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Ukraine Macroeconomic Situation

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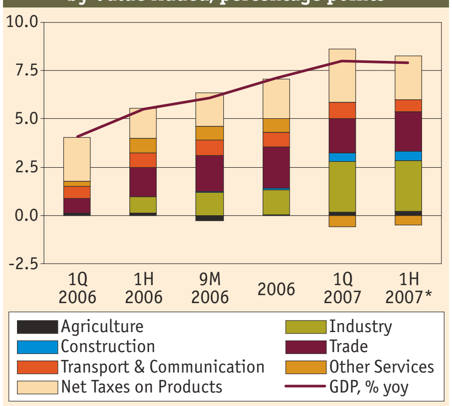
Summary

- In January-June, real GDP grew by 7.9% year-over-year (yoy) underpinned by strong external and domestic demand. On the supply side, the industrial sector regained its position as the leading driver of economic growth.
- Thanks to faster growth of budget revenues and under-execution of expenditures, the consolidated budget was in surplus of 1.75% of period GDP over the first half of the year.
- Due to a sluggish privatization process, the government resumed issuance of external and domestic debt. As a result, the stock of public and publicly guaranteed debt grew by 5% month-over-month (mom) to $15.7 billion at the end of June.
- In June, traditionally a low-inflation month, the consumer price index (CPI) unexpectedly grew by 2.2% mom, which translated into 13% growth in annual terms.
- The growth of forex-denominated loans has been losing speed in the last two months. However, commercial banks credit portfolios remain biased towards forex-denominated loans.
- Though Ukraine's export performance has been strong during the first five months of the year, the FOB/CIF merchandise trade deficit widened to $3.7 billion at the end of May.
- According to Ministry of Economy estimates, the size of the shadow economy in Ukraine declined to 27% of GDP in 2006.

Economic Growth

Contributions to Real GDP Growth by Value Added, percentage points

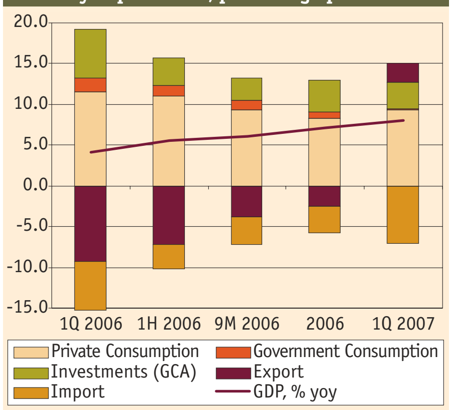


* Estimates based on operative statistics
Source: State Statistics Committee, The Bleyzer Foundation

According to operative data of the State Statistics Committee, the Ukrainian economy posted robust growth in the first half of 2007 as real GDP grew by 7.9% year-over-year (yoy). In fact, real GDP growth in June accelerated to 7.8% yoy, up from 7.7% yoy in the previous month. However, due to an increased statistical base, cumulative growth was slightly lower than in the first quarter of the year (8% yoy). Following an impressive evolution of Ukraine's main macroeconomic indicators, most experts revised their GDP forecast upwards for 2007. According to the recent Consensus Forecast, GDP is expected to grow by a real 6.9% yoy in 2007, while the previous forecast was 6.4% yoy. A more favorable external environment, faster than expected growth of consumption and investment, and the strong resilience of the Ukrainian economy to energy price shocks and political instability were among the main reasons for improved expectations.

GDP growth was supported by robust value added growth in industrial and service sectors, particularly wholesale and retail trade, as well as by strong expansion of construction. Unlike last year, industry was the most important source of economic expansion in the first half of 2007. Value added generated by this sector explained almost one third of GDP growth over the period. However, performance among industries was uneven. Manufacturing, which accounts for 18% of total value added, reported impressive 15% yoy growth in 1Q 2007 and a slightly lower but solid 13.7% yoy in the first half of the year. High international prices for ores and strong domestic demand stimulated a 4% yoy increase in the mining sector over the first half of the year. At the same time, production and distribution of electricity, gas and water reported a 6% yoy decline in value added in 1Q 2007 on the back of weaker electricity demand due to an unusually warm winter this year. Though industrial performance improved in the second quarter, it was insufficient to compensate for the previous quarter decline. As a result, industry reported a 0.7% decrease in value added over the first half of the year.

