Ukraine
Macroeconomic Situation

June 2006

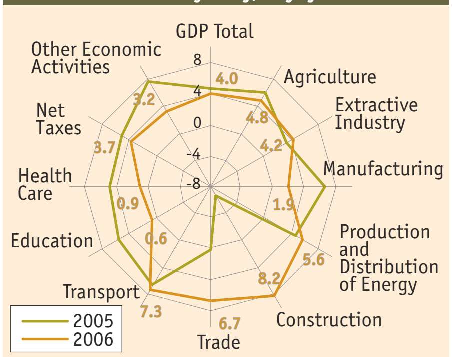
Olga Pogarska, Edilberto L. Segura

Summary

- In May, the Ukrainian economy grew at an impressive 8.5% year-over-year (yoy), bringing the cumulative growth to 4% yoy. The growth was underpinned by robust value added growth in the service sector and construction, and most importantly by resumed industrial output growth.
- Stronger economic growth in recent months allowed the government to meet its budget revenue targets. However, the early budget deficit this year calls for urgent government measures to rationalize public finances.
- Consumer inflation decelerated to 7.3% yoy in May as the impact of increased service tariffs was outweighed by decelerating food prices. However, the disinflation trend is expected to reverse in the coming months following the second wave of tariff increases in June-July.
- The merchandise trade balance continued to worsen, posting a $2.1 billion deficit over January-April 2006; however, the data revealed some signs of improvement.
- The current account reported a deficit of $743 billion in the first quarter (1Q) of 2006. Despite a more than 2.5 times increase in FDI, the financial account balance was negative with both deficits financed by the NBU international reserves.
- In July, the head of the Socialist Party, Mr. Oleksander Moroz was elected as the Speaker of the Parliament

Economic Growth

Real GDP and Value Added Growth by Sector in January–May, % yoy



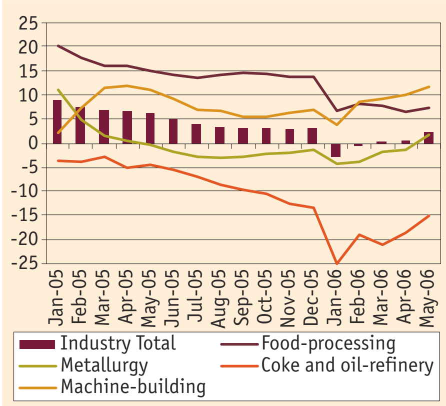
Source: State Statistics Committee

The Ukrainian economy continued its strong recovery in May, with GDP expanding by an impressive 8.5% yoy according to preliminary data from the State Statistics Committee (SