Ukraine
Macroeconomic Situation

October 2007

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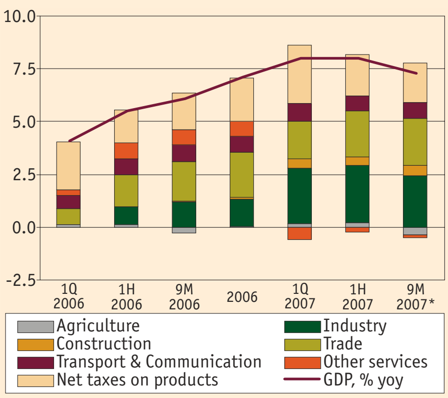
Summary

- The Ukrainian economy continued to demonstrate solid economic growth, underpinned by impressive growth in domestic trade and construction as well as strong performance of industry. At the same time, the shortfall in agriculture caused real GDP growth to gradually decelerate to 7.3% yoy in January-September.
- The consolidated budget reported a 1.2% of period GDP surplus in January-September. In September, for the second month in a row, planned budget revenues remained under-fulfilled. Also taking into account the sluggish privatization process, the government's cautious execution of budget expenditures looks appropriate.
- Inflationary pressures intensified in September, while consumer price growth accelerated to 14.4% yoy. Though inflation, to a significant extent, is supply-driven, growing inflationary pressures may lead the NBU to liberalize its foreign exchange rate policies.
- Though export performance remained strong over January-August, faster growth of imports caused Ukraine's foreign trade deficit to widen. As a result, the current account (CA) balance continued to gradually deteriorate. According to preliminary estimates of the NBU, the CA deficit stood at about 2.6% of period GDP in the first nine months of 2007.
- The impressive inflow of foreign capital not only fully covered the CA deficit, but helped to further replenish gross international reserves.
- Despite political uncertainty, net FDI inflow to Ukraine amounted to a record high $6.8 billion in the first nine months of the year.
- On September 30th, Ukraine held early parliamentary elections. Since no single political party obtained a majority of votes, the new government will be formed by a majority coalition. Regardless of the format of the government coalition, the new government will be "pro-business".

Economic Growth

Contributions to Real GDP Growth by Value Added, percentage points

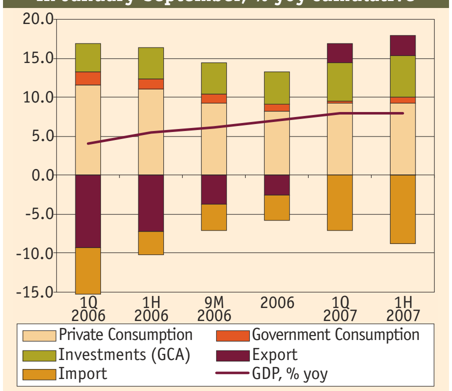


* Estimates based on operative statistics
Source: State Statistics Committee, The Bleyzer Foundation

According to operative data of the State Statistics Committee of Ukraine (SSC), real GDP grew by 7.3% yoy over January-September. The slowdown in August-September (from average 7.7% yoy growth during January-July) was primarily attributed to poor agricultural performance. During the first seven months of the year, agriculture reported robust 5.2% yoy growth in value added. However, unfavorable weather conditions during spring-summer caused a rather thin crop of cereals, sugar beets and vegetables. As a result, value added in the sector declined by a cumulative 4.7% yoy.

According to the SSC, Ukraine had harvested about 25.5 million tons of grain by the end of September, which is about 16% lower than in the respective period last year. Though the harvest of wheat was about 1% higher than in the respective period last year (primarily thanks to about a 10% larger sown area), it was outweighed by the extremely poor harvest of barley. Barley holds the second largest share in total grain production after wheat (41.6% and 51% respectively as of August 2006). At the end of summer 2007, Ukraine had collected only 6.3 million tons of barley, which was almost 50% lower than in the same period last year. As of the end of September, Ukraine had also produced about 50% and 15% lower amounts of sugar beets and vegetables respectively. However, this was partially compensated for by the rich harvest of corn and fruits. Ukraine gathered a 2.3 times larger amount of corn than in the same period last year, while the harvest of fruits was 26.6% yoy higher. The sharp increase in grain prices, and thus fodder, on both domestic and foreign markets, is likely to result in a decline of cattle stock and output of the majority of livestock products, exerting downward pressure on agricultural performance. On the back of good harvest of corn, fruits and sugar beets and the winter sowing campaign, agricultural performance may slightly improve through the end of the year. However, the sector is expected to post a moderate decline in value added this year.

