

Olga Pogarska, Edilberto L. Segura

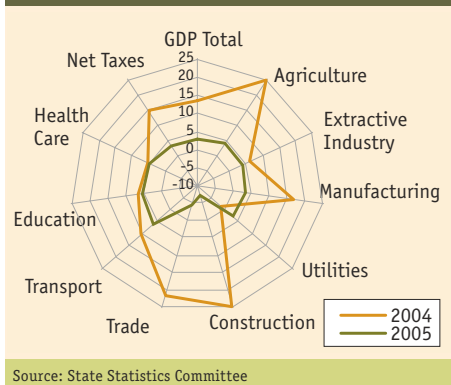
### Summary

- In September, Ukrainian economic growth recovered, expanding by 3% yoy while cumulative growth remained unchanged at 2.8% year-over-year (yoy).
- Over January-August 2005, the consolidated budget registered a surplus of about 2.7% of period GDP on the back of over-fulfillment of revenues and lower than expected expenditures.
- In October, the government successfully placed EUR 600 million of Eurobonds and re-sold Kryvorizhstal steel plant for a record high price for Ukraine. While the sale will soften budget deficit concerns for this and next year, it raised a number of challenging questions related to distribution of privatization receipts and future re-privatization deals.
- Consumer price inflation decelerated to 13.9% yoy in September; price and exchange rate stability in the near future will crucially depend on how and when the money from the Kryvorizhstal privatization will be spent.
- Ukraine intensified negotiations to join NATO.

### Economic Growth

Following contraction of the gross domestic product (GDP) by 1.6% yoy in August, the Ukrainian economy rebounded at 3% yoy growth in September. As a result, cumulative GDP growth remained unchanged at 2.8% yoy over January-September. The stabilization of the cumulative growth rate occurred thanks to acceleration in agriculture and the extractive industry, still moderate growth in the processing industry and slower contraction in domestic trade and construction.

**GDP Growth by Sector in January-September, % yoy**

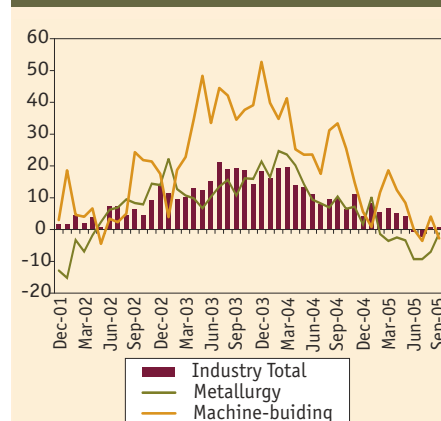


Due to a good harvest this year, value added in agriculture increased by 3.9% yoy over January-September. However, this is a considerable slowdown compared to the impressive 24.7% yoy growth in the respective period last year. Domestic trade continued to decline, though at a slower pace. Over January-September, value added in the sector contracted by 4.2% yoy; however, reduction was actually reported for wholesale trade rather than for retail. In fact, benefiting from rising household demand (due to a 24.4% yoy increase in real income over January-August), retail trade turnover increased by 21.8% yoy over January-September. At the same time, turnover in wholesale trade declined by almost 10% yoy

over the period. The reduction in wholesale trade should be primarily attributed to the considerable slowdown in manufacturing. Compared to January-September 2004, this year's value added in manufacturing declined by 13.5 percentage points (pps), reaching 3.1% yoy growth. Following completion of large repair and infrastructure works, construction continued to report decline in its value added, which contracted by 7.2% yoy. However, the sector performance improved slightly compared to the 8.1% yoy reduction in January-July.

In general, this year's sharp deceleration of Ukrainian GDP growth is partly attributed to a high base effect, rising energy prices, declining world demand for metals and, most importantly, a sharp downturn in both domestic and foreign investments. Considering current macroeconomic performance, the government downgraded its GDP forecast for 2005 to 3.5% yoy in mid-October, down from 4% yoy set just a month ago. This was the fourth downgrade of economic growth for this year, down from the original 8.2% yoy growth set in March. Despite quite optimistic GDP growth for 2006 (forecasted by the government to reach 7% yoy), the prospects for economic growth next year are not very favorable. Following two years of good harvest, agriculture may perform quite poorly due to a high base effect and smaller planted areas (down by 22.6% yoy as of October 3rd). Moreover, despite another socially-oriented budget, consumption may grow at a more modest rate due to a high base effect, while acceleration in investment activities may be expected only in the second half of the year due to political uncertainties related to parliamentary elections in spring 2006.

