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Ukraine
Macroeconomic Situation

April 2007

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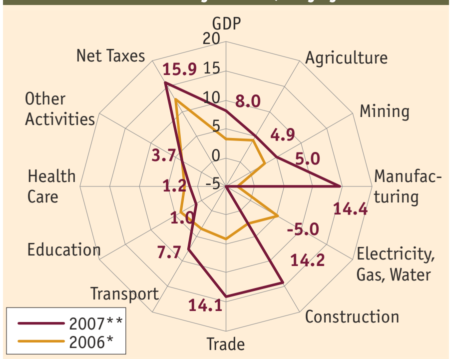
Summary

- Ukraine continues to enjoy rapid economic growth as real GDP grew by 8% yoy in the first quarter of 2007. Despite recent heightening of political tensions, Ukraine's macroeconomic fundamentals remain strong.
- Due to over-fulfillment of budget revenues and under-execution of expenditures, the state budget posted a record high surplus of 4.8% of period GDP for January-March. This allowed the government to further expand social expenditures
- In March, annual consumer inflation accelerated to 10.1% yoy; however, the government forecast of 7.5% yoy year-end inflation in 2007 may still be realistic.
- The National Bank of Ukraine is taking steps to curb expansion of commercial bank lending in foreign currency as the stock of forex-denominated bank loans almost doubled in one year.
- A favorable external environment drove a 34.5% yoy expansion in goods exports. However, the merchandise trade deficit continued to wide on robust growth of imports.
- Early elections will take place in Ukraine, although the date of elections remains uncertain.
- Major international investment rating agencies confirmed Ukraine's sovereign ratings despite the current political crisis.

Economic Growth

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

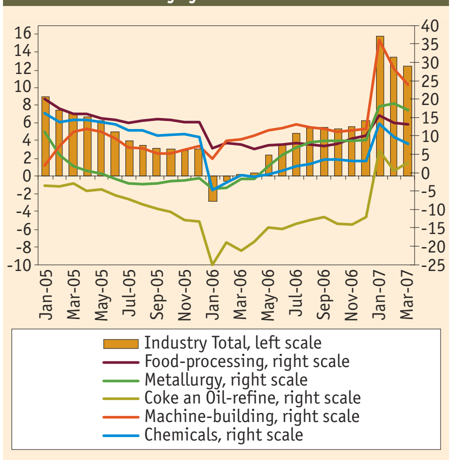


* Revised figures; ** Operative data
Source: State Statistics Committee

According to preliminary data released by the State Statistics Committee of Ukraine, real GDP growth slightly decelerated in March compared to a remarkably good start during the first two months of the year. During March, GDP grew by a real 7% yoy, bringing the cumulative growth to 8.0% yoy. The deceleration from 8.6% yoy over January-February is primarily attributed to an easing low base effect and the decline in value added in production and distribution of electricity, gas and water. The latter reported a 5% yoy decline in value added over January-March primarily affected by a warm winter this year, which caused lower demand for energy resources. In addition, despite a rather inelastic demand (both household and industrial) for energy, higher prices (particularly for imported natural gas) may have inspired more efficient use of energy resources, thus also weakening demand.

The growth of value added in all other sectors continued to decelerate but remained strong and broad-based. Though real household disposable income kept decelerating (to 11.1% yoy over January-March, down from 12.8% yoy in January 2007 and 16.1% yoy in 2006), private consumption was supported by high growth rates of bank lending operations. An increase in consumption was reflected in further expansion of net taxes on products and domestic-market-oriented sectors and industries such as retail trade (whose turnover grew by 25.6% yoy in real terms over the first quarter of 2007) and food processing (production increased by 14.8% yoy over the period). In combination with strong investment demand, this triggered a 24% yoy expansion in machine-building production and a 14.2% yoy increase in value added in construction. Expansion in these two sectors contributed to an 18% yoy growth in metallurgical output, though high world prices for steel products remained the main driver for output expansion in this industry. In turn, strong growth in metallurgy stimulated extraction of iron ores (up by 11.8% yoy over January-March). At the same time, despite expansive imported energy resources, domestic extraction of fossil fuels decreased by 0.4% yoy over the period. This is explained by a roughly 3% yoy decline in extraction of coal due to lower demand from heating and power generating companies and re-orientation of some large domestic enterprises on cheaper and higher-quality imported coal.

