions for metallurgy, and a drastic slowdown in machine-building and oil-refining. These industries, accounting for about 50% of total industrial sales in 2004, were the main drivers of industrial growth last year. Over January-July 2005, metallurgical output reported an almost 3% yoy decline in contrast to 16.1% yoy growth in the respective period last year. Export-oriented metallurgy is negatively affected by declining world prices for steel products and higher production costs (higher iron ore prices, transportation tariffs and more expensive energy resources).

Machine-building, the second largest industry in Ukraine, reported a 3.6% yoy decline in July; cumulatively the output increased by 7% yoy over the period, down from impressive 30.8% yoy growth during January-July last year. After April-May's gasoline crisis (when the country experienced a shortage of gasoline stemming from government efforts to administratively prevent an abrupt increase of petroleum prices), oil-refining production continued to rebound, increasing its output by 4% month-over-month (mom) in July. At the same time, oil-refining production contracted by a cumulative 7.1% yoy over January-July. On the upside, encouraged by robust growth of household income, food processing output accelerated to 11% yoy in July, bringing the cumulative growth to 13.5% yoy. Enjoying buoyant demand, the wood, pulp and paper, and chemical industries grew by a robust 18.4% yoy, 12.7% yoy, and 11.5% yoy respectively over January-July.

Industry Growth - Selected Sectors, % yoy



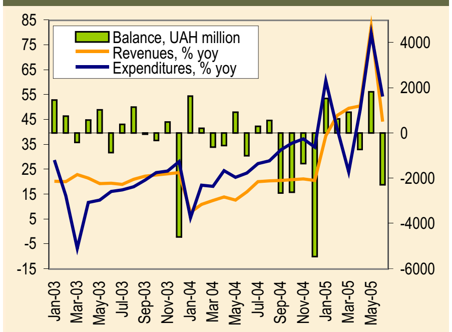
Source: State Statistics Committee

In addition to a high base effect, government officials tend to explain the growth slowdown by the higher quality and accuracy of gathering and processing of statistical information this year. Doubts regarding the reliability of data released for last year arose mostly due to the revealed facts of artificially overstated exports and understated imports, non-transparent methodology and inaccessibility of information regarding individual components of aggregated indicators. Although this year's statistics were declared realistic and its accessibility notably improved, more endeavors are needed to make the methodology of calculating statistical indicators more transparent. There is, however, another important reason for the growth slowdown this year. The uncertainties created by the approaching April 2006 parliament elections, occasionally weak policy-making, and unresolved issues of reviewing past privatization deals dampened both domestic and foreign direct investments. However, the successful resolution of the Kryvorizhstal deal and recommencement of the privatization process may improve the situation.

Taking into account current real sector performance, the official GDP forecast for 2005 at 8.2% yoy looks unrealistic. In June, government officials declared that the GDP forecast may be downgraded by 0.2 percentage points (pps) to 8% yoy. However, at the beginning of August, it was announced that the forecast may be lowered to 6-6.5% yoy. At the same time, international organizations forecast an even more modest 5% yoy growth in 2005.

Fiscal Policy

Consolidated Budget Dynamics, 2003-2005



Source: Ministry of Finance

Over the first half (1H) of 2005, the consolidated budget surplus amounted to UAH 1.85 billion (about $370 million), which is equivalent to 0.9% of period GDP. The favorable budget balance was achieved due to improved tax enforcement and tax administration, which resulted in a 37.4% yoy increase in real budget revenues to UAH 58.5 billion ($11.6 billion). Despite an economic growth slowdown, which may jeopardize ambitious plans to collect tax revenues in 2005 by 50% higher than last year (according to the amended budget in late-March 2005), tax revenue collection has been successful so far. The proceeds from corporate tax and import duties increased 57.5% yoy and 50.3% yoy in real terms respectively over January-July. Value added tax reported the largest increase in receipts, by a real 76% higher than in the corresponding period last year. However, the figure should be treated with some caution due to accumulation of VAT refund arrears.