**Industry Growth - Selected Sectors, % yoy**



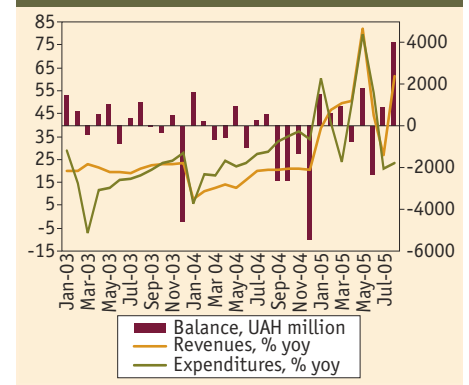
After declining over June-July, industrial output growth rebounded in August, expanding by about 1% yoy. Despite September's reported industrial output increase of same 1% yoy, cumulatively it kept decelerating. Over January-September, the growth in industry slowed to 3.2% yoy compared to 14.4% yoy in the corresponding period last year. The major reason for growth deceleration in the sector was a further slowdown in manufacturing. The slowdown should be attributed to considerable deceleration in machine-building and further contrac-

tion in metallurgy. On the back of explosive growth in the respective period last year (33.5% yoy) and lower investments in machinery and equipment, growth in machine-building slowed to 5.3% yoy over January-September. Cumulatively, metallurgical output declined by almost 3% yoy over the period. However, following stabilization of world steel prices, contraction in metallurgy slowed considerably to 1.2% yoy in September, up from a 7% yoy decline a month ago. On the upside, output in the extractive industry grew by 6.5% yoy in September, bringing cumulative growth to 3.5% yoy. The food industry expanded by 14.5% yoy over January-September, up from 12.1% yoy recorded in the respective period last year.

### Fiscal Policy

Over January-August 2005, the consolidated budget surplus reached UAH 6.8 billion (about \$1.34 billion), which is equivalent to 2.7% of period GDP. So far, positive budget performance was achieved thanks to over-fulfillment of consolidated budget revenues and lower than expected expenditures. Budget revenues constituted UAH 84 billion (\$16.6 billion), increasing by 35.8% yoy in real terms. Over the period, collections from enterprise profit tax and import duties increased by 48.2% yoy and 55.7% yoy in real terms, respectively. Value added tax reported the largest increase in receipts, by a real 81.3% higher than in the corresponding period last year. However, this success is somewhat exaggerated due to advance payment of enterprise profit tax and accumulation of VAT refund arrears in the amount of UAH 2.6 billion (about \$515 million) as of October 1st.

**Consolidated Budget Dynamics, 2003-05**

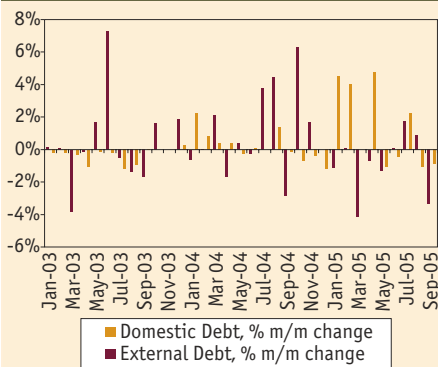


At the same time, expenditures grew by a more moderate 27.3% yoy in real terms to reach UAH 77.2 billion (\$15.3 billion). According to the State Treasury of Ukraine, over eight months of the year, state budget expenditures were executed by 53.6% of the planned amount for 2005. At the same time, expenditures of the general fund of the state budget were under-financed by 6.3% of the planned amount for January-August. At the same time, social expenditures were fully executed. Over January-August, social payments grew by a real 58.5% yoy. Under-fulfillment of other expenditures may be explained by un-

certainties related to the financing of the targeted fiscal deficit.