Industrial Output by Selected Industries, % yoy cumulative



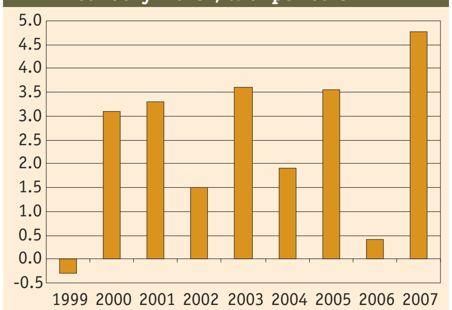
Source: State Statistics Committee

Strong economic growth over the first quarter of the year as well as expectations that world steel prices will remain high throughout the rest of the year support a positive outlook for the Ukrainian economy in 2007 despite the current political crisis. Over the past three years, Ukraine has experienced several election campaigns (one of which led to massive public protests known as the Orange Revolution), frequent re-forming of the government, amendments to the constitution that led to deep dissention between the president and the prime minister and between parties supporting them in the parliament. However, the Ukrainian economy proved to be rather resilient to political instability as businesses learned to incorporate possible political shocks in their economic programs. Hence, real GDP growth forecasted at 6.5% yoy in 2007 may be quite realistic.

Fiscal Policy

Thanks to robust economic growth, consolidated budget revenues grew by a nominal 34% yoy in January-March to UAH 44 billion ($8.7 billion). At the same time, consolidated budget expenditures grew more moderately, expanding by only 16% yoy in nominal terms over the period to UAH 37.7 billion ($7.5 billion). As a result, the consolidated budget surplus stood at UAH 6.3 billion, which is equivalent to almost 4.8% of period GDP. A record high surplus for January-March was achieved due to over-fulfillment of budget revenues and considerable under-execution of expenditures in the first two months of the year. Though execution of planned budget expenditures has improved in March (spending from the general fund of the state budget was 5.1% above target), cumulatively they lagged 12% behind the target. On the other hand, revenue collections to the general fund of the state budget were 6% above the planned amounts.

Consolidated Budget Balance, January-March, % of period GDP



Source: Ministry of Finance

Though high rates of economic growth had a positive effect on overall fiscal revenues, the rate of execution varied considerably among taxes. Thus, proceeds from the value added tax (VAT) grew by a nominal 23.5% yoy over January-March; however, in March they were almost 5% below target. Since VAT is essentially a tax on consumers, lower collection of VAT may indicate a deceleration in consumption, which in turn contributed to slower growth of value added in industry, agriculture and service sectors. On the other hand, an upsurge in proceeds from the enterprise profit tax (EPT) offset the shortfall of VAT collection. In March, receipts from EPT grew by almost 90% yoy in nominal terms, exceeding the target by about 70%. An over-execution of the EPT was in line with improving the financial stance of Ukrainian enterprises. In January-February, profits before taxes were almost 65% higher than in the same period in 2006, while the share of profitable enterprises increased to 65.1% (up from 60.9% last year). Though higher profitability of Ukrainian enterprises was achieved on the back of a more favorable external environment (particularly, higher world steel prices)

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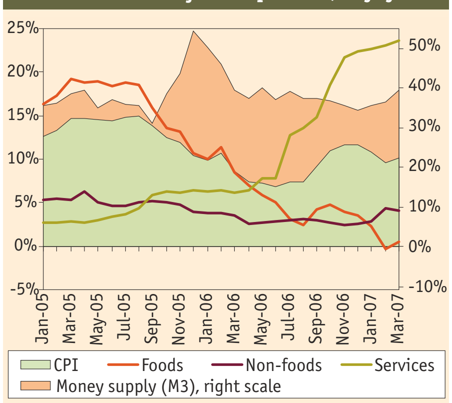
and a low statistical base, it is more evidence of the stronger than expected resilience of Ukraine's economy to gas price shocks.

On the back of over-execution of state budget revenues and large surpluses reported by local budgets, the government decided to further expand social expenditures. At the beginning of May, the Cabinet of Ministers approved amendments to the budget law envisaging an increase in consolidated budget expenditures by UAH 4.8 billion ($950 million). More than 87% of these funds are to increase wages in the public sector, while the rest will finance upward revisions of pensions for veterans and participants in WWII (World War II). This is the second pro-cyclical fiscal loosening in two months. The state budget deficit, however, was left unchanged thanks to an upward revision of state budget revenues and reduction of net lending from the budget. At the same time, the second pro-cyclical fiscal policy loosening in two months threatens the feasibility of inflation and current account balance targets set in the 2007 budget.

