Ukraine
Macroeconomic Situation

August 2006

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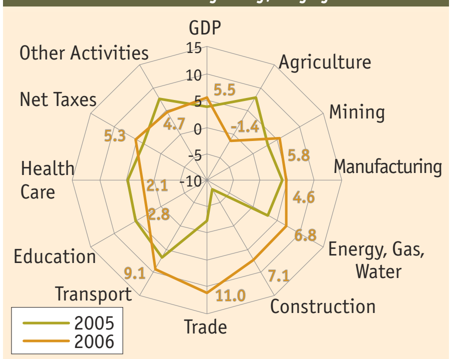
Summary

- In July, the Ukrainian economy continued to enjoy broad-based growth. Real GDP grew by 7.7% yoy in July, bringing cumulative growth to 5.5% yoy.
- Over January-July, the consolidated fiscal deficit was maintained at a reasonable 0.5% of period GDP.
- With a sluggish privatization process this year, the government plans to resume both domestic and external borrowings in the fall. So far, total public debt has declined by 5.1% year-to-date.
- Consumer price index (CPI) growth moderately accelerated to 7.4% yoy in July. The impact of the second wave of service tariff increases was to a large extent compensated for by continuing food deflation.
- Rebounding investment demand and more expensive imported energy resources stimulated the growth of imports. However, in June the growth rate of Ukraine's merchandise exports outpaced that of imports on the back of favorable conditions for exports of metallurgical products, machinery, equipment, and transport vehicles.
- Over January-June, FDI inflow amounted to $1.7 billion, which is almost 3.5 times more than in the respective period last year.
- At the end of August, Standard & Poor's international rating agency confirmed Ukraine's credit ratings.

Economic Growth

The Ukrainian economy continued to show remarkable growth in July, underpinned by strong external and domestic demand. According to preliminary data from the State Statistics Committee (SSC), Ukrainian GDP advanced by 7.7% yoy in July, bringing cumulative growth to 5.5% yoy over January-July. The major sectors contributing to this growth were industry, domestic trade, transport and construction.

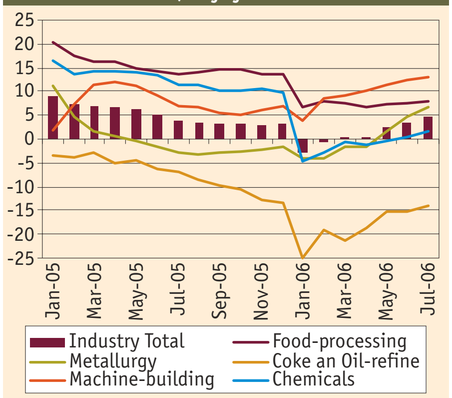
Real GDP and Value Added Growth by Sector in January-July, % yoy



Source: State Statistics Committee

On account of the buoyant growth of residential construction, several Greenfield projects in mining and energy sectors, and a number of repair and infrastructure works, the construction sector demonstrated a 7.1% yoy increase in value added between January and July. At the same time, the growth was achieved on a low base effect as value added declined by about 8% yoy over the respective period last year. High domestic demand and acceleration of exports contributed to an 11% yoy increase in wholesale and retail trade. Value added in transport grew by 9.1% yoy over January-July, which is closely linked to recovered industrial production (volumes of cargo transportation grew by 3.7% yoy) and robust growth of household income (passenger traffic was 2.7% yoy higher).

Industrial Output by Selected Industries, 2005-06, % yoy cumulative



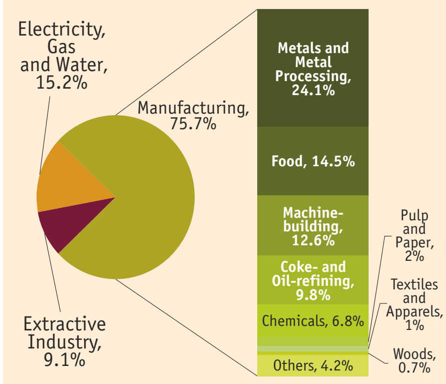
Source: State Statistics Committee

Slight deceleration in GDP growth from 9.3% yoy in June to 7.7% yoy in July is attributable to the decline in agriculture. Over January-July, agriculture reported a 1.4% decline in value added. Despite good prospects for this year's harvest, it is expected to be lower than last year's. In addition, overproduction on some commodity markets (such as milk, meat, etc.) resulted in a notable reduction in their purchase prices, and hence a decline in production output. Most likely, agriculture will demonstrate a small reduction of value added for the whole year, which will be more than compensated for by further expansion in the service and industrial sectors.