Contributions to Real GDP Growth by Expenditure, percentage points

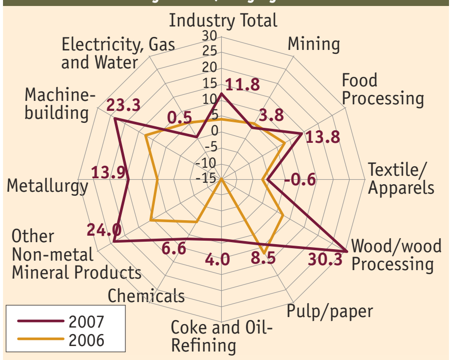


Source: State Statistics Committee, The Bleyzer Foundation

Over January-June, construction demonstrated an 11.8% yoy increase in value added on the back of a number of infrastructure and repair projects and strong demand for commercial property and industrial buildings. At the same time, demand for residential housing weakened due to high real estate prices and tighter bank requirements on borrower's financial stance. This may explain the deceleration in value added growth in construction in the second quarter from 13.3% yoy in 1Q 2007. Value added in wholesale and retail trade grew at an accelerating speed. Expanding by 15.5% yoy in January-June, this sector explained about ¼ of GDP growth over the period. Sector performance is closely linked to robust growth in industry, construction, as well as imports on the one hand and the population's growing propensity to consume on the other.

Rather unexpectedly, agriculture reported an acceleration of value added growth in 1H 2007 compared to January-May. Due to May-June's draught, the government downgraded its grain harvest forecast. As a result, further deterioration of agricultural performance was expected. However, hot weather during these months resulted in the early start of the harvest campaign, causing a surge in value added growth. At the same time, this statistical effect is expected to rapidly diminish in the coming months.

Industrial Output by Industries in January-June, % yoy cumulative



Source: State Statistics Committee

On the expenditure side, real GDP growth was driven by vigorous private consumption growth, which advanced by 14.7% yoy in 1Q 2007. Though it is a deceleration from 20.2% yoy growth in 1Q 2006, private consumption grew at a faster-than-expected rate. Though real household income growth decelerated to 11.1% in 1Q 2007, down from 16.1% yoy in 2006, private consumption was fueled by booming consumer credit. The continuing credit boom, robust corporate borrowing from abroad, the need to renovate production capacities and to introduce energy-saving technologies were among the major reasons of the impressive 24.4% yoy increase in gross fixed capital formation, up from 19.9% yoy in 1Q 2006. At the same time, its contribution to total GDP growth was smaller than in the respective period last year due to a contraction in inventories. Meager growth in government consumption (up by 0.8% yoy) in 1Q 2007 may reflect significant under-spending of state budget programs over the period. Robust growth of consumption triggered rapid growth of imports, which accelerated to 12.9% yoy from 10.7% yoy in 1Q 2006. Despite a lower contribution from domestic demand and faster growth of imports, a higher economic growth rate in 1Q 2007 compared to the respective quarter last year (8% yoy vs 4.1% yoy respectively) was achieved thanks to stronger export performance. Favorable external conditions helped compensate for the harmful effect of a 36% increase in prices for imported natural gas on energy-intensive export-oriented metallurgy and chemicals. At the same time, this impact was less painful than in the previous year as the price increase in 2007 was lower and, more

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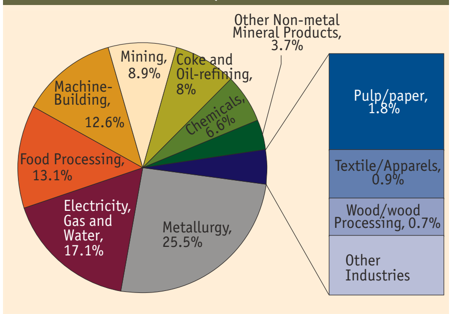
importantly, was anticipated. Together with strong investment demand in the main destinations for Ukraine's machine-building exports (mainly Russia), this triggered almost 5% yoy real growth of exports of goods and services.

