SigmaBleyzer

Ukraine Macroeconomic Situation

December 2006

Olga Pogarska, Edilberto L. Segura

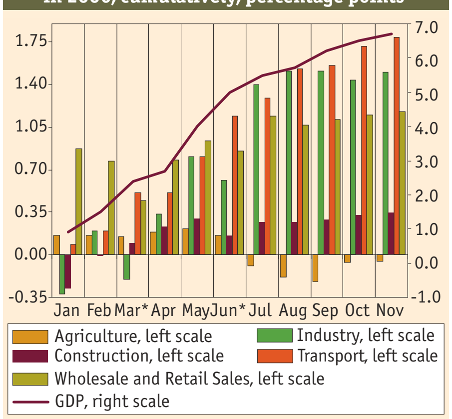
Summary

- Over January-November, GDP grew by 6.7% yoy. Robust economic growth in 2006, despite the price hike on imported energy resources, gives reason to be optimistic about Ukraine's economic performance in 2007.
- In December, the 2007 State Budget Law was adopted; however, it is likely to be amended early next year.
- The ongoing tariffs adjustment was the primary cause of consumer price inflation soaring to 11.6% yoy in November.
- Though the cumulative merchandise trade deficit continued to deteriorate, current account performance has been improving. In the third quarter, the current account balance returned to a surplus of $460 million, bringing the cumulative deficit to less than 0.5% of period GDP.
- Ukraine has demonstrated generally good reform progress in 2006 despite a long period of political instability. However, the progress in deregulation and liberalization was uneven.

Economic Growth

Ukraine continued to enjoy rapid economic growth. According to preliminary data from the State Statistics Committee (SSC), the Ukrainian economy advanced by 8.2% yoy in November, bringing cumulative growth to 6.7% yoy. The growth was supported by vigorous consumption and robust investment activity. Private consumption was fuelled by an ongoing, though decelerating, rise in real household disposable income (up by 17% yoy over ten months of the year), and booming consumer credit. In addition, it was favored by the postponement of a gas price pass-through on utility tariffs to the second half of the year. Though political uncertainty persisted beyond the parliamentary elections and formation of the new government, it seemed to be outweighed by the growing pressures to modernize existing production capacities and invest in energy-saving technologies. Investment growth is underpinned by improving access to domestic banking services (commercial banks lending to businesses grew by 49.3% yoy in January-November) and borrowing from abroad. Over the first nine months of the year, the growth of investments into fixed capital accelerated to 16.1% yoy, up from 12.2% yoy in 1H 2006.

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

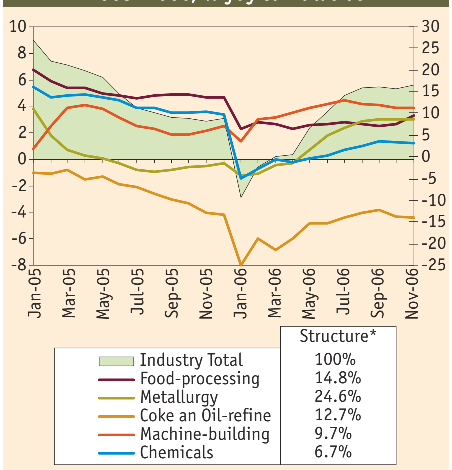


* Revised figures
Source: State Statistics Committee, The Bleyzer Foundation

Accordingly, robust private consumption growth favored domestically oriented sectors and industries, such as retail trade, food, production of vehicles, and residential housing construction. At the same time, favorable external conditions and a rise in investment activity sustained growth in machine-building, metallurgy, industrial building construction and wholesale trade. In particular, wholesale and retail trade and construction demonstrated 15.6% yoy and 8.8% yoy increases in value added respectively in January-November. Benefiting from robust growth in the industrial sector and construction and rising household income, transportation reported an almost 10% yoy increase over the period.

Following deceleration in October, industrial output growth posted a marked acceleration in November. That month industrial production picked up by 8.3% yoy, bringing the year to date total to 5.6% yoy. The largest contributors to industrial output growth were metallurgy, food processing, and machine-building. Together, they explained more than 80% of industrial output growth.

