Ukraine

Macroeconomic Situation

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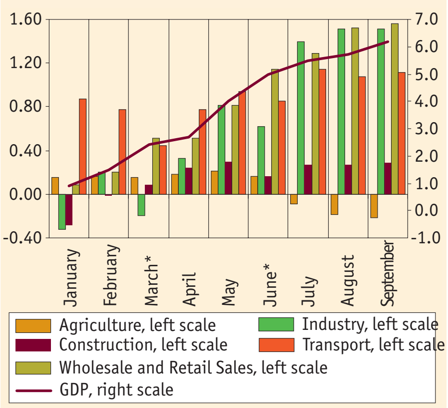
Summary

- Real GDP growth accelerated to 8.9% yoy in September, bringing cumulative growth to 6.2% yoy.
- Above-target budget revenue collections combined with under-execution of expenditures allowed the consolidated budget to achieve a surplus of 0.7% of period GDP. However, successful execution of the 2006 budget may be a challenging task due to under-fulfillment of privatization proceeds.
- Consumer price index (CPI) growth accelerated to 9.1% yoy in September, driven by the further adjustment of service tariffs and an upturn in food prices.
- Favored by strong external demand, Ukraine's export performance continued to improve. However, booming consumption and recovered investment demand stimulated further expansion of imports. As a result, Ukraine's merchandise trade deficit continued to widen in August.
- In late-October, Fitch confirmed Ukraine's long-term sovereign ratings at BB– and improved its outlook from stable to positive.
- During the Ukraine-EU summit, Ukraine and the EU signed visa facilitation and readmission agreements.

Economic Growth

According to preliminary estimates by the State Statistics Committee of Ukraine (SSC), GDP rose by 8.9% yoy in September, with an increase of 6.2% yoy in the nine month total to UAH 350.6 billion ($69.4 billion). This represents a solid increase as compared to the 3% yoy GDP growth reported for January-September last year.

Real GDP Growth by Selected Sector Contributions in 2006, cumulatively, percentage points

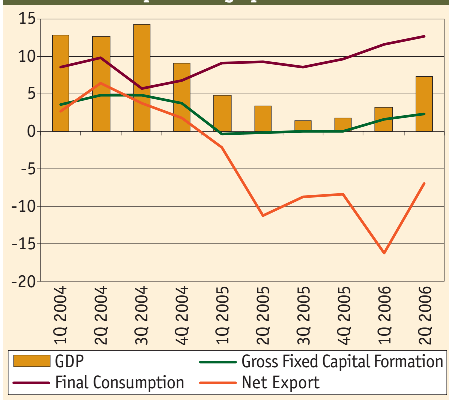


* Revised figures
Source: State Statistics Committee, The Bleyzer Foundation

In the first nine months of 2006, GDP growth was supported by further expansion of value added in wholesale and retail trade, industry, and transport, which more than compensated for a decline in agriculture. In particular, value added in agriculture shrank by 2.3% yoy due to a lower crop yield this year and smaller cultivated area. At the same time, thanks to the good harvest of vegetables, potatoes, sugar-beets and continuing growth in animal production, agricultural performance may improve in the coming months. Nevertheless, the sector's contribution to GDP growth for the year is expected to remain slightly negative.

Strong consumption, robust investment activity and improving export performance stimulated value added growth in other sectors of the economy. According to the GDP data released for the second quarter (2Q 2006), final consumption growth accelerated to 16.2% yoy, up from 14.8% yoy in 1Q 2006. In addition to vigorous private consumption, which rose by 19.9% yoy in 2Q on the back of continuing growth in real household income, government consumption rebounded strongly at 7.3% yoy, up from a 2% yoy increase in the previous quarter. The recovery of government consumption (particularly individual — up by 9.1% yoy in 2Q 2006 compared with a 0.3% yoy decline in 1Q 2006) was reflected in value added growth acceleration in education, health care and housing. Investment demand has been gaining strength, as gross fixed capital formation surged by 10.2% yoy in 2Q 2006 compared with a 8.2% yoy increase in the first quarter of 2006. Favorable external conditions in combination with decelerating imports helped reduce the negative contribution of net exports to GDP growth twice as much as in 1Q 2006.