The targeted budget deficit for 2005 is planned to be financed through increases in privatization revenues and new borrowings. At the end of October, however, it was unclear whether the government would have sufficient resources to finance the expected deficit. In particular, in the Budget Law 2005, receipts from privatization were envisaged at UAH 7 billion (\$1.39 billion), while less than 10% of that amount was received as of October 1st. Thus, the government actively issued domestic T-bills over January-July to compensate for modest privatization revenues and reduce the cost of previous borrowings. However, in August-September, it stopped issuing new domestic instruments. As a result, domestic debt declined during these months; since the beginning of the year it has increased by 7% to UAH 22.4 billion (\$4.4 billion). External debt declined by 7.7% year-to-date (ytd) to \$11.2 billion (in hryvnia equivalent, external debt shrunk by an impressive 12.1% ytd). To secure enough resources to finance the budget deficit on the back of stalled privatization, declining public debt and considerable non-resident interest in Ukrainian securities, the Ministry of Finance successfully placed 10-year Eurobonds of EUR 600 million at the beginning of October. Robust demand for Ukrainian Eurobonds, which exceeded EUR 2 billion according to the Ministry of Finance, allowed the securities to be placed at a record low annual yield rate of 4.95%. The leading international ratings agencies, Standard & Poor's and Fitch, assigned a BB- credit rating to these securities.

**Change in Public Debt Structure, 2003-2005**



Source: Ministry of Finance

Poor privatization performance over January-September should be primarily attributed to the controversial re-privatization issue. The situation changed dramatically in October. On October 24th, Ukraine sold 93.02% of the shares of Kryvorizhstal, a large and profitable plant accounting for about 20% of Ukraine's steel production with its own significant raw-material reserves and a close location to the Black Sea ports. Kryvorizhstal was sold to Mittal Steel for about \$4.8 billion on an open auction. The price was six times higher than the amount paid in the mid-2004 tender by the previous owner and exceeded

the most optimistic forecasts. However, despite the fact that the auction was fair and transparent, the re-privatization process was not smooth. Just one week before the event, the Ukrainian parliament adopted a number of resolutions aimed at suspending the re-sale of Kryvorizhstal and retention of the plant into state ownership. Since these decisions were not fully lawful (due to the existence of the law and a decree by the government regarding privatization of the plant) and the deal was successfully resolved, this did not help the international image of Ukraine.

The sale of Kryvorizhstal for the record high price (for both Ukraine and the region) will soften budget deficit concerns for this and next year. Moreover, it provided a powerful political boost for President Yushchenko and his administration as one of his main election promises was fulfilled. However, the resolution of the Kryvorizhstal deal will most likely not be sufficient to revive the privatization process and attract foreign investments in Ukraine despite the fact that there are a lot of other large and potentially very interesting state-owned enterprises remaining. The major reasons lie in slow economic reforms and political uncertainties related to forthcoming parliamentary elections and subsequent appointment of the new government.

Shortly after the Kryvorizhstal privatization, a number of challenging questions were raised. The first was whether the sale ends re-privatization. There were about 30 more enterprises whose privatization might have been reconsidered. With the appointment of Mr. Yekhanurov as Prime Minister, a clear message was sent that despite popular pressure to continue re-privatization, the government will be seeking to negotiate with the current owners of companies rather than initiate the re-privatization procedure. However, it is unclear how those enterprises that privatization was already contested will be treated.

The second quite important question was how the funds received from the privatization of Kryvorizhstal will be spent. Excluding amounts to be repaid to the former owner and reserved for budget deficit financing, it is still a substantial amount equivalent to approximately one-fifth of the annual state budget revenues planned for 2005. The opinions divide into those advocating using the money for social needs and those for stimulating economic growth. The variety of opinions, even among the ruling team, signifies that there is no clear vision and strategy for the country's sustainable development.

