SigmaBleyzer

Ukraine
Macroeconomic Situation

March 2007

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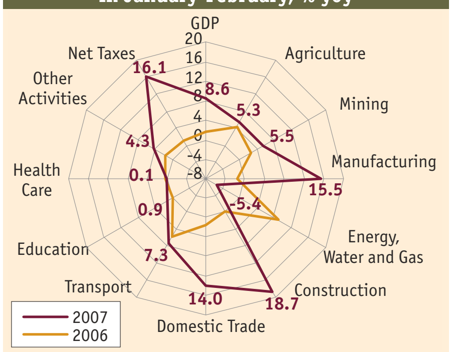
Summary

- Supported by a favorable external environment and robust domestic demand, real GDP grew by 8.6% yoy over the first two months of 2007.
- The consolidated budget ran a surplus of 7.2% of period GDP over January-February. Higher budget revenues and strong macroeconomic fundamentals encouraged softening of income policy. Though the targeted state budget deficit remained unchanged, de facto it was raised by 19%.
- Annual consumer inflation decelerated to 9.5% yoy in February. Moderation of consumer price index growth was the result of food price deflation, tightening of monetary aggregates and postponement of energy price pass through to consumers.
- Benefiting from robust external demand for its traditional commodities, growth of world steel prices and a low base effect, Ukraine demonstrated very strong export performance at the beginning of 2007.
- On April 2, the President issued a decree dissolving the Parliament and calling for early elections. Despite short term disruptions, over the medium term the country is not expected to change its basic economic direction towards a free market economy.

Economic Growth

In February, real GDP increased by 7.9% yoy, bringing the cumulative growth to 8.6% yoy. Some deceleration in February compared to the previous month may be explained by a low statistical base effect and adjustment to higher energy costs. The latter may be rather mild this year, considering that the Ukrainian economy showed high resilience to the shock in 2006 and the 2007 increase in gas prices was anticipated. At the same time, the effect of higher energy prices was more apparent in February 2007 than in the previous month due to January's unusually warm weather.

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

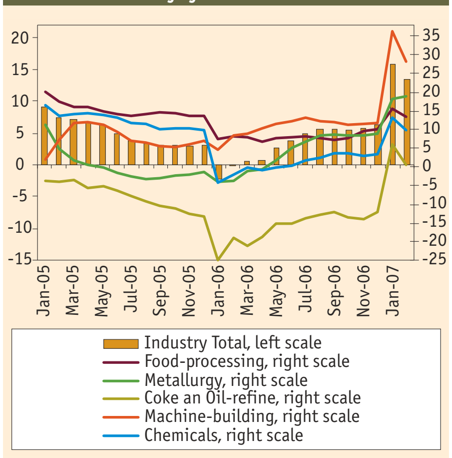


Source: State Statistics Committee

Economic growth in the first two months of 2007 was led by an increase in value added in construction, industrial production, trade, and transportation. In particular, strong investment and consumer demand, supported by continuing expansion of bank credit to the real sector, triggered a 18.7% yoy increase in value added in construction, 14% yoy and 7.3% yoy growth in wholesale and retail trade and transport. Together these sectors explained almost 40% of GDP growth during these months. Another 30% was explained by the value added growth in the industrial sector.

Underpinned by favorable external conditions and robust domestic demand, industrial output grew by 11% yoy in February. Despite the deceleration from a remarkable 15.8% yoy expansion in January, the cumulative growth rate remained at a high 13.4% yoy. At the product level, the largest contributors to industrial output growth were metallurgy, machine-building and food processing. An 18.9% yoy rise in production of metallurgical products over January-February was supported by high world prices for steel products, robust growth in machine-building and construction. Output in machine-building increased by 28.1% yoy over the period, primarily thanks to continuing expansion in production of vehicles and transport equipment (up by about 36% yoy). The industry benefited from robust investment demand in the CIS countries (the primary outlet for Ukraine's exports of these commodities) and strong domestic demand. A favorable external environment supported a 9.8% yoy increase in chemicals. Buoyant domestic consumption triggered a 13.5% yoy output increase in the food industry, though relaxation of Russia's ban on Ukraine's exports of meat and meat products also contributed to the expansion. In particular, the meat industry reported a 20.9% yoy increase in output during the first two months of the year, up from 17.5% yoy in January and 13.6% yoy in 2006.

