Ukraine
Macroeconomic Situation

June 2007

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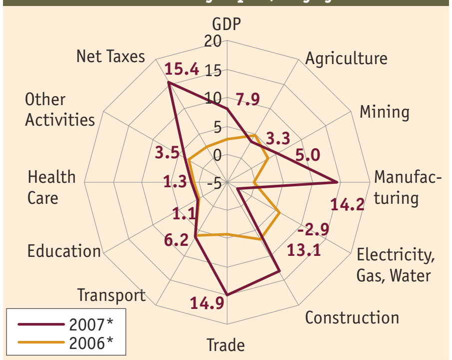
Summary

- Despite the current political crisis, Ukraine's macroeconomic fundamentals have remained strong.
- For January-April, real GDP grew by 7.9% yoy, supported by robust growth in industry, domestic trade, construction and transport.
- The consolidated state budget was in surplus of 3.4% to period GDP. Despite favorable performance so far, successful budget execution in 2007 may be a challenging task.
- Annual consumer inflation sped up to 10.6% yoy in April due to faster growth of food prices, monetary aggregates and spill over of producer price inflation.
- The National Bank of Ukraine decided to reduce its discount rate to 8%, urging commercial banks to decrease their credit rates.
- Though the growth rate of exports continued to outpace the growth of imports, the merchandise trade deficit kept widening, reaching $2.2 billion over the first quarter.
- Early parliamentary elections in Ukraine are scheduled for September 30, 2007.
- Despite the political crisis, Ukraine adopted all legislation necessary to finalize WTO entry.

Economic Growth

Despite a politically turbulent month, the Ukrainian economy continued to demonstrate remarkable performance in April. In particular, real GDP growth accelerated to 7.6% yoy in April, bringing the cumulative growth to 7.9% yoy. The major contributors to economic growth were wholesale and retail trade, industry, transport and construction.

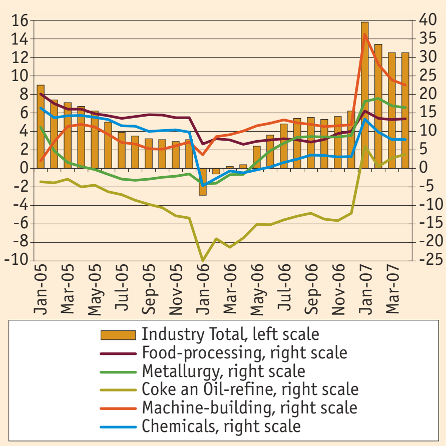
Real GDP and Value Added Growth by Sector in January-April, % yoy



* Operative data
Source: State Statistics Committee

Though data on the composition of GDP growth by expenditure is not available yet, a notable increase in net taxes on products (up by 15.4% yoy over January-April) suggests that private consumption continued to grow at a high rate this year. The growth is supported by the softer than expected income policy of the government (household disposable income rose by a real 11.1% yoy over January-March) and the ongoing credit boom. Private consumption, in turn, stimulated expansion in domestic-market-oriented industries and sectors. Thus, value added growth in wholesale and retail trade picked up to about 15% yoy, and output in the food industry increased by 13.4% yoy (up from 13.2% yoy over January-March). At the same time, robust investment demand, evident from a 32.2% yoy nominal increase in fixed capital investments over the first quarter 2007, contributed to 13.1% yoy value added growth in construction and a 22.5% yoy increase in machine-building production for the first four months of 2007. Buoyant growth in construction and machine-building formed strong domestic demand for metallurgical products, which coupled with favorable export opportunities (high international steel prices) triggered a 22.5% yoy increase in metallurgy. High international prices on metal ores encouraged their domestic extraction (up by 14.3% yoy over January-April). However, due to lower demand for coal, stemming from the re-orientation of several large enterprises (particularly in metallurgy) to cheaper and higher-quality imported coal and stagnation in the power-generating sector, domestic extraction of fossil fuels declined by 0.5% yoy over January-April. A 12.5% growth in total industrial production over January-April and increasing household income formed strong demand for transportation services. Thus, cargo and passenger turnover expanded by 8.6% yoy and 3.1% yoy over the period, contributing to a 6.2% yoy increase in value added in the sector. On the downside, light industry and production and distribution of electricity, which reported a 1.1% yoy increase and a 2.1% yoy decline in output respectively, were among the lagging sectors.

