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Ukraine Macroeconomic Situation

September 2005

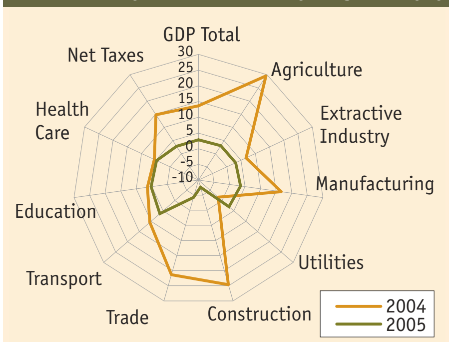
Olga Pogarska, Edilberto L. Segura

Summary

- In August, Ukraine's gross domestic product (GDP) contracted for the first time during the last six years, bringing the cumulative figure to a modest 2.8% year-over-year (yoy).
- Over January-July 2005, the consolidated budget registered a surplus of about 1.1% of period GDP on the back of improved tax enforcement and tax administration.
- The government approved the draft state budget for 2006 with a 2% of GDP deficit and further increases in social expenditures with over-optimistic economic growth.
- Consumer price inflation accelerated to 14.9% yoy in August; inflationary pressures continue to grow.
- The National Bank of Ukraine is undertaking liquidity restraining measures aimed at containing high inflation; however, the targeted year-end inflation is likely to be surpassed, while the banking system may experience a deficit of liquid funds.
- The likelihood that Ukraine will join the WTO before the end of the year diminished given that passing of required WTO legislation through the parliament has been lingering.
- At the beginning of September, the government and a number of other top officials were dismissed; the new Prime Minister of Ukraine became Mr. Yekhanurov.

Economic Growth

GDP Growth by Sector in January-August, % yoy

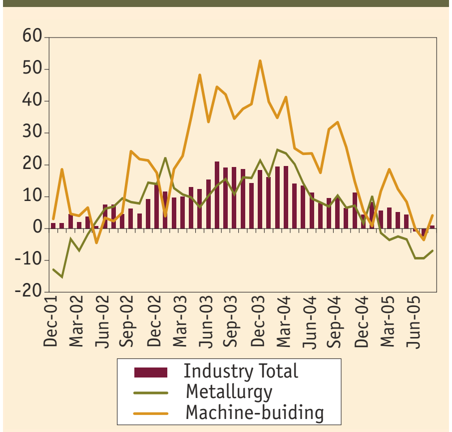


Source: State Statistics Committee

In 2003-2004, Ukraine was one of the best-peforming economies in the world, with GDP growth rates of 9.5% yoy and 12.1% yoy respectively. However, since the beginning of 2005, the country has experienced a dramatic slowdown in economic growth to 2.8% yoy over January-August. In August alone, for the first time in the last six years, GDP showed a 1.6% yoy contraction. The sharp deceleration of Ukrainian GDP growth should be partly attributed to a high base effect, rising energy prices and declining world demand for metals. However, there may be another important reason. Political turbulence at the end of 2004/beginning of 2005 and the ensuing drastic change in the country's management, with sometimes controversial movements (like the re-privatization issue and attempts to introduce price controls), resulted in a sharp downturn in both domestic and foreign investments. Considering current macroeconomic performance, the government downgraded its GDP forecast for 2005 in mid-September to 4% yoy, down from 6-6.5% yoy.

Out of the GDP growth slowdown by 9.3 percentage points (pp) over January-August 2005 from a record high 12.1% yoy growth in 2004, almost 40% is explained equally by deceleration in manufacturing and agriculture and another 30% by the recession in domestic trade. Despite the good harvest this year, value added in agriculture increased by a moderate 3.1% yoy over the period, decelerating from impressive 29.5% yoy growth in the respective period last year. Partly owing to high base effect (21.3% yoy increase over January-August 2004), domestic trade reported a 4.3% yoy decline. The main reason for this decline was a reduction in wholesale trade rather than in retail trade, which actually expanded thanks to rising household demand. The reduction in wholesale trade is linked to the drastic slowdown in manufacturing, which showed modest 3.5% yoy growth compared with a 16.5% yoy increase in January-August 2004. With the completion of large infrastructure and repair works, construction has been contracting since the beginning of the year. Because of a high base effect, the sector reported a 7.7% yoy decline, negatively contributing to GDP growth.