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



* Approximation based on industrial sales statistics in January-October 2006
Source: State Statistics Committee

Though world steel prices have been generally on a declining trend since September, price developments were rather sluggish on Ukraine's major steel export destination markets, remaining at a rather high level. Moreover, according to MEPS, steel prices on EU and Asian markets even slightly increased in November compared to the previous month. Facing also stronger domestic demand due to robust growth in construction and machine-building, metallurgy reported a 8.5% yoy increase in output over January-November.

Though only about 11% of domestically produced foods and beverages are exported (compared to about 74% in metallurgy, 67% in chemicals and 45% in machine-building), external conditions are an important factor affecting industry performance. At the start of 2006, Russia introduced restrictions on Ukraine's export of meat, milk and dairy products, which resulted in overproduction of these goods on the domestic market, thus leading to deceleration of output growth in the industry to just 3% yoy in September. At the beginning of October, Ukraine and Russia signed a memorandum setting out new conditions for Ukraine's export of meat. Moreover, following Russia's audit of Ukrainian meat and milk enterprises in November-December, the restrictions are expected to either be abolished or considerably softened. However, the output growth acceleration to 23.1% yoy in November was primarily caused by domestic reasons. Increasing spending power of the population and a good harvest of sunflower seeds and sugar beets as well as healthy growth in livestock farming contributed to the industry's expansion. Cumulatively, the industry reported 9.4% yoy growth in output in January-November.

Machine-building production expanded by 11.5% yoy in January-November, favored by both domestic and external demand. Continuing growth in metallurgy as well as high world prices on iron ores stimulated output growth in the extractive industry, which expanded by 5.8% yoy over the period. At the same time, coke and oil-refining and agriculture, reporting a 14.1% yoy reduction in output and a 0.6% yoy decline in value added respectively, remained among the lagging sectors.

Despite price hikes on energy resources, the Ukrainian economy demonstrated good economic performance during 2006. Though some of the factors (such as booming consumption and high world steel prices) that helped to absorb the shock in 2006 are likely to be considerably weaker next year, 2006's performance allows for reasonable optimism. Thus, we expect GDP to grow by 5-6% yoy in 2007 despite a 37% increase in imported gas prices.

Fiscal Policy

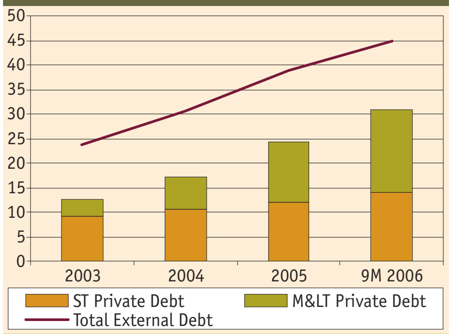
Robust growth of domestic trade, rising household income and improving enterprise performance allowed the government to over-fulfill revenues to the general fund of the state budget by 3.3% over January-November. This translates into a more than 20% nominal increase compared to the respective period last year. As in the previous periods, VAT proceeds showed the largest rate of increase. However, it was achieved on the back of growing VAT refund arrears. Just in August-November, VAT refund arrears rose by 25% to reach almost UAH 7 billion (about $1.4 billion) at the end of November.

In the previous several months, the government managed to keep the state budget deficit low (0.7% of period GDP at the end of October) thanks to under-execution of expenditures. Such a strategy was explained by the government's concerns over deficit financing.

Due to sluggish privatization this year (January-November's privatization revenues made up just 20.3% of the planned amount) and the absence of public borrowings (both domestic and external) during the first eight months of the year, the primary source of state deficit financing in the previous periods was the funds received from the re-sale of metallurgical plant Kryvorizhstal in October 2005. However, they were not enough to finance the full-year budget deficit of 2.5% of GDP anticipated in the budget law and confirmed during its revision in mid-November. That is why the government resumed its borrowing operations on both domestic and external markets in September. However, since domestic debt redemption and service payments generally exceeded the newly borrowed amounts, domestic public debt continued to decline. As of the end of November, it decreased by 12.1% year-to-date (ytd) to $3.3 billion.

