Ukraine

Macroeconomic Situation

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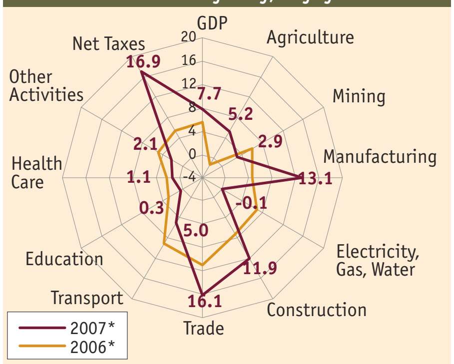
Summary

- Real GDP grew by 7.7% year-over-year (yoy) over January-July. This good result was achieved thanks to double-digit growth rates in manufacturing, wholesale and retail trade, and construction.
- The consolidated budget surplus constituted 1.4% of period GDP in January-July. The surplus was achieved thanks to large local budget surpluses and under-execution of state budget expenditures.
- The year-end fiscal deficit may be lower than the projected 2.5% of GDP considering over-execution of fiscal revenues and likely moderate tightening of expenditures.
- July saw an 11-year record high monthly increase in consumer inflation, bringing annual CPI growth to 13.5%.
- On the back of continuing deterioration of the merchandise trade deficit, the current account deficit widened to 3.4% of period GDP in the first half (1H) of 2007. However, the current CA deficit is not raising concerns since the financial account surplus exceeded the CA deficit by three times.
- Recent turbulence on world financial markets is unlikely to have severe consequences on Ukraine's macroeconomic fundamentals.

Economic Growth

According to operative data of the State Statistics Committee, the Ukrainian economy grew by a real 7.7% year-over-year (yoy) over January-July. The growth was broad-based with double-digit growth rates in manufacturing, wholesale and retail trade, and construction.

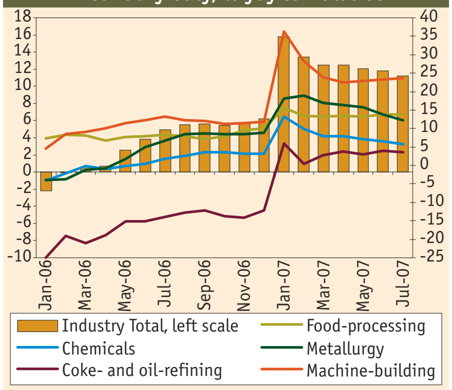
Real GDP and Value Added Growth by Sector in January-July, % yoy



* Operative data
Source: State Statistics Committee

Domestic-market-oriented sectors and industries benefited from robust growth of real disposable household income (up by 10.8% yoy in 1H 2007) and a continuing credit boom. Thus, turnover in retail trade grew by a real 15.4% yoy while food processing output expanded by almost 14% yoy over the first seven months of the year. Machine-building and metallurgy continued to grow from vigorous domestic demand, buoyant economic growth in Ukraine's main trading partner countries, and high international prices for Ukraine's main exporting commodities. Although a high statistical base effect gathered full steam during June-July, production of machines and equipment continued to accelerate and was up by 23.7% yoy over January-July. Acceleration of machine-building production was driven by an impressive 50.5% yoy growth in production of automobiles, a 21.2% yoy increase in output of electric equipment and electronics and 15.4% yoy growth of machinery and equipment production.

Industrial Output by Industries in January-July, % yoy cumulative



Source: State Statistics Committee

Though international steel prices kept declining in July, they were still at a very high level. For the heavily export-oriented metallurgical industry (according to the SSC, about 72% of total metallurgical output is exported), high international steel prices allowed for higher profits with a moderate increase in output. As reported by the SSC, metallurgical enterprises saw 83% higher profits before taxes in nominal terms over 1H 2007 than in the corresponding period last year. At same time, rising international steel prices, which also spilled over into domestic prices, spurred traders to accumulate significant inventories of metallurgical products. In addition, imports of metallurgical products notably accelerated this year, contributing to overproduction in the market. All of this, coupled with an increased statistical base effect, explains the moderate 3.2% yoy growth in metallurgical output production in July. However, thanks to impressive growth in previous months, the seven month total production of metallurgical products was up by a remarkable 12.2% yoy. Strong performance of food processing and machine-building explained about 2/3rds of total industrial output growth over January-July, which was 11.2% higher than in the corresponding period last year.

