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Ukraine
Recent Political and Economic Developments

- The political situation has been settled in a positive manner with the formation of a government coalition with a democratic, pro-Western orientation.
- The coalition agreed to implement a 100 page Action Program that includes major economic and social reforms.
- The economic situation looks more promising with GDP growth in May 2006 reaching 8.5% year-over-year (bringing cumulative GDP growth to 4% yoy), while inflation stayed at single digit levels.
- Increased foreign direct investments and plentiful international reserves will cover the likely current account deficit for 2006. Privatization receipts will help finance the likely fiscal budget deficit.
- Asset prices continue to strengthen. Equity prices grew at an average growth rate of 31% per annum since the beginning of 2005. Real estate prices have also continued to strengthen.

1. Political Developments

The political situation in Ukraine has now settled in a favorable manner with the formation of a democratic, pro-reform coalition in Parliament. On June 22nd three political forces - the Block of Yulia Tymoshenko, Our Ukraine and the Socialist Party - formed a coalition that holds 243 seats in Parliament. This is enough to appoint a new government and pass legislation, but short of the two-thirds majority needed to adopt constitutional changes. Under last year's Constitutional Amendments, the Prime Minister has more power than the President.

The functional capacity of the coalition was further enhanced with an agreement on how key positions in the new government will be distributed. The Party of the new Prime Minister (Ms. Tymoshenko) will also appoint and control the ministries of Finance, Economics, Agriculture, Energy, and the State Property Fund. This will avoid the situation in 2005 under which the PM had little scope for action without control of key economic ministries.

The prospects of accelerated economic reforms were enhanced after all the coalition members signed a comprehensive agenda on social and economic reforms. Policy strategies supported by the coalition are based on the pro-Western and pro-European orientations with the ultimate target of complete integration of Ukraine into the European Union. Top policy priorities declared by coalition members include:

- Amendments to current legislation to ensure WTO membership by the end of 2006.
- Strengthening of property rights and a free and competitive market.
- Improvement of the investment climate and a significant reduction of administrative control over prices and state interventions in the markets.
- Creation of a favorable environment for small and medium enterprises.
- Improvement in the coordination between the central bank and the government to promote price stability.
- Comprehensive tax reform (emphasis on lower tax rates): modernization and simplification of the tax administration and elimination of market distortions created by preferential tax regimes.
- Negotiations with the EU on free-trade agreement.
- Tight partnership and cooperation with NATO with possible membership only if supported by a national referendum.
- Ensuring energy safety and independence by establishing transparent and reliable market mechanisms of energy supply. All major oil and gas pipelines will remain under state ownership and energy cooperation with the EU will be intensified. Ms. Tymoshenko, has stated that she will initiate a revision of recent gas deals imposed on Ukraine by Russia, with primary emphasis on efficiency and transparency of the energy market.
- Transparent and fair privatization of state property and an enhancement of the administrative capacity of the State Property Fund. Elimination of arbitrary interventions by the authorities in the management of privatized state property.
- Import duties on gasoline might be raised to create incentives for the domestic oil processing industry. Several policies to facilitate the creation of a strategic oil reserve will be implemented.
- The moratorium on the sale of agricultural land is to be extended until 2009 and necessary legislation is to be drafted to ensure the development of a full-fledged land-market infrastructure. Issuance of Land Deeds is to come in force by July 2007.
- Abolishment of immunity from prosecution for Parliament Deputies, a crucial step in launching an efficient anti-corruption campaign.
- Accelerated reforms of the pension system.
- Implementation of public administration reform and judicial reforms to comply with EU standards.

The agreement on the above Action Program will facilitate the implementation of economic measures. It will avoid inconsistencies in economic approaches that plagued the previous governments.

2. Macroeconomic Developments

The Ukrainian economy continued its strong recovery, with **GDP** expanding by an impressive 8.5% year-over-year (yoy) in May 2006. As a result, cumulative GDP growth from January to May reached 4% yoy. On the demand side, GDP growth was supported by strong domestic demand that originated from large increases in real wages and social security payments. GDP growth was also supported by rebounding investment demand, which was reflected in booming machine-building output and construction activities. In particular, the machine-building industry advanced by 11.5% yoy since the beginning of the year. Following more than a year of stagnation, construction strongly rebounded at 8.2% yoy over January-May. On the supply side, economic growth was primary driven by the service sector. Value added in transport and domestic trade, which cumulatively account for about 23.5% in total GDP, advanced by 6.7% yoy and 7.3% yoy respectively over January-May.