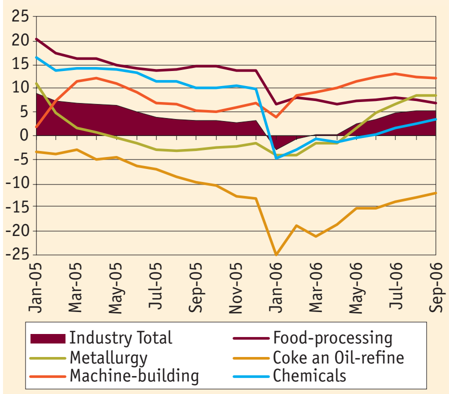
Contributions to GDP Growth, 2004–2006, percentage points



Source: State Statistics Committee, The Bleyzer Foundation

Wholesale and retail trade and transport reported 13.7% yoy and 9.2% yoy increases in value added over the first nine months of the year, respectively, which explain about 45% of the GDP growth over the period. Another 25% and 5% is explained by strong expansion in the industrial sector and construction. Value added growth in construction accelerated to 7.6% yoy over January-September, while the growth rates in manufacturing and utilities increased to 5.4% yoy and 7.6% yoy respectively. Output growth in manufacturing was supported by strong growth in machine-building, metallurgy, food processing and the chemical industry, which expanded by 11.9% yoy, 8.6% yoy, 7.1% yoy and 3.6% yoy, respectively. In addition, the coke and oil refining industry continued to improve as output decline in the industry markedly decelerated by almost 25% yoy in January to about 12% over January-September. As a result, total industrial output reported a 5.5% yoy increase in January-September, slightly up from 5.4% yoy over January-August.

Industrial Output by Selected Industries, 2005–2006, % yoy cumulative



Source: State Statistics Committee

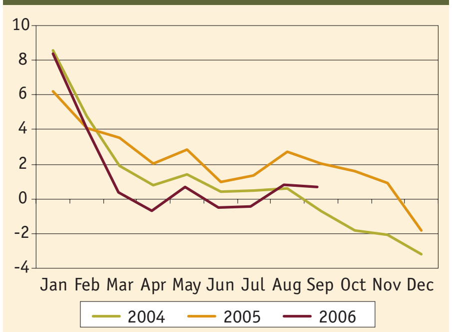
At the same time, September revealed output growth deceleration in several key industries. In particular, output in food processing decelerated to about 3% yoy, down from 5.3% yoy in the previous month, which may be attributed to the overproduction of several products (such as meat, milk and dairy products), a more modest harvest this year and growing food imports. At the same time, taking into account recent progress in trade relations with Russia, performance in this industry may improve in the coming months. Export-oriented metallurgy reported a 10.8% yoy increase, a notable deceleration from the 19.7% yoy growth in the previous month, which is closely linked to the moderation of external demand (reflected in stabilization of world steel price growth over June-September) and a weakening low base effect. However, the industry may benefit from the increase recently agreed with the EU in Ukraine's steel export quota for 2006 by 6% due to the transfer of unutilized quota in 2005. This became possible thanks to a Ukraine-EU agreement on steel trade for 2005-2006 signed in July of last year, which contained a provision allowing for the transfer of unutilized quota in the previous year up to 15% of the quota. The deceleration, however, was compensated for by higher growth rates in machine-building (9.1% yoy in September versus 6.8% yoy a month before) and chemicals (12.2% yoy and 9.3% yoy, respectively).

Throughout the rest of the year, industrial production as well as GDP is expected to continue to grow, though at a slower rate due to weakening external demand, a waning low base effect and decelerating consumption (affected by slower growth of real household income and redistribution of expenditures in favor of utilities). Over the next year, the economy will continue to perform reasonably well, even taking into account a further increase in imported gas prices by about 37% to $130 per 1,000 m3. Robust investment activity this year may be evidence of the realized need to introduce energy saving technologies. This will partly compensate for the effect of the gas price increase next year; however, the actual growth rate will crucially depend on steel price developments on the international markets and the ability of Ukraine to improve the business environment and implement economic reforms. In the meantime, the forecasts for next year's GDP growth by both domestic and international experts widely diverge — from 4.2% yoy to 8% yoy.

