SigmaBleyzer

Ukraine

Macroeconomic Situation

May 2006

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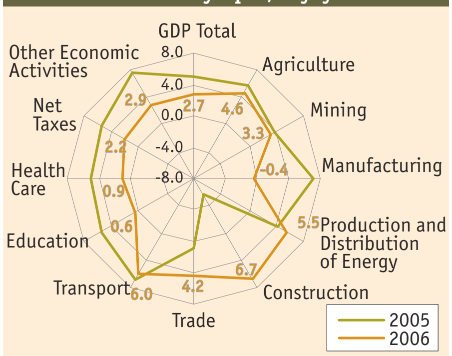
Summary

- Over January-April, real GDP grew by an encouraging 2.7% yoy, underpinned by robust value added growth in the service sector and recovered growth in construction.
- The government approved the draft of the Budget resolution, setting the goal to keep the budget deficit below 2% of GDP in 2007. With the end of elections, next year's budget is expected to be more balanced compared to 2006.
- In April, consumer inflation continued to decelerate to 7.4% yoy; however, inflation is unlikely to stay in single digits in 2006.
- Sizable sale interventions by the National Bank of Ukraine (NBU) on the foreign exchange market and slowing growth of hryvnia-denominated deposits resulted in liquidity difficulties in the banking sector. To increase the liquidity in the banking system, the NBU reduced reserve requirements on deposits.
- The merchandise trade balance continued to worsen, posting a $1.8 billion deficit over January-March 2006, but was partially compensated for by a larger surplus of services trade.
- Despite political uncertainties, net FDI inflows were at a record high for the first quarter.

Economic Growth

Real GDP and Value Added Growth by Sector in January-April, % yoy

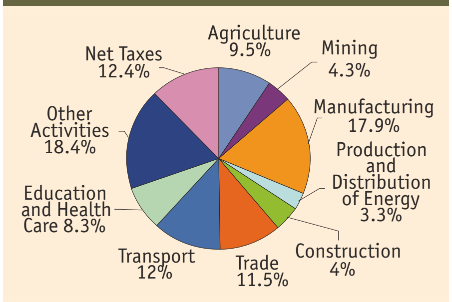


Source: State Statistics Committee

Preliminary State Statistics Committee (SSC) data for January-April suggests that the recent price increase on imported gas has had a rather limited effect on economic performance so far. GDP grew by 3.5% yoy in April, bringing the cumulative growth to 2.7% yoy. Economic growth was underpinned by value added increases in transport and domestic trade, of which the composite share in GDP constitutes about 24%. In particular, value added in these sectors grew by 6% yoy and 4.2% yoy over the first four months of the year, respectively. At the same time, the investment-oriented sectors are also being revived. Over the period, value added growth in construction accelerated to 6.7% yoy compared to 5% yoy in the previous period. Although the acceleration occurred on the back of a low statistical base, it may also be attributed to recovering investment demand and improved budget financing.

In line with expectations, manufacturing (holding the largest share in total GDP) suffered the most from the energy price hike. Although value added in the sector grew by about 0.6% yoy on average each month during February-April, it contracted by 0.4% yoy in the four months to date. Metallurgy and chemicals, the most energy-intensive industries, posted 1.6% yoy and 1.2% yoy reductions in output, respectively. The decline in metallurgy continued despite recovered growth of world steel prices, which may be explained by the orientation of Ukraine's metal exports to Asian countries, where prices on steel and steel products grew slower than in the EU and North America. On a positive note, the continued increase in output of steel pipes (by 5.4% yoy over January-April) may signify a re-orientation of the Ukrainian metallurgical sector towards manufacturing of higher value added products.