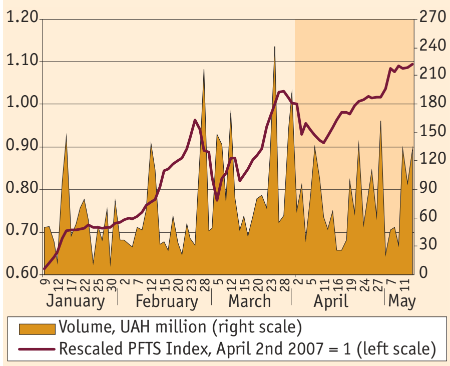
Industrial Output by Selected Industries, % yoy cumulative



Source: State Statistics Committee

Though political turmoil persisted over April-May, the economy demonstrated that it was not too much of a constraint on domestic and foreign businesses' decision-making. Strong macroeconomic fundamentals with real GDP growth at 7.1% yoy in 2006 and 6.5% yoy expected in 2007, the economy's resilience to energy price and political shocks, and a large domestic market with rapidly growing household propensity to consume were the key factors attracting foreign investors. A booming stock market may be convincing evidence of this. During the week and a half after the President issued his first decree on April 2nd dissolving the parliament and calling for early elections, PFTS index (the index of the major stock exchange in Ukraine) fell by 9%. However, by the end of the month it had gained back its position and even reported moderate growth of 1.3%. As of mid-May, the PFTS index had grown by almost 80% since the beginning of the year. A compromise on early elections, found at the end of May, resolved the political crisis. In addition, it also brought long-awaited progress in passing the legislation necessary to finalize WTO talks. All of these promote investment activities in Ukraine, paving the way for robust economic growth.

PFTS Index and Trade Volumes



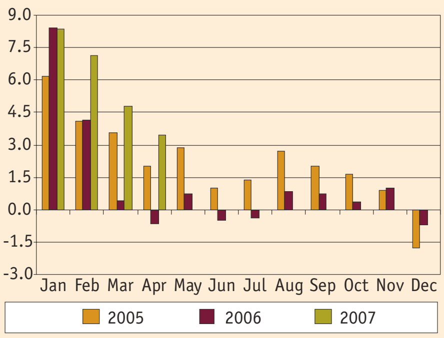
Source: PFTS, The Bleyzer Foundation

Fiscal Policy

Buoyant economic growth has led to healthy fiscal surpluses since the beginning of the year. Tax revenues to the general fund of the state budget were 6.1% and 1.2% above target for April and January-April respectively. Over-execution of budget revenues occurred thanks to the improving financial stance of Ukrainian enterprises, booming domestic and robust growth of external trade. In particular, over January-April, 63.2% of all enterprises reported profits before taxes that were almost 50% higher than in the same period of 2006. Thanks to growing household disposable income, which stimulated consumption of both domestically produced and imported goods, VAT receipts, proceeds from import/export duties and excises increased by more than 35% yoy, 38% yoy and 25% yoy in nominal terms respectively. Though budget revenues were over-fulfilled in April, expenditures from the general fund of the state budget were below plan by 4.5% in April and 10.2% since the beginning of the year. Thanks also to large surpluses of local budgets (generated due to plentiful personal income tax collections), the consolidated budget reported a surplus of UAH 6.2 billion ($1.23 billion), which is equivalent to 3.4% of period GDP.

Despite favorable performance so far, successful budget execution in 2007 may be a challenging task. In addition to budget amendments approved in mid-March and the beginning of May, the 2007 budget law was amended again at the beginning of June. The previous amendments were aimed at further increasing the government's social liabilities. This time, the budget was amended in accordance with an agreement between the president, the prime minister and the head of the parliament, envisaging allocation of funds to finance early parliamentary elections (set on September 30, 2007), among other things. The new election campaign is estimated at UAH 365 million ($72.3 million). Together with some other increases in budget expenses (including $43 million to increase public sector wages), total state budget expenditures were raised by about UAH 1.2 billion to UAH 174.6 billion ($34.6 billion). At the same time, thanks to an upward revision of state budget revenues and a reduction of net lending from the budget, the fiscal deficit was left unchanged at UAH 15.7 billion.