The upsurge in GDP growth in May is also attributed to a revival of **industrial output**, which had been stagnant due to higher prices on gas and other energy inputs. In fact, the growth of industrial output resumed at an impressive pace of 10% yoy in May, bringing the cumulative growth to 2.4% yoy (up from a meager 0.4% yoy in January-April). The rebound in industrial output occurred primarily thanks to machine-building, metallurgy and food processing (which were up by 17% yoy, 12.4% yoy, and 9.8% yoy respectively in May). This growth was driven by stronger investment demand, favorable external conditions (international prices for steel have been increasing since February and accelerated during April-May), and positive developments in private consumption.

The initial forecast of real GDP growth by the Ministry of Economy of Ukraine was 2.8% yoy for 2006. However, taking into account the recent real sector improvements, the original estimate may be exceeded with GDP growing by 3%-5% in 2006. In 2007, GDP growth is likely to increase to around 5%-6%.

In addition to GDP growth, other developments have been favorable to Ukraine. In particular, consumer price **inflation** has been decelerating since February. CPI declined from 10.7% yoy in February to less than 7.5% yoy in May. The disinflation occurred due to a combination of factors: (1) considerable deceleration of monetary aggregates growth as the growth of money supply (M3) decelerated from 52% yoy in February to 41% yoy in May; (2) robust growth of food output despite more limited export opportunities (due to Russia's ban of milk and meat exports from Ukraine) and lower food inflation (foods account for about 63% of the consumer basket), which decelerated from 11.4% yoy in February to less than 6% yoy in May; (3) limited effect of rising service tariffs on the CPI due to their low share in the consumer basket (about 10%); and (4) low import prices due to reduced import tariffs implemented in May last year.

The deterioration of the merchandise trade balance in the first quarter of 2006 was the principal cause of the **current account** deficit over the period. However, the deficit was almost covered by a surplus in the financial account. In particular, net inflows of FDI in the first quarter of 2006 amounted to $662 million, which is 170% larger than in the same period of 2005. Although Ukraine may face a current account deficit for 2006 of around $2.8 billion (due principally to more expensive energy imports and increases in imports of machinery and equipment), this deficit will be easily financed by inflows of foreign direct investments (expected at $2.2 billion), by the large size of international reserves (currently at $17 billion, covering about 4 months of future imports), and by foreign financing (as the level of public debt is still quite low at below 20% of GDP).

Stronger than expected economic growth over the last few months helped the government to meet its financial targets. In January-April, the **consolidated fiscal budget** reported a deficit of 0.7% of period GDP, which signals better budget execution this year and may further ease inflationary pressures. In 2006, the fiscal deficit is not expected to exceed 3% of GDP.

The **exchange rate** has been stable at 5.05 UAH/$, maintained by the NBU through selling interventions on the forex market. As political uncertainty eased after parliamentary elections and the external situation was favorable in April-May, the Ukrainian forex market was almost balanced during April-May. This allowed the NBU to start replenishing its foreign reserves in May to $17.7 billion (up from $17.2 billion in April).

3. Equity Market Developments

The equity market is continuing to develop rapidly. Market capitalization of the First Securities Trading system (PFTS) has tripled since the beginning of 2005. It increased from $11.8 billion in January 2005 to $29.1 billion in January 2006 and to $33.3 billion by June 2006. As of May 31, the largest companies on the PFTS were Ukrtelecom ($ 3.9 billion), Ukrnafta ($3.6 billion), and Kryvorizhstal ($2.8 billion).

Equity prices continue to show strong performance, growing at an average annual rate of growth of 31% per annum since the beginning of 2005. The PFTS equity price index increased from 259 at the beginning of 2005, to 352 at the beginning of 2006 and to 388 in June 2006. The SigmaBleyzer-50 index (SB-50) rose by 11% from the beginning of 2006 from 407.6 to 452.4 as of June22nd.

Growth of equity prices in 2006 has been mostly due to developments in the banking and energy sectors and in petrochemicals (represented by “Ukrnafta”).