Industry Growth - Selected Sectors, % yoy



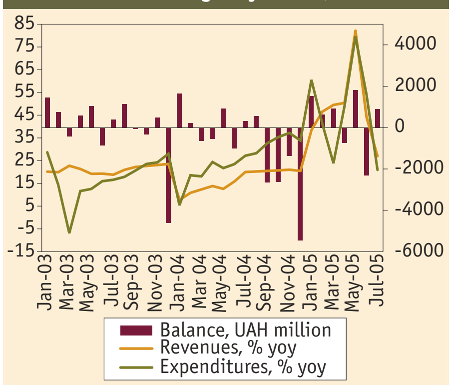
Source: State Statistics Committee

Following a two-month decline, industrial output rebounded in August, expanding by 1% yoy. Cumulative growth, however, kept decelerating to 3.5% yoy compared to 14.4% yoy in the corresponding period last year. The major reason for growth deceleration in the sector was poor performance of metallurgy and machine-building. The decline in metallurgy is mostly related to lower international prices for steel. Over January-August, metallurgical output shrunk by 3.2% yoy compared with almost 15% yoy growth in the respective period last year. Another important reason is lower investments in machinery and equipment by local enterprises due to political uncertainties and the stalled privatization process. The growth in machine-building slowed from above 33.5% yoy over the respective period in 2004 to a moderate 6.6% yoy this year. On the upside, increasing household incomes drove expansion of food processing, the second largest industry after metallurgy. Over the period, the food industry expanded by 14% yoy, slightly higher than the 13.4% yoy growth recorded in the respective period last year.

Fiscal Policy

Over January-July 2005, the consolidated budget surplus reached UAH 2.75 billion (about $545 million), which is equivalent to 1.1% of period GDP. So far, the growth of consolidated budget revenues outpaced that of expenditures. In real terms, budget revenues went up by 32.5% yoy to UAH 70 billion ($13.8 billion), while expenditures grew by 29.5% yoy to reach UAH 67.2 billion ($13.3 billion). Successful budget execution on the back of decelerating economic growth may indicate improvements in tax enforcement and administration. Over the period, collections from enterprise profit tax and import duties increased by 44.5% yoy and 53% yoy in real terms, respectively. Value added tax reported the largest increase in receipts, by a real 72% higher than in the corresponding period last year. However, this success is somewhat exaggerated due to accumulation of VAT refund arrears in the amount of UAH 2.9 billion (almost $575 million) as of September 1st.

Consolidated Budget Dynamics, 2003-05



Source: Ministry of Finance

Despite the current favorable budget balance, a drastic deceleration of economic growth may weaken the ability of fiscal authorities to collect enough budget revenues to finance debt obligations and generous social expenditures. Over January-July, social payments grew by a real 58.5% yoy and will continue to increase. Starting September 1st, the government once again raised wages for budget sector employees by 15% and the minimum wage by 7% to UAH 332 ($65.7). As a result, the so far positive fiscal outlook may reverse in the fall this year.

In mid-September, the government approved the draft fiscal budget for 2006 and passed it to the parliament for consideration. Next year, state budget revenues and expenditures are estimated at UAH 118.7 billion ($23.5 billion) and UAH 127.4 billion ($25.2 billion).

Where Opportunities Emerge.

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer Rudkin

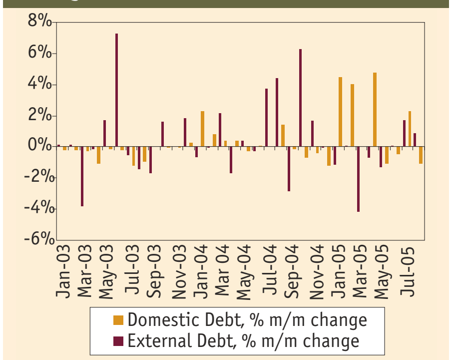
The deficit is forecasted to reach almost UAH 10 billion (about $2 billion). Although it represents less than 2% of 2006 GDP, it is more than 40% yoy higher due to larger amounts of credits to be allocated from the budget. Despite rather moderate growth of both revenues and expenditures, the successful execution of 2006 budget parameters may be quite a challenging task.