Unlike domestic debt, external public debt grew by 3.8% ytd to $12.1 billion at the end of November on the back of several successful Eurobond placements in September and November. As Ukraine demonstrated good economic performance, the government took advantage of growing investor interest in emerging markets and in mid-December placed JPY 35.1 billion (about $300 million) Eurobonds with 4 year maturity, 3.2% yield and a 1.2% discount.

External Debt Developments, $ billion



Source: National Bank of Ukraine

At the same time, private sector borrowing from abroad has been expanding rapidly. According to NBU data, private external debt rose by 26.3% ytd over the first nine months of the year to $30.7 billion. Though such rapid expansion of private external debt is a potential cause for concern, the rising share of long-term private external debt can be considered a positive development. Total external debt surged to $44.9 billion at the end of September, which corresponds to almost 45% of full-year GDP.

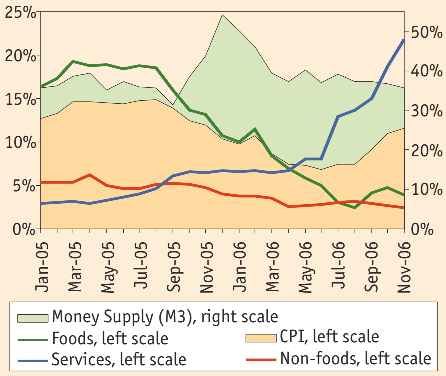
At the beginning of December, the parliament adopted the 2007 Budget Law, which envisaged a state budget deficit at UAH 15.72 billion ($3.1 billion), or 2.6% of forecasted GDP. The targeted state budget deficit is 18.6% higher than in 2006. State budget revenues are set to increase by 16% yoy to UAH 147.9 billion ($29.3 billion), while expenditures will be 15.4% yoy up to UAH 161.8 billion ($32 billion). However, a few days later, the president vetoed the budget law and returned it to the parliament. The main disagreement lied in social security provisions, such as the minimum subsistence level and minimum wages next year (minimum wage and the subsistence level are used as a basis for determination of a number of social care and protection payments). On December 19th, the parliament adopted an amended state budget law, taking some presidential suggestions. However, basic social provisions were left unchanged. The new version of the budget was signed by the president only after the parliament adopted a resolution that obliged the government to develop amendments to the budget law envisaging upward revision of the minimum subsistence level and minimum wage based on economy and budget performance in the fist quarter of 2007. Most likely, the 2007 budget law will be amended at the beginning of the second quarter of 2007.

The 2007 budget law envisages that about two-thirds of the targeted deficit will be financed by receipts from privatization. Though the parliament adopted a list of about 560 enterprises to be privatized in 2007, which includes several potentially interesting enterprises such as Ukrainian telecommunication monopoly "Ukrtelekom", Odessa port plant and government shares in 12 energy-distribution companies (oblenergo), the targeted amount may be hard to achieve. Moreover, at the end of December, the president vetoed the law arguing that it violates some constitutional provisions and shareholder rights. According to the president, the parliament defines the list of enterprises that are not subject to privatization. The adoption of the privatization list makes it impossible to privatize enterprises not included in the list without respective amendments to it by the parliament. This will make the privatization process more cumbersome and time-consuming. Moreover, an important innovation of next year's privatization was the sale of government shares in the enterprise together with the land that belongs to that particular enterprise. According to the law, a buyer of a more than 25% government stake in a joint stock company accrued the right to become a single purchaser of the entire land that belongs to the enterprise. This provision violates other shareholder rights and is in conflict with international standards of corporate governance. The absence of a clear privatization plan makes successful budget execution in 2007 a rather challenging task.

Monetary Policy

In November, the annual growth in consumer prices soared to 11.6% yoy, driven by ongoing service tariffs adjustment and some agricultural products. In particular, housing and utility tariffs grew by 9.3% month-over-month (mom), which translated into 83.2% annual growth. That month, they were accompanied by 10% mom and 6.8% mom increases in communication and rent tariffs respectively. Despite a high base effect, rent services were almost 42% more expensive than in November 2005, reflecting robust growth of real estate prices and utility tariffs.