In March, the stock of public and publicly guaranteed debt declined by 3.3% month-over-month (mom) mainly due to a 4% mom decrease in external debt as the government repaid its external obligations due in March. At the same time, despite rather moderate privatization receipts over January-March, the government did not issue new debt instruments during the period. A possible reason may be higher than expected budget revenues and considerable cash balances accumulated on state accounts at the end of 2006. Thus, the stock of public and publicly guaranteed debt declined to $15.2 billion, or about 12% of forecasted full-year GDP. The level of external public debt, accounting for about 80% of total public debt, went down by 5% year-to date (ytd) to $12 billion at the end of March.

Monetary Policy

CPI and Its Major Components, % yoy



Source: State Statistics Committee, The Bleyzer Foundation

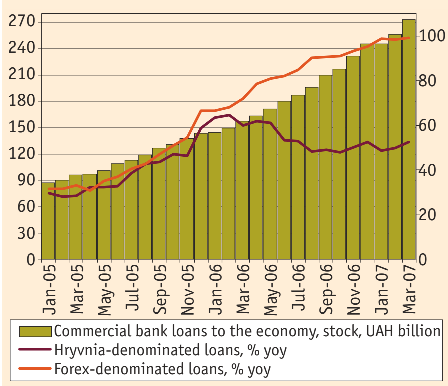
According to the State Statistics Committee of Ukraine, the consumer price index grew by 0.2% mom in March, bringing year-to-date inflation to 1.3%. The lower than expected inflation in March[1] was the result of continuing downward revisions of utility tariffs in a number of regions of Ukraine (utility tariffs declined by 0.3% mom in March), a decrease in domestic gasoline prices (by 0.8% mom), which followed the descending trend on international markets, and a decrease in the cost of communication services (mostly cellular) by 0.8% mom.

In annual terms, however, service tariffs continued to increase, reaching almost 52% yoy in March (up from 50.9% yoy a month before) on higher costs of railway transportation, healthcare and recreation services. Despite some deceleration of non-food prices, total consumer price inflation sped up to 10.1% yoy in March, up from 9.5% yoy in February. Despite this acceleration, the government forecast of 7.5% yoy year-end inflation still may be realistic due to the rather moderate food price inflation in the first three months of the year, slower energy price pass through to consumers and a high base for comparison.

Acceleration of CPI growth in March also reflected faster growth of monetary aggregates during February-March. Thus, despite the NBU continuing to sterilize excess banking sector liquidity, extracting UAH 24.5 billion ($4.8 billion) in March alone, the growth of the monetary base and money supply sped up to 27.7% yoy and 39.6% yoy, up from 21.1% yoy and 36.6% yoy a month before. The developments of monetary aggregates were primarily driven by the changes in government deposits with the NBU and NBU forex market operations. In particular, government deposits were up by 7.4% mom in March and 63.4% since the beginning of the year, which is explained by higher-than-expected budget revenues and under-execution of budget expenditures over January-March. Robust forex inflow due to a favorable external environment and active private borrowing from abroad led to excess supply of foreign currency on the forex market. Since the National Bank of Ukraine is continuing the policy of de facto pegging the hryvnia exchange rate to the US dollar, net NBU purchases of foreign currency amounted to more than $500 million in March and almost $1 billion since the beginning of the year.

Acceleration of money supply growth also reflected faster growth of deposits, which increased by 44% yoy. This allowed commercial banks to further expand their lending operations. Bank credits grew by 73.1% yoy in March, up from 71% yoy a month before. The growth was led by corporate loans as they account for almost two thirds of the total credit portfolio of the banking sector and are rapidly increasing (up by 54.7% yoy in March compared to a 51.6% yoy increase in February). At the same time, loans issued to households are catching up. Though the growth of these loans slightly decelerated in March, it stayed at an impressive 129.2% yoy. In addition, the share of credit issued to households in total credit increased to almost 32.7% in March 2007 from 24.7% a year ago. The high growth rate of credit contributes to expansion of economic growth as access by the corporate sector to credit resources stimulates investment activity, while lending to individuals is a factor of consumption growth. At the same time, forex-de-