Structure of Industrial Production*
1H 2007, % of total



* Approximation based on industrial sales statistics
Source: State Statistics Committee

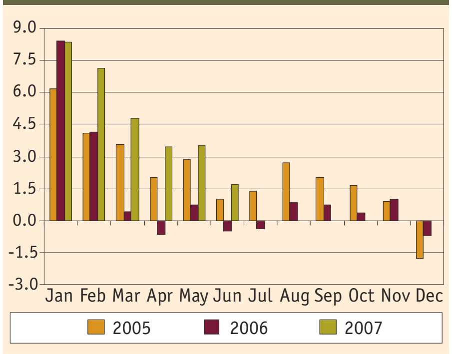
In June, the growth of industrial production accelerated slightly to 10.4% yoy from 9.9% yoy in May. However, due to statistical base effects, in cumulative terms it continued to decelerate, expanding by 11.8% yoy in 1H 2007 down from 12.1% yoy in January-May. Benefiting from strong consumption and favorable external conditions, machine-building and food processing reported acceleration in output growth to 23.3% yoy and 13.8% yoy, respectively. However, output growth in the metallurgy slowed to 13.9% yoy over the first half of the year compared to 15.8% yoy over January-May. Slower growth in metallurgy may be attributed to the downward tendency of international steel prices that resumed in June this year, though the effect of a growing statistical base was also present. Together with slower growth in chemicals, mining and other non-metal minerals, this caused total industrial production to decelerate. The likely worsening of the external environment in the second half of the year and political uncertainty in the fall (due to parliamentary elections and formation of the new government) will result in further moderation of industrial production and economic growth. The government forecasts industrial production and GDP growth to decelerate to 8.5% yoy and 6.5% yoy respectively in 2007.

Fiscal Policy

According to the Ministry of Finance, consolidated budget revenues grew by a nominal 31.6% yoy over the first half of the year to UAH 95 billion ($18.8 billion), while expenditures grew at a slower rate of 22.6% to UAH 90 billion ($17.8 billion). Since the execution rate of budget expenditures notably improved in June, the consolidated budget registered a smaller surplus of 1.72 % of period GDP, down from 3.5% of GDP in January-May. At the same time, for the corresponding period last year, there was a deficit 0.5% of GDP. This year's favorable fiscal performance was achieved due to improved tax collections and tight control over expenditures.

In particular, robust domestic consumption (of both domestically produced and imported goods and services) spurred tax revenues to the state budget as collections from VAT and excises advanced by about 33% yoy and 23% yoy in nominal terms. At the same time, the financial stance of Ukrainian enterprises continued to improve on the back of rapid economic growth and strong export performance. This caused corporate profit tax receipts to move up by a nominal 27% yoy. In sum, tax revenues to the general fund of the state budget were 4.6% above target for January-June.

Consolidated Budget Balance, % of period GDP



Source: Ministry of Finance

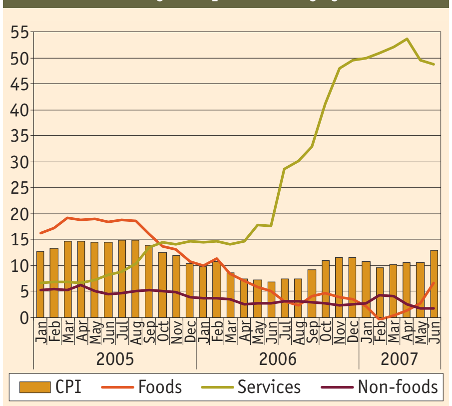
In June, expenditures from the general fund of the state budget were over-fulfilled by 2.1%. However, due to significant under-spending in the pervious periods, they were still 7.5% below the planned amount. Tight control over expenditures may be attributed to a sluggish privatization process. For the first half of the year, the State Property Fund of Ukraine allocated UAH 1.3 billion ($250 million) to the state coffers, which represents just 12.5% of the targeted amount for 2007. Considering the government's decision to privatize state enterprises by putting up only minority stakes for auctions and keeping a 50%+1 share of potentially the most interesting enterprises (such as telecommunication monopoly Ukrtelecom and Odessa port plant), the forthcoming parliamentary elections and subsequent formation of the new government, it is unlikely that the targeted privatization proceeds will be raised.

