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Ukraine
Macroeconomic Situation

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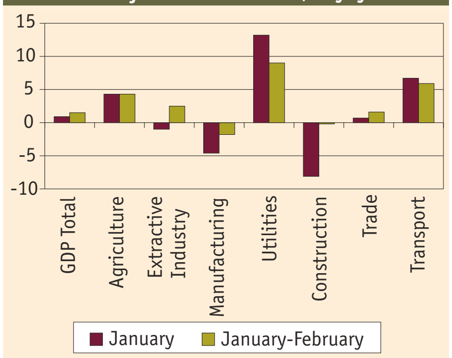
Summary

- Over the first two months of the year, real GDP grew by 1.5% yoy (up from 0.9% yoy in January), signaling the revival of economic activity in the country.
- Inflation accelerated slightly in February driven by a temporary imbalance on the domestic sugar market.
- In February, growth of the money supply decelerated to 46.0% yoy partially reflecting the sluggish inflow of household deposits before the parliamentary elections.
- In 2005, the current account balance remained positive at $2.5 billion (3.1% of GDP), while the financial account surplus reached an impressive $7.7 billion (9.4% of GDP) driven by long-term corporate borrowings and record high FDI inflow.
- On March 26th, Ukraine held elections for parliament, regional and district councils, as well as city mayors. The preliminary results of the voting suggest that five political blocs and parties will enter the Verkhovna Rada.
- Ukraine and the Unites States signed a bilateral protocol on accession to goods and services markets in the framework of Ukraine's WTO accession, which marks a milestone in the country's WTO negotiations.

Economic Growth

February real sector data signaled the revival of economic activity in the country. Real GDP grew by 1.5% yoy during the first two months of the year, up significantly from 0.9% yoy in January. Economic growth was primarily led by an increase in value added in transport, which grew by 5.9% yoy. Growth of value added in distribution of electricity, gas, and water (utilities) decelerated to 9.0% yoy, down from 13.2% yoy in January, but remained the second largest contributor to GDP growth.

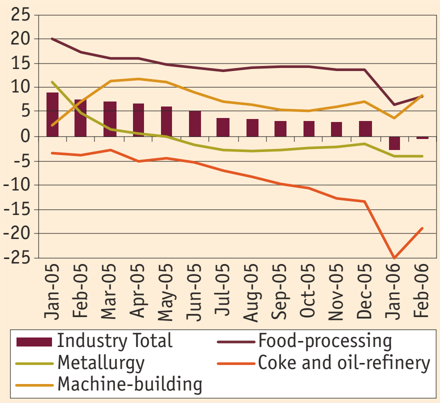
Growth of GDP and Value Added in Major Sectors in 2006, % yoy



Source: State Statistics Committee

On an encouraging note, construction and industry improved their performance, albeit not substantially. The reduction of value added in construction shrank to –0.2% yoy, a significant improvement from –8.1% yoy in January. The same trend was observed in manufacturing, which posted a lower reduction in value added compared to the first month of the year: –1.8% yoy in January-February versus –4.6% in January. Following the increased demand for domestic energy materials, the extractive industry showed a 2.5% yoy increase in value added, compared to a 1% yoy reduction a month before.

Growth of Industrial Output and Selected Industries, 2005–06,% yoy cumulative



Source: State Statistics Committee

The improvement in industrial performance was led by two sectors: food-processing and machine-building. Food-processing showed a 8.0% yoy increase in output over the first two months of the year stimulated by robust consumption demand. Machine-building went up by 8.6% yoy, driven mainly by production of vehicles and vehicle equipment.