Industrial Output by Selected Industries, % yoy cumulative



Source: State Statistics Committee

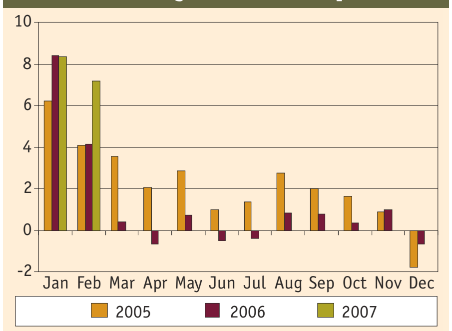
On the downside, following a 6% yoy increase in output in January, production of coke and oil-products declined by 4.7% yoy in February. The worsening of domestic industry performance is related to the upward trend of world crude oil prices in February. The industry's outdated technologies do not allow for deep oil refining, thus making domestically produced gasoline products noncompetitive with higher-quality imports. Another laggard industry is production and distribution of energy, gas and water. During January-February, the industry's output declined by 4.5% yoy due to lower demand caused by a warm winter this year and a high base effect.

Given the high resilience to energy price shocks demonstrated by the Ukrainian economy in 2006 and the robust growth at the beginning of 2007, GDP is forecasted to grow by 6.5% yoy in 2007 according to the recent Consensus Forecast. On the back of a favorable external environment and likely faster than expected consumption growth (due to the recently amended 2007 budget law envisaging a faster rise in the subsistence level and minimum wages), the forecast may be realistic. Though Ukraine's economic growth outlook is quite positive for 2007, achievement of sustainable economic growth in the medium-term is a challenging task. Continuing reliance on fiscal policy and a credit boom-driven consumption may generate significant inflationary pressures and increase vulnerability of the banking sector to foreign exchange and credit risks. In addition, the likely further increases in energy prices and sensitivity to world steel price developments represent the main downside risks for the Ukrainian economy in the medium run. Hence, to achieve strong and sustainable economic growth in the long-run, the country will require new investments and technology.

Fiscal Policy

Thanks to robust economic growth and under-execution of expenditures (typical for the beginning of the year), the consolidated budget ran a surplus of UAH 6.3 billion ($1.2 billion) in January-February, which is equivalent to about 7.2% of period GDP. Consolidated budget revenues increased by a nominal 32.2% yoy to UAH 27.3 billion, while expenditures grew by less than 16% yoy to UAH 21 billion. For January-February 2007, revenues to the general fund of the state budget exceeded the target by 7.3%. Tax revenues, which account for almost 85% of general fund revenues, grew by more than 40% yoy in nominal terms and were 9% above the target. Proceeds from major taxes were over-executed with a rate approaching 6% for taxes on international trade to almost 10% for VAT. Enterprise profit tax receipts were 6.5% above target, reflecting strong financial performance of Ukrainian enterprises. In the previous periods, considerable growth of VAT proceeds was treated with caution due to accumulation of VAT refund arrears. However, the VAT refund was also over-executed by 5.7% this year.

Consolidated Budget Balance, % of period GDP



Source: Ministry of Finance

Plentiful budget revenues and strong macroeconomic developments encouraged an upward revision of the state budget earlier than expected. In the middle of

Date*	Previous budget						Amended budget			
	Jan-07	Apr	Jul	Oct	Dec	Dec- 07 /Dec-06, %	Apr	Jul	Oct	Dec- 07 /Dec-06, %
Minimum wage, UAH	400		420		450	12.5	420	440	460	15.0
Living wage for retired and disabled (minimum pension), UAH	380	387		395		7.9	410		415	13.4

* As of the beginning of the month

	Previous budget	Amended Budget	% change
State budget revenues, UAH million	147,888	152,503	3.1
State budget expenditures,** UAH million	163,604	171,204	4.6
Balance, UAH million	15,716	15,716 (18,700)	0 (19)

** Including net credits from the budget

Source: The Law "On Amendments to the 2007 State Budget Law" # 749 as of March 15, 2007.

