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Ukraine
Macroeconomic Situation

March 2005

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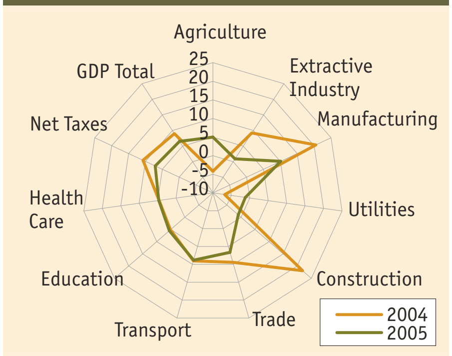
Summary

The Ukrainian economy continued to show remarkable growth in 2005, supported by strong external and domestic demand. Real gross domestic product (GDP) growth picked up by a healthy 6.5% year-over-year (yoy). Despite concerns over significant fiscal loosening, the consolidated budget posted a healthy surplus of 6.3% of period GDP. The fiscal outlook for 2005 is still unclear because the government has yet to amend the 2005 the budget in order to finance election pledges. With money market stabilization after the liquidity crisis in December, inflationary expectations have eased. In January, consumer inflation reached 12.6% yoy. With the end of political turbulences associated with the presidential elections, a subsequent liquidity crisis in the banking system has been alleviated. January's dynamics of loans and deposits suggests that the public is gradually regaining confidence in the national banking system. The country's external balances remain very strong. During 2004, net inflow of FDI grew by 31% yoy to $1.56 billion, which is the largest annual inflow since 1991.

Economic Growth

Ukraine started 2005 with impressive economic growth. In January, real GDP grew by 6.5% yoy despite a slowdown in several sectors. The major contributors to economic growth were industry (8.4% yoy), wholesale and retail trade (6.6% yoy), and agriculture (5% yoy). Unlike last year, construction performance deteriorated, posting a 1% yoy decline compared to 22% yoy growth in January 2004. However, this may be a temporary phenomenon caused by a sharp contraction of credit resources available to the real sector in recent months.

Industry Growth by Sector, % yoy



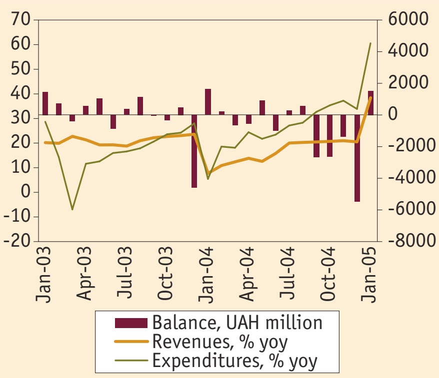
Source: State Statistics Committee

Enjoying robust external demand, industrial production continued to expand at an impressive rate of 8.4% yoy. Though this rate of growth is considerably lower than that in January 2004, when industrial growth reached 16.1% yoy, it is twice as high as December's figure. In January, metals production kept growing at impressive rates (10.2% yoy) driven by high world prices for metals. Good agricultural output in 2004 encouraged the development of the food processing industry, which demonstrated 19.8% yoy growth in January. Other growth areas included domestic-market-oriented wood processing (31.4% yoy) and chemicals (17.1% yoy). At the same time, machine-building, an undisputable growth leader in 2004, showed less than 1% yoy growth in January compared to 40% yoy growth over the same period last year. Overall, real sector development suggests a positive growth outlook for the year. Assuming a favorable external environment in 2005, Ukraine's economic growth may reach 8%. The current 2005 State Budget envisages a more conservative scenario of 6.5% annual growth

According to a recent report of the State Statistics Committee, last year's GDP growth reached 12.1%. This remarkable economic growth was encouraged by 13% yoy expansion of domestic demand and 10.2% yoy growth in fixed capital investment. The fact that the export component in total GDP reached almost 60% in 2004 shows the importance of the external environment for Ukraine's economic growth. Taking into account the poorly diversified export structure, the country's high dependence on external demand remains its major source of vulnerability.

Fiscal Policy

Consolidated Budget Dynamics, 2003-05



Source: Ministry of Finance

The robust rate of economic growth in January encouraged good fiscal performance. Despite a number of concerns, the consolidated budget posted a healthy surplus of UAH 1.52 billion ($286 million), which is equivalent to 6.26% of period GDP. Deflated consolidated budget revenues grew by 26% yoy to UAH 6.92 billion ($1.3 billion), while expenditures increased by 48% yoy to UAH 5.4 billion ($1.01 billion). Considerable growth of corporate income and value added (VAT) tax proceeds contributed to accelerating fiscal revenues. In January, fiscal authorities collected twice as much corporate income tax proceeds as over the same period last year, reflecting significant expansion of economic activity and a reduction of the shadow sector. At the same time, receipts of personal income tax fell by 9.3% in real terms, suggesting that the base for this tax has increased only slightly following a major tax reduction last year. Part of this decline, however, was compensated by VAT and excise duties receipts.