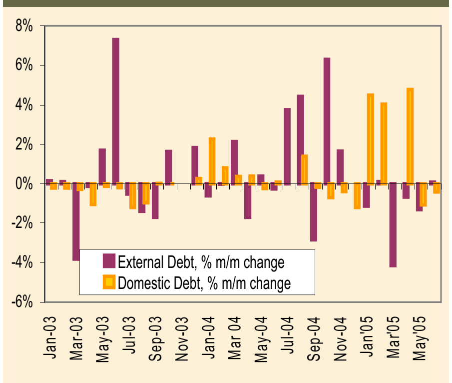
Despite the encouraging data for budget revenues, the targeted deficit of 1.86% of GDP remains quite a challenging task due to generous social payments and the government's firm intention to further increase budget sector wages. So far, consolidated budget expenditures grew at a slower pace than revenues, advancing by a real 35% yoy to UAH 56.7 billion ($11.2 billion) at the end of June 2005. Over January-June, social expenditures soared by almost 67% yoy in real terms. Furthermore, the government keeps increasing social payments despite the fact that they cause inflationary pressures. Starting September 1st, the government will raise wages for budget sector employees by 15%, while the minimum wage will be increased to UAH 332 ($65.7), up from UAH 310 set at the beginning of July. This will be the 4th minimum wage increase and the 3rd budget sector wage increase since the beginning of the year. The minimum wage hikes are carried out in order to eliminate the imbalance between minimum wage and pensions, originating from the government's decision to raise retirees' pensions to the subsistence level in September 2004. Now one year later, minimum wage and pensions will match.

Despite poor privatization performance so far, the government may have enough resources to finance the expected fiscal deficit this year. Considering that receipts from privatization amounted to less than 10% of the targeted amount in 1H 2005, the government increased its reliance on new borrowings. The government pursued quite a prudent public debt policy during this period, repaying more expensive external obligations while issuing cheaper medium-term domestic T-bills. In addition, the burden of external debt on the economy has been declining due to the appreciating national currency and favorable $/EUR dynamics (61.5% and 8.5% of Ukraine's total external debt are denominated in US dollars and Euros respectively). Since the beginning of the year, domestic debt increased by 6.9% year-to-date (ytd) to UAH 22.4 billion ($4.4 billion) while external debt declined by 7% ytd to $11.3 billion (in hryvnia equivalent, external debt shrunk by an impressive 11.3% ytd). May-June, however, showed a slight decline in domestic debt, which may be attributed to redemption volumes exceeding those of the newly issued instruments in these months. Considering that domestic T-bills turned out to be attractive for non-residents, the Ukrainian government decided to issue 10-year Eurobonds of EUR 600 million with an annual yield rate of 5-6%. Most likely, allocation of the Eurobonds will be carried out in late-September, when the situation with privatization receipts becomes clearer.

The privatization process is expected to revive in October if the re-sale of Kryvorizhstal is successful. The disputed privatization of Kryvorizhstal is considered one of the major reasons for poor privatization performance this year. Following the decision of the Kyiv Commercial Court of Appeals confirming that the privatization of Kryvorizhstal was carried out illegally, the auction was scheduled for October 24th. Fair and transparent resolution of the Kryvorizhstal deal is of vital importance for the whole privatization process to be successful, and for Ukraine's investment climate and international image to improve. The starting price for the 93.02% share of the mill was set at $2 billion (in June 2004, it was sold to the Investment-Metallurgical Union for about $800 million). In addition, the government developed an extensive modernization program that will require an extra $1 billion from the winner. Moreover, the winner should secure the mill's annual sales in the amount of at least UAH 9.5 billion (about $1.9 billion) during the next 5 years after the purchase. Regardless of the high bidding price and considerable commitments, a number of powerful foreign enterprises such as Mittal Steel, Arcelor, and Germany's RSJ Erste Beteiligung have already announced their intentions to participate in the tender. A group of Ukrainian companies affiliated with Privatbank have expressed their interest in participating, while two Russian companies (Severstal and Eurazholding) are examining the possibility as well.