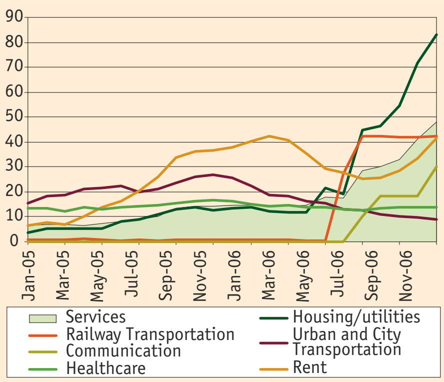
Dynamics of Money supply, CPI and Its Major Components, 2004–2006, % yoy



Source: State Statistics Committee, National Bank of Ukraine

The development of food prices was rather modest this year (up by 3.9% yoy in November). However, it still explained about 20% of total CPI growth since food products comprise the largest share in the consumer basket (more than 60%). By product breakdown, the largest increase in prices was reported for fruits (up by 43.3% yoy), cereals (up by 16.5% yoy), and bread and bakery products (up by 16.1% yoy). Their impact on the total food price index was mitigated by an 11.8% yoy, 6.7% yoy and 3.5% yoy reduction in prices for vegetables, meat and eggs, respectively.

The Growth Rates of Selected Service Tariffs, % yoy



Source: State Statistics Committee, The Bleyzer Foundation

An acceleration of flour and bread prices growth over August-September was mainly the reflection of higher production costs (during the harvest campaign the prices on petroleum products reached their peak; minimum wages were raised twice — by 8.7% in January and 7.1% in July, driving the labor costs up). At the same time, the increase in domestic bread prices on the back of revised downwards estimates in the grain harvest this year and a robust increase in global prices for grain has worried the government. In an attempt to curb bread price growth, the government introduced grain export restrictions at the end of Sep-

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

tember. However, the effect of these measures was rather limited so far, as wheat prices constitute only a fraction of the production costs of bread. Indeed, flour and bread prices continued to accelerate over October-November.

At the same time, non-food prices continued to slow down in November, primarily on account of the notable deceleration in domestic gasoline prices. Though world crude oil prices returned to an upward trend, domestic petroleum prices declined by 10.2% mom in November as a result of the agreement reached between the government and gasoline traders at the beginning of the month.

The weight of monetary factors in inflation dynamics continued to decline. In November, the growth of the monetary base and money supply slowed to 17.2% yoy and 35.7% yoy respectively (down from 22.4% yoy and 36.4% yoy a month before). In monthly terms, the monetary base advanced by a meager 0.2% mom, which was the result of lower NBU net foreign exchange purchases on the interbank market ($227 million in November compared to $363 million in the previous month) and accumulation of government cash balances on the account with the NBU (up by 9.4% mom.) The slowdown in annual money supply growth may also be attributed to continuing deceleration of deposits rate of increase (39.8% yoy in November compared to 41.8% yoy a month before).

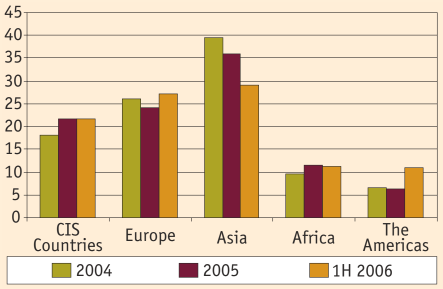
Though decelerating, the growth of deposits remained at a decent level, which accompanied by active borrowing from abroad, allowed commercial banks to further gather momentum in lending activities. Gradually declining lending rates and increasing demand for financial resources from both households and companies stood behind 68.6% yoy expansion in credit. Consumer lending was an important contributor to overall credit growth. In November, more than one third of all loans were issued to households. A 135.7% yoy increase in consumer credit was supported by growing purchasing power, a gradual shift of consumer preferences towards durable goods, booming real estate prices, and increasing competition on the consumer credit market, which manifested itself through the reduction in credit costs.