To secure enough funds to finance all government obligations (the state budget deficit is targeted to reach 2.5% of GDP in 2007), the government resumed both external and domestic issuance of public debt. In June, the government placed $0.5 billion eurobonds. As a result, external public debt increased to $12.4 billion at the end of June; however, due to large debt redemption in the previous months, external public and publicly guaranteed debt was still 1.5% lower than at the beginning of the year. The placement of UAH 0.8 billion ($160 million) of government domestic bonds and issuance of state mortgage institution bonds under state guarantee in the amount of UAH 275 million ($54.5 million) resulted in accumulation of both domestic public and publicly guaranteed debt (an accumulation of the latter was not observed for about 10 years). As a result, the stock of total public and publicly guaranteed debt grew by 5% mom to $15.7 billion. The funds received from the new debt issuances and still significant consolidated budget surplus funds are accumulated on the government accounts with the State Treasury. As of the end of June, cash balances on the government account with the Treasury amounted to about UAH 22 billion ($4.4 billion), which is equivalent to more than 7% of the total money supply. If rapidly disbursed, these funds may create significant inflationary pressures. However, we believe the government will continue to pursue tight control over budget expenditures, despite the forthcoming parliamentary elections in late September, to alleviate financing risks at the end of the year.

Monetary Policy

In 2006, consumer inflation was primarily driven by a pass-through of energy prices. The beginning of 2007 saw some downward revision of utility and housing tariffs. In addition, expectations of a further service tariffs adjustment this year did not materialize as the authorities decided to postpone the energy price pass-through to consumers. Though the annual CPI remained in double digits, these, together with a high base effect, gave reason to be optimistic that year-end inflation will be below 10%. Moreover, January-May inflation of just 1.9% year-to-date made the government forecast of year-end inflation at 7.5% quite realistic. However, in June (traditionally a low-inflation month), CPI unexpectedly grew by 2.2% mom, which translated into 13% in annual terms.

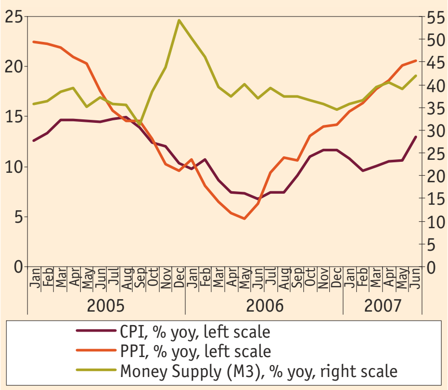
CPI by Component, % yoy



Source: State Statistics Committee

June's acceleration was primarily attributed to faster growth in food prices (6.7% yoy in June compared to 2.8% yoy in May), the weightiest component of CPI (about 60%), and the likely spill-over of producer price growth (the producer price index accelerated to 20.6% yoy in June, up from 20.2% yoy in May). The methodological weaknesses of accounting for new-crop-vegetables, a gradual shift in the consumption structure towards more-expensive products (due to a steady growth of real household income over the last three years), and apprehensions concerning lower-than-expected grain harvest due to droughty weather during May-June were the primary reasons for this acceleration. High international prices on crude oil drove up domestic prices for fuel to 12.5% yoy in June compared to 8.2% yoy a month before. However, due to price growth deceleration for other non-foods (such as transport vehicles, textiles and apparels, furniture, audio-, video- and computer equipment), the non-food price index remained unchanged at 1.8% yoy. On an increasing statistical base, the service price index continued to decelerate, reporting 48.8% yoy higher service tariffs than last year (down from 49.5% yoy a month before). Due to recent acceleration, we expect inflation to be around 10% this year.