Despite the successful fiscal performance in January, the outlook for 2005 is still uncertain. The government still has to amend the 2005 budget in order to finance all social security payments, including pension outlays promised by the previous government. The current Law on 2005 State Budget envisages only a small fraction of the resources needed to execute the promised social payments. Thus, the current fiscal targets, which include a planned UAH 8.9 billion ($1.7 billion) deficit equivalent to 2.2% of GDP, are unrealistic. According to different estimates, the government is short of about UAH 18-25 billion. President Yuschenko stated that the government was preparing amendments that envisage an increase of budget revenue targets by UAH 15-19 billion. In particular, additional revenues might be generated after the elimination of tax privileges, the liquidation of free economic zones, and the increase of profit deductions to the budget for state-owned enterprises from the current 15% to 50%. The government plans to submit these amendments to the Parliament by mid-March.

The expected 2005 fiscal gap will be financed through new borrowings and privatization receipts. So far, the privatization process has stalled because the validity of the sale of Kryvorizhstal was questioned by the new government. Moreover, the whole privatization strategy is likely to be revised. The new government intends to re-privatize those enterprises whose sale procedures were violated. The new government has indicated a wide range of how many enterprises may be subject to re-privatization or resale (from several dozens to several thousands). Acknowledging that re-privatization talks may have detrimental effects for Ukraine's investment climate and international image, President Yuschenko assured there would be no nationalization. The government is developing a new privatization program, which should be submitted to the Parliament for approval in early March. A moratorium for privatization of large enterprises that was approved by the parliament in mid-January is to be prolonged until the privatization program is adopted. Meanwhile, the government announced that Ukrtelecom would not be sold in 2005 as initially planned. According to the State Property Fund (SPF), privatization in Ukraine is expected to resume in March.

In 2004, sound external debt management reduced public debt as a percentage of GDP to 22% from 24% in 2002. In absolute terms, the stock of public debt grew by 10.7% yoy to $16.1 billion. In 2004, external public debt picked up to $12.2 billion, while domestic debt remained relatively stable at around $4 billion. The increase was the result of Eurobonds placements on the external market and the VAT refund debt restructuring to domestic creditors.

Monetary Policy

Following the marked acceleration of inflation over the last few months of 2004, retail price growth slowed slightly in January. During the month, CPI increased by 1.7% month-over-month, thus bringing the annual inflation rate to 12.6% yoy. Current CPI dynamics show that consumer prices are catching up

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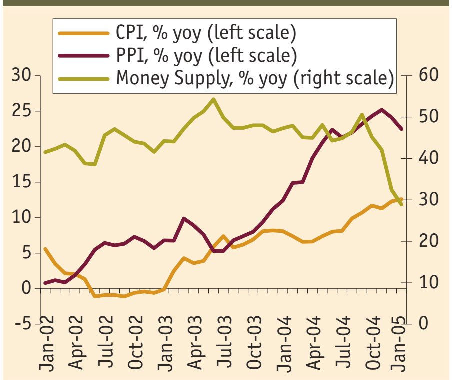
with considerably higher producer inflation. Food prices increased by 16.3% yoy primarily on account of 50% and 24% yoy growth in meat and milk prices, respectively. At the same time, non-foods and service prices decelerated. In January, the non-food price index slid to 5.3% yoy following slight deceleration of gasoline prices to 60% yoy. Over the period, service tariffs growth declined to 6.6% yoy thanks to deceleration of utilities prices. In January, producers' inflation went down to 0.2% month-over-month, which is relatively low compared with the previous year's figures. As a result, the annual producer price index (PPI) declined to 22.5% yoy in January.

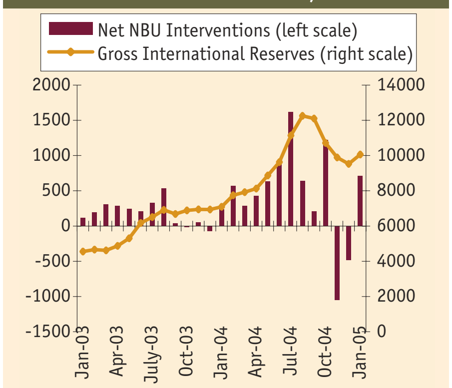
Prices and Money Supply Dynamics, 2001–04



Source: State Statistics Committee, NBU

Consumer inflation is expected at about 10% for 2005. The government forecast for CPI growth is at an optimistic 8.7% eop for 2005. However, large social payouts out of budget may generate excess demand for goods and services, thus creating additional inflationary pressures. More conservative scenarios envisage CPI growth at 11% in 2005, which is in any case lower than the last year's inflation. The NBU has already announced its intentions to follow tight monetary policy to accommodate inflationary pressures.