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



Source: State Statistics Committee

The shortfall in the agricultural sector was compensated for by continuing double-digit growth in wholesale and retail trade, construction and manufacturing. Industry and service sectors continued to demonstrate remarkably good performance, underpinned by robust demand and good export performance. According to State Statistics Committee preliminary data, private consumption advanced by 15.5% yoy in 2Q 2007, up from 14.7% yoy in 1Q 2007, fueled by continuing growth of real disposable income (up by 10.8% yoy in 1H 2007) and the credit boom. The rising cost for energy resources (and thus the need to introduce energy-saving technologies), outdated production capacities and intensifying competition on both domestic and external markets feeds investment demand. Gross fixed capital formation grew by about 24% yoy in 1H 2007, up from 19.5% yoy in the respective period last year. Thanks to a favorable external environment, exports reported decent growth of 5% yoy in real terms. However, vigorous consumption and investment resulted in imports growth significantly surpassing the growth of exports. A 16.4% yoy real growth of imports during 1H 2007 imposed tangible pressure on real GDP growth.

Strong domestic demand favored domestically oriented industries. Output growth in food processing grew by 13.3% yoy in January-September. Slight deceleration from 14% yoy growth in January-August may be linked to poor agricultural performance. High domestic and external demand underpinned robust growth in machine-building. Over January-September, production in this industry grew by about 25% yoy, further accelerating from 24% yoy registered in the first eight months of the year. The growth in machine-building was driven by 33.1% yoy, 22.5% yoy and 15.6% yoy increases in production of transport vehicles, electric machines and machinery respectively. At the same time, growth in metallurgy (10.5% yoy in January-September vs. 11.3% yoy in January-August) may be explained by descending world steel prices on the European markets since May 2007. The latter accounts for about 30% of Ukrainian export of metallurgical products. The growth in the chemical industry decelerated to 4.3% yoy in January-September, from 5.4% yoy in January-August. The slowdown may be a result of declining international prices on fertilizers during March-August and ammonia during March-July. At the same time, the rebound of world steel and chemical prices in August-September will help to maintain high growth in these industries and is expected to be reflected in industries' statistics in the coming months. So far, due to the slowdown in metallurgy and chemicals, which together account for about 1/3 of total industrial production, industrial output growth slightly decelerated to 10.7% yoy in January-September from 11.2% yoy in January-July.

During January-September, vigorous domestic demand and strong exports supported impressive 17.1% yoy growth in wholesale and retail trade, up from 16.7% yoy in January-August. Value added growth in the construction sector accelerated to 11.6% yoy in the first nine months of 2007, up from 10.9% yoy in January-August. Successful economic performance in January-September 2007 despite a higher price on imported energy (the price on imported natural gas almost twice as high as in 2005, plus skyrocketing international prices on crude oil) and political instability support a positive outlook for the Ukrainian economy for the rest

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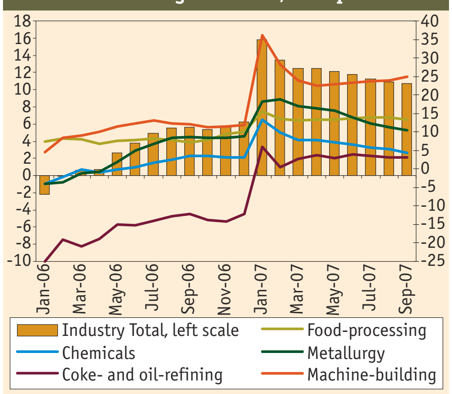
of 2007 and 2008. The nine month evolution of the main macroeconomic indicators supports the government forecast of 6.5% yoy GDP growth for 2007. At the same time, despite a high statistical base due to impressive economic growth in 4Q 2006 (9.5% yoy vs. 6.1% yoy over the first nine months of 2006), we believe real GDP growth may reach 7.0% yoy. In 2008, the government expects GDP to grow by 7.2% yoy assuming moderate increase in imported gas prices and benign external conditions for Ukraine's main exporting commodities. However, considering the expected world economic slowdown in 2008, less favorable conditions for Ukraine's external private borrowing (due to the recent turmoil on international financial markets related to the US sub-prime mortgage crisis) and exports (international steel prices are expected to stabilize or moderately decline in 2008), 6%-6.5% yoy real GDP growth looks more realistic.