March, the parliament adopted amendments to the 2007 state budget law, envisaging softer income policy. According to the amended budget, state budget revenues were raised by 3.1% compared to the revenues envisaged in the previous budget, while expenditures (including net credits from the budget) were raised by 4.6%. Though the difference between state budget revenues and expenditures (including net credits) constitutes UAH 18.7 billion ($3.7 billion), the targeted state budget deficit was kept unchanged in the amended budget law at UAH 15.7 billion. The latter became possible due to a special provision in the law permitting the government to use almost UAH 3 billion ($575 million) from cash balances accumulated on state accounts in 2006[1] to finance the general fund of the state budget. De facto, however, the state budget deficit increased by 19% to UAH 18.7 billion, or 2.9% of forecasted 2007 GDP.

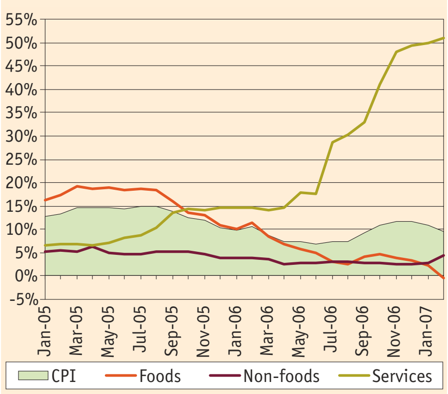
The financing of the targeted deficit remained unchanged with the lion's share of the funds to be received from privatization. For January-February, privatization proceeds amounted to UAH 91.8 million ($18.2 million), which represents less than 1% of the targeted amount. The privatization process is expected to accelerate in the coming months. Yet in March, the State Property Fund of Ukraine sold at auction 76% shares of Luhansteplovoz, one of the leading companies of Ukraine's heavy engineering industry, for UAH 292.5 million ($57.9 million) and placed a number of minority stakes on domestic stock exchanges. In particular, placement of 0.17% and 0.078% shares of JSC "Mittal Steel Kryvyj Rih" and 7.8% shares of "Pavlogradvuhillia" (coal extraction enterprise) attracted about UAH 66 million ($13 million) and UAH 108.4 million ($21.4 million) to the budget respectively. In addition, during March the SPF received approval for the privatization of telecom monopoly "Ukrtelecom" and one of the largest chemical enterprises "Odessa port plant". In the absence of new government borrowings on both domestic and external markets, the stock of Ukraine's public and publicly guaranteed debt has declined by 1.24% since the beginning of the year to $15.7 billion.

Monetary Policy

In February 2007, the State Statistics Committee of Ukraine reported consumer inflation at 0.6% month-over-month (mom), which translated into a 9.5% annual increase in the consumer prices index. Inflation was substantially lower than initially expected by most experts, whose forecasts were based on a considerable fiscal loosening at the end of the previous year, expectations of a further service tariffs adjustment in light of the imported natural gas price increase at the beginning of the year and a low statistical base[2]. However, it seems the authorities decided to postpone the energy price pass-through to consumers this year. Moreover, though February's CPI incorporated the increases in housing and utility tariffs in Kyiv, its impact was partially mitigated by a downward revision of the tariffs in a number of regions[3]. At the same time, services remained the main inflationary component of CPI growth — the service price index growth accelerated to almost 51% in annual terms. In addition, despite a notable deceleration in the rate of growth of gasoline prices, the non-food price index accelerated to 4.4% yoy in February, up from 2.8% yoy in the previous month. The speed up occurred on account of higher prices on medicines and medical appliances, transport vehicles and printed materials. However, these developments were outweighed by food price deflation.