NBU's Forex Market Interventions and International Reserves, USD mn

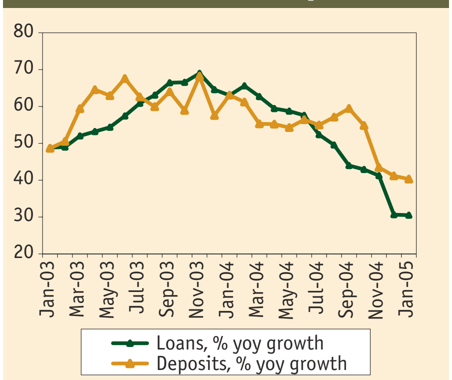


Source: National Bank of Ukraine

With the end of political instability associated with the presidential elections, a liquidity crisis in the banking system was alleviated. As a result, monetary and banking indicators started to stabilize in January. Banking system liquidity gradually improved as demand for NBU refinancing credits dropped to just UAH 65 million from UAH 13 billion in December. Over the month, money supply (M3) growth sped up slightly to 36% yoy. Recovery of deposits growth (32% yoy) contributed to money supply expansion the most, while cash in circulation expanded by less than 29% yoy. Monetary aggregates growth is likely to be more moderate in 2005 due to expectations of slower economic growth and lower inflation.

In January, the NBU's gross international reserves started to recover; the NBU was selling them to satisfy the sudden increase in demand for foreign exchange and to prevent large exchange rate fluctuation in November-December. A robust inflow of export receipts allowed the NBU to net purchase $711 million in January. As a result, the NBU's forex reserves reached $10.1 billion, up 42% yoy. The overall stabilization on the forex market led the NBU to promise a cancellation of a 2% fluctuation band for cash exchange rates. This measure was introduced in November 2004 in order to curb large fluctuations in the cash foreign exchange rate, which may have taken place due to extraordinarily high demand for foreign cash over the last few months of 2004. Converting hryvnia into foreign cash was a way for people to hedge against inflation acceleration and possible hryvnia devaluation during the political uncertainty. Meanwhile, the official hryvnia rate kept appreciating, but very gradually. In January, the official hryvnia exchange rate remained virtually unchanged at 5.305 UAH/USD. Over the same period, the hryvnia/euro rate declined by 4.2% to 6.91 UAH/EUR, reflecting euro fluctuations on the international forex markets.

Growth of Loans and Deposits

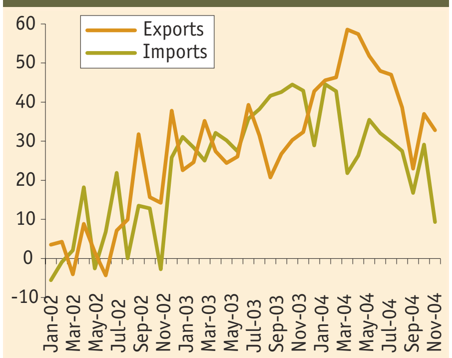


Source: National Bank of Ukraine

January's dynamics of loans and deposits suggests that the national banking system is gradually regaining the public's confidence. The stock of household deposits at commercial banks picked up by 6.7% from December. The annual growth of deposits made up almost 32% yoy in January, which is quite high, although lower the last year's average of 55%. Commercial bank lending to the real sector also started to recover in January after a sharp contraction of credit growth over the last few months of 2004. Over the month, commercial bank credit expanded by 31% yoy. However, the average cost of loans increased in January to 15%, some 40 basis points higher than in December. Deposit rates were also on the rise as the average annual rate reached 9.2%, primarily due to the increase in the rate on hryvnia deposits. The latter development is explained by the commercial banks' attempts to restore their pre-crisis liquidity positions by attracting hryvnia resources lost during November-December.

International Trade and Capital

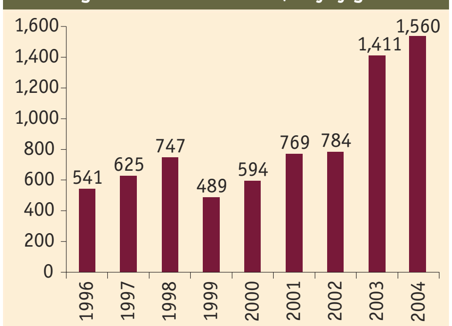
Foreign Trade Performance, % yoy growth



Source: State Statistics Committee

A favorable external environment supported stellar export performance in 2004. Over The merchandise trade surplus reached a record high $3.7 billion, compared to a tiny $59 million surplus in 2003. In 2004, goods exports expanded 42% yoy to $32.7 billion, while goods import increased 26% yoy to reach $29 billion. The main export commodities remained ferrous metals, which accounted for 33% of total goods exports, machinery and transportation equipment with a 15.5% share, refined oil with a 10% share, and chemicals with a 8.5% share. To a great extent, the export increase is attributed to high growth of exports of metals and metal products as well as machines and equipment. In particular, the cross-border sales of metals and machinery and transport equipment grew by 50% and 62% yoy respectively. On the imports side, energy resources and machines and transport equipment are the biggest items contributing to total import growth.