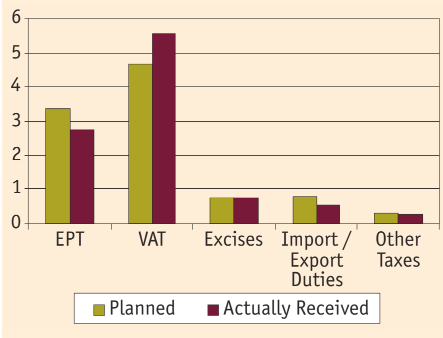
At the same time, metallurgy and coke and oil-refinery industries showed only slight improvement compared to January, still significantly contributing to a decline in industrial output. Metallurgy has still not recovered from an increase in gas prices and reduction of world steel prices. Output of metals and metal products posted a 1.0% yoy reduction in January-February. Accordingly, lower demand on the side of metallurgical enterprises contributed to lower production of coke. The oil-refinery industry suffers from outdated technologies that do not allow for the production of high quality gasoline. The reduction of import tariffs on oil products introduced in 2005 stimulated imports of higher-quality gasoline to the country. In addition, introduction of seasonal export quotas on oil products discouraged production of diesel and black oils. As a result, the two largest oil refineries were closed in 2005 and volumes of processed oil declined to 2.3 million tons in January-February 2006, compared to 3.2 million tons in the same period last year.

However, industrial production may recover in the coming months. According to the Ministry of Economy, industrial output will increase by 1–1.5% yoy in the first half of the year driven by sectors oriented towards domestic demand (food processing, light industry) as well as by machine-building. Also, there will be a reduced statistical base effect stemming from deceleration of industrial output throughout 2005.

Fiscal Policy

In January-February, consolidated budget revenues increased by a nominal 33% yoy to UAH 20.6 billion ($4.1 billion), down from 36% yoy in January. At the same time, budget expenditures grew by 36% yoy to UAH 18.2 billion ($3.6 billion), compared to 28% yoy a month before; this shows better execution of planned expenditures, which traditionally takes place throughout the fiscal year. The resulting budget balance constituted UAH 2.4 billion ($0.5 billion) remaining virtually unchanged in nominal terms compared to January, but declining in relation to period GDP to 4.0%, down from 8.4%.

Execution Rate of Major Taxes in January-February 2006, UAH billion



Source: State Treasury

According to the State Treasury information, revenues of the general fund of the central budget were 4.1% above target. Collection of tax revenues, which account for almost three quarters of all state budget revenues, was fully in line with the target, while non-tax revenues were overexecuted by 25%. At the same time, the execution rate of major taxes differed substantially. The enterprise profit tax (EPT) was almost 20% below the target, reflecting deterioration in performance of enterprises. In January, profits before taxes of Ukrainian enterprises were 37% less than in the same period of 2005, mostly on account of industrial enterprises (primarily metallurgy) and firms operating in the trade sector. But another major tax, the value added tax (VAT), was overexecuted by 20%, more than offsetting the shortfall in EPT collection. VAT from both domestic and imported products was above the plan. In addition, there is no evidence of accumulation of VAT refund arrears, as VAT refunds were almost in line with the target. Since VAT is essentially a tax on consumers, its overexecution may indicate that private consumption is growing at a higher pace than expected, even by the rather optimistic macroeconomic forecast envisaged in the budget. This gives additional grounds to expect further revival of economic growth later this year. However, the recovery is not going to be strong since growth of domestic demand will be partially satisfied by imports.

Execution of budget expenditures improved in February. Expenditures of the general fund of state budget were 15% below the target, compared to almost 20% in January. This trend is very likely to continue, with the budget surplus turning to deficit by year-end.

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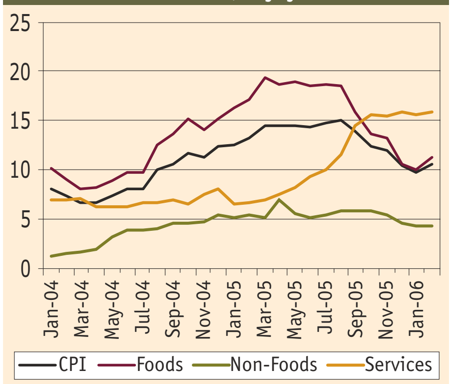
Editor Rina Bleyzer Rudkin

Monetary Policy

In February, consumer prices grew by 10.7% yoy, up from 9.8% yoy a month before. Acceleration of inflation was primarily attributable to an increase in prices on food products, the major component of the consumer price index (CPI). Food product prices sped up to 11.4% yoy from 9.9% in January, explaining more than two-thirds of CPI growth. At the same time, non-food product prices were on a moderate track posting a 4.4% yoy rise. Services tariffs preserved their high growth rate reaching 15.8% yoy in February, but contributed to the inflation rate moderately due to the low share of this group in the consumption basket.