4. Developments in Key Economic Sectors:

Banking Sector. Commercial **bank lending** has continued to expand at a robust rate of 69.3% yoy in May 2006, up from 61.5% yoy in December 2005. The increases in bank lending took place both at the retail and corporate levels. Consumer lending growth was driven by growing households’ income and the development of financial innovations for consumers, including credit cards, mortgages, and retail financing. The growth of corporate lending is seen as an additional sign of growing investment demand in the country. Over the last two years, some of the larger Ukrainian banks have been of a great interest to foreign investors. SEB of Sweden, Raiffeisen International Bank-Holding AG of Austria, Vneshtorg Bank of Russia, Banca Intesa of Italy, BNP Paribas of France, and OTP Bank of Hungary have each purchased Ukrainian banks in the last two years. As a result of this interest, prices for Ukrainian banks have risen considerably, reaching a multiplier in some cases of more than 6 times equity. There are still significant opportunities in the sector.

Real Estate Sector. Ukraine’s real estate market has been growing rapidly. During January-May 2006, construction activities grew by 8.2% yoy reflecting increasing investment demand in the country and robust household consumption.

The main features of the market are as follows:

- Demand on commercial real estate considerably outperforms available supply. This is especially true for high quality retail spaces. It is unlikely the demand for commercial property (especially Grade A space) will be met over the next few years.
- Although the city of Kyiv has the highest demand for commercial property, there are tremendous opportunities outside the capital with prices up to 50-75% cheaper compared to Kyiv.
- Residential prices are up 10-20% in most cities with under-supply of quality spaces in big cities.

IT and Telecommunications Sector. According to the State Department of Communications and Information the total amount of FDI into the telecommunications industry was $146.4 million in 2005. For Q1 2006, investments in the sector totaled $297 million.

The state-owned company Ukrtelecom is expected to be privatized in the near future. Currently, it has a monopoly on the fixed line telecom market with 9.7 million subscribers. It also has an exclusive license to provide 3G mobile services, which should boost the value of the company before privatization.

Internet penetration is growing at a fast pace, but the growth opportunities are still large. According to official statistics, there are about 8.5 million Internet users (18% of population). Mobile communications is also a dynamically growing sector. Penetration of mobile phone users was more than 74% in May 2006 with 35 million users, over two times higher than in the same month of 2005. Revenues from mobile phone providers for January-April 2006 were 43% higher than revenues for the same period of 2005. Turkcell and Vimplecom recently entered the market.

Machine-building Sector. Machine-building output increased by 11.5% yoy over January-May, primarily on account of a 33.2% yoy increase in the car industry, 32.8% yoy increase in production of equipment for metallurgy, and 25.6% yoy in production of equipment for telecommunication industry. More moderate increases in output were registered for consumer electronics (up by 10.3% yoy), electric machines and equipment (8.9% yoy), and equipment for processing agricultural goods (up by 5.5% yoy).

Food Industry. The food industry and food processing is one of the most rapidly growing sectors in the economy, helped by solid household consumption. As of April 2006, the sector had attracted $1.2 million in FDI. Most sub-sectors were performing well in the first four months of 2006 after a solid 2005 including meat (up 17%), water and juice (14%), beer (14%), canned goods (50%), dairy (4%), sunflower oil (54%), and confectionery (5%). Prepared foods, breakfast foods, and the dietary and health food segments have seen surging growth from a low base. There are still numerous opportunities in the sector.

Metallurgy. Metallurgical output increased by an impressive 12.4% yoy in May, bringing the cumulative growth to 1.7% yoy. The strong rebound in the industry is explained by resumed growth of world steel prices in February this year. Production of pig iron, steel and ferroalloys grew by 1.3% yoy over January-May, production of pipes advanced by 3.6% yoy.

Pharmaceuticals. According to the State Committee of Statistics, output in pharmaceuticals increased by 6.8% year-over-year in January-May 2006. The exports of pharmaceuticals for the same period totaled $26 million, a decrease of 4.5%, while imports expanded by 26.7% to $357 million. On the retail side, sales increased by 60% in Q1 2006.

Retail Trade. Retail trade continues to expand fueled by a robust increase in earnings. According to official statistics the total volume of retail trade grew 27.2% yoy in real terms in January-May of 2006 (in January-May 2005 the growth rate was 20.5). Three of the largest Ukrainian supermarket chains plan to open at least 15 additional stores each in 2006, with dozens more planned.