At the same time, the growth of industrial production has been decelerating since the beginning of the year. In addition to slower gr owth in metallurgy, deceleration in output growth was reported in the chemical and extractive industries. Together accounting for about 15% of total industrial production, these industries reported moderate 5.7% yoy and 2.8% yoy growth over January-July. Production of energy-intensive chemical products, which suffered from price hikes on imported natural gas at the beginning of the year and rising crude oil prices during May-July, was also affected by declining international prices for fertilizers, which hold a large share in chemical production and exports. The mining industry experienced a 2.8% yoy reduction in extraction of energy materials, which is explained by lower demand of metallurgical companies for domestically extracted coal.

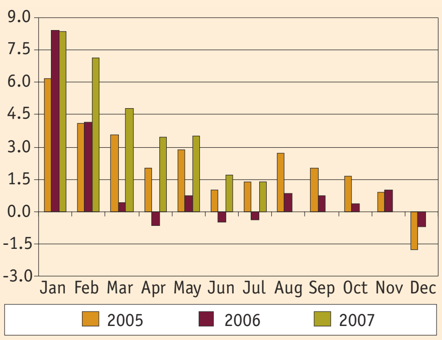
Robust industrial sector growth and steady demand for new housing, supported by the continuing credit boom, stimulated further expansion of construction, which posted a 11.9% yoy increase in value added over January-July. Closely linked with industry, construction, and foreign trade, wholesale trade turnover grew by a nominal 11.2% yoy. Value added growth in retail and wholesale trade therefore accelerated to 16.1% yoy in January-July, up from 15.5% yoy in January-June. Agriculture rather unexpectedly regained its position as an important contributor to economic growth during the period. Contrary to expectations of meager growth (the forecast for this year's harvest was downgraded due to May-June's drought), the sector reported a 5.2% yoy increase in value added over January-July. Such robust growth is explained by the early start of the harvest campaign, which temporary caused a statistical distortion due to a relatively low base for comparison.

GDP growth in the coming months is expected to continue to decelerate for several reasons. First, it is very likely that the external environment will be less benign in the second half of the year (flatter international steel prices, high energy prices, etc.). At the same time, we believe external demand for Ukraine's key export commodities will remain strong enough to maintain Ukraine's export growth at a decent level. Secondly, poorer agricultural performance in the coming months will contribute to an economic growth slowdown. Third, political uncertainty related to parliamentary elections in late-September and the formation of a new government may dampen investment activity. Fourth, the effect of a high statistical base will be more evident in the second half of the year. Taking the above into consideration, we believe real GDP growth will slow to 6.5% yoy in 2007, despite the exciting 7.7% yoy growth in the first seven months of the year.

Fiscal Policy

Robust economic growth along with under-execution of expenditures allowed the government to report a UAH 4.86 billion ($960 million) surplus of the consolidated budget over January-July, which is equivalent to 1.37% of period GDP. At the same time, the consolidated fiscal surplus was achieved primarily on account of surpluses in local budgets, as the state budget turned into a small deficit of 0.3% of period GDP. According to the budget execution report presented by the Ministry of Finance on its official website and referencing State Treasury data, proceeds from personal income tax (PIT), the main revenue source for local budgets, grew by a nominal 47.9% yoy. Considering that nominal household income grew by 27.3% yoy over January-July, much faster growth of PIT receipts suggest improved tax administration and/or tax compliance. Over the period, state budget revenues reached UAH 83.8 billion ($16.6 billion). A 23.3% yoy nominal increase in state budget revenues was underpinned by 31.6% yoy and 25.4% yoy growth of VAT and EPT (corporate profit tax) proceeds, which account for more than a half of total state budget revenues.

Consolidated Budget Balance, % of period GDP



Source: Ministry of Finance

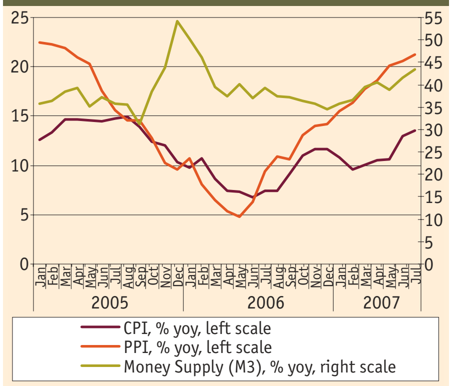
Though most tax collections were above the targeted amounts, the government continues to under-execute expenditures. In particular, expenditures from the general fund of the state budget were 7% below target for January-July. Despite under-fulfillment, state budget expenditures were 21.3% higher in nominal terms than in the corresponding period last year with the largest rate of increase reported for public wage expenditures and social transfers. According to consolidated budget data presented by the Ministry of Finance, social transfers grew by a remarkable 52.1% yoy over January-July, while expenditures for public sector wages were almost 29% yoy higher. Government social liabilities should maintain a robust increase in the coming months considering indexation of pensions by about 28%[1] effective on September 1st and an increase in the minimum living wage for retired to UAH 415 ($83) on October 1st. In addition, the government will face higher wage bills in October as the minimum wage will be raised to UAH 460. Moreover, in the run up to the parliamentary elections, execution of budget expenditures may notably improve. An increase in social expenditures and a catch-up of previously under-fulfilled expenditures may contribute to inflationary pressure at the end of 2007. In addition, the government may lack sufficient resources to finance the expected fiscal deficit in 2007.

