Ukraine Macroeconomic Situation

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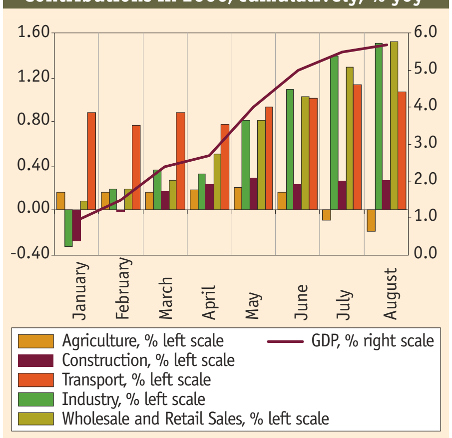
Summary

- Supported by dynamically growing industry, trade and transportation, real GDP grew by 5.7% yoy over January-August.
- Robust GDP growth contributed to above-target budget revenues collection. Coupled with under-execution of budget expenditures, the consolidated fiscal deficit reported a 0.84% of period GDP surplus over January-August.
- In mid-September, the government presented the draft budget law for 2007, envisaging a fiscal deficit at 2.6% of GDP.
- Consumer price index (CPI) growth remained unchanged at 7.4% yoy in August, favored by the continuing slowdown in food prices.
- Thanks to improving export performance, the current account deficit narrowed to $39 million in the second quarter (2Q) of 2006.
- A surplus in financial and capital accounts, achieved on account of robust FDI inflows and growing private sector borrowing from abroad, allowed the NBU to start replenishing its international reserves in 2Q 2006.
- A recent World Bank/International Finance Corporation report indicated an improving business environment in Ukraine in 2006.

Economic Growth

During August, Ukraine continued to enjoy a high rate of economic growth. Over the month, GDP grew by 7.1% yoy, bringing cumulative growth to 5.7% yoy. The growth was supported by robust external and domestic demand, which translated into strong recovery of industry, wholesale and retail trade, construction and transportation.

Real GDP Growth by Selected Sector Contributions in 2006, cumulatively, % yoy

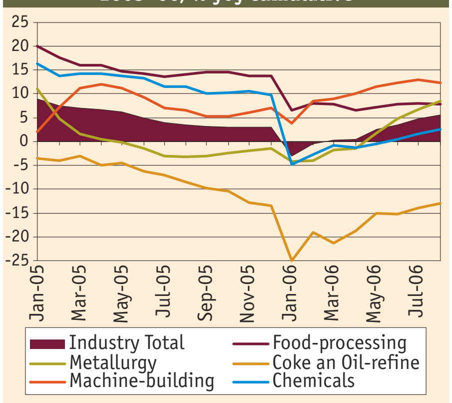


Source: State Statistics Committee, The Bleyzer Foundation

Over January-August, the construction sector demonstrated a 7.1% yoy increase in value added (in contrast to a 7.7% decline over the respective period last year), boosted by strong demand for new residential housing and industrial buildings as well as a number of repair and infrastructure works. Robust growth of household income (by a real 19.5% yoy over January-July), booming consumer credit and a sharp rebound in industrial production over the last four months contributed to a 13.2% yoy increase in wholesale and retail trade between January and August and a 8.7% yoy increase in transport.

A favorable external environment and robust domestic demand encouraged the rapid expansion of industrial production. Over May-August, monthly industrial output grew by 10% yoy on average. As a result, eight month cumulative growth in industry reached 5.4% yoy in contrast to the meager 0.4% yoy growth over January-April. The main contributors to industrial output growth were metallurgy, machine building, food processing, utilities and mining. Benefiting from high world steel prices and recovered construction, metallurgy posted a 19.7% yoy increase in August, bringing cumulative growth to 8.4% yoy. The need to renovate existing production capacities and introduce energy saving technologies prompted a 12.3% yoy increase in machine building over January-August. Output in food processing grew by 7.7% yoy over the period, stimulated by high domestic demand. Production of chemicals and electricity, gas and water increased by 2.5% yoy and 7.4% yoy between January and August, taking advantage of strong external demand. Expensive imported fossil fuels triggered a 6.2% yoy output increase in mining over the period under review. On the downside, output in coke and oil-refining continued to decline, though at a slower pace (-12.9% yoy over January-August compared to more than a 15% yoy decrease over 1H 2006).