Taking into account this year's macroeconomic performance and expected further worsening of external conditions, the government's forecast for GDP growth for 2006 looks overly optimistic. In addition, the government will need to solve the problem with VAT refund arrears. Moreover, there are some losses expected in tax revenues due to the 2 percentage points (pps) reduction in the payroll tax and the 0.75 pps cut in the rate of duty on non-cash foreign exchange operations. On the expenditure side, the government increased investment spending (the development expenditures), although their share in total budget expenditures remained at a negligibly low 20% level. The rest will be directed to finance substantial social obligations taken in 2005 and additional increases in pensions and the minimum wage scheduled for 2006. As a result, the actual fiscal gap in 2006 may be higher than the targeted figure. Another socially-oriented budget coupled with two-digit inflation and slow economic reforms may have negative effects on the country's overall economic development in the medium-term.

The targeted budget deficit for 2006 is planned to be financed through increases in privatization revenues and new borrowings. In 2006, the government plans to receive UAH 8.1 billion ($1.6 billion) from privatization. The ambitious target may be realistic in case a number of strategic enterprises (like Ukrtelecom, Odessa port plant, etc.) are included in the privatization program for next year. This year's poor privatization performance should be primarily attributed to the controversial re-privatization issue. Over January-August 2005, receipts from privatization amounted to UAH 694.3 million, representing less than 10% of the targeted amount (UAH 6.99 billion). At the same time, the privatization plan for 2005 may still be fulfilled if the re-sale of Kryvorizhstal is successful. The auction is scheduled for October 24th with an asking price of $2 billion for 93.02% of shares. However, fair and transparent resolution of the Kryvorizhstal deal will not be sufficient to revive the privatization process since there are about 30 more enterprises whose privatization may be reconsidered. Moreover, recent scandals regarding the re-privatization of Nikopol Ferroalloy Plant negatively affected Ukraine's international image. Hence, the crucial condition for the privatization process to be successful this and next year is extensive government actions to improve Ukraine's investment climate and international image.

According to the draft budget law for 2006, new borrowings on both domestic and external markets will amount to UAH 11.6 billion ($2.3 billion). At the same time, service and principal payments are estimated to reach UAH 10.1 billion ($2 billion). As a result of fairly low net borrowings, the public debt-to-GDP ratio is expected to decline to about 14%. Unlike this year, the government has decided to place greater weight on external borrowing in 2006 — UAH 7 billion ($1.4 billion), out of which $500 million is expected to be received from International Financial Institutions (IFIs). In 2005, the government actively issued domestic T-bills to compensate for modest privatization revenues and reduce the cost of external borrowings. Over January-August, domestic debt increased by 8% year-to-date (ytd) to UAH 22.6 billion ($4.4 billion) while external debt declined by 4.5% ytd to $11.6 billion. A slight increase in external debt during July-August may be attributed to an increase in the country's obligations to the World Bank under the Second Programmatic Adjustment Loan (PAL-2) and the First Development Policy Loan (DPL-1).

Change in Public Debt Structure, 2003-2005

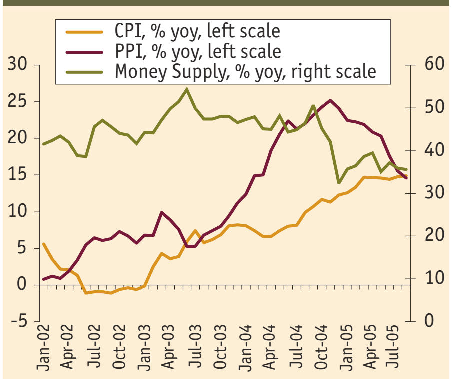


Source: Ministry of Finance

Monetary Policy

In August, the monthly consumer price index (CPI) remained unchanged from the previous month's figure. Although it kept increasing in annual terms to 14.9% yoy, the achieved inflation level may be considered a success in light of considerable inflationary pressures from ongoing growth in gasoline prices, loose fiscal policy and NBU purchases of foreign exchange. Favorable consumer price performance in August should be attributed to deceleration of food inflation to 18.5% yoy on the back of slower price growth for sugar, meat and potatoes. However, further increases in social payments, which stimulate consumption (particularly of lower income groups, whose spending on food accounts for the largest share of their basket), may reverse this trend in the coming months. Gasoline prices gained 11.8% month-over-month (mom), contributing to further acceleration of non-food prices. In annual terms, however, non-foods reported the lowest rate of inflation, 5.1% yoy. The recent surge in gasoline prices will spur rapid growth in transportation tariffs, which already advanced by 21% yoy. Together with an almost 11% yoy increase in the cost of public utilities, they caused service tariffs to accelerate to 10.3% yoy. In August, the producer price index (PPI) continued to decelerate, reaching 14.6% yoy in July.