Food products, which account for more than 60% in the consumer basket, reported a 0.3% yoy decline in prices in February on the back of over-saturation on several food markets (both due to domestic over-production and import acceleration) and a high base effect. For instance, sugar prices surged 25% mom in February last year, affected by an increase in world prices for white and raw sugar. This year, the rich harvest of sugar beets and a high base effect resulted in a 28.4% yoy decline in sugar prices. The decline in prices of some other products (such as meat and meat products, eggs, etc.) may be also attributed to limited export opportunities and warm weather conditions. On the back of current price developments and likely slower energy price pass-through, the government forecast of 7.5% yoy inflation may be realistic.

CPI and Its Major Components, % yoy



Source: State Statistics Committee, The Bleyzer Foundation

Lower than expected inflation in the first two months of the year was also achieved thanks to moderate monetary tightening. The NBU continued to sterilize excess liquidity in the banking sector, extracting UAH 16.8 billion ($3.3 billion) in February alone. Coupled with growing cash balances on government accounts with the National bank (up by 23.2% in February and more than 52% since the beginning of the year), the monetary base declined by almost 3% mom. In annual terms, the growth rate of the monetary base declined to 21.1% yoy, down from 26.7% yoy a month before. At the same time, the growth of money supply (M3) accelerated to 37.1% yoy in February, reflecting the speed up of deposits growth. In particular, deposits grew by 8% mom, driving the annual growth to 40.8%. Acceleration of money supply, however, had limited impact on inflation due to strong money demand. The latter was triggered by robust economic growth in the first two months of the year and revealed through the accelerating pace of credit disbursement. In particular, commercial bank credits grew by 71.1% yoy in February, up from 70.1% yoy a month before.

[1] In 2006, the government secured resources to finance a projected budget deficit in an amount that considerably exceeded the actual deficit. As a result, cash balances on state accounts amounted to UAH 10.6 billion ($2.1 billion) as of the end of the year, according to the Ministry of Finance.

[2] During the first half of 2006, annual inflation was decelerating due to an administrative delay in energy price pass-through. However, since the second half of the year, most service tariffs were revised upwards (some of the tariffs remained unchanged for 6 years), driving year-end consumer inflation up to 11.6%.

[3] A comprehensive audit of the current level of utility tariffs throughout the regions of Ukraine was initiated at the beginning of 2007. The lack of a generally accepted methodology of calculating utility tariffs makes it difficult to substantiate the magnitude of recent increases in utility tariffs, thus resulting in their moderate downward revision. The most significant revision was registered in Kyiv, where tariffs were increased by 1.9 times instead of the previously announced 3.4 times.

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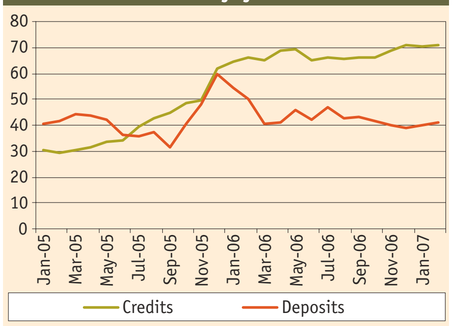
The foreign exchange market was almost balanced in February. The NBU continued to maintain the hryvnia peg to the US dollar at 5.05 UAH/$. On the back of robust inflow of foreign currency (in the form of export revenues, private sector borrowings and FDI) on the one hand and high demand for foreign currency (due to robust imports and the need to service foreign-currency-denominated private debt) on the other hand, net NBU purchases of foreign currency constituted $265.4 million. This allowed the NBU's international reserves to exceed $22.8 billion at end-February.

Commercial Banks Credits and Deposits Growth, % yoy



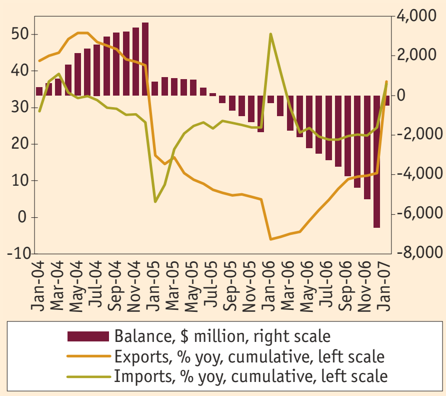
Source: State Statistics Committee, The Bleyzer Foundation

International Trade and Capital

According to the SSC, merchandise exports surged by 37.2% yoy in January 2007 to $3.2 billion, slightly outpacing 36.5% yoy growth of imports. At the same time, imports reported growth rates exceeding 35% yoy for the second month in a row, driven by strong consumer and investment demand in the country. As a result, the merchandise trade balance generated a deficit of $492 million.