Dynamics of CPI and Its Major Components, 2004-06, % yoy



Source: State Statistics Committee

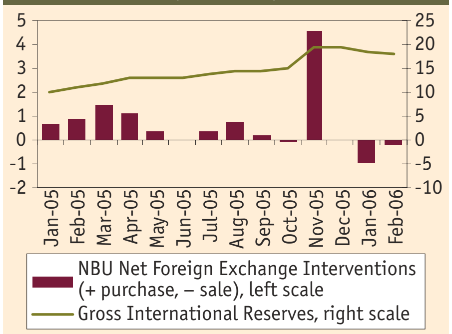
A rapid increase in sugar prices (which surged by 25% month-over-month (mom), or 56.6% yoy, in February) was among the major causes of the higher growth of food prices and the whole price index. The domestic sugar market was indirectly affected by an increase in world prices of white and raw sugar. Although domestic sugar prices exceed world prices due to prohibitive import tariffs, sugar prices in Russia surged far above the world average at the beginning of 2006 thereby stimulating supply of sugar to Russia from CIS countries, including Ukraine. Thus, higher external demand for domestically produced products drove up prices in Ukraine. However, domestic sugar prices are likely to go down soon thanks to licensing of sugar exports introduced by Ukrainian authorities in February as well as cooling of the overheated Russian market, which already started in mid-March.

In February, growth of the monetary base and money supply decelerated to 36.4% yoy and 46.0% yoy respectively (down from 39.4% and 50.1% yoy in January), reflecting the slowdown of deposits to the banking system. According to the NBU, total bank deposits grew by 50% yoy, compared to 54.5% yoy a month before. On the one hand, this reflects the increasing statistical base effect related to the resumption of deposits inflow in early 2005, after the presidential election turmoil. On the other hand, the inflow of deposits was rather sluggish at the beginning of 2006, since households tried to stay on the safe side before the parliamentary elections, reorienting part of their savings from bank deposits to foreign currency cash holdings. At the same time, the demand for bank credit remained robust, as banks continued to disburse credit at an accelerating pace. In February, bank credit grew by 66.2% yoy, up from 64.8% yoy a month before.

Overall, monetary policy remained quite loose in February. The interest rate on interbank credit, which serves as the closest indicator of banks' liquidity and monetary stance, stood at a low 3.0% per annum. By the end of February, the estimated excess liquidity of the banking system rose by 17.7% mom to UAH 5.7 billion. This is despite the NBU's sterilization operations, which amounted to UAH 2.2 billion in gross volume.

Still, the NBU considered it worthwhile to ease monetary policy further through its fine-tuning instruments. Starting March 1, the daily requirement for the amount of bank funds to be kept on the correspondent account within the NBU was reduced from 90% to 70% of the previous month's obligatory reserves. According to our estimates, this will add about UAH 1.7 billion to banks' excess liquidity. Most likely, the NBU's decision is motivated by the possibility of higher political risks following the parliamentary elections at the end of March. A weaker reserve requirement will give banks more flexibility to manage their flow of funds in case of unexpected difficulties.