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



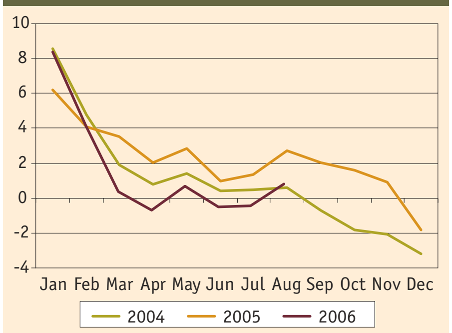
Source: State Statistics Committee

Dynamically growing industry and trade more than compensated for the slowdown in agriculture. The cumulative decline in agricultural value added worsened from 1.4% yoy in January-July to 2.3% yoy in January-August due to the moderate harvest this year compared to 2005. Although the contribution of agriculture is expected to remain negative in 2006, it will be rather small. At the same time, the current evolution of Ukraine's main macroeconomic indicators makes the revised government forecast of real GDP growth at 6% yoy for 2006 quite realistic. High reliance on exports makes Ukraine's economy quite vulnerable to changes in the external environment. Although the prospects for Ukraine's economy in 2007 look rather good (high domestic demand, buoyant investment activity), further increases in the price for imported gas in 2007 and the likely decline of world steel prices will not allow GDP growth to accelerate beyond the 2006 level. We expect GDP to grow by about 5.5% yoy in 2007.

Fiscal Policy

Unlike the previous month, collections of revenues to the general fund of the central budget were 1.8% above the target in August. The over-fulfillment was achieved thanks to the over-execution of VAT proceeds and non-tax revenues. In particular, VAT collections were 33.3% above target in August. At the same time, this figure is exaggerated as VAT refunds were under-fulfilled by almost 24%. As a result, VAT refund arrears increased to UAH 5.6 billion (more than $1.1 billion) as of September 1st, up from UAH 4.4 billion at the beginning of the year. On the back of higher rent on domestic extraction of crude oil and natural gas, and larger dividend payments of state-owned enterprises, non-tax revenues became the second largest contributor (after VAT proceeds) to consolidated budget revenues. On the downside, corporate tax collections continued to be under-executed by 13.2% over January-August due to lower profitability of industrial enterprises (though improving over the recent months) and increased tax evasion. Under-execution of foreign trade tax collections by 24.4% over the period was primarily due to unrealized gas re-export plans and deceleration of imports.

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



Source: Ministry of Finance

At the same time, expenditures of the general fund of the central budget were over-executed by 8.9% in August. However, due to considerable under-fulfillment in the previous periods, cumulative budget expenditures were almost 4% below target. Due to over-execution of revenues and under-execution of expenditures, the central budget deficit declined from UAH 4.4 billion over January-July to about UAH 1.7 billion over January-August. Thanks to surpluses in local budgets, the consolidated budget reported a surplus of UAH 2.5 billion or 0.8% of period GDP during the first eight months of 2006.

Current fiscal sector performance suggests considerable fiscal loosening at the end of the year as the 2006

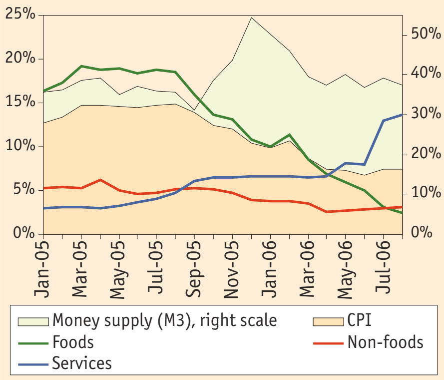
Budget Law envisages a budget deficit at 2.6% of GDP. According to the law, more than 85% of the targeted fiscal deficit is planned to be financed through privatization revenues (UAH 2.1 billion from new privatization deals, with the rest covered by funds received from the privatization of Kryvorizhstal in the fall of 2005). However, as of September 1^{st}, privatization proceeds amounted to less than UAH 280 million, representing only 13.2% of the targeted amount. To secure enough resources to finance the expected year-end fiscal deficit, the government resumed issuance of domestic T-bills and Eurobonds in September, which had been terminated in July and October of last year respectively. In August, however, with the absence of new issuance of debt instruments, Ukraine's public debt continued to decline. In particular, public debt has declined by almost 6% since the beginning of the year to $14.6 billion.