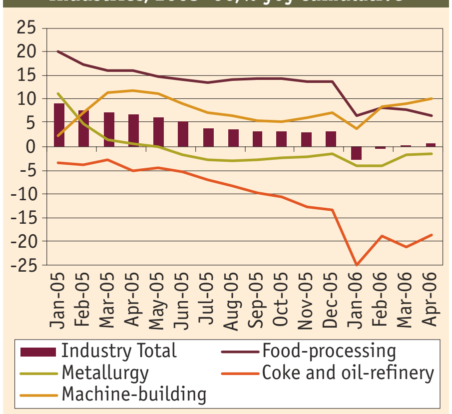
GDP Structure by Value Added in 2005, % of total



Source: State Statistics Committee, The Bleyzer Foundation

More expensive imported fossil fuels stimulated demand for domestic energy sources. As a result, the extractive industry and production and distribution of energy showed 3.3% yoy and 5.5% yoy increases in value added over the period. The growing need to renovate existing production technologies (which are largely outdated and energy-consuming) and introduce energy-saving equipment stimulates the development of machine-building. Over the period, machine-building went up by 10.1% yoy, driven by production of equipment for metallurgy, transport, and communication, electrical equipment, and food-processing machines.

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



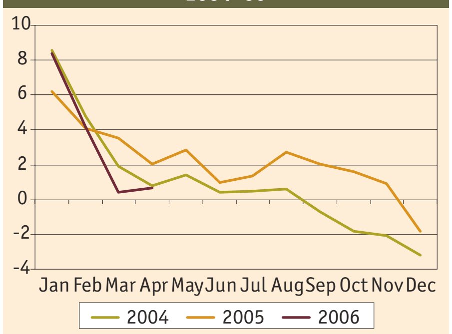
Source: State Statistics Committee

Positive developments in retail trade, production of vehicles, construction and food processing were favored by robust domestic demand, stimulated by a 24.2% yoy increase in real population income.

Fiscal Policy

According to preliminary data, the consolidated budget posted a surplus of UAH 855 million ($170 million) in January-April, which is equivalent to about 0.7% of period GDP. Over the period, consolidated budget revenues increased by a nominal 24% yoy to UAH 44.8 billion ($8.9 billion). The growth of expenditures outpaced that of revenues, posting a 36.5% yoy increase to UAH 45.8 billion ($9.1 billion). The data revealed further deceleration of consolidated budget revenues, which is attributed to an increasing statistical base effect and weak industrial sector performance. Although the effect of the high statistical base was also attributable to consolidated budget expenditures, their growth remained high due to the scheduled 3% increase in the minimum subsistence level to UAH 359 ($71) in April. This, in turn, led to an upward revision of pension liabilities. Social security continues to hold the largest share in total budget expenditures.

Consolidated Budget Balance, % of period GDP, 2004–06



Source: Ministry of Finance

In mid-May, the government approved the draft of the Budget resolution for 2007, which describes the main goals of its fiscal policy next year. In particular, the budget deficit is planned to not exceed 2% of GDP or UAH 10 billion (about $2 billion), and is to be primarily financed from privatization receipts. Such an ambitious target of privatization revenues may be realistic in case of privatization of a number of strategic enterprises next year (like telecommunication monopoly Ukrtelecom). Otherwise, the government will have to resort to new borrowings. So far, with the absence of new borrowings, the state debt remained virtually unchanged in April, declining by 3.5% since the beginning of the year. By the end of the month, the stock of public debt (guaranteed and non-guaranteed) constituted $14.9 billion, which translates into 15.8% of forecasted full-year GDP.