Though hryvnia-denominated loans grew at a robust 50.2% yoy in November, foreign currency loans grew considerably faster. Expanding by 93.4% yoy over the period, the share of loans issued in foreign currency grew to 49% in November, up from 43% at the beginning of the year. Thus the exposure of the banking sector to foreign exchange risks has been increasing. The share of forex-denominated loans issued to households reached 64% in November, which raises even more concerns as household incomes are mainly hryvnia-denominated. Though the NBU has addressed banking sector risks through differentiation of reserve requirements, tightening of capital requirements, additional measures are required to respond to rising banking sector vulnerability.

International Trade and Capital

In October, merchandise exports increased by about 18% yoy, bringing cumulative growth to 11.2% yoy. At the same time, vigorous domestic consumption and growing investment demand continued to fuel imports expansion. Rising by 25.7% yoy in October, merchandise imports reported 22.6% yoy growth since the beginning of the year. As a result, the fob/cif merchandise trade deficit increased to $4.6 billion at the end of October, which is equivalent to 5.9% of period GDP.

Geographical Breakdown of Ukraine's Exports of Metallurgical Products, %



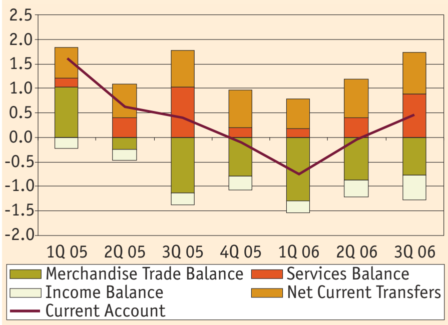
Source: National Bank of Ukraine

Despite general improvement, export performance by select industries was rather mixed. Robust external demand stimulated exports of machines, equipment and transport vehicles, which expanded by about 15% yoy over January-October (up from 13.8% in January-September). Though world steel market conditions were deteriorating, the growth of exports of metallurgical products accelerated to 14.7% yoy. The acceleration became possible thanks to wide differentiation of steel price developments at various markets (steel prices on EU markets, though slightly decelerated, remained at a very high level; though prices on Asian markets revealed signs of an increasing trend, their level was significantly lower than the 2005 average) and the diversified geographical structure of Ukraine's metal exports. Following introduction of grain export restrictions in September-October, exports of this group showed a 26% yoy reduction in October. As a result, cumulative growth of grain exports decelerated sharply from 25.7% yoy in January-September to just 17.3% yoy in January-October. However, since it accounts for only about 4% of total merchandise exports, the deceleration did not have a significant impact on cumulative export developments.

On the import side, imports of mineral products (the weightiest group in total goods imports) were on the decline due to lower import volumes. In October, imports of energy resources reported only 7.6% yoy growth (down from an almost 39% yoy increase in the previous month) due to a more than 35% yoy decline in crude oil imports. The decline in crude oil imports is closely linked to poor coke and oil-refining industry performance. Due to high world crude oil prices and record high duties on Russia's crude oil exports, gasoline imports have been displacing domestic production. For these reasons Ukraine's exports of gasoline products have deteriorated in 2006. Since the increase in gasoline imports did not fully compensated the decline in crude oil imports, cumulative imports of energy resources decelerated from 15% yoy in January-September to about 14% yoy in January-October despite almost 22% yoy increase in the natural gas imports over the period. Robust investment activity and rising household income stimulated imports of machines, equipments and vehicles, which expanded by 34% yoy over January-October.

Though the cumulative merchandise trade deficit continued to deteriorate, the current account performance has been improving. According to the recent NBU report, the merchandise trade deficit constituted $770 million in 3Q 2006, slightly up from a $876 million deficit registered in the previous quarter. On the back of growing surpluses in foreign trade of services ($885 million in 3Q 2006) and net transfers ($846 million) accounts, the current account balance returned to a surplus of $460 million, which was equivalent to 1.6% of period GDP. As a result, the cumulative current account deficit declined to less than 0.5% of nine month GDP.