Prices and Money Supply Dynamics, 2001–05



Source: State Statistics Committee, National Bank of Ukraine

Considering the economic growth slowdown and worsening of Ukraine's foreign trade balance, the National bank of Ukraine (NBU) adhered to the policy of maintaining exchange rate stability. Following the sharp hryvnia appreciation in April, the official exchange rate remained almost unchanged at UAH/$5.05 during May-September. The cash exchange rate showed larger short-term volatility in both directions responding to the rumors regarding possible further hryvnia strengthening and political instability. It is very likely, however, that the exchange rate will remain stable through the end of the year. The main objective of monetary policy in 2006, defined by the NBU, will be stability of the national currency exchange rate. At the same time, the NBU reserved some flexibility in its actions, forecasting the average exchange rate for next year within a rather wide range — UAH/$5.0-5.2.

State Budget Parameters for 2005-2006

	Amended Budget for 2005		Draft Budget for 2006		
	UAH billion	% of GDP	UAH billion	% of GDP	%, yoy growth
Revenues	106.7	24.5	118.7	23.2	11.25
Expenditures	114.6	26.3	127.4	24.9	11.17
Budget deficit*	-7.05	-1.62	-9.9	-1.93	40.4
Consumer inflation, %, eop	9.8		8.7		
Annual GDP growth, %	8.2		7.0		
Nominal GDP, UAH billion	436.0		512.5		

* Including net credits to the State Budget

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

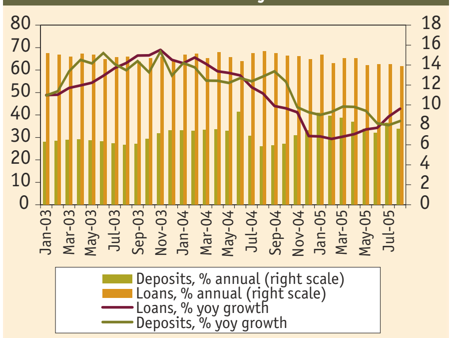
Kyiv Office, Ukraine
21, Pushkinska Street, Suite 40
Kyiv 01004, Ukraine
Tel: (380-44) 244-9487 Fax: (380-44) 244-9488
E-mail: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (380-57) 714 1180 Fax: (380-57) 714 1188
E-mail: kharkov.office@sigmableyzer.com.ua

So far, to keep the national currency stable, the NBU has continued to purchase the surplus of foreign currency on the interbank market. The net purchases of foreign currency in August amounted to $736 million, up from $397 million a month before. This allowed the NBU to further replenish its gross international reserves to $14.5 billion at the end of August. However, being aware of the inflationary nature of such measures, the NBU tried to reduce speculative inflow of foreign exchange into the country. In particular, starting September 9th, the NBU introduced a 20% reserve requirement on foreign currency loans with a maturity of less than 180 days attracted from abroad. To balance the foreign exchange market, the central bank partly liberalized interbank trading at the beginning of September. Commercial banks were allowed to buy and sell foreign currency during the same trading day, while previously individual banks could be either seller or buyer of foreign currency. At the same time, the NBU continued the practice of partial purchases of excess foreign currency supply in August.

To contain inflation, the central bank raised its refinancing rate in mid-August by 0.5 percentage points (pps) to 9.5%. On September 1st, it tightened regulations on reserve requirements (reserve requirements on deposits were raised from 7% to 8%, commercial banks were required to form 100% of the required reserves on a daily basis, up from 80%). Although some of the measures were slightly softened shortly thereafter (daily formation of requires reserves were allowed at 90%), the NBU limited commercial banks' access to the central bank's refinancing resources. Despite these measures, it is unlikely that the targeted year-end inflation level of 9.8% yoy will be achieved. The reason lies in the limited monetary influence on inflation so far.