According to the draft resolution (which will serve as the basis for drafting next year's budget if approved by the parliament), social payments are expected to in-

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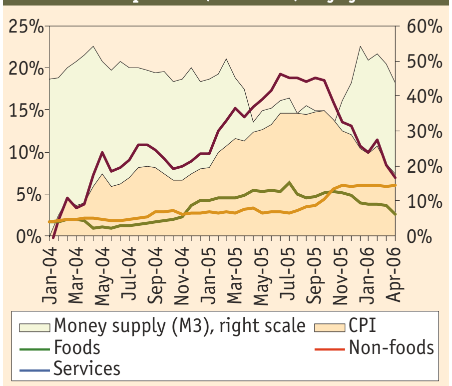
crease further in 2007, albeit moderately just to compensate for inflation forecasted at 10% yoy. At the same time, the execution of the budget may be rather challenging, as budget expenditures will remain considerable due to the recurring nature of previous liabilities and the need to finance new government programs (such as government support of the introduction of energy-saving technologies, reforms in the healthcare and education sectors, etc). Moreover, the government plans to introduce a unified social tax, reducing the total rate of insurance payments, and cut the duty on foreign currency sales in order to stimulate de-shadowing of population income and reduce the tax burden for businesses. Although passing through the parliament may change the document beyond recognition, there is a chance to obtain a more balanced and realistic budget for 2007 with the elections out of the way.

Monetary Policy

In April, the consumer price index (CPI) posted a surprising 0.4% month-over-month (mom) decline. As a result of the unexpected deflation two months in a row (0.3% mom in March), annual inflation decelerated to 7.4% yoy, down from 10.7% yoy in February. Despite considerable disinflation in annual terms during March-April, inflation is unlikely to stay in single digits in 2006. In addition to the already approved 25% increase in energy tariffs for households since May 1st, the price dynamics will be affected by rather loose fiscal policy this year, plans to adjust service tariffs to cost-covering levels, and likely acceleration of monetary aggregates growth in the second half of the year. The latter may occur on the back of faster growth of currency inflow, as investment activity is expected to rise with the end of political uncertainty caused by parliamentary elections and the formation of a governing coalition.

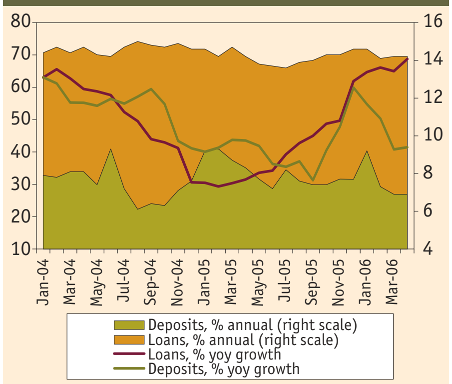
Dynamics of Money Supply, CPI and Its Major Components, 2004-06, % yoy



Source: State Statistics Committee

So far, the deflation was primarily driven by developments of food prices and service tariffs helped by moderate growth of monetary aggregates. Food prices, which account for about 65% of the consumer basket, fell by 0.4% mom in April, bringing the annual growth to below 7% yoy. Prices for meat and milk products continued to decline (down by 0.8% mom and 1.5% mom respectively in April), as there was excess supply of these goods on the domestic market following the introduction of export bans by the Russian Federation at the beginning of 2006. As the domestic market stabilized after temporary imbalances caused by a jump in international prices for sugar, internal prices for sugar reported a 1.3% mom decline in April. Service tariffs, accounting for about 20% of the consumer basket, fell by 0.8% mom, which may be attributed to the end of the heating season. In annual terms, however, the growth of service tariffs slightly accelerated to 14.6% yoy. The pace of growth is expected to increase in the coming months due to increases in energy tariffs for households and transportation fares. On a high statistical base, non-food prices continued to decelerate in annual terms, posting a 2.5% yoy increase compared to 3.5% yoy a month before.