CPI, PPI and Money Supply Developments

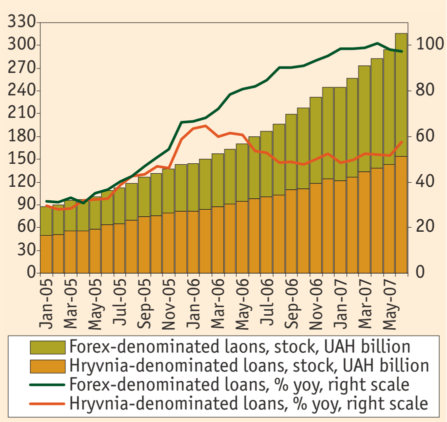


Source: State Statistics Committee, The Bleyzer Foundation

Faster growth of monetary aggregates growth in recent months also contributed to acceleration of consumer inflation. In particular, the growth of the monetary base sped up to 38.5% yoy in June 2007 from 36.9% yoy in May and just 17.5% yoy in December 2006. Considerable expansion of the monetary base is attributable to massive NBU interventions on the interbank forex market, underpinned by robust export performance and particularly the inflow of foreign capital in the form of FDI and external borrowing by private sector. For the first half of the year, net NBU purchases of foreign currency reached $3.4 billion. As the NBU kept the unofficial hryvnia peg to US dollar (and is unlikely to change its foreign exchange policy before the end of the year), this resulted in accumulation of gross international reserves to $25.9 billion at the end of June, which is enough to cover 4.8 months of future imports of goods and services. The steep upward trend of the monetary base and acceleration of deposit growth to 45.1% yoy (up from 42.3% yoy in May) were the main reasons of rising money supply at a high speed (42% yoy in June). At the same time, the impact of robust growth of monetary aggregates on prices was rather moderate due to strong money demand.

In June, commercial banks continued to expand credit operations as their growth accelerated to 75.7% yoy, up from 72.6% yoy a month before. Strong demand for credit was underpinned by growing real disposable income, buoyant investment activity and gradually declining credit rates. Though in June the weighted average credit rate slightly increased to 13% per annum (up from 12.7% pa in May), it was still lower than the average rate of 13.7% pa in 2006. The credit growth was led by corporate loans as they account for about two thirds of the total credit portfolio of the banking sector and are growing at an increasing speed (up by 59.4% yoy in June compared to 54.7% yoy a month before). At the same time, loans issued to households continued to decelerate, though their growth rate remains impressive — 119% yoy in June.

Commercial Banks Loans to the Economy of Ukraine



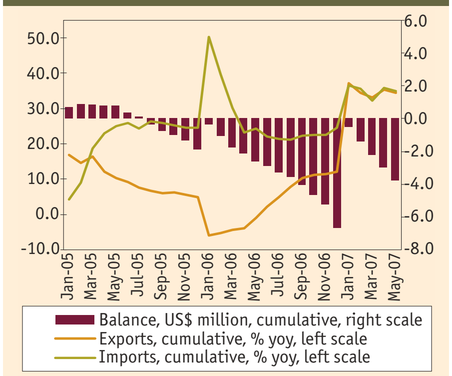
Source: NBU, The Bleyzer Foundation

By currency, robust growth of forex-denominated loans was underpinned by aggressive external borrowing of the financial sector and a number of acquisitions by foreign banks. However, the growth of forex-denominated loans has been losing speed in the last two months (the growth rate declined from 100.8% yoy in April to 97.4% yoy in June) following the NBU tightening of reserve requirements for forex denominated consumer loans in April and depreciation of hryvnia with respect to other main world currencies (particularly Euro)[1]. However, this deceleration was insufficient to tangibly effect the composition of commercial bank credit portfolios. The share of forex denominated loans remained virtually unchanged at 51.3% at the end of June (51.2% in April), indicating the high exposure of Ukraine's banking system to foreign exchange risk.