NBU Interventions and Gross International Reserves, 2005–06, $billion



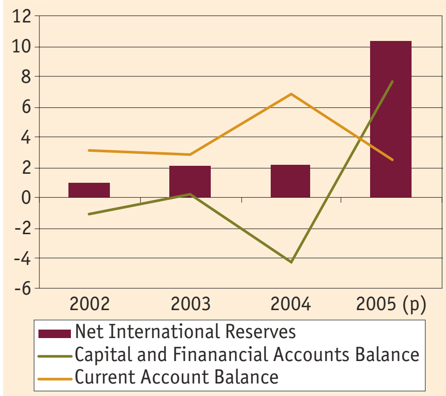
Source: National Bank of Ukraine

In February, the foreign exchange market was almost balanced and the NBU sold only $179 million of its international reserves, compared to $939 million in January. Although sale interventions by the NBU are likely to continue in March, the reduction of central bank reserves shall not raise serious concerns. By the end of February, the total amount of reserves constituted $18.3 billion, which is sufficient enough to allow the NBU to compensate for temporary imbalances on the foreign exchange market. Furthermore, the inflow of foreign currency is likely to resume in the coming months after stabilization of the political situation. By the end of 2006, the NBU's international reserves are expected to post a moderate increase compared to 2005 thanks to a positive financial account balance, which will cover the small current account deficit expected this year.

International Trade and Capital

According to preliminary NBU data, the current account surplus stood at $2.5 billion or 3.1% of GDP in 2005, while the financial account surplus (analytical presentation) reached an impressive $7.7 billion or 9.4% of GDP. As a result, the NBU's international reserves more than doubled and constituted $19.4 billion, which corresponds to 4.9 months of prospective imports of goods and services.

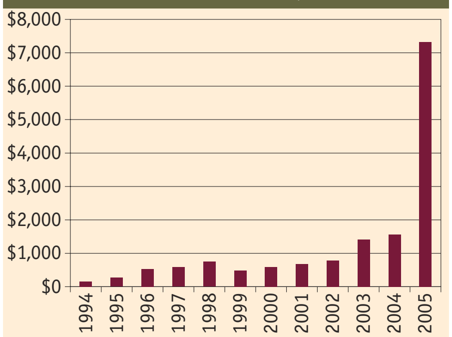
Balance of Payments in 2002–2005, $billion



Source: National Bank of Ukraine

The decline in the current account surplus from a remarkable $6.8 billion (10.5% of GDP) in 2004 was mainly because of merchandise trade balance deterioration. Contraction of external demand, an increase in production costs, the real appreciation of the hryvnia with respect to the US dollar and the euro, and liberalization of import tariffs were among the major factors that contributed to reversal of the merchandise trade balance from a high surplus in 2004 to a moderate deficit in 2005. On a positive note, the services trade surplus that stood at $1.8 billion (2.2% of GDP) was high enough to compensate for the $1.1 billion (1.4% of GDP) of goods trade deficit (FOB/FOB). Along with the net inflow of current transfers that reached $2.8 billion (3.5% of GDP), this ensured a positive current account balance.

Net FDI Inflow to Ukraine, $ million



Source: State Statistics Committee

The impressive improvement in the financial account, which reversed from a sizable deficit of $4.5 billion (7% of GDP) in 2004 to the present surplus, was primarily due to record high growth of net foreign direct investment (FDI) and intensification of private borrowings from abroad. By the end of the year, net inflow of foreign investment reached $7.5 billion, which almost equals the total amount of FDI attracted since independence. The bulk of this sum, $4.2 billion, was received thanks to the successful re-privatization of the country's largest metallurgical plant Kryvorizhstal to the German subsidiary of world leader Mittal Steel. The acquisition of Aval Bank, one of the biggest local banks, by Austrian Raiffeisen International brought another $1 billion of FDI. These acquisitions will bring new know-how and management technologies to Ukrainian metallurgy and the banking system, thereby increasing the competitiveness of these sectors and the economy as a whole.

External borrowings also grew considerably in 2005, mostly on account of private sector debt. The country's gross external debt increased by $8.2 billion, out of which about $7 billion was expansion of private debt. Both the banking system and the non-bank corporate sector were active in attracting funding from abroad. The continuing expansion of domestic demand gave impetus to banks to look for longer and cheaper resources compared to household deposits, which for a long time were the major source of bank credits. At the same time, the high fragmentation and low capitalization of the domestic banking system impeded development of large-scale and long-term lending, forcing corporate firms to seek resources abroad as well.