In mid-August, the government presented the draft 2007 Budget Law, which a few weeks later was taken by the parliament as a basis for consideration. Next year, state budget revenues and expenditures are estimated at UAH 136.2 billion ($27 billion) and UAH 151.3 billion ($30 billion). Despite a moderate increase in revenues and expenditures, the successful execution of budget parameters may be a challenging task. In particular, the deficit is forecasted to represent less than 2.6% of 2007 GDP, which is planned to be financed by privatization proceeds (estimated in the amount of UAH 10 billion, or approximately $2 billion) and new borrowings on the domestic and external markets at about UAH 9.8 billion. Unlike the previous years, the government has made public in advance the list of enterprises suggested to be privatized next year. Though the list contains about 480 enterprises, it may be insufficient to raise the targeted amount. At the same time, this amount may be realistic if the proposed innovation to sell land that belongs to the enterprise together with the enterprise is approved by the parliament.

In addition, the government developed the draft budget on the back of a rather optimistic macroeconomic forecast. In particular, despite the fact that the imported gas price was predicted to increase from the current $95 per 1000 m^3 to $135 per 1000 m^3, GDP was forecasted to grow at a real 6.5% yoy. Moreover, the government assumes that the external environment will be favorable enough to allow a small surplus in foreign trade of goods and services. Both assumptions we consider to be overly optimistic. Furthermore, the government plans to reduce the rate of obligatory profit transfers to the budget from state-owned enterprises from the current 50% to 15% and the duty on foreign exchange sales from the current 1.3% to 1%. Though the personal income tax (PIT) rate will be raised to 15% (as the transition period during which the PIT rate was set at 13% expires at the end of this year), these reductions coupled with the government plans to restore special economic zones may make the targeted amount of consolidated budget revenues difficult to attain. On a positive note, the draft budget law envisages a moderate increase in social payments (mainly to compensate for inflation), considerably higher expenditures on economic development and investments, and greater fiscal decentralization (the share of local budget expenditures in consolidated budget expenditures is proposed to increase from 36.2% in 2005 to 43.4% in 2007).

Monetary Policy

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

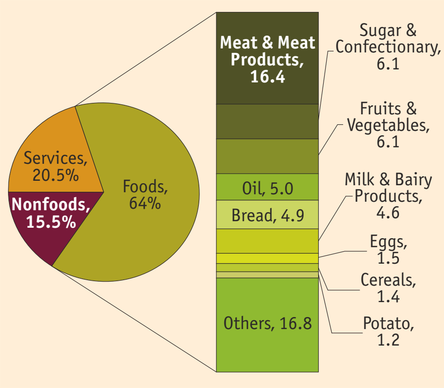


Source: State Statistics Committee

Higher prices for imported energy resources continued to affect consumer prices. As in previous months, the most inflationary components in August remained services and fuels. In particular, service tariffs grew by 30.2% yoy in August. Further acceleration from 28.5% yoy in the previous month was driven by the increasing costs of housing services, water supply and communications. High international prices on crude oil as well as an increase in Russia's crude oil export duty as of August 1st by 8.3% to $216.4 per ton triggered a 12.2% month-over-month (mom) increase in prices for domestic fuels. This translated into 24.6% growth in annual terms.

The consumer price index (CPI) stood at 7.4% yoy in August, unchanged from the previous month. Further growth of service tariffs and non-food prices was compensated for by decelerating food prices. The decline in food prices on a monthly basis, observed since March this year, also continued in August. As a result, annual growth of food prices slowed from 11.4% yoy in February to a meager 2.4% yoy in August. At the same time, while the previous months' deflation was primarily driven by declining prices for meat, milk and dairy products, the deflation was registered on account of sugar, potato, vegetables and fruits in August. Led by a good harvest, the reduction of prices on these products more than compensated for the price growth on bread, cereals, macaroni and flour as the grain harvest was not as good as in the previous year.

Composition of Consumer Basket, end of 2005



Source: Ministry of Economy of Ukraine

Despite the scheduled (25% on electricity as of September 1^{st}) and expected further increases in service tariffs (on heating, water supply, etc.), current price dynamics give reason to expect year-end inflation at about 9% in 2006. At the same time, the Ukrainian parliament adopted a moratorium on increases in gas, electricity, utility and public transportation tariffs in mid-September[1]. According to the moratorium, current tariffs for households should be those applicable as of January 1^{st} 2006. Most likely, however, the moratorium will be abolished, though in exchange for a partial reduction in previously raised tariffs. Although the government has already proposed such measures; we believe the reduction in tariffs will be marginal (as in the other case, this will negatively affect the utility sector performance and put additional pressure on the budget), and thus did not change our year-end inflation forecast.