According to the state budget law for 2007, the deficit is targeted at UAH 15.7 billion ($3.1 billion), about 2/3rds of which was planned to be financed with privatization revenues. However, the execution of privatization raises serious concerns, as privatization proceeds reached only UAH 1.57 billion (about $310 million) as of the end of July, which represents less than 15% of the targeted amount for 2007. Political uncertainty related to late-September's parliamentary elections and formation of a ruling coalition thereafter may impede carrying out the large privatizations scheduled for this fall (for instance, there is a very high probability that privatization of telecommunication monopoly Ukrtelekom, which was expected to bring the lion's share of privatization revenues to the state coffers, will be delayed until next year). At the same time, the borrowing activity of the government is restricted by the budget law, according to which new government external and domestic borrowings are planned in the amount of $1.5 billion and UAH 3.8 billion (about $760 million) respectively. During June-July, it attracted $0.5 billion and UAH 2.1 billion (about $425 million). Moreover, the government managed to reduce the cost of borrowing over the period with each domestic bond auction (the weighted average yield for 1.5-year domestic securities declined from 7.12% for bonds issued in June to 6.76% in July). In addition, the government moved on to offering only medium and long-term bonds since mid-July. These actions may explain the rather moderate amount of funds attracted from issuance of domestic bonds during August — UAH 110.5 million ($22 million) — as proposed yields were plainly unattractive for domestic buyers, while foreign investors, the principal buyers of longer-term domestic securities during June-July, adhered to a risk aversion strategy due to the volatile global markets caused by the US subprime mortgage crisis. Lower investor demand for riskier emerging market bonds (including Ukrainian sovereigns) coupled with high international interest rates (such as LIBOR[2]) made external borrowing a rather costly source of financing for both the government and the private sector of Ukraine. Under these circumstances, the government will have to increase the attractiveness of issued securities or tighten expenditures. It is likely that the government will choose some combination of the two approaches, which will translate into a lower-than-forecasted fiscal deficit in 2007 but higher debt-service payments in the medium term.

Monetary Policy

Following a 2.2% month-over-month (mom) increase in June, consumer price inflation surged another 1.4% mom in July. An 11-year record high monthly increase in July, traditionally a low inflation or deflation month, translated into annual CPI growth of 13.5%. Consumer price growth continued primarily due to growing food prices, which advanced by 10.9% yoy. The increase was led by 16.5% yoy and 36.6% yoy growth in prices on bread and flour, 25.1% yoy on milk and dairy products, as well as 23% yoy and 66% yoy increases in prices of fruits and vegetables. A surge in consumer prices was driven by both supply-side and demand-side factors. On the supply side, expectations of a poorer harvest this year drove prices on grain up, while this in turn spilled-over to costs of grain-related products (flour, bread, fodder, and hence meat, milk and dairy products). Robust growth of producer prices also brought pressure on consumer prices. The producer price index advanced 1.7% mom in July, which is equivalent to a 21.2% increase in annual terms. Rapid growth of producer prices is explained by high international prices for steel products, iron ores and grain (though prices on steel products have moderated in the last two months, domestic prices may respond with a several month lag to these developments), continuing pass-through of higher energy prices, etc. On the demand side, increases in government spending stimulated the growth of aggregate demand, which in turn spurred consumer prices. Recent consumer inflation developments make the government forecast of 7.5% inflation at year end unrealistic. Taking into account the very high base effect through the end of the year, full-year CPI growth may decelerate to about 10%.

CPI, PPI and Money Supply Developments



Source: State Statistics Committee

Acceleration of money supply growth has also contributed to mounting inflationary pressure. In July, the growth of money supply soared to 43.1% yoy on the back of sizable central bank interventions on the interbank forex market. In July, the NBU bought out $1.16 billion of surplus foreign exchange. Robust inflow of foreign currency is attributed to strong export performance, private sector borrowing from abroad and funds received from issuance of Eurobonds in late June. The impact of this influx of domestic currency was partly compensated for by growing government deposits with the NBU. In July, cash balances grew by 13.3% mom to UAH 15.5 billion ($3.07 billion).