Fiscal Policy

According to the Ministry of Finance, the consolidated budget posted a surplus of almost UAH 5.8 billion (about $1.15 billion) in the first nine months of the year, which is equivalent to 1.2% of period GDP. Successful budget performance was achieved thanks to faster-than-expected nominal GDP growth and under-execution of expenditures. In nominal terms, consolidated budget revenues grew by 27.2% yoy to UAH 151.7 billion ($30 billion) over January-September with most tax collections above the targeted amount.

Consolidated Budget Balance, % of period GDP



Source: Ministry of Finance

Collections from the personal income tax (PIT), the main source of local budget revenues, continued to grow at an accelerating pace. For January-September, PIT proceeds were 49.4% higher than in the respective period last year. High growth of PIT receipts is explained by the increase in the PIT rate from the previous 13% to 15% since the beginning of 2007 and a loose income policy, as a result of which nominal household income grew by about 28.5% yoy over January-September. Thanks to rapid growth in domestic trade and industry as well as strong export performance, corporate profit tax and VAT revenues increased by 30.2% and 19.6% yoy respectively. EPT collections were 24.6% above plan in September and 11.8% above plan for the first nine months of the year. At the same time, VAT collections were below the targeted amount in August-September. Since VAT is essentially a tax on consumers, the under-execution may indicate private consumption is growing at a slower pace. This inference is in line with the decelerating real GDP growth from 8% yoy in 1H 2007 to 7.3% yoy in January-September 2007. In addition, the under-fulfillment of VAT proceeds was reported for just domestic products, while VAT from imported products continued to be above plan. This indicates that robust domestic demand is satisfied by imports to a considerable extent. At the same time, under-fulfillment of tax revenues on the back of the recent acceleration of inflation (all other things being equal, higher prices should have made it easier to fulfill tax collection plans, particularly VAT) may be explained by weaker fiscal discipline as a number of large state monopolies were allowed to pay their tax obligations in installments.

Consolidated Budget Revenues, January-September 2007

	UAH billion	% yoy, nominal change	% of total
Tax Revenues	110.7	27.7	73.0
PIT	24.3	49.4	16.0
EPT	20.3	30.2	13.4
VAT	42.7	19.6	28.1
Excises and Duties	14.3	30.2	9.4
Other Revenues	41.0	26.0	27.0

Source: Ministry of Finance, The Bleyzer Foundation

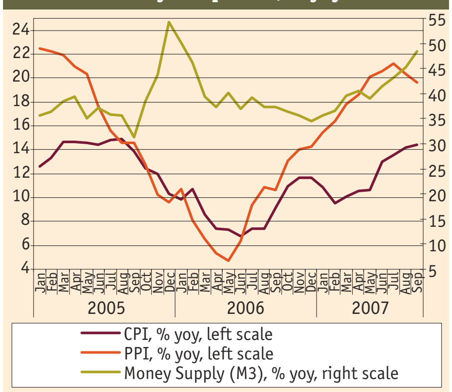
Consolidated budget spending grew at a much slower pace than revenues. Over January-September, expenditures grew by a nominal 24.7% yoy to UAH 145.5 billion ($28.8 billion). Though budget execution improved in September, cumulative spending from the general fund of the state budget was 5% below plan. The consolidated budget surplus was achieved primarily on account of local budgets, while the state budget reported a deficit of 0.6% of January-September's GDP. The rather cautious execution of the budget may be primarily attributed to poor privatization performance, which put targeted deficit financing at risk. As of the end of September, privatization receipts accounted for just 16% of the planned amount for 2007 (UAH 10.7 billion, $2.1 billion). Due to parliamentary elections and the process of formation of the new government, the privatization of telecommunication monopoly Ukrtelekom and chemical Odessa port plant were delayed, most likely until next year. As for debt financing, the government issued $500 million Eurobonds (30% of the target for 2007) and UAH 2.6 billion ($515 million, or 68.5% of the target for 2007) of domestic securities in January-September. Recent turbulence on international financial markets caused worldwide risk reassessment, which particularly affected emerging markets. This makes external borrowing a rather costly source of deficit financing for Ukraine. Thus, the government continued to issue domestic bonds. However, given the rather unattractive yields proposed for domestic bonds, demand for them remained rather weak.