Lower-than-expected consumer price inflation over the period was also achieved thanks to moderate growth of monetary aggregates. Monetary base performance in August was affected by two opposing forces. On the one hand, acceleration of exports over recent months, active private sector borrowing from abroad, robust FDI, and a relatively stable cash forex market resulted in $500 million of net purchases of foreign currency by the NBU on the interbank market. On the other hand, starting August 1st, the NBU reduced reserve requirements for commercial banks[2] to supply them with necessary liquidity needed for further expansion of credit operations. In sum, the monetary base reported a 0.4% mom decline, contributing to sharp deceleration of monetary base growth in annual terms to 19.5% yoy, down from almost 24% yoy a month before. Reduction of reserve requirements as well as buoyant growth of deposits caused the money multiplier to increase to a record high 2.77 level in August. However, on the back of considerable slowdown of monetary base, the growth rate of money sup-

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[1] The Verkhovna Rada of Ukraine adopted a law that imposes a moratorium on increases of gas, electricity, other utility and public transportation tariffs yet at the end of January 2006, but the law was vetoed by the president. On September 22^{nd}, the parliament overcame the veto. According to the law, the moratorium will be active until the minimum wage is equal to the subsistence level (currently the ratio is about 75%).

[2] Starting August 1^{st}, 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.

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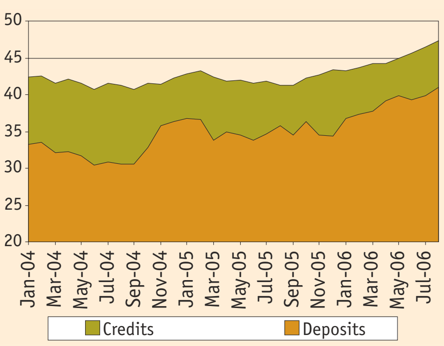
ply (M3) has moderately declined to 37.5% yoy (down from 39.2% yoy in July).

Dynamics of Forex-denominated Loans and Deposits, % of total



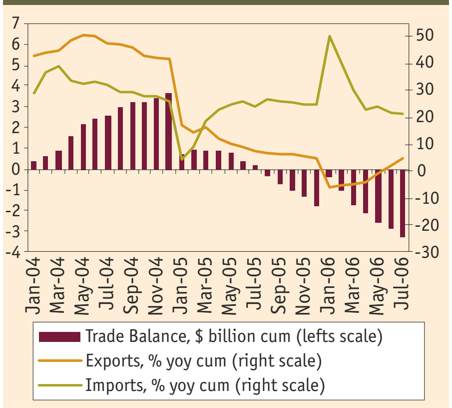
Source: National Bank of Ukraine

A significant reduction of reserve requirements for hryvnia-denominated deposits increased their attractiveness for commercial banks. In turn, commercial banks slightly increased the interest rate on hryvnia deposits to 7.3% pa, while the rate on foreign currency deposits continued to decline to 5.3% pa. The opposite developments were observed for the lending rate; while the interest rate on hryvnia-denominated loans continued to decline to 14.6% pa, the interest rate on foreign-currency denominated loans slightly increased to 11.2% pa. At the same time, due to political turmoil at the beginning of August (related to the formation of the new government) and active borrowing by commercial banks from abroad, forex-denominated deposits and loans continued to grow considerably faster than hryvnia-denominated ones (5.5% mom and 6.8% mom in contrast to 0.3% mom and 3.1% mom, respectively). The reduction of reserve requirements helped commercial banks to further increase their lending operations. In annual terms, credits grew by 65.7% in August. Although the growth is primarily driven by corporate lending, whose contribution exceeds 55%, consumer credits are quickly catching up. Since the beginning of the year, consumer lending grew by 73.3%, which translates into 141.3% yoy growth. Though the volume of consumer credits is still rather small, buoyant consumer lending growth (which is usually treated as a positive phenomenon since it drives consumption and thus economic growth) raises a number of concerns. First, it contributed to the growth of imports, which may increase the country's external imbalances. Second, it puts the whole set of issues such as improvement of credit quality through development of sophisticated credit scoring models, creation and effective functioning of credit bureaus, etc. on the agenda.