International Trade and Capital

According to the State Statistics Committee of Ukraine, exports of goods grew by 31.6% yoy in May, decelerating from 41.7% yoy a month before. However, the deceleration is primarily attributed to the increased statistical base (following a six month decline from November 2005 to April 2006, the growth of exports rebounded at a strong 11.5% yoy in May 2006). Though the growth of imports also slowed to 31.5% yoy in May, down from 47% in April, cumulatively it continued to outpace the growth of exports. Over January-May, exports grew by 34.4% yoy while imports grew by 35% yoy. The growth of exports was underpinned by a 53.5% yoy increase in exports of machinery and transport equipment, and a 40.4% yoy and 23.6% yoy increase in export of metals and chemicals respectively. Robust consumption and investment demand and a price increase on imported natural gas stimulated the growth of imports. In particular, the value of imported mineral products grew by 33% yoy in January-May, chemicals and machinery and transport equipment grew by 35% yoy and 41.5% yoy respectively. As a result, the merchandise trade deficit exceeded $3.7 billion at the end of May.

Merchandise Trade Performance



Source: State Statistics Committee

The widening foreign trade deficit is the primary cause of the increasing current account gap this year. However, thanks to robust FDI inflow (estimated by the NBU at $2.1 billion over January-May), the issuance of external and domestic debt securities (with a high external demand for the latter ones), and aggressive private sector borrowing allowed for coverage of the CA deficit and replenishment of the NBU's gross international reserves.

International Programs

According to the Ministry of Finance, on July 20th, Ukraine and the World Bank agreed on a Power Transmission Project with the overall objective of improving the security, reliability, efficiency and quality of the energy supply in Ukraine. The WB will provide a loan of $200 million for 20 years with a 5 year grace period. An agreement is expected to be signed by the end of this year. Currently, Ukraine and the WB are also negotiating a $140 million "Urban Infrastructure Project".

At the end of July, Ukraine and the European Investment Bank (EIB) signed an agreement, according to which the EIB will provide a ˆ200 million loan to Ukravtodor, the Ukrainian road administration. The loan is granted for 20 years at EURIBOR+0.55% with a 5 year grace period for principal payments. The funds will be directed to finance reconstruction of "Kyiv-Chop" motorway, which connects Ukraine with

[1] US dollar and Euro are the most preferred currencies of forex borrowing in Ukraine. Though US dollar holds the lion share of all forex-denominated loans, the share of Euro is also substantial. Since hryvnia is de facto pegged to US dollar, recent depreciation of the latter with respect to Euro and other main world currencies on the international markets caused the respective depreciation of hryvnia.

the EU countries. According to the Ministry of Finance, this loan is the first one under a large "Ukraine's European Roads" project between Ukraine and EBRD/EIB, envisaging total financing of about ˆ648 million for construction and repair of Ukrainian roads.

Other Developments and Reforms Affecting the Investment Climate

According to "Governance Matters VI: Aggregate and Individual Governance Indicators, 1996–2006", released by the World Bank at the beginning of July, the quality of governance in Ukraine has notably improved since 2002. According to the report, Ukraine achieved the most substantial progress in the area of Voice and Accountability. In addition, Ukraine showed further significant improvement in this area in 2006. At the same time, perceptions regarding Political Stability and the Risk of Violence were mixed, but on average demonstrated an improvement in 2006 compared to the previous year.

In mid-July, the government promulgated the draft of the government program of economic and social development of Ukraine for 2008. According to the draft, the government expects real GDP to grow by 7.2% yoy in 2008. The government defined the main goals of economic policy in 2008 as improving living standards of Ukrainian citizens, increasing competitiveness of Ukrainian goods as a precondition for sustainable economic growth, and ensuring energy security of the country. To realize key policy and institutional reforms, the government plans to attract $300 million as a second Development Policy Loan (DPL2) from the IBRD.

According to the Ministry of Economy of Ukraine, the size of the shadow economy in Ukraine was estimated at 27% of official GDP in 2006, which is 2 percentage points lower than in the previous year. By sector, the size of the shadow economy diminished in agriculture and manufacturing (particularly, machine-building), while in real estate, insurance, and car sales it continued to increase.

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