Consolidated Budget Balance, % of period GDP



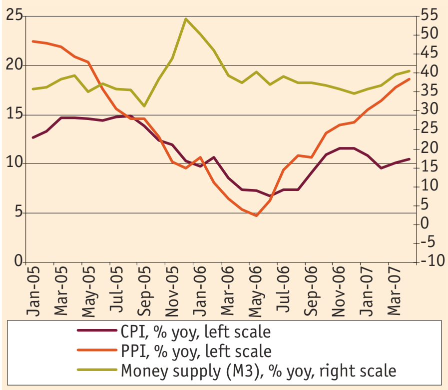
Source: Ministry of Finance

Though execution of the privatization plan for 2007 slightly improved in April, funds attracted during January-April were still a negligible amount compared to the targeted UAH 10.6 billion ($2 billion.). To secure enough funds to finance the planned fiscal gap, the government started to prepare debt issuance on both domestic and external markets. In particular, the government expects to attract $1 billion via placement of 5-year Eurobonds. So far, however, in the absence of new debt issues on the back of large debt service payments, the stock of public and publicly guaranteed debt continued to decline. At the end of April, it fell to $15.2 billion, which is equivalent to less than 12% of forecasted full-year GDP.

Monetary Policy

The State Statistics Committee of Ukraine reported zero consumer inflation in April. As a result, year-to-date inflation remained at 1.3%. Zero monthly inflation was achieved thanks to a 2.6% month-over-month (mom) decline in utility tariffs, which was mainly the result of a 9.5% mom decline in payments for hot water and heating due to the end of the heating season. This compensated for the 0.6% mom increase in food prices and the 3.2% mom increase in gasoline prices. In annual terms, however, the service price index kept accelerating due to a low base effect and more expensive medical and education services. Monthly deflation for food products during March-August 2006 formed the low basis for annual comparison in the respective months this year. As a result, food prices sped up to 1.5% yoy in April, from 0.5% yoy a month before. Though non-food price growth continued to slow (2.5% yoy in April compared to 4.4% yoy a month before), accelerating food prices and service tariffs drove consumer price index growth to 10.5% yoy (up from 9.6% yoy in February and 10.1% yoy in March). In addition, faster growth of consumer prices may reflect the spillover of producer inflation and the higher pace of monetary aggregates growth.

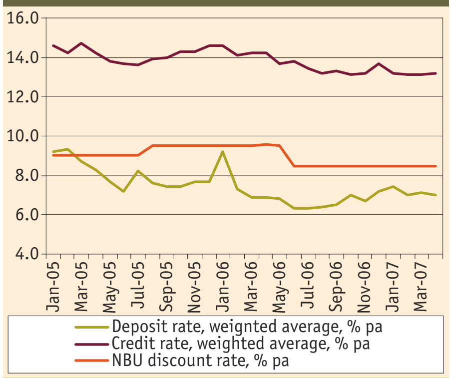
CPI, PPI and Money Supply Developments



Source: State Statistics Committee, The Bleyzer Foundation

Since May 2006, producer prices have been gaining speed, reflecting resumed growth of international steel and chemical prices and rising natural gas and oil prices. For a year, the pace of growth of the producer price index (PPI) tripled, increasing to 18.6% yoy in April 2007 from 5.4% yoy a year ago. The highest growth of prices was registered in resource-intensive and export-oriented industries like metal processing, mining, production and distribution of electricity, gas and water. The wide discrepancy between the CPI and PPI indices is explained by a number of administratively regulated prices and tariffs.

Deposit and Credit Interest Rates Dynamics



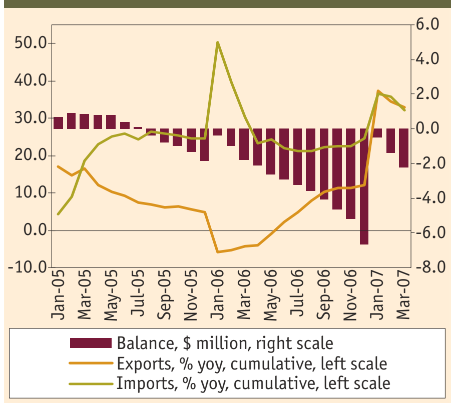
Source: NBU

According to NBU data, the monetary base and money supply (M3) grew by 27.7% yoy and 40.5% yoy in April. The growth of the monetary base was driven by NBU foreign currency purchases on the interbank market and a decline in government deposits. The political crisis stimulated the population's demand for cash foreign exchange. At the same time, foreign currency sales by the population remained considerable and to a large extent compensated for this demand swing. Though net purchases of cash foreign currency by the population increased to $381 million in April (while it was negative in March), it did not caused shortages of foreign exchange on the market. The hryvnia exchange rate was supported by robust export performance and capital flows to the country, which was evident from net NBU purchases of foreign currency on the interbank market in the amount of $335.7 million in April. The decline of government deposits with the NBU by 2.2% mom also contributed to this increase. An increase in the monetary base and the multiplicative effect of growing deposits were the main reasons for money supply acceleration. Despite political turmoil, deposits grew by 2.8% mom in April. Though it was a deceleration from the 4.1% mom increase in March, the growth of deposits continued to accelerate in annual terms (44.3% yoy in April compared to 44% yoy a month before).