International Trade and Capital

In July, export performance continued to improve. On the back of favorable external conditions for Ukrainian metallurgy, chemicals, machines and equipment and transport vehicles, merchandise exports reported 21.1% yoy growth, which translated into a 4.8% yoy increase to date. At the same time, imports demonstrated a moderate 17% yoy increase in July and 21.3% yoy over January-July. Despite recent improvements, the monthly merchandise trade deficit remained negative at $340 million in July, while the cumulative trade deficit widened to $3.3 billion.

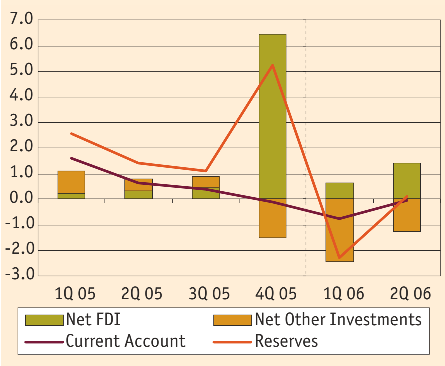
Merchandise Trade Flows in 2004–2006



Source: State Statistics Committee

By export breakdown, exports of metals continued to accelerate in July, bringing the cumulative growth to 4.6% yoy. Strong external demand contributed to further expansion of Ukraine's export of chemicals and machinery (13.5% yoy and 9.2% yoy, respectively). Recovered investment activity and robust growth of household income stimulates the import of metals, machinery, transport vehicles, and food products. Over January-July, imports of these commodities grew by 28.7% yoy, 18.2% yoy, 70% yoy, and 23.3% yoy, respectively. At the same time, imports growth slowdown may be explained by a high base effect and lower volumes of mineral products imports, the weightiest component in total merchandise imports. In particular, imports of mineral products decelerated to 11% yoy, down from 12.3% yoy over January-June.

Balance of Payments in 2005-2006, flow, $ billion



Source: National Bank of Ukraine

Further deterioration of the merchandise trade deficit, though at a considerably slower pace, was partially compensated for by larger surpluses in foreign trade of services and net transfers. In particular, the surplus of foreign trade of services increased to $401 million in 2Q 2006 (compared with $176 million in the previous quarter), while net transfers amounted to $782 million (up from $616 million in 1Q 2006). As a result, the current account deficit shrunk to a meager $39 million in 2Q 2006, bringing the cumulative deficit to less than $800 million, or 2.1% of period GDP.

Unlike in the previous quarter, the financial account reported a surplus of about $160 million, achieved on account of robust FDI inflows and growing private sector borrowing from abroad. In particular, net FDI inflow posted $1.4 billion, mainly directed to the financial sector of Ukraine (during the period, a number of merger & acquisition deals in the banking sector were completed). A similar amount was attracted by the private sector (primarily banks) in the form of long-term non-guaranteed and short-term loans. These amounts more than compensated for the outflow of short-term capital related to buy-out of government securities from non-residents and large demand on cash foreign currency in the first months of the quarter. As a result, in the 2Q 2006 the NBU started to replenish its reserves after a decline by $2.3 billion in the previous quarter. At the end of June, the NBU's net international reserves constituted $17.6 billion, which was equivalent to 3.9 months of future imports of goods and services.

Other Developments and Reforms Affecting the Investment Climate

According to the latest World Bank/International Financial Corporation report, Doing Business 2007: How to Reform, the business environment in Ukraine has improved in 2006. Ukraine was placed 128th out of 175 countries in 2006, compared with the 132nd rank in the previous year, which reflected considerable progress in simplifying business registration procedures (introduction of one-stop shop registration offices, simplification of procedures for obtaining licenses and permits, etc.). At the same time, WB/IFC experts advocated a speed up of economic reforms, particularly in the areas of taxation, foreign trade regulations, and investor protection.

Doing Business in Ukraine 2007

Ease of...	2006 rank	2005 rank	Change in rank
Doing Business	128	132	+4
Starting a Business	101	122	+21
Dealing with Licenses	107	117	+10
Employing Workers	107	109	+2
Registering Property	133	134	+1
Getting Credit	65	59	–6
Protecting Investors	142	141	–1
Paying Taxes	174	174	0
Trading Across Borders	106	98	–8
Enforcing Contracts	26	26	0
Closing a Business	139	135	–4

Source: World Bank

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