Besides Kryvorizhstal, there are about 30 other enterprises whose privatization may be reconsidered. However, according to the Prime Minister (PM), there are hundreds of cases at trial regarding earlier privatization deals; hence, the number of such enterprises may be considerably higher. Considering that the re-privatization process has been lingering and being fully aware of its harmful impact on Ukraine's investment climate and image, the government decided to elaborate procedures for privatization amnesty. In the meantime, to accelerate the process and secure enough privatization receipts for this year and the next, the Cabinet of Ministers approved about 520 companies to be privatized in 2005-2006. Just a month ago, the government endorsed a list of 34 enterprises to be urgently prepared for privatization before the end of this year. In particular, it contains the largest Ukrainian company in terms of market capitalization, "Ukrtelecom". The government plans to sell the package of 42.86% of the enterprise's shares before the end of the year. The winner will be allowed to manage an extra 25% of the shares. The intentions to privatize "Ukrtelecom" were repeatedly expressed by various Ukrainian governments during the last eight years; however, they were never realized. It is considered that the peak of investment attractiveness of telecommunication companies has already passed. Moreover, due to short-sight management in the past, the company missed the opportunity to hold a leading position on the mobile services market. Now, to enlarge the its market capitalization and increase its competitiveness, the company is actively seeking the necessary license for providing mobile services. With the state's support of these actions, "Ukrtelecom" may receive the license at the end of August. However, it will require around $250-300 million investments during 2006-2008 to develop mobile services, which may lower the attractiveness of the enterprise. Considering also the dissent among various officials regarding "Ukrtelecom" privatization, privatization of the company this year looks doubtful.

Change in Public Debt Structure, 2003-2005

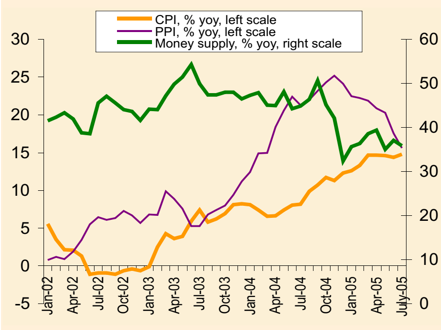


Source: Ministry of Finance

Monetary Policy

Following the sharp hryvnia appreciation in April, the National Bank of Ukraine (NBU) returned to the policy of targeting exchange rate stability in May-July. However, increasing inflationary pressures, primarily caused by expansionary fiscal policy, growing gasoline prices and considerable NBU forex purchases in July-August, may lead to further nominal appreciation of the hryvnia. Just in July, net NBU purchases of foreign exchange amounted to about $400 million, while they are just over $5 billion since the beginning of the year. Considerable inflow of foreign exchange continues in spite of the economic growth slowdown and worsening export conditions, which may be attributed to speculative capital coming to the market and expected recommencement of large-scale privatization in the near future. During July-August, various Ukrainian and international (IMF) officials expressed the need to liberalize the exchange rate in order to curb inflation. Shortly after the statements, the NBU tried a non-intervention policy. Over several days it did not purchase excess supply of foreign currency on the interbank market. However, observing rapid currency appreciation (sometimes to UAH/$4.88), the National Bank returned to the practice of buying out the surplus foreign exchange, although unlike its usual practice it purchased only part of the excess supply. As a result, the hryvnia exchange rate varied between UAH/$4.9-4.98 at the interbank trades, the NBU purchased at UAH/$4.98-5.01, while the official rate remained constant at UAH/$5.05.

Price and Money Supply Dynamics, 2001–2005



Source: State Statistics Committee,NBU

Being aware that further strengthening of the national currency will further exacerbate an already worsening foreign trade balance and economic growth slowdown but experiencing pressure to contain the growth of inflation, the NBU raised its refinancing rate by 0.5 percentage points (pps) to 9.5% on August 9th. In addition, reserve requirements on corporate and household demand and time deposits in local and foreign currencies will be raised by 1 pp to 8% starting September 1st. Though these measures may help, they are insufficient to restrain inflation and return it to single digits as is targeted through the end of the year (the official year-end inflation target remains unchanged at 9.8% yoy). Considering also that one of the NBU's top-managers who opposed strengthening of the national currency as a tool to combat inflation resigned in mid-August, it is very likely that the hryvnia will be allowed to strengthen. At the same time, it remains unclear when this may happen. The situation may become clearer in a few weeks when the government makes public the draft of the 2006 budget and the Ministry of Justice processes four NBU resolutions regarding liberalization of the foreign exchange market and regime for foreign investments.