Loans and Deposits Growth and Interest Rate Dynamics



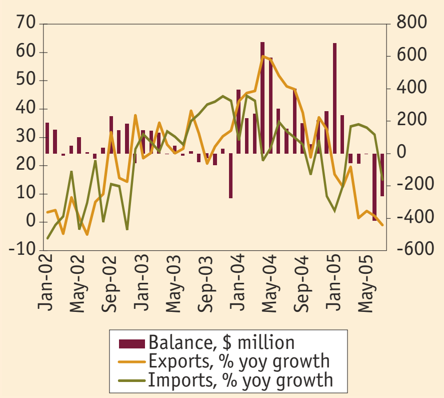
Source: National Bank of Ukraine

As a result of the new regulations, September registered an increase in interest rates on the interbank market while commercial banks experienced a shortage of liquid financial resources. Since interbank resources became more expensive, commercial banks started to increase their interest rates on deposits. During the first eight months of the year, the average deposit interest rate declined from an annual 9.2% in January to 7.6% in August, which is below the average inflation rate for the period. In addition, banks actively sought alternative financial resources through issuing bonds or negotiating syndicated credits. However, it is expected that the credit interest rate will start growing in the near future. Declining credit interest rates since the beginning of the year allowed commercial banks' lending activities to grow at an accelerating pace. The growth of bank credit to the private sector increased to 42.8% in August, up from 30.5% yoy in January.

International Trade and Capital

In January-July, the surplus in the trade of goods account declined to $118 million, more than 20 times lower than in the same period last year. For the fifth month in a row, the merchandise trade balance reported a deficit of $263 million in July. At the same time, the deficit narrowed slightly compared to the previous month due to considerable deceleration of imports growth to 15% yoy, down from 31% yoy in June. Cumulatively, the growth of imports exceeded that of exports by three times. For the first time since mid-2002, monthly exports declined by almost 1% yoy in July. Robust growth in the previous months, especially in the first quarter of 2005, allowed exports to report cumulative 7.5% yoy growth over January-July.

Merchandise Trade Performance, % yoy growth



Source: State Statistics Committee

By product breakdown, cross border metals sales remained the largest contributor to growth of goods exports over January-July. At the same time, drastic deceleration of exports growth since April 2005 may be explained by the substantial reduction in the pace of metallurgy export expansion from above 50% yoy in 2004 to below 20% yoy over January-July 2005. The deceleration is explained by lower world demand for metals and April's sharp national currency appreciation. Exports of machinery and equipment account for the second largest share in total merchandise exports. However, it declined by 14.7% yoy in January-July, in contrast to the more than 30% yoy growth in 2004. On the imports side, imports of energy resources, accounting for the largest share in total imports, advanced by 11% yoy over the period. Oil and gas imports were on the decline in July, explaining total imports deceleration that month. On the positive side, machines and equipment imports increased by 35.5% yoy.

Sharp deceleration of exports and acceleration of imports in the first half of 2005 resulted in a narrower current account (CA) surplus as compared with the previous year. In fact, the CA surplus in 1H 2005 was more than 40% yoy lower. Despite expected further worsening of Ukraine's foreign trade balance through the rest of the year, it is unlikely to be strong enough to erode the CA surplus altogether by the end of the year.

Other Developments and Reforms Affecting the Investment Climate

Following continuing dissent among top country officials, the President of Ukraine dismissed the government of Ms. Yulia Tymoshenko and the Secretary of the National Security and Defense Council Mr. Poroshenko on September 8th. A few days earlier, the State Secretary of Ukraine Mr. Zinchenko resigned, emphasizing corruption at top levels. The President appointed Mr. Yekhanurov as acting prime minister. From the second attempt, only after Mr. Yushchenko enlisted the support of the "Regions of Ukraine" party of his former rival Mr. Yanukovich, the Ukrainian parliament endorsed Mr. Yekhanurov as Prime Minister of Ukraine.

According to EC representatives, Ukraine may still be granted market economy status from the EU in the fall this year. Obtaining such status will expedite Ukraine's accession to the World Trade Organization (WTO) and may enhance negotiations on signing a free-trade agreement with the EU. At the same time, due to the recent government reshuffle, the beginning of talks regarding joining the WTO was postponed until mid-October. In the meantime, however, Ukraine continued its negotiations to complete bilateral agreements on joint access to the market of goods and services. In September, Ukraine signed the respective protocol with Iceland and signed the memorandum on mutual understanding on Ukraine's joining the WTO with Peru. However, to enter WTO by the end of 2005, Ukraine should endorse all necessary legislation and sign the agreements on joint access with the remaining 10 countries, including the US and Australia, during the next two months.

At the end of August, the United States lifted trade sanctions imposed on Ukraine in 2002, recognizing Ukraine's government efforts in the field of intellectual property rights protection. At imposition, the cost of the sanctions (in the form of 100% duty on 23 of Ukraine's export goods) was estimated at $53 million. The lifting of the sanctions may be the first step on the way to granting Ukraine functioning market economy status from the US.