Loan and Deposit Growth and Interest Rate Dynamics

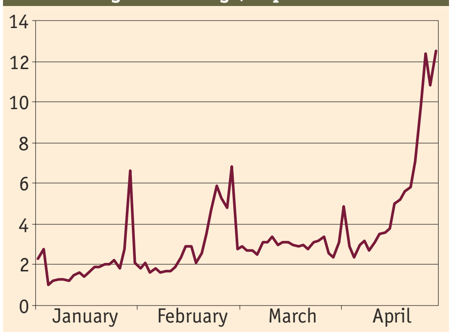


Source: National Bank of Ukraine

Moderate growth of monetary aggregates has also supported disinflation over the period. The growth rates of money supply (M3) and the monetary base have declined from 50.1% yoy and 40.1% in January to 43.5% yoy and 24% yoy in April respectively. This pattern is a reflection of NBU actions to support the hryvnia exchange rate. On the back of a worsening foreign trade balance and increased domestic demand for foreign currency (due to more expensive energy imports and political uncertainties), the NBU had to sell about $2.2 billion of its reserves since the beginning of the year to keep the hryvnia exchange rate stable at 5.05 UAH/$. With the end of political turmoil related to parliamentary elections and the formation of a governing coalition, the anticipated reduction of foreign currency supply due to further worsening of Ukraine's foreign trade balance may be compensated for by investment-related currency inflow. Accordingly, the hryvnia to US dollar exchange rate is likely to either remain stable this year or depreciate very slightly to 5.2 UAH/$. In any case, the NBU's gross international reserves will remain significant enough to redress potential temporary imbalances on the foreign exchange market.

Decelerating money aggregates growth and vigorous demand for bank credits resulted in liquidity difficulties in the banking sector during April. Although deposits grew by 41.5% yoy over the month (slightly up from 40.8% yoy a month before), the growth of bank loans considerably outpaced the growth of deposits, expanding by almost 69% yoy. The shortage of liquid resources translated into rising interest rates on interbank credits. To encourage hryvnia-denominated deposits, commercial banks raised the respective interest rate to 7.8% pa, which exceeded the annual inflation rate for the first time since mid-2004. The NBU supported commercial banks through its refinancing operations, which amounted to UAH 3.5 billion ($680 million) in April, compared to about UAH 540 million ($106 million) over the first three months of the year. As the situation did not improve, which was reflected in the soaring interbank credit interest rate to 12.5% pa at the end of the month, the NBU decided to reduce the norms of required reserves from 6% to 4% for term deposits and from 8% to 6% for demand deposits and current accounts. The new norms are effective May 10th.

Interest Rate on Interbank Credit in 2006, weighted average, % per annum



Source: National Bank of Ukraine

International Trade and Capital

In March, Ukraine's merchandise export performance improved slightly, which is consistent with the recovering industrial sector. Although exports continued to decline, its pace decelerated to 4.4% yoy over January-March 2006 compared to 5.3% yoy registered for the first two months of the year. At the same time, merchandise imports growth kept decelerating on a high statistical base. Import volumes grew by 30.2% yoy over the first quarter compared to almost 40% yoy during January-February. However, Ukraine's merchandise foreign trade balance continued to deteriorate, reporting a deficit of about $1.8 billion.

By product breakdown, merchandise exports continued to be driven by ferrous metals, which account for 34% of total exports. Increased production costs and a high statistical base explain the almost 13% yoy decline in ferrous metal exports. On a positive note, exports of machinery and transportation vehicles continued to benefit from recovered external demand for these commodities, expanding by 7% yoy and 29.5%

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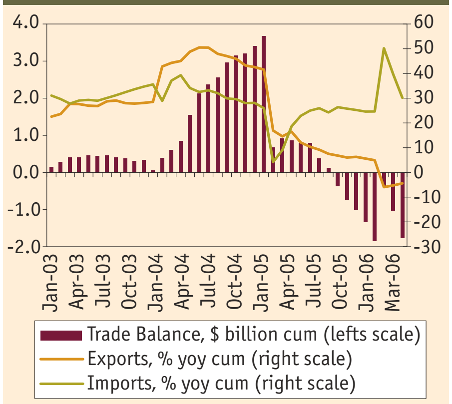
yoy respectively over the period. Robust growth of commodity imports is linked to rising population income and a high price on imported energy resources (particularly oil and gas). Mineral products hold the largest share in merchandise imports, accounting for almost 36%. The data also signifies the growing investment goods imports. For January-March, imports of machinery and transportation equipment grew by 26% yoy and 80% yoy respectively.