In July, monthly consumer inflation decelerated to 0.3% mom, down from 0.6% mom a month before. In annual terms, however, it reached 14.8% yoy, slightly up from 14.4% yoy in June. Foods, accounting for the largest share in the consumer basket, became 18.8% yoy more

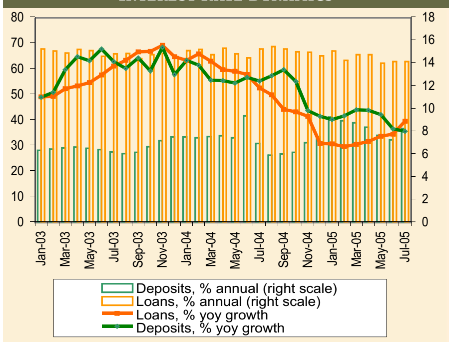
Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1713) 6213111 Fax: (1713) 6214666
Email: sbleyzer@sigmableyzer.com

21, Pushkinska Street, Suite 40
Kyiv 01004, Ukraine
Tel: (38044) 2449487 Fax: (38044) 2449488
Email: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (38057) 714 1180 Fax: (38057) 714 1188
Email: kharkov.office@sigmableyzer.com.ua

expensive in July, while nonfoods and services showed a more moderate increase in prices (4.7% yoy and 8.8% yoy, respectively). Acceleration of food prices since the beginning of the year should be attributed to the extensive social payments which stimulated consumption, particularly of lower income groups. By product breakdown, the largest increase in prices in July was reported by meat and sugar, up by 36.1% yoy and 62.7% yoy, respectively. At the same time, following a reduction of import duties on meat products, the growth of prices continued to decelerate in July. In contrast, sugar prices gained 24.1% mom in July. However, the trend should reverse as the government-increased quota on imported raw sugar and sugar manufactured from the new harvest will soon start flooding the market. Non-food prices accelerated slightly, responding to growing international gasoline prices (according to an agreement between the government and major gasoline market players, the level of gasoline prices in Ukraine is conditional on their international price dynamics). Acceleration of service tariffs is primarily attributed to a lag effect of the gasoline price increase on transportation tariffs. The producer price index (PPI) continued to decelerate, reaching 15.6% yoy in July.

Loans and Deposits Growth and Interest Rate Dynamics



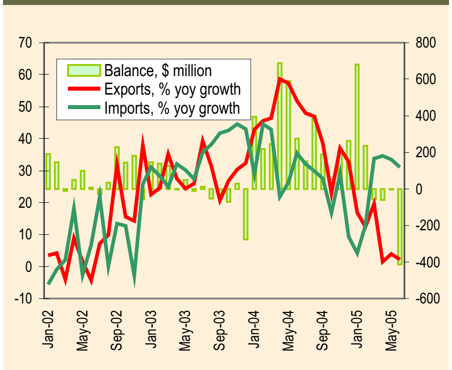
Source: National Bank of Ukraine

The upward trend of monetary aggregates growth reversed in July, which should be attributed to slower growth of deposits and the increase of government deposits in national currency with the NBU (due to larger tax revenues, redemption of government credits by the Pension Fund of Ukraine, and dividend payments from state enterprises). In July, money supply (M3) decelerated to 35.9% yoy, down from 37.1% yoy in June. Despite a gradual increase of annual deposit rates, the growth of deposits continued to decelerate responding to the high annual inflation rate. At the same time, commercial bank lending continued to accelerate at a robust 39.3% yoy pace (up from 34.2% yoy in June) while the average cost of loans stabilized around a 14 % annual rate. Rapid expansion of credit to the private sector stimulates household consumption, which puts pressure on prices. Moreover, together with appreciating domestic currency and growing population income, it stimulates the growth of imports. Recent NBU decisions to raise the refinancing rate and reserve requirements may help to contain rapid growth of bank lending and further reduce money supply growth. At the same time, they may result in a temporary shortage of liquidity in the banking sector.

International Trade and Capital

As a result of a stronger national currency and weakening external demand on Ukrainian exports, Ukraine's foreign trade balance continued to worsen in June. With annual growth rates of imports considerably outpacing those of exports (2.3% yoy and 31% yoy, respectively), June's merchandise trade balance reported a $413 million deficit. It is the fourth month in a row that foreign trade registered a negative balance. At the same time, due to considerable surpluses in the first two months of the year, the cumulative trade balance remained positive at $381 million. It was almost 84% lower than that achieved in the same period last year. At the same time, Ukraine's foreign trade of services registered a surplus of $1.56 billion over 1H 2005, just 3% lower than in the corresponding period last year. As a result of decelerating exports and accelerating imports, the current account will narrow considerably but may still remain in surplus by the end of the year.