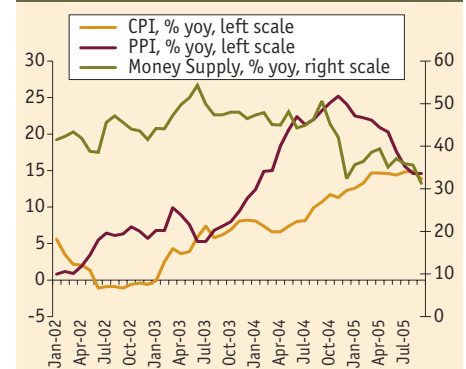
In mid-October, the parliament refused to approve the draft fiscal budget for 2006 developed by the Cabinet of Ministers as a basis for further considerations. The major disagreement between the parliament and government officials was the size of the fiscal deficit next year. According to the draft, state budget revenues and expenditures were estimated by the government at UAH 118.7 billion (\$23.5 billion) and UAH 127.4 billion (\$25.2 billion) with the deficit representing less than 2% of 2006 GDP. At the same time, mem-

bers of parliament insist on increasing the deficit to 3% of GDP and approving the budget with more realistic macroeconomic parameters. The debates on the budget in the parliament are expected to recommence at the beginning of November.

### Monetary Policy

In September, the monthly consumer price index (CPI) accelerated slightly to 0.4% month-over-month (mom), up from zero inflation reported for the previous month. At the same time, it changed the trend to descending in annual terms, reporting a 13.9% yoy increase, down from 14.9% yoy in the previous month. Favorable consumer price performance in September should be attributed to deceleration of food inflation to 16% yoy on the back of slower price growth for sugar, bread, meat and vegetables. Gasoline prices gained 7.4% month-over-month (mom), contributing to further acceleration of non-food prices. In annual terms, non-food prices accelerated to 5.2% yoy in September. The surge in gasoline prices by more than 20% over August-September compared to July's level may stimulate a further increase in transportation tariffs, which already advanced by 23.7% yoy. Together with a 13.2% yoy increase in the cost of public utilities, they caused service tariffs to accelerate to 13.5% yoy. At the same time, stabilization of world prices for crude oil may have a positive effect on both non-food and service prices. In September, the producer price index (PPI) stood at 14.6% yoy, unchanged from the previous month's figure.

**Prices and Money Supply Dynamics, 2001-05**



Source: State Statistics Committee, National Bank of Ukraine

The favorable price index dynamics was partly achieved thanks to NBU measures to contain inflation and smaller purchases of foreign exchange. In particular, the net purchases of foreign currency amounted to about \$210 million, down from \$736 million a month before. During September, the foreign exchange market was almost balanced, which may be explained by a smaller supply of foreign currency on the back of increasing demand for it. As a result of substantial external debt service and redemption payments and smaller purchases of foreign currency, the NBU's international reserves declined by \$194.4 million. During October, the market for foreign currency was almost balanced as growing de-

#### 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

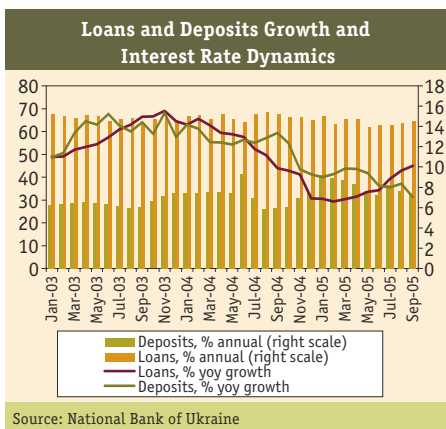
21, Pushkinska Street, Suite 40  
Kyiv 01004, Ukraine  
Tel: (380-44) 244-9487 Fax: (380-44) 244-9488  
E-mail: kiev.office@sigmableyzer.com.ua

#### 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

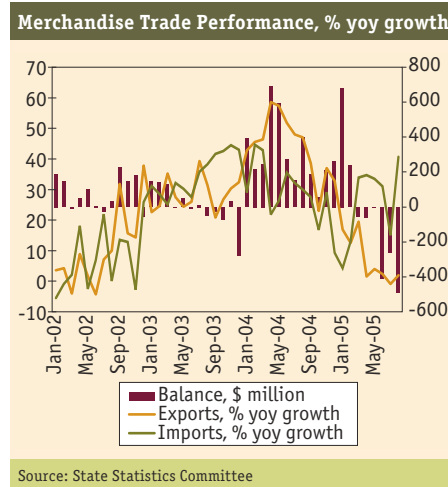
mand for foreign currency due to increasing imports of fuel was compensated by a larger foreign currency supply as a result of the government's placement of EUR 600 million of Eurobonds.