Supported by vigorous growth in metallurgy, machine-building, mining and electricity, gas and water, industrial production surged by 11.4% yoy in July, bringing January-July growth to 4.8% yoy (up from 3.6% over 1H 2006 and 0.2% over 1Q 2006). In particular, metallurgy reported an 18.9% yoy increase in output in July, which is, however, slightly lower than in the previous month (21.9% yoy). The deceleration may be attributed to the resumption of a downward trend for steel prices on Asian markets, an important destination of Ukraine's metallurgical exports. However, as steel prices on other markets (such as Europe, North America, etc.) continued to grow, the prospects for output growth in metallurgy are rather favorable.

Closely linked with metallurgy and construction, and helped by strong external demand, machine-building reported a 13.1% yoy increase in output for January- July. On the back of favorable external conditions, output in the chemical industry and electricity, gas and water grew by 1.6% yoy and 6.8%, respectively. In contrast, a 5.8% yoy increase in the extractive industry's output was primarily driven by domestic demand. On the downside, declines in output continued to be observed in coke and oil-refining (down by 13.9% yoy) and textiles and apparels (down by 2.8% yoy).

Composition of Industrial Output, January-July 2006*



* Approximation, based on industrial sales statistics
Source: State Statistics Committee, The Bleyzer Foundation

Considering current real sector performance, the government upgraded its forecast of real GDP growth for 2006 to 6% yoy while industrial output is expected to increase by real a 5-5.5%. Taking into account that the price for imported gas will remain unchanged through the end of the year, this forecast looks realistic. At the same time, the government's 2007 GDP forecast of 6.5% yoy may be overly optimistic considering the rise in imported gas prices to $130 per 1,000 m3 (up from the current $95 per 1,000 m3). In 2006, unexpectedly high real GDP growth (the government as well as domestic and foreign experts originally forecasted GDP to grow at 2.5-2.8% yoy in 2006) is partially explained by enterprises' internal capacities to absorb the gas price shock (through a reduction in their profitability) and resumption of world steel price growth (contrary to the expected gradual reduction throughout the year). Next year, external conditions for Ukraine's steel and chemical exports may not be as favorable as in 2006. Thus, GDP growth at about 5% yoy for 2007 looks more realistic.

Fiscal Policy

Despite improving real sector performance, July's collection of revenues to the general fund of the central budget was under-fulfilled by 4.3%, for the first time since the beginning of the year. However, due to above-target collections in previous months, cumulatively revenues were 1.2% above target over January-July. Under-execution of tax revenues by 6.2% in July was primarily related to poor enterprise profit tax (EPT) receipts, which were 27.3% below target. Poor EPT collections this year is attributed to the decline in industrial sector profitability, a change in EPT tax accounting methodology and tax evasion-for 1H 2006, EPT tax arrears amounted to almost UAH 2 billion ($400 million). However, over-fulfillment of VAT proceeds by 12.7% over January-July (up by a real 25.9% over the period), robust growth of personal income tax collections (up by a real 26.4% over Janu-

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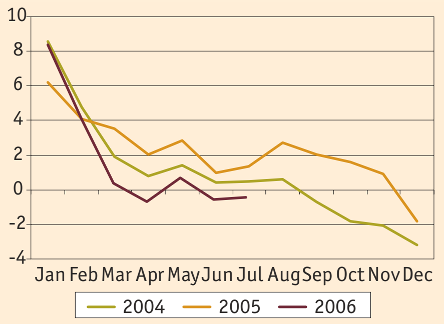
ary-July), and under-execution of budget expenditures (expenditures from the general fund of the central budget were 4.5% below target) allowed the government to maintain the consolidated fiscal deficit at a controllable 0.5% of period GDP.

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



Source: Ministry of Finance

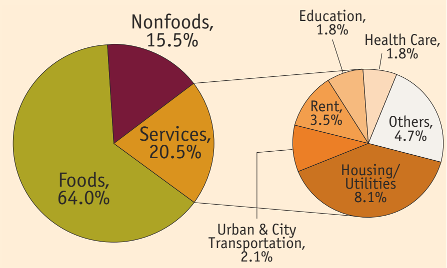
So far, the fiscal deficit has been primarily financed by the remainder of the funds received from last year's privatization of Kryvorizhstal. Considering the sluggish privatization process this year (proceeds from privatization amounted to UAH 185 million ($36.6 million), or 8.6% of the full-year targeted amount) and the traditional loosening of fiscal policy at the end of the year, the government plans to start issuing new domestic T-bills in September this year. According to the 2006 State Budget Law, new borrowings on the domestic market are envisaged in the amount of UAH 4.55 billion ($0.9 billion). In addition, the government may issue Eurobonds in the amount of about $500 million, which is likely to take place in October-November. So far, in the absence of new borrowing (both domestic and external), Ukraine's public debt has continued to decline. Since the beginning of the year, total public debt (public and publicly guaranteed debt) has declined by 5.1% to $14.7 billion, or about 14% of forecasted full-year GDP.