Despite moderate new government borrowings this year and rather sizable principal payments, Ukraine's public and publicly guaranteed debt rose 2.1% year-to-date (ytd) to $16.3 billion as of the end of September. The increase occurred mainly on account of domestic guaranteed debt, which grew by 4.4% ytd due to the second issuance of securities by the state mortgage institution this year. The issuance of these securities is aimed at further reducing the cost of mortgages for the public. Attracted funds are directed to refinance mortgage-lenders (bank and non-bank financial institutions), providing them with additional liquidity and helping to diversify risks. In addition, external guaranteed debt grew by about 1% ytd on account of several loans allocated by International Financial Institutions to finance government infrastructure projects. Despite an increase since the beginning of the year, the stock of public and publicly guaranteed debt to GDP is expected to continue to decline (to about 12% at the end of the year, down from 15% at the end of 2006). Thanks to faster-than-expected nominal GDP growth this year, the consolidated fiscal deficit may be below 2% of GDP in 2007.

Monetary Policy

In September, consumer price inflation continued to accelerate. A monthly surge of 2.2% (mom) brought annual inflation to 14.4%. Acceleration of consumer inflation this year is attributed to both demand and supply-side factors. On the supply side, poor agricultural performance drove food prices up by 15.4% yoy in September. An 8.7% ytd increase in service tariffs may be explained by continuing pass through of higher energy prices to consumers and cost revisions in healthcare and education. In addition, faster consumer price growth reflects the spillover of producer prices into the retail market. In September, producer prices increased by 19.7% yoy, driven by high international prices on steel products and energy, as well as the growing labor cost and purchasing prices on agricultural products. On the demand side, inflation is boosted by robust growth of real household disposable income and the continuing credit boom. On the back of strong inflationary pressures, consumer prices are now expected to grow by about 14% in 2007.

CPI by Component, % yoy



Source:State Statistics Committee, The Bleyzer Foundation

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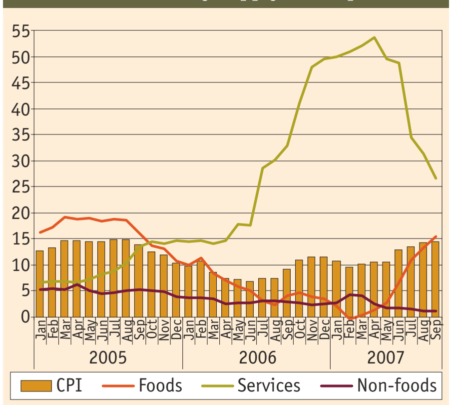
Acceleration of money supply growth has also contributed to mounting inflationary pressure. The growth of monetary aggregates was driven by sizable central bank interventions and continuing rapid expansion of domestic credits. Due to strong export performance and private sector borrowing from abroad, net foreign exchange purchases by the NBU on the interbank market amounted to $2.4 billion over August-September. Though the forex purchases were almost fully sterilized by the NBU through issue of deposit certificates, the growth of the monetary base and the money supply continued to accelerate, reaching 50.6% yoy and 48.3% yoy in September. This occurred due to continuing rapid expansion of bank loans. Although credit growth slightly slowed in September, it still constituted an impressive 75.1% yoy. With the exception of 2004, the average growth of commercial bank loans to the private sector grew on average by 65% per annum over 2002-2007. To a large extent, such rapid credit expansion became possible thanks to commercial banks active borrowing from abroad. For 2.5 years, the banking sector's external debt grew eight times and reached $21.2 billion at the end of June 2007. Access to cheap financial resources abroad allowed commercial banks to provide foreign currency loans cheaper than domestic currency loans. This formed strong demand for foreign currency-denominated loans, with the growth of the latter considerably outpacing the growth of hryvnia-denominated loans (60.8% yoy vs. 91% yoy in September 2007). A fairly stable hryvnia exchange rate with respect to the US dollar since 2000 could have created the illusion of low foreign exchange risk. However, growing external imbalances on the back of accelerating inflation may lead the NBU to liberalize its foreign exchange policy. To curb private sector borrowing, the NBU decided to introduce an interest rate cap on borrowed financial resources from abroad. The measure will be effective starting January 1, 2008. The interest rate cap will depend on the average yield of Ukraine's sovereign debt securities, the average interest rate spread between government and corporate Eurobonds and the rating of the borrower.