The sale of Kryvorizhstal for a record high price raised concerns regarding stability on the foreign exchange market and fulfillment of the monetary targets for this year. On October 26th, the NBU Council decided to convert the whole amount received from privatization of the plant into national currency. Not to endanger price stability and stability of the forex market, the respective hryvnia amount will be immediately placed into the State Property Fund account at Ukrainian Treasury. However, the situation will crucially depend on how and when this money will be spent.



Following a number of restrictive measures introduced by the NBU in August-September (including tightening of the regulations on reserve requirements and an increase in the refinancing rate), September reported deceleration of money supply growth at 31.3% yoy, down from a 35.6% yoy increase in August. At the same time, despite the gradually increasing lending interest rate, the growth of credit to private sector expanded to 45% yoy in September. In contrast, the growth of deposits continued to decelerate, slowing to 31.3% yoy, down from a 37.1% yoy increase a month ago, responding to declining deposit interest rates.

### International Trade and Capital



On the back of strong national currency, weakening external demand for Ukrainian exports and higher production costs, Ukraine's foreign trade balance continued to worsen in August. Although exports growth recovered that month, advancing by 2% yoy up from an almost 1% yoy decline in July, the deficit widened considerably compared to the previous month due to a 40.7% yoy surge in imports. As a result, the merchandise trade deficit reached \$491 million in August, a record low for the last six years. Robust growth in the first quarter of 2005, allowed exports to report a cumulative 6.8% yoy growth over January-August. However, the growth of imports exceeded that of exports by almost four times. Thus, for the first time during the last five years, the cumulative trade of goods account reported a deficit of \$372 million over January-August. For the same period last year, the trade of goods was in surplus of about \$3 billion.

By product breakdown, cross border metals sales remained the largest contributor to growth of goods exports over January-August. At the same time, exports of metallurgical products continued to decelerate sharply as monthly growth rates turned into a nega-

tive 11.1% yoy in August, down from an impressive 60% yoy increase in January. Cumulative growth decelerated from 50% yoy in 2004 to below 16% yoy over January-August. Exports of mineral products and machinery and equipment account for the second and third largest shares in total merchandise exports. While growth in the volume of exported mineral products decelerated from 23.5% yoy in 2004 to 15.7% yoy over January-August, exports of machinery and equipment declined by 13.3% yoy in January-August, in contrast to more than 30% yoy growth in 2004. On the upside, export of cereals, primarily grain, expanded by 70% yoy over the period, up from 50% yoy growth in 2004.

On the import side, imports of energy resources, accounting for the largest share in total imports, advanced by 10.4% yoy over the period. Following a decline in oil and gas imports in July, they rebounded in August, expanding by about 8% yoy. Acceleration was reported for almost all imported goods, especially for foods, textiles, vehicles and machines and equipment. Considering merchandise trade performance, this year's current account will considerably narrow, but may remain in surplus by the end of the year due to a positive trade balance of services and net transfers (mainly remittances from abroad).

### Other Developments and Reforms Affecting the Investment Climate

During October, NATO General Secretary Mr. Scheffer visited Ukraine and held a number of meetings with Ukrainian authorities. The visit was the result of intensified dialogue on Ukraine's membership in the Alliance, begun in April of this year. While Mr. Scheffer did not announce the possible date of Ukraine joining the Alliance, Ukrainian authorities hope this will occur in 2008. During the informal Ukraine-NATO consultations in the defense ministers' session held in Lithuania in late October, NATO representatives expressed their readiness to help Ukraine implement necessary reforms and provide financial support to utilize obsolete ammunition.