Monetary Policy

In July, the government carried out the second wave of service tariffs increases. In particular, starting July 1st, gas prices for households and budget organizations were raised by about 85%, which were still below the price for imported gas ($95 per 1,000 m3). In addition, starting July 12th, the cost of railway passenger carriage was increased by 50%. Surging by 28.5% yoy, services were the most inflationary component of consumer price index (CPI) growth. Another inflationary component was gasoline prices, which expanded by 24.1% yoy over the month, responding to considerably higher international crude oil prices and a number of increases in Russia's crude oil export duty (the latest was in June, when the duty was increased by 7.2%). However, due to its small share in the consumer basket (0.8%), it had a rather limited effect on CPI dynamics.

However, June's surge in service tariffs was to a great extent compensated for by continuing food price deflation. Foods, which account for about 64% in the consumer basket, reported a 1.8% month-over-month (mom) decline in prices. Food price deflation has been observed for five months in a row and is primarily attributed to overproduction of several products and a high base effect. In annual terms, food inflation decelerated to 3% yoy, the lowest level since mid-2003. As a result, CPI growth accelerated just moderately to 7.4% yoy in July. Considering better-than expected consumer inflation performance during the first eight months, year-end inflation may be below 9% in 2006.

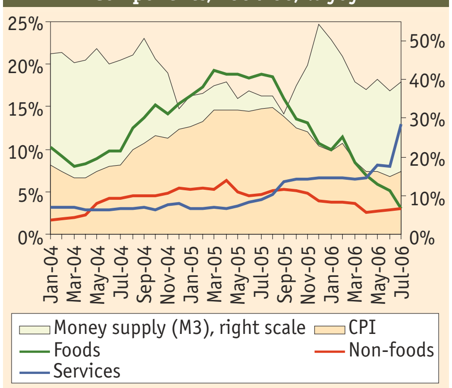
Composition of Consumer Basket, end of 2005



Source: Ministry of Economy of Ukraine

Consumer price developments this year were favored by moderate growth of monetary aggregates. In turn, developments of monetary aggregates were closely related to exchange rate policy. Since mid-2005, the exchange rate of hryvnia to US dollar has been stable. Under political instability and unclear macroeconomic prospects (related to the price increase for imported energy resources), keeping the exchange rate unchanged was seen by NBU authorities as an important measure to retain confidence in the future economic stability of the country. In addition, although the nominal exchange rate remained unchanged, the hryvnia depreciated against other currencies, causing the real effective exchange rate to depreciate by 5.1% over January-July, according to Ministry of Economy calculations.

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

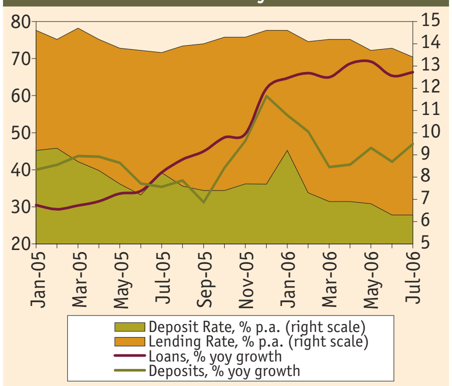


Source: State Statistics Committee

To maintain a stable exchange rate in July, the NBU continued to intervene in the forex market. Thanks to stabilization of the cash foreign exchange market, acceleration of exports, robust FDI, and active commercial bank borrowing from abroad, the net balance of NBU interventions was positive for the third consecutive month. This helped the NBU to further replenish its international reserves to $18.1 billion at the end of July.

As a result of the NBU's net purchases, the growth of the monetary base slightly accelerated from 22.4% yoy in June to 23.8% yoy in July; however, it has decelerated considerably since the beginning of the year (40.1% yoy growth in January). Money supply (M3) grew by 39.3% yoy in July, up from 37% yoy a month before, thanks to acceleration of the monetary base and deposit growth.