Credit Boom Indictors



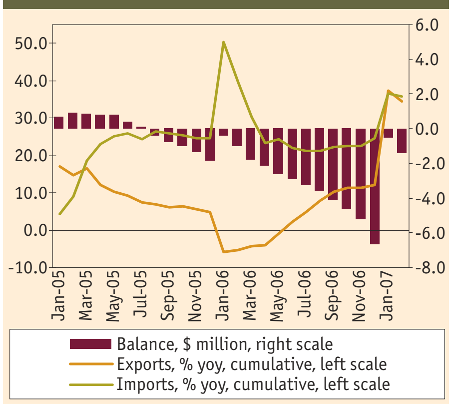
Source: NBU, The Bleyzer Foundation

nominated loans continued to accelerate with the stock of foreign-currency-denominated credits almost doubling compared to March 2006, which raises banking sector exposure to foreign exchange risk. Responding to this concern, the NBU has tightened reserve requirements for commercial bank credits in foreign currency to households up to UAH 20,000 ($4,000), effective since April 10th. The reserve rate will depend on the measure of risk and borrower's availability of foreign currency inflow.

International Trade and Capital

According to State Statistics Committee data, Ukraine's export performance remained strong in February as merchandise exports grew by 34.5% yoy in January-February. At the same time, robust consumption and investment demand triggered 35.7% yoy growth of imports. As a result, the merchandise trade deficit widened to $1.38 billion, or 34% yoy higher.

Merchandise Trade Performance



Source: State Statistics Committee

By product breakdown, the leading exporting commodities were metallurgical products, machines and equipment, transport vehicles, chemicals and foods. On the

[1] A few days before the SSC released data on consumer price developments, the Minister of Economy expected inflation at 0.7% mom.

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back of high world steel and chemical prices, exports of these commodities grew by 49% yoy and 29% yoy respectively during the first two months of the year. Strong external demand triggered 58.5% and 67% yoy growth in exports of machinery and transport vehicles respectively. Export of food products also expanded at an impressive 25.5% yoy. On the downside, due to the introduction of grain export quotas in the fall of last year, exports of cereals continued to decline. Over January-February 2007, exports of these commodities were 32.5% lower than in the respective period last year. On the import side, it was traditionally led by mineral product imports, which expanded by 30.7% yoy over the period. On a positive note, the share of investment goods in total merchandise imports is also gradually increasing. Thus, imports of machinery and transport vehicles rose by 42% yoy and 56.5% yoy respectively over the period, bringing the total share to 26.5%, up from 24.3% in the corresponding period last year.

Other Developments and Reforms Affecting the Investment Climate

The political situation has remained rather complex over the last couple of months. Political tensions between the ruling coalition and the president heightened April 2 as the President issued a decree dissolving parliament and calling for early elections on May 27. At the same time, the ruling coalition in the Parliament and the government questioned the legality of the decree and appealed to the Constitutional Court. On April 26, the President issued another decree, postponing the date of early elections to June 24 due to deficiencies in legislation necessary to hold early elections. As in the previous case, the ruling coalition contested the decree in the Constitutional Court. Despite the confrontation, political forces have been making attempts to find a compromise suitable for all parties. On May 4, during a meeting between the President and the Prime Minister, a principal decision was made that early elections will indeed take place in Ukraine. The two leaders agreed to create a working group that will agree on a package of political and legal decisions, which are needed to ensure fair, transparent and democratic elections to the Parliament. At the same time, no specific date for early elections was disclosed.

Despite the political crisis, major international investment rating agencies (Fitch and Standard & Poor's) confirmed Ukraine's sovereign ratings at the beginning of April. According to Fitch experts, Ukraine's current long-run sovereign rating 'BB–' (positive outlook) already incorporated the short-term political risks. Taking into account strong macroeconomic fundamentals, the rating was left unchanged. S&P shares a more conservative vision of current political developments, revising the outlook on Ukraine from stable to negative. According to S&P representatives, the negative outlook reflects the growing risks that Ukraine could see a prolonged constitutional crisis, paralyzing policy making and undermining economic growth prospects. At the same time, improved political stability and moderate progress in structural and economic reforms would lead to a revision of the outlook back to stable.

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