Current Account Components, flows, $ billion



Source: National Bank of Ukraine

The capital and financial accounts balance (analytical representation) has also demonstrated an impressive improvement, as it moved from a $1.6 billion deficit in 1Q 2006 to a $0.85 billion surplus in 3Q 2006. The improvement was due to record high growth of net foreign direct investment (FDI) and intensification of private borrowings from abroad. For the first three quarters of this year, net FDI reached $3.7 billion. The bulk of this sum was achieved thanks to a number of mergers and acquisitions in the banking sector. The growing involvement of foreign banks in Ukraine will bring new know-how and managing technologies to the sector, increase competitiveness and bring down interest rates.

Thanks to balance of payments improvements, the NBU was able to replenish its gross international reserves from a reduction during the first half of the year. At the end of September, they almost reached end-of-2005 levels and constituted $19.1 billion,

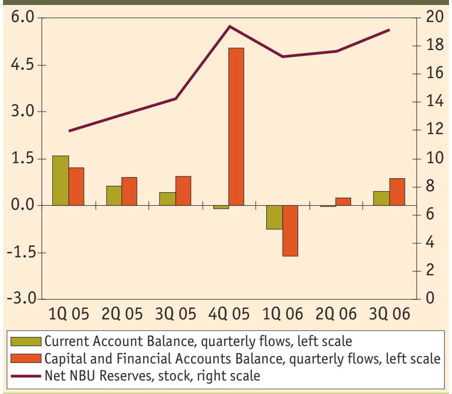
Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

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

which corresponds to 4 months of prospective imports of goods and services.

Balance of Payments, analytical representation, $ billion



Source: National Bank of Ukraine

Though Ukraine's terms of trade deteriorated in 2006, their developments were much better than expected due to favorable world steel market conditions. 2007 is forecasted to witness a moderate decline in world steel prices, thus the merchandise trade deficit will keep widening throughout the year. The rise in imported gas since the beginning of 2007 will negatively affect export-oriented and energy-intensive industries such as metallurgy and chemicals, while merchandise imports are likely to continue growing at double-digit rates. In addition to rising nominal volumes of imported mineral products, imports will be stimulated by expected robust growth of investment demand and still high domestic consumption. As a result, the current account is forecasted to be in deficit of about 3% of GDP, which will be securely covered by the financial account surplus (due to a further increase in private debt and the relatively high net inflow of FDI).

Other Developments and Reforms Affecting the Investment Climate

In 2005, Ukrainian authorities announced an extensive reform program aimed at strengthening the country's democracy, sustaining economic growth and preparing Ukraine for eventual EU membership. Aspirations to join the European Union were behind the outstanding achievements in macroeconomic performance and public policy reforms in candidate countries. Following declaration of the strategic goal of EU membership in early 2005, the three-year Ukraine-EU action plan was scheduled. At the beginning of December 2006, the European Commission positively assessed the implementation of the action plan, emphasizing fair and transparent parliamentary elections in spring 2006, high-level cooperation in the foreign policy arena, tighter observance of human rights and the supremacy of the law, and progress on adopting legislation necessary for Ukraine's accession to the WTO. Currently the European Commission and Ukraine have been negotiating directives for the new Enhanced Agreement. The Commission proposed that the new agreement should go beyond the existing Partnership and Co-operation Agreement wherever possible. One of the key elements of the new agreement will be creation of a free trade area, negotiations for which will start shortly after Ukraine completes its WTO accession process.

Despite the long periods of political instability before and after the elections, Ukraine made good progress on structural reforms in 2006. At the same time, the capacity to influence domestic market developments through market-based mechanisms remained rather weak. Some of the recent government actions revealed a tendency to intervene in the economy. In particular, the government negotiated fixation of gasoline prices with major players on the market and attempted to intervene with price-setting mechanisms for selected foods. In September, observing rapid growth of bread and bakery products on the back of accelerating grain exports and revised downward grain harvest estimates, the government introduced grain export licensing, which was replaced by export quotas in mid-October. In addition to considerable losses to grain producers and traders, the introduction of quantitative restrictions contradicts WTO principles, provides ample opportunities for rent-seeking activities and negatively affects the investment climate as a whole.