Merchandise Trade Flows in 2004–2006



Source: State Statistics Committee

As expected, the merchandise trade deficit was partially compensated for by the services trade surplus. According to the SSC, exports of services increased by 21% yoy over January-March, primarily on account of the 30% yoy increase in pipeline transportation services. At the same time, imports grew by 14.6% yoy over the period. As a result, Ukraine's foreign trade of services reported a surplus of $1 billion. Although the transfer surplus is expected to be substantial, the first quarter current account may post a small deficit as total foreign trade of goods and services made up a deficit of about $770 million (or about 4% of period GDP). At the same time, it is expected to be securely covered by the financial account surplus due to further increases in medium- and long-term private debt and robust FDI inflows. According to the SSC, net inflow of FDI amounted to $922 million in the first quarter of 2005, which is almost 4 times higher than in the corresponding period last year. The bulk of this sum was received thanks to several acquisitions in the banking sector. At the same time, such a robust inflow of FDI is unlikely to persist in the coming periods, considering the sluggish privatization process and the slow pace of economic reforms (due to parliamentary elections and the prolonged formation of a new government coalition).

Other Developments and Reforms Affecting the Investment Climate

Ukraine continued to make progress towards integration with Western institutions. In mid-May, Ukraine and Australia signed the bilateral agreement on joint access to the market of goods and services. Endorsement of the protocol put an end to one of the longest bilateral negotiation processes, the most critical issue of which were conditions for mutual access to sugar markets. Ukraine has almost completed its WTO negotiations with just two remaining countries — Kyrgyzstan and Taiwan. Thus, Ukraine has a good chance to become a WTO member by the end of this year, although it still needs to complete the adjustment of its legislation to WTO standards. This includes a number of politically sensitive laws, envisaging reduction of export duties on live cattle, hide and metal scrap. Currently, the legislative process is stalled due to the prolonged formation of the government coalition. Regardless of the composition of the future coalition, Ukraine's foreign policy is likely to remain pro-Western.

On the back of a much cooler bilateral relationship with Russia, Ukraine continues to succeed in developing relationships with NATO and is increasing its participation in organizations favoring closer ties with the West. Ukraine hopes to join NATO's road map in the fall of this year. In mid-May, the president of Ukraine signed a decree creating an inter-departmental commission for preparing Ukraine for NATO membership. NATO has also expressed willingness to support Ukraine on its way to join the alliance.

During May 22–23, Ukraine was the host country for the GUAM summit. GUAM is a regional organization of Georgia, Ukraine, Azerbaijan, and Moldova, established in 1997 with the aim to enhance energy and economic cooperation between the countries. During the summit, GUAM was transformed into an international organization "Organization for Democracy and Economic Development — GUAM." The functions of the organization include "the creation of a regional space of democracy, security, and stable economic and social development," strengthening the relations with the European Union and NATO, coordination of policies to solve common challenges for the region (like organized crime, drug trafficking, terrorism, energy security, etc.) During the summit, the countries decided to activate an agreement on creation of a free trade zone. The decision came at a time when Russia imposed import restrictions for Ukrainian, Georgian and Moldavian goods.

On May 22nd, Moody's introduced a new scale of national rating with the .ua marker, ranging from C.ua (the most risky level) to Aaa.ua (the least risky). According to Moody's, the national rating scale will provide more transparency regarding the local credit market since the international country rating, reflecting political and economic risks in the country, may obscure company-specific risks. Moody's also developed a new methodology for setting its foreign-currency country ceilings for bonds, which will reflect the risk that a foreign-currency government bond default would be accompanied by a moratorium on external foreign-currency payments. According to the new methodology, Ukraine obtained a Ba3 rating with stable outlook.

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