Faster growth of monetary aggregates, however, had a minor impact on inflation due to higher money demand. The latter was reflected in further growth of commercial banks' lending operations, which were up 3.7% mom in April. In annual terms, the growth of credits to the Ukrainian economy accelerated to 73.7% yoy, up from 73.1% yoy in March. Though commercial banks' lending operations continued to gather momentum, the liquidity stance of the banking system remained rather loose. However, this did not translate into a credit rate decline. For about a year, the weighted average interest rate on credit has been fluctuating around 13.2–13.3% per annum. To change the situation, the National Bank decided to reduce its discount rate by 50 basis points to 8% starting June 1st. Although the NBU discount rate does not affect the cost of credit resources directly, it serves as a signal for commercial banks to reduce their credit rates.

International Trade and Capital

Merchandise Trade Performance



Source: State Statistics Committee

According to the State Statistics Committee of Ukraine, exports of goods increased by 31.3% yoy in March, bringing the year-to-date growth to 33% yoy. Although exports continued to decelerate (down from

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34.5% yoy in January-February and 37.2% yoy in January), the rate of growth remains impressive, while the deceleration may be attributed to an easing low statistical base. Also on a positive note, the growth rate of exports continued to outpace the growth of imports. In particular, merchandise imports grew by about 28% yoy in March and 32.2% yoy over January-March. Despite this, the merchandise trade deficit continued to widen, reaching $2.2 billion over the first quarter.

By product breakdown, exports of metallurgical and chemical products expanded by about 41% yoy and 29% yoy respectively, favored by high international prices. Robust growth in Ukraine's main trading partners (particularly Russia, which alone accounts for more than 25% of Ukraine's total merchandise export) triggered 52.1% yoy and 56.5% yoy growth in export of machinery and transport equipment respectively. Following the increase of the export quota on bread-grain and the abolition of the export quotas on fodder grain, barley and corn in February 2007, export of cereals grew by 25.6% yoy in March, for the first time since fall 2006. Since the beginning of the year, export of these commodities has declined by 8.7% yoy, which is a notable improvement compared to the 32.5% yoy decline over January-February.

High international prices on steel and chemicals caused 48% yoy and 34.5% yoy respective growth in the imports of these products over the first quarter of 2007. Robust private consumption encouraged imports of food products, textiles and vehicles. Mineral products remained the weightiest commodity group in total merchandise imports, expanding by 34.3% yoy. On a positive note, robust investment demand drove imports of machinery and transport equipment. Expanding by 41.6% yoy over January-March 2007, the share of investment goods in total merchandise imports grew to 27.8%, up from 23.4% yoy in January 2007 and 26% yoy over January-March 2006.

Other Developments and Reforms Affecting the Investment Climate

The political situation remained rather tense in May. Although on May 4th, the President and the Prime Minister agreed to create a working group that will agree on a package of political and legal decisions needed to ensure fair, transparent and democratic elections to the Parliament, the next few weeks demonstrated rather weak compliance to the achieved agreement. Mutual distrust among political forces participating in the working group resulted in a dead-end to the negotiations. In the meantime, the reputation of the Constitutional Court of Ukraine, which opened proceedings on the constitutionality of presidential decrees dissolving the parliament, suffered from accusations of political bias and breach of duty. As several judges took vacations or sick leaves, the Constitutional Court remained paralyzed due to the lack of a quorum. An acceptable solution that resolved the current political crisis was achieved on May 27th during a meeting between the president, the prime minister and the head of the parliament. In particular, the agreement envisages:

1. Early elections will take place on September 30, 2007. The legal grounds for the elections will be resignation of opposition members of the parliament and annulment of election lists by the opposition parties and blocs (according to the Constitution of Ukraine, if there are less than 300 deputies in the parliament, it is considered illegitimate, which leads to its automatic dissolution).

2. The parliament will adopt three packages of documents:
   a. The first package will provide the legal foundation necessary to carry out elections (amendments to the election laws, allocation of funds to finance elections, etc.).
   b. The second package includes decisions adopted by the parliament since April 2nd (the first presidential decree, dissolving the parliament);
   c. The third package includes legislation necessary to finalize WTO entry.

In accordance with the agreement, the president suspended his decree dissolving the parliament for several days for the parliament decisions to be legitimate. As of the beginning of June, all legislative requirements were met, including legal amendments necessary for WTO entry. This gives top Ukrainian officials reason to expect WTO entry yet in November of this year.

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