Foreign Trade Performance, % yoy growth



Source: State Statistics Committee

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The geographical orientation of Ukraine's foreign trade is becoming more diversified as it gradually shifts away from the CIS region. Though Russia remains the single biggest trade partner, accounting for 18% of all exports and 40% of all imports, European countries' share of total merchandise exports and imports keeps increasing, reaching 36.1% and 34% in 2004, respectively.

Strong macroeconomic fundamentals and alleviated political tensions are likely to result in a significant acceleration of foreign investment flows into the Ukrainian economy. Last year's capital flow dynamics support this argument. During 2004, net FDI inflow grew by 31% yoy to $1.56 billion, the largest annual inflow since 1991. By the end of 2004, the cumulative FDI stock since Ukraine's independence had increased to $8.35 billion, which is equivalent to $176 per capita. This figure is considerably lower than in other transition economies suggesting that Ukraine still has huge investment potential. The largest amount of FDI originated from the USA (14% of the total), Cyprus (12%), and the UK (11%). Judging by the amount of FDI attracted, the most attractive sectors for foreign investment are wholesale and retail trade and food processing, which received 17% and 14% of total FDI stock respectively. However, in recent years foreign investors are becoming more interested in more sophisticated and higher value added operations like machine building, where foreign investors directed 8.1% of total FDI stock. The readiness of investors to make longer-term investments is a highly positive development as it provides evidence that foreign investors are becoming more confident in the sustainability of Ukraine's economic development.

International Programs

An IMF mission visited Ukraine at the end of February to discuss the terms of its future cooperation with the new Ukrainian government. The last Precautionary Stand-By Program was valid through March 2005. This program launched in March 2004 for 12 months, during which time Ukraine could use funds amounting to $607 million (or 30% of Ukraine's quota) in case an urgent need arises. However, to reach a new agreement with the IMF, the Ukrainian government has to clarify all outstanding fiscal problems. In particular, the IMF is concerned with a significant increase in the share of social security payments in total budget expenditures and the expected fiscal deficit associated with them. Thus, the terms of the next agreement with the IMF depend on the amended 2005 Budget parameters.

Following the meeting with key government officials, the World Bank management in Ukraine expressed its readiness to extend the remaining $175 million under the Second Programmatic Adjustment Loan (PAL-2) Program in the nearest future. The first tranche of the $75 million under the PAL-2 was disbursed in December 2003. With regard to future lending programs, the World Bank Director for Ukraine, Moldova and Belarus Paul Birmingham stated that Ukraine might get another $500 million as the third PAL by July 2005. In total, the World Bank plans to increase its loan portfolio in Ukraine to about $3 billion during the next two years.

Other Developments and Reforms Affecting the Investment Climate

The victory of the Orange Revolution has encouraged Ukraine's integration towards the EU. In particular, the new Ukraine-EU action plan scheduled for three years envisages a number of steps, the implementation of which will lead Ukraine to the beginning of the EU accession negotiation process. A positive development is that approval of the plan will facilitate achievement of market economy status from the EU, negotiations on creation of a free trade zone with the EU and liberalization of the visa regime. Upon successful implementation of the reform agenda specified in the action plan by 2007, Ukraine may conclude a new agreement with the European Union that is likely to guarantee the country's membership in the EU in 2010-2014.

In March, the government introduced the 20% VAT on oil imports to Ukraine. Earlier, oil importers paid zero VAT. It is worth mentioning that in August 2004, Russia abolished the VAT on oil and gas exports for CIS countries starting in January 2005. Therefore, Ukrainian importers enjoyed preferential tax treatment for a rather short period. In addition, the government reduced the delay of VAT payments for oil imports. According to Prime Minister Tymoshenko, the decision to levy VAT on oil imports was made after discussions with oil traders. The reason for this decision was to deal with illegal re-export schemes that allowed claiming fraudulent VAT refunds from the budget. On February 16, the government adopted a temporary ban on crude oil re-export because the State Customs Service uncovered that Russian crude oil entering Ukraine at zero VAT rate was illegally cleared at customs and later re-exported. After that, the entities involved in these operations applied for VAT refunds.

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