Merchandise Trade Performance, % yoy growth



Source: State Statistics Committee

Despite the extensive country promotion campaign and the policy of maximum assistance to foreign investors declared by top Ukrainian officials, stalled privatization (due in part to the unresolved Kryvorizhstal deal), sometimes controversial policy measures (as in April, when the government tried to intervene in the gasoline market to prevent rapid increase of gasoline prices) and government infighting resulted in 14.4% yoy lower FDI over 1H 2005. According to the State Statistics Committee, the cumulative FDI stock that Ukraine managed to attract amounted to $9.061 billion, which is equivalent to $192 per capita. To promote and inform foreign investors about business opportunities in the country and coordinate activities aimed at improving the business environment, the foreign investment promotion agency was created at the beginning of July. In mid-August, similar tasks were imposed by the President on the Ukrainian diplomats. Moreover, since April 2005, the functioning of the Advisory Council on Foreign Investments was renewed with the first plenary meeting scheduled for October 20th. During the meeting, foreign members of the council and representatives from the Ukrainian authorities will address the issues of improving Ukraine's investment climate and effective realization of investment opportunities. In the meantime, the council's expert commission has been developing measures to improve the regulatory framework of doing business in Ukraine and liberalize foreign exchange regulations regarding foreign investments.

International Programs

During the end of July/beginning of August, an IMF mission visited Ukraine to assess current macroeconomic developments in the country. The mission primarily focused on current economic and financial, fiscal and monetary policies, and progress in structural reforms. In particular, IMF representatives stressed that reducing inflation is currently the main macroeconomic challenge of the Ukrainian government. Among other measures to reduce inflation to single digits, the IMF recommended allowing greater flexibility of the exchange rate and maintaining a tight fiscal stance in 2006. In terms of fiscal policy, the IMF praised government efforts to close a number of loopholes, at the same time indicating possible risks for the deficit to exceed this year's target (such as accumulation of the VAT refund claims payable, possible shortfalls in transfers from state enterprises and considerable social payments). According to the IMF team, structural reforms such as rapid and transparent resolution of the reprivatization issue, early implementation of the remaining legislation needed for World Trade Organization (WTO) membership, development of domestic capital markets, strengthening the financial sector, and restoration of the financial viability of the state pension fund are the key steps to ensure economic growth in the future and improve Ukraine's business environment and investment climate.

Other Developments and Reforms Affecting the Investment Climate

In mid-August, Ukraine and China agreed on joint access to the market of goods and services. Negotiations regarding completion of bilateral agreements on joint access intensified following parliament's approval of the seven laws necessary for World Trade Organization (WTO) accession out of the 15 proposed by the Cabinet of Ministers at the beginning of July. With the entry to be discussed by the WTO's ministerial meeting scheduled for December 2005, Ukraine should endorse all necessary laws and sign the agreements on joint access with the remaining 12 countries. Despite a very comprehensive agenda over a fairly short period of time, Ukraine still has a chance to join the WTO before the end of this year. Obtaining market economy status from the EU is an important step towards joining the WTO and may occur before or during the Ukraine-EU summit. According to the deputy prime minister for European integration, the summit will be held in Kiev on December 1st. The very fact that Ukraine will host the summit is one more opportunity for Ukrainian authorities to draw attention from potential investors to the country.

During August, top Ukrainian officials made a number of controversial statements regarding Ukraine's participation in the Common Economic Area (CEA). On August 19th, the minister of economy declared that Ukraine will not participate in the CEA project. Instead, it will intensify bilateral trade and economic relations with Russia, Belarus and Kazakhstan. A few days after, however, the president of Ukraine declared that Ukraine will join the trading block with the mentioned countries. The creation of the CEA within the borders of Ukraine, Russia, Belarus and Kazakhstan envisages gradual integration of the countries' trade and economic policies and, eventually, formation of a customs union. Following Ukraine's firm statement to limit its participation in the CEA to the creation of a free trade zone, negotiations have been stalled. While a free trade zone may benefit Ukraine, deeper integration to a customs union will have harmful consequences for WTO accession and overall Ukraine-EU cooperation plans.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1713) 6213111 Fax: (1713) 6214666
Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
21, Pushkinska Street, Suite 40
Kyiv 01004, Ukraine
Tel: (38044) 2449487 Fax: (38044) 2449488
Email: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (38057) 714 1180 Fax: (38057) 714 1188
Email: kharkov.office@sigmableyzer.com.ua