Loan and Deposit Growth and Interest Rate Dynamics



Source: National Bank of Ukraine

The growth of deposits accelerated to 47% yoy in July, up from 42.2% yoy in June. At the same time, the growth of commercial banks credit operations considerably outpaced that of deposits. In July, credit portfolios of commercial banks expanded by 66.3% yoy, up from 65.3% in June. Further expansion of credit operations on the back of a rather tight liquidity stance became possible thanks to active commercial banks' borrowing from abroad. To support banking sector liquidity, the NBU announced the second reduction in reserve requirements for this year. Starting August 1st, reserve requirements for term and demand deposits in national currency were reduced to 2% pa and 3% pa, respectively, while those in foreign currency to 3% pa and 5% pa respectively. The differentiation of reserve requirements by currency may be related to the NBU measures to reduce growing foreign exchange risk in the banking system and dollarization of the economy.

International Trade and Capital

In June, for the first time since early 2005, the growth rate of Ukraine's merchandise exports outpaced that of imports. In particular, the growth of exports accelerated to 17.4% yoy (up from 11.5% increase in June and a 4.4% yoy decline over 1Q06), while the growth of imports decelerated to 12.7% yoy (down from 30.1% yoy a month before and 30.2% yoy over the first quarter). As a result, cumulative growth rates constituted 2.1% yoy and 22.1% yoy respectively.

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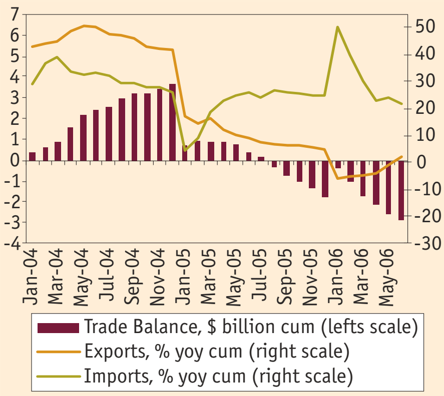
Acceleration of exports growth over May-June is primarily attributed to growing world metal prices and robust external demand for Ukraine's chemicals, machines, equipment, and transport vehicles. In particular, exports of metallurgical products grew by 22.3% in June, up from 6.2% a month before. However, it was not enough to compensate for the considerable decline in the four previous months. As a result, the export of metals still reported a 0.4% yoy decline to date.

Merchandise Trade Flows in 2004–2006



Source: State Statistics Committee

The notable deceleration of imports may be explained by considerable deceleration of mineral products imports, the weightiest component in total merchandise imports; they increased by only 12.3% yoy over 1H 2006, although the prices for imported gas and crude oil were considerably higher than last year. A possible explanation for this could be a decline in imported volumes of these commodities. The deceleration of imports may also be attributed to the vanished low base effect (May 2005's reductions in a number of import duties started to show up in June's import statistics). More expansive imported mineral resources (particularly, gas and crude oil), Ukraine's production and export of gasoline declined sharply, while exports of natural gas almost ceased. However, these declines were more than compensated for by a 12.5% yoy increase in the export of chemicals and a 16% yoy increase in exports of machines, equipment and transport vehicles over 1H 06.

The commodity structure of Ukraine's imports continued to improve. The share of mineral products in total merchandise imports declined to 32.3% for January-June, down from 41% at the beginning of the year. At the same time, the share of machines, equipment and transport vehicles expanded to 27.5%, up from 23.4% at the beginning of the year. The almost 40% yoy increase in imports of these goods over 1H 2006 reflects strong investment and consumer demand in the country.

Thanks to improved export performance, Ukraine's merchandise trade balance started to improve. In particular, the foreign trade deficit constituted $2.9 billion at the end of June, up by about $300 million in June (about half the growth of the previous month). At the same time, according to SSC data, the surplus of Ukraine's foreign trade of services made up $1.9 billion for 1H 2006, suggesting that the current account deficit did not exceed $1 billion over the period. Despite political uncertainties, FDI inflow amounted to $1.7 billion for 1H 2006, which is almost 3.5 times more than for the respective period last year. The largest amounts of FDI were directed to the financial sector, which is related to a number of commercial banks acquisitions, followed by real estate, metallurgy, and trade. Robust inflow of FDI over 1h 2006 and active commercial bank borrowing from abroad gives reason to expect a considerable financial account surplus, which will not only securely cover the expected CA deficit at 2.1% in 2006 but also allow the NBU to replenish its international reserves to end-of-2005 levels.

Other Developments and Reforms Affecting the Investment Climate

At the end of August, Standard & Poor's confirmed its 'BB–' long-term foreign, 'BB' long-term local, and 'B' short-term sovereign credit ratings for Ukraine with a stable outlook. S&P acknowledged the better than expected macroeconomic performance of Ukraine to date (higher economic growth, lower inflation, and a controllable fiscal deficit) and the improved political situation. On the other hand, lack of progress with structural reforms and economic modernization were the primary reason for keeping Ukraine's ratings unchanged.