By product breakdown, exports of metals and chemicals, accounting for 48% and about 10% of total merchandise exports, grew by 51.3% yoy and 46.6% yoy respectively. Another significant contribution to the overall growth of merchandise exports came from machinery and transport equipment. Exports of these commodities, accounting for 14% in total exports, advanced by almost 60% yoy, driven by robust economic growth in CIS countries, the main outlet for Ukrainian produced machines. On the downside, due to the ban on the export of grain and some other cereals introduced in the fall of last year, exports of grain were almost twice as low as in January last year, bringing the whole group trading volumes down by about 60% yoy.

Merchandise Trade Performance



Source: State Statistics Committee

On the import side, mineral products remained the largest contributor to overall import growth. Accounting for 41.2% of total imports, mineral products imports surged up 37.3% yoy in January. The growth was underpinned by a 47.3% yoy increase in natural gas imports (primarily due to the rise in imported natural gas prices since the beginning of 2007) and a more than growth rate of coal imports that was almost twice as high. The latter may be explained by re-orientation of a number of large enterprises (such as Mittal Steel Kryvyj Rih) to higher quality and often cheaper imported coal. On the positive side, the import of investment goods was also on the rise. In particular, imports of machinery and transport vehicles expanded by 36.6% yoy in January 2007.

Despite strong export performance at the beginning of the year and a favorable outlook for world steel price developments, the merchandise trade deficit is projected to keep widening throughout 2007, though the pace of it is likely to be slower than initially expected. A worsening merchandise trade balance will be the primary reason for the growing CA deficit, which is expected to reach 3% of GDP. However, the CA deficit is expected to be securely covered by the high inflow of FDI anticipated at around $5 billion, according to the recent Consensus Forecast, and a further increase in private debt. According to NBU data, gross external debt grew by 37% to $54.3 billion in 2006, or 51.2% of GDP. The growth was primarily underpinned by robust private sector borrowing, which expanded by more than 60% yoy and exceeded $40.5 billion at the end of 2006. Though the level of gross external debt is sustainable according to international standards, the pace of its increase raises concerns.

Other Developments and Reforms Affecting the Investment Climate

Shortly after the launch of negotiations on a new Enhanced Agreement between the EU and Ukraine at the beginning of March 2007, the EC officials announced a substantial increase in financial assistance to Ukraine over the next four years. About EUR 500 million is planned to be allocated to Ukraine during 2007–2010 to support the reform process and the implementation of the EU-Ukraine Action Plan. In addition, Ukraine will be eligible for the Neighborhood Investment Fund. This Fund will be used to leverage additional lending from financial institutions including the European Investment Bank and the European Bank for Reconstruction and Development.

On April 2, following the prolonged power struggle between President V.Yushchenko and Prime Minister V. Yanukovich, the President issued a Decree dissolving the Parliament and calling for early elections on May 27. At the same time, the ruling coalition (consisting of the Party of Regions, Socialist and Communist Parties) questioned the legality of the Decree and appealed to the Constitutional Court. All parties have agreed to abide by the resolution of the Constitutional Court. Despite short term disruptions, the current political turmoil is seen as a necessary process of political adjustment since the amended 2005 Constitution of Ukraine allowed for overlapping mandates and ambiguous interpretation of a number of important provisions. Nevertheless, over the medium term, regardless of how the crisis is resolved — either by compromise or by new elections — the country is not expected to change its basic economic direction towards a free market economy. It will continue market reforms, join the WTO and seek a FTA+ with the EU. The Ukrainian economy is expected to show positive developments even in 2007, unless the crises were to spread into civil strife, which is quite unlikely.

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