On the back of active commercial bank borrowing from abroad as well as robust growth of deposits (up by 46.4% yoy in July), bank liquidity remained rather loose (cash balances on the corresponding accounts grew 30.5% since the beginning of the year to UAH 19.5 billion at the end of July; the weighted average interest rate on the interbank credit market was below 1.7% compared to 2.05% in the previous month). However, the NBU did not perform sterilization operations as robust investment activity and growing household income stimulated demand for money. Commercial banks continued to expand their credit portfolios in July. During the month, the volume of commercial

[1] According to the Cabinet of Ministers Decree #685 as of May 3, 2007, all pensions fixed before 2004 will be raised by 28% starting September 1st 2007, which is roughly equivalent to the nominal growth of average monthly wages in 2006. Pensions set during 2004-2005 will be raised by 20%. Considering that the number of retired people during 2004-2005 is relatively small compared to those retired before 2004, the majority of pensioners will receive pensions raised by 28%.

[2] It is a usual practice to define the cost of borrowing/lending money taking into account LIBOR (the London Interbank Offered Rate) dynamics. For instance, LIBOR-borrowings represent more than 30% of Ukraine's total public and publicly guaranteed debt.

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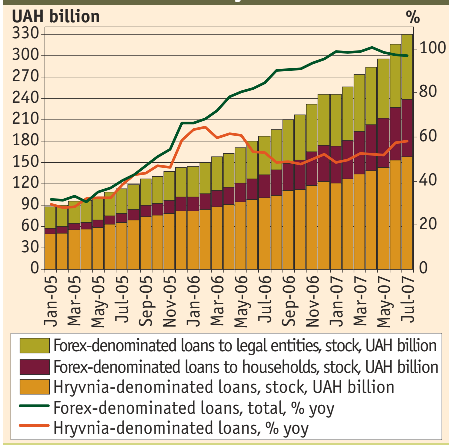
bank credit grew by a record high 76.1% yoy. Though increasing financial intermediation helps to sustain economic growth, it also increases demand for foreign goods, contributing to deterioration of the foreign trade balance. In addition, rapid expansion of bank loans for a relatively long period (the stock of commercial bank loans grew by about 62% in 2005, 71% in 2006 and 34.5% year-to-date (ytd) over seven months of 2007) increases banking sector vulnerabilities to various risks (credit, foreign exchange, liquidity, etc.).

Commercial Banks Loans to the Economy of Ukraine



Source: NBU, The Bleyzer Foundation

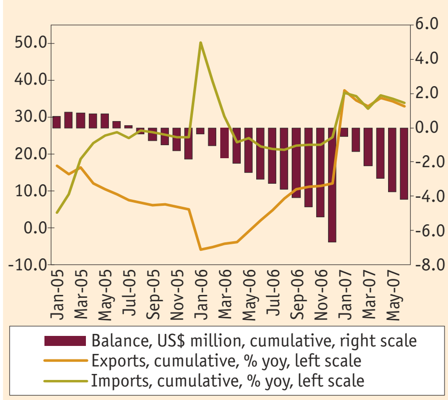
Though official statistics show improving prudential indicators for Ukraine's banking sector (for instance, the ratio of non-performing loans has been declining steadily since 2004) and the entry of a number of large systemic foreign banks during the last couple of years facilitated commercial bank and NBU efforts to improve risk management and loan practices, the continuing lending boom still raises serious concerns about the banking sector's resilience to possible shocks. Though the prudential indicators are improving, credit risk may be under-estimated as risk management practices are still developing. In addition, various risks are assessed based on strong current macroeconomic performance, high mortgage prices (hence, in case mortgage prices will sharply decline, the values of collateral may be over-estimated), robust growth of real household disposable income, etc. The Ukrainian banking sector is also exposed to significant foreign exchange risk as the share of loans denominated in foreign currency remains very high. Following NBU measures to reduce dollarization of the Ukrainian economy, the growth of forex-denominated loans has been decelerating since April, while that of hryvnia-denominated ones continued to accelerate. However, forex-denominated loans kept growing much faster than hryvnia-denominated loans (96.9% yoy and 58.1% yoy respectively in July). As a result, the share of foreign currency loans continued to increase, reaching 69% and 42.7% of total loans granted to households and legal entities in July, respectively (up from 60.6% and 40.8% a year before).