The 2005 trends in Ukraine's balance of payments are expected to continue in the nearest future. In particular, the merchandise trade deficit will keep on widening throughout 2006. Merchandise imports are likely to grow at a double-digit rate stimulated by the ongoing increase in consumption demand and the revival of investment demand expected in the second half of 2006. The increase in prices for imported gas will also have a direct effect on imports, raising nominal volumes. Merchandise exports will be adversely affected first of all by an increase in gas prices, which substantially raises the production costs in metallurgy and chemistry, the two major export-oriented industries. In addition, metallurgy will face a certain reduction of output prices due to increasing competition on the world metal markets. These expectations have already been confirmed by January merchandise trade statistics. According to the State Statistics Committee, the monthly goods trade balance remained at a negative $0.37 billion, which translates into 6.3% of period GDP.

Nevertheless, Ukraine's external position will remain rather strong in 2006. The merchandise trade deficit will be partially compensated for by the services trade surplus and net current transfers, which are expected to increase moderately. Although the current account is very likely to turn to small deficit, it is expected to be securely covered by the financial account surplus. The latter will be primarily based on a further increase in long-term private debt and the relatively high net inflow of FDI anticipated at around $3 billion. As a result, the gross international reserves are likely to grow moderately in 2006 and stay at rather comfortable levels in terms of import coverage.

Other Developments and Reforms Affecting the Investment Climate

On March 26th, Ukraine elected the national parliament (the Verkhovna Rada), as well as regional and district councils and city mayors. International observes (OSCE, International Republican Institute, etc.) concluded that the parliamentary elections met international standards and were carried out in accordance with Ukrainian election law. According to preliminary information from the Central Election Commission, five political blocs and parties passed the 3% threshold to the Verkhovna Rada. The Party of Regions, headed by Viktor Yanukovich (the main opponent of current President Viktor Yuschenko during the 2004 presidential elections) led the race with 32.12% of the vote. Yulia Tymoshenko's bloc was in second place with 22.27%. Pro-presidential Our Ukraine secured 13.94% of the vote. The Socialist Party of Ukraine enters the Verkhovna Rada with 5.67% and the Communist Party with 3.66%. After official results of the voting are announced, the newly elected parliamentary factions will have to form a coalition that will appoint the Prime Minister.

Ukraine and the Unites States signed a bilateral protocol on access to goods and services markets in the framework of Ukraine's WTO accession. Endorsement of the protocol marks significant progress in Ukraine's trade relationship with the US and paves the way for Ukraine to complete other bilateral WTO negotiations. As of the end of March, Ukraine also finalized negotiations with Egypt, Morocco and Romania. Among the remaining countries, negotiations with Australia are expected to be quite tough due to a strong disagreement between Ukrainian and Australian authorities regarding protection of Ukraine's agricultural market. Some progress in negotiations with Australia has been made recently. In particular, according to the Ministry of Economy, Ukraine and Australia agreed on the main principles of distribution of the import tariff quota on raw cane-sugar during the unofficial Working Party meeting in Geneva.

To become a WTO member, Ukraine also needs to adopt several laws, including those envisaging reduction of export duties on live cattle, hide and metal scrap. These issues are politically sensitive as they reduce protection of certain industries. Provided the laws are enacted by the new Parliament soon after elections, Ukraine has a good chance of entering the WTO by the end of 2006.

In March, the US repealed Ukraine from the Jackson-Vanik amendment to the US Trade Act of 1974. The respective bill was passed by Congress and signed by President Bush in late March. The amendment links US trade relations with former communist countries to the rights of their citizens to emigrate freely. Termination of the Jackson-Vanik amendment for Ukraine is not likely to substantially influence trade flows between the countries, since an annual waiver from the amendment was issued for Ukraine on a regular basis. But the decision will play an important role in improving Ukraine's international image and clear the way for the two countries to apply the WTO Agreement when Ukraine becomes a WTO member.

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