Fiscal Policy

Acceleration of economic growth in September allowed the government to collect revenues to the general fund of the state budget in an amount exceeding the target by 10.9%. VAT collections remained the largest contributor to budget revenue growth. In particular, VAT proceeds were over-fulfilled by 25%. At the same time, VAT refunds that month were under-executed by almost 26%. Improving performance by enterprises (the share of profitable enterprises increased from 61.2% over the first half of the year to 64% over January-August) contributed to the growth of enterprise profit tax (EPT) proceeds. In September, EPT collections were 7.3% above target. However, due to poor receipts in the first half of the year, the cumulative EPT collections remained under-executed by 12%.

Consolidated Budget Balance, % of period GDP, 2004–2006



Source: Ministry of Finance

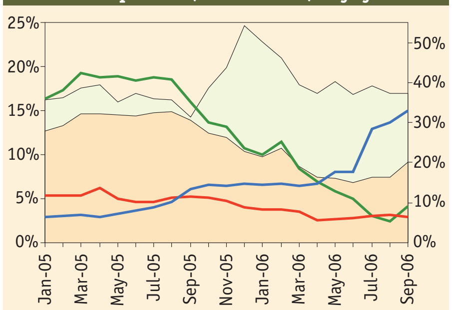
Proceeds from taxes on international trade continued to be under-executed by 24.7% over January-September. In addition, collections from excises were 11% below the target over the period, which is closely linked to poor oil-refining industry performance. Overall, tax collections were over-executed by 2.4% over the first nine months of the year. This, in addition to under-execution of expenditures from the general fund of the state budget by 2.4% in September and 3.7% to date, allowed the state budget to be in surplus in September. As a result, the cumulative state budget deficit declined from UAH 1.7 billion over January-August to UAH 1.4 billion over January-September. Thanks to surpluses in local budgets, the consolidated budget registered a surplus of UAH 2.6 billion or 0.7% of period GDP.

At the same time, despite reasonable fiscal sector performance so far, successful execution of the 2006 budget may be a challenging task. According to the 2006 Budget Law, the budget deficit is envisaged at 2.6% of GDP and is to be financed through privatization revenues (85%) and government borrowings. Proceeds from new privatization deals were planned in the amount of UAH 2.1 billion. However, as of October 1st, the collected amount represented only 16% of the target. Scheduled for September 6th and October 3rd were privatization contests of 38.14% of limestone extractive and production enterprise "Komsomolsk ore directorate" and 76% of "Luganskteplovoz" (the only main-line locomotive producer in Ukraine and one of the largest producers of railway and mining machines and equipment). However, the deals were either eliminated or postponed in October. Hence, in mid-October it became clear that the government plans regarding privatization proceeds will not be realized this year.

In September, the government resumed issuance of domestic T-bills and Eurobonds. During the month it attracted UAH 110 million ($21.8 million) and about $300 million on domestic and external markets respectively. However, these amounts are considerably lower than public debt interest and principal payments. Due to the lack of funds for expected budget deficit financing, the government plans to revise the 2006 Budget Law in mid-November.

Monetary Policy

Dynamics of Money supply, CPI and Its Major Components, 2004–2006, % yoy



Source: Ministry of Economy of Ukraine

In September, the consumer price index (CPI) surged by 2% month-over-month (mom). In annual terms, consumer inflation accelerated to 9.1% yoy, up from 7.4% yoy a month before. As in the previous months, the acceleration was primarily driven by growing service tariffs. In particular, starting September 1st electricity tariffs were raised by 25%. Since the beginning of the year, the cost of electricity for households grew by 56.3%. In addition, more expensive energy resources prompted price increases on housing services, water supply, urban and city transportation. Rent services, the cost of which increased by 8.7% mom in September, contributed to an almost 6% mom increase in service prices that month as well. In annual terms, the growth of service prices accelerated to 33% yoy, up from about 30% yoy a month ago.

Following six months of deflation, the food price index grew by 1.1% mom in September, which translated into a 4.2% increase in annual terms. The upsurge in food prices may be related to a moderate grain harvest this year (prices on bread, flour, and macaroni), expectations of export resumption (prices on meat, milk and dairy products), the change in methodology of recording prices (potatoes), and common to all commodities higher production costs related to more expansive energy resources, utilities and transportation services. Prices for non-foods grew by 0.4% mom in September on account of a 1.2% mom increase in gasoline prices. However, due to a high base effect, annual growth of non-food prices continued to decelerate, posting less than 3% yoy in September.