The stock of commercial banks loans considerably exceeds the stock of deposits (by about 46% in July 2007 compared to 21% in July 2006), which means that commercial banks increasingly rely on external borrowings as a source of funding their credit operations. In particular, the stock of external debt incurred by commercial banks grew 2.3 times in 2006 to $14.1 billion at the end of the year. It further expanded to $21.2 billion during the first half of 2007, an increase of more than 50%. Recent world financial and liquidity turmoil, caused by the US subprime mortgage crisis, resulted in investor re-assessment of risks and thus the growing cost of borrowed financial resources for emerging markets. In addition, to reduce private sector exposure to foreign indebtedness, the National Bank decided to introduce an interest rate ceiling on external borrowings by the private sector, which will be equivalent to the average yield on Ukraine's sovereign bonds during the last two quarters plus 2 percentage points. The decision will be enforced in mid-October. Considering recent developments on international capital markets, the measure may turn out to be too restrictive, as only large corporations and/or banks will be able to attract foreign resources under these conditions. This will lead to higher demand for domestic financial resources, driving their costs up. At the same time, it is unlikely to lead to severe liquidity shortages considering the currently loose liquidity stance of the banking system, robust inflow of foreign currency (due to strong export performance and FDI), and the considerable anticipated rise in fiscal expenditures in the run-up to the parliamentary elections. Overall, however, Ukraine's banking system remains rather susceptible to various risks, which requires thorough monitoring of the situation, further improvement of the National Bank's capacity to control the money supply and conduct effective prudential supervision.

International Trade and Capital

Over January-June, Ukraine's merchandise foreign trade balance continued to worsen. Though export of goods showed a remarkable growth of 32.9% yoy over the first half of the year, imports grew at a faster pace. In addition, the growth of exports decelerated to 26.9% yoy in June compared to about 35% yoy on average during January-May. The deceleration in exports in June may be attributed to weaker external demand for metallurgical products, which was evident from flat or moderately declining international steel prices during those months and falling international prices for fertilizers (which account for more than 40% of the total export of chemical products). As a result, the growth of exports of metallurgical and chemical products slowed to 36.6% yoy and 23.2% yoy in 1H 2007, down from 40.4% yoy and 25.2% yoy over January-May respectively. On the upside, the abolishment of the ban on exports of grain harvested in the previous year contributed to the acceleration of grain imports to 12.5% yoy in the first half of 2007 compared to a decline of 3.3% yoy in January-May. Thanks to strong investment demand in Ukraine's main trading partner countries, exports of machinery and transport equipment continued to increase at a remarkable rate of 52.3% yoy, just marginally down from 53.1% yoy in January-May.

Merchandise Trade Performance



Source: State Statistics Committee

Benefiting from robust growth of household disposable income and the continuing credit boom, Ukraine's imports rose by 33.8% yoy during 1H of 2007, driving the cumulative FOB/CIF trade deficit in goods to $4.2 billion, according to State Statistics Committee data. In FOB/FOB prices, the deficit constituted $3.2 billion, which is equivalent to 5.5% of period GDP. By product breakdown, import growth was traditionally driven by mineral products, which were up by 33.2% yoy over January-June. At the same time, import growth of machinery and transport equipment, chemical and metallurgical products slightly slowed to 39.9% yoy, 33.2% yoy and 47.2% yoy respectively.

The increasing merchandise trade deficit contributed to further deterioration of the current account balance. According to NBU data, the current account deficit widened to $1.96 billion as of the end of 1H 2007, which is equivalent to 3.4% of period GDP. However, the CA deficit was fully covered by the robust inflow of foreign direct investments (FDI). In particular, net FDI constituted a record high $3.3 billion for this period. External borrowings also grew considerably in 1H 2007. The country's gross external debt increased by about 20% to $65.4 billion, primarily on account of external borrowings of commercial banks, whose foreign indebtedness grew by 50.5% in 1H 2007. As a result, the financial account balance (analytical representation) reported a surplus of about 10.2% of period GDP. This allowed the NBU to replenish its gross international reserves to $26 billion at the end of June, which was sufficient to finance 4.4 months of future imports of goods and services. Though recent turmoil on international financial markets may result in a lower inflow of foreign capital from private sector borrowing, we believe robust FDI, a good growth outlook and high international reserves keeps the projected year-end CA deficit from being a concern. Nevertheless, the situation is being thoroughly monitored by the National bank of Ukraine.