CPI, PPI and Money Supply Developments



Source: State Statistics Committee

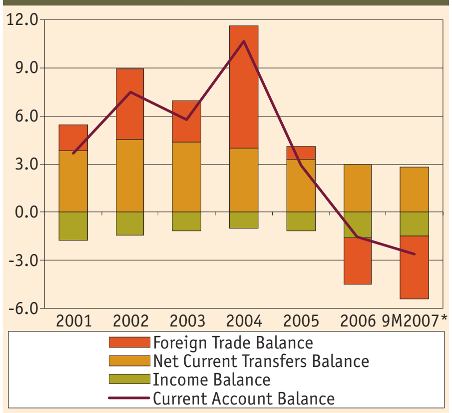
So far, the NBU has been maintaining the hryvnia exchange rate with respect to US dollar at an unchanged 5.05. According to estimates of various international and domestic institutions, the hryvnia still turns to be undervalued despite the fact that the current account shifted from large surpluses in 2000-2005 (in 2004, the CA surplus reached 10.6% of GDP) to moderate but widening deficits in 2006-2007. In mid-October 2007, the head of the NBU also admitted that the hryvnia was under-valued. Recent acceleration of inflation and growing external imbalances reinforced the need to switch to a more flexible exchange rate regime. This has formed strong expectations that the hryvnia will be allowed to strengthen in the near future. However, the prospects of hryvnia appreciation are still unclear. The most probable explanation of the NBU's reluctance to liberalize its exchange rate policy is that greater exchange rate flexibility in the short run will cause hryvnia appreciation with respect to the US dollar. This will contribute to the deterioration of Ukraine's foreign trade balance. A further widening CA deficit will form downward pressure on the exchange rate. Considering also the possibly less benign external environment in the coming years given still underdeveloped financial markets, the shift to inflation targeting is likely to be carried out rather gradually. We believe that the hryvnia exchange rate will be maintained stable at the current 5.05 UAH/$ rate until the end of the year. The hryvnia may be allowed to moderately appreciate in 2008; however, the trend is likely to reverse in late 2008-2009.

International Trade and Capital

Over January-August, Ukraine's export of goods grew by 30% yoy, primarily on account of exports of metals (32% yoy increase), chemicals (17.7% yoy) and machinery and transport vehicles (58% yoy). Except for machine-building and transport vehicles, exports of other goods continued to decelerate. Deceleration metallurgical exports, the weightiest commodity group in Ukraine's total exports, may be attributed to stabilization of steel prices on Asian markets and a continuing steel price decline on EU markets. Slowdown in export growth of chemical products during April-August may be the result of a lagged response to declining international prices on fertilizers during March-mid August. Export of agricultural products somewhat accelerated in July, driven by globally soaring prices on agricultural products. At the same time, due to the introduction of new quotas on export of cereals harvested in 2006 and 2007 and a high base effect, cereal exports fell almost 15% yoy over January-August, explaining the deceleration of agricultural exports to 37.1% yoy. On the upside, strong investment demand in neighbouring countries, particularly Russia, stimulated export of machinery and transport.