As we expected, the moratorium on increases of service tariffs adopted by the Ukrainian parliament in mid-September was abolished at the beginning of October. In exchange, the government proposed to decrease gas prices for households using gas-stoves by 18%. The other tariff increases were retained. With the abolishment of the moratorium, service tariffs are expected to continue to grow this year, as the process of utility tariff adjustment to cost-covering levels differs in speed and magnitude throughout Ukraine. As a result, the government forecast of 10% yoy year-end inflation this year looks quite realistic.

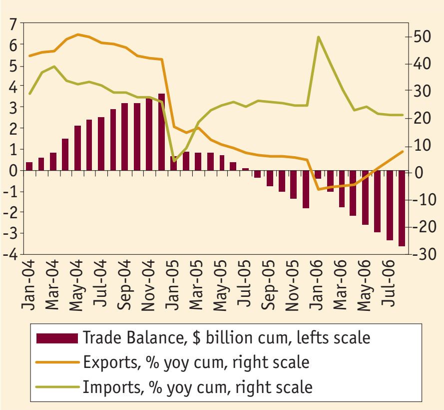
Monetary factors have also contributed to acceleration of inflation in September, though they were not dominant. In particular, the monetary base grew by 3.5% mom compared with a 0.4% mom decline in the previous month. The annual growth posted 20.3% yoy, up from 19.5% yoy in August. The acceleration was primarily attributed to NBU net foreign exchange purchases on the inter-bank market, which amounted to $552 million in September, and a further decline of funds on government accounts with the NBU. NBU interventions were aimed at maintaining the hryvnia exchange rate at 5.05 UAH/$, an unchanged level since summer 2005. This, in turn, allowed the NBU to further accumulate its international reserves. By the end of September, they amounted to $19.14 billion. The growth of the money supply (M3) remained virtually unchanged at 37.3% yoy thanks to an increased multiplication effect (the money multiplier reached a record high 2.77).

A more significant reduction of reserve requirements on deposits in national currency prompted commercial banks to further increase the hryvnia deposit rate to 7.4% per annum in September (the deposit rate on foreign-currency-denominated deposits remained at 5.3% p.a.). This, coupled with the end of the vacation season and strong growth of household incomes, were the major drivers for deposit growth acceleration in September. During the month, deposits in national currency grew by 6.6% mom, while deposits in foreign currency rose by only 1% mom. In annual terms, however, the growth of forex-denominated deposits still considerably outpaced that of hryvnia-denominated deposits (64.4% yoy versus 31.7% yoy, respectively).

Further growth of deposits (up by 43% yoy in September) as well as active borrowing from abroad allowed commercial banks to continue to expand their loan portfolios in September. During the month, the volume of private sector lending by commercial banks increased by 66.1% yoy, while the average cost of loans increased by 10 basis points to 13.3% per annum. The differentiation of reserve requirements by currency, however, has had a rather limited effect on the structure of banks' lending portfolios so far. Though the growth of national currency denominated loans accelerated to 49% yoy in September (up from 48.3% yoy a month before), the growth of forex-denominated loans accelerated as well to 90.4% yoy. With the aim to speed up the process of balancing banks' credit portfolios by currency, and thus diminish commercial banks' exposure to foreign exchange risk, the NBU decided to further manipulate with reserve requirements. At the same time, to offset the likely monetary expansion caused by this move, the NBU increased the daily minimum reserve requirement from 70% to 100%[1].

International Trade and Capital

Merchandise Trade Flows in 2004–2006



Source: State Statistics Committee

Favored by strong external demand for Ukraine's metals, chemicals, machinery, and transport vehicles, merchandise export performance continued to improve. In August alone, goods exports surged by 30% yoy, bringing the cumulative growth to about 8% yoy over January-August. At the same time, the ongoing increase in consumption demand as well as revived investment demand stimulated the growth of imports. During the month, merchandise imports growth accelerated to 20.4% yoy, up from 17% yoy a month ago. The year-to-date growth remained virtually unchanged at 21.2% yoy. As a result, the merchandise trade deficit continued to widen, reaching $3.6 billion at the end of August, which is equivalent to about 6% of January-August GDP.

Ukraine's main export commodities remained metals, chemicals, machinery, and transport vehicles. The resumed growth of world prices for metals in April-August was the primary engine of improved performance of Ukraine's merchandise exports. Metal exports, still the weightiest component of total merchandise trade (42.6%), grew by 9.1% yoy between January and August, a notable acceleration from 4.6% yoy growth in January-July. Strong external demand has contributed to further expansion of Ukraine's chemicals, the cross-border trade of which increased by 15.5% yoy. This year's metal (and to a lesser extent chemical) export performance has proved once more the high vulnerability of Ukraine's economy to sudden shifts in the external environment. A possible solution is enhancing high-value-added exports like machines, equipment, and transport vehicles. Currently, these commodities account for about 13% of total goods export, increasing by 10.5% yoy over the eight months of the year.

On the import side, energy resources and investment goods remained the two largest groups in its structure, together accounting for about 60%. In January-August, imports of fossil fuels grew by 11.9% yoy. The growth acceleration from 10.9% yoy over January-July may be attributed o higher world crude oil prices and an increase in Russia's duty on crude oil exports in August rather than an increase in import volumes. Robust growth of machines and equipment and transport vehicle imports (38.1% yoy over January-August) is another evidence of recovered investment demand in the country.

The geographical breakdown of Ukraine's foreign trade remains biased towards Russia, which accounted for 32% of merchandise imports and 21% of exports, while the EU-25's share of imports and exports constituted 33.4% and 28% respectively and is steadily growing in the course of this year.

International Programs

On October 24th, a Japanese Policy and Human Resource Development (PHRD) Grant Agreement was signed by the Ministry of Economy of Ukraine and the World Bank. The US$700,000 grant will assist the government in preparing the second Development Policy Loan (DPL-2) from the World Bank by implementing policy commitments and planning future reform steps in three major areas: improvements in the investment climate, better public administration and public financial management and greater social inclusion.

Other Developments and Reforms Affecting the Investment Climate

On October 25th, Fitch revised its outlook for Ukraine's long-term rating in foreign and national currency from BB– stable to BB– positive. According to agency experts, the impressive economic growth that Ukraine has demonstrated this year in spite of a notable increase in the price of imported gas and political instability were the primary reasons for the upgrade. Though it was too early to judge about new government policies, the government commitment to secure WTO entry in early 2007 was seen as a positive sign by the agency.

During the EU-Ukraine summit that took place in Helsinki on October 27th 2006, the EU's highest-ranking officials welcomed the progress that Ukraine has made in political and economic reforms and called for continuation of the overall reform process. The reform of the judiciary, the fight against corruption and improving the business climate, together with the finalization of Ukraine's WTO accession, were named as the highest priorities. During the summit, Ukraine and the EU signed visa facilitation and readmission agreements. The agreement on visa facilitation eases the procedures for issuing short-term visas for Ukrainian citizens, sets out simplified criteria for issuing multiple-entry visas for many groups of people, such as close relatives, truck drivers, businessmen, students, journalists and members of official delegations. The agreement on readmission sets out clear obligations and procedures for the authorities of both Ukraine and the respective EU Member State as to when and how to take back people who are illegally residing in their territories. The signing of these agreements is seen by the Ukrainian authorities as an important step towards deeper integration with the EU.

Reserve Requirements for Commercial Banks in 2005–2006

Reserve requirements on:	Effective date					
	September 1, 2005	October 1, 2005	March 1, 2006	May 10, 2006	August 1, 2006	October 1, 2006
Term deposits in national currency	6%			4%	2%	0.5%
Term deposits in foreign currency	6%			4%	3%	4%
Demand deposits in national currency	8%			6%	3%	1%
Demand deposits in foreign currency	8%			6%	5%	5%
Daily minimum mandatory reserve requirements		90%	70%			100%

[1] The daily requirement for the amount of bank reserves to be kept on the correspondent account with the NBU, % of the previous month's obligatory reserves.

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