At the same time, strong consumption and investment activity triggered 33.8% yoy growth in CIF imports over January-August, driven principally by energy and equipment imports. In particular, import of mineral products grew by 29.3% yoy over the period. A deceleration from 31.4% yoy growth in January-July may be attributed to slower natural gas imports, which decelerated from 54.6% yoy in 1H 2007 to 37.4% yoy in January-August. Faster fill-up of Ukrainian gas storages in the previous months may explain the gas imports deceleration during July-August. Strong investment demand and growing household disposable income on the back of the continuing credit boom supported 34.4% yoy and 54.4% yoy growth in imports of machinery and transport equipment respectively. As the growth of imports considerably outpaced exports, the FOB/CIF merchandise trade deficit continued to widen, approaching $6 billion.

Current Account Balace by Components, $ billion



Source: State Statistics Committee

The widening merchandise trade deficit was the main driver of further deterioration of Ukraine's current account deficit. According to preliminary estimates of the National Bank of Ukraine, the foreign trade deficit in goods and services widened to $3.8 billion. Though it was partly softened by the growing surplus in the transfers account, the current account deficit stood at $2.5 billion, which is equivalent to 2.6% of period GDP. At the same time, large capital inflows (due to FDI and active private sector borrowing from abroad) resulted in an impressive financial account surplus. The lion's share of the $10.4 billion financial account surplus came in the form of FDI. According to NBU estimates, net FDI amounted to $6.8 billion for the first nine months of the year due to a number of acquisitions, particularly in banking and food processing. The robust capital inflow not only covered the CA deficit, but also replenished gross international reserves. At the end of September 2007, NBU gross foreign reserves exceeded $30 billion, which covers more than 5 months of future imports. Thanks to the benign external environment and stronger growth of nominal GDP, the current account deficit is expected to remain at a moderate 2.5% of GDP in 2007.

Other Developments and Reforms Affecting the Investment Climate

On September 30th, Ukraine held early parliamentary elections, which were recognized as free and fair by all international and domestic observers. This demonstrated that Ukraine has moved forward in its transfor-

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mation toward an open and democratic society. As in the previous parliament, five political parties and blocs passed the 3% threshold to the Verkhovna Rada. In addition, four out of these 5 parties were also present in the previous Parliament.

	% of Voters		Number of Seats	
	Mar-06	Oct-07	Mar-06	Oct-07
Party of Regions	32.14	34.37	186	175
Yulia Tymoshenko Bloc	22.29	30.71	129	156
Our Ukraine-People's Self-Defense Bloc	13.95	14.15	81	72
Communist Party	3.66	5.39	21	27
Lytvyn's Bloc	2.44*	3.96	*	20
Socialist Party	5.69	2.86*	33	*

* Not represented in the parliament
Source: Central Election Committee of Ukraine

Since no single political party obtained a majority of votes, the new government will be formed by a majority coalition. Shortly after the preliminary election results were announced, the two former allies of the "Orange Revolution" — Yulia Tymoshenko and Our Ukraine-People's Self Defense — announced that they will have enough seats to form a majority coalition and a new government. They signed a coalition agreement on October 17th. However, together these blocs obtain a rather thin majority of 228 votes. In addition, the blocs have different positions on a number of issues such as the timing for lifting the moratorium on the sale of agricultural land, the conversion of mandatory military service to a professional service, compensation for past lost banking savings of the population, the implementation of an imperative mandate for members of Parliament, and the composition of the Cabinet of Ministers. Hence, whether this coalition will actually be formed depends on the bloc representatives' ability to make compromises. In addition, the president required adoption of key legislation such as the Law of the Cabinet of Ministers before nominating the prime minister. At the same time, we believe that regardless of the coalition that is formed, the current balance of political forces in the Parliament will ensure greater transparency, checks-and-balances and accountability in the future. Moreover, as the economic programs of the three leading parties were very similar, the new government is likely to focus on macroeconomic stability, deregulation and liberalization of the economy, tax reform, completion of WTO accession, and deeper relationships with the EU, including agreement on an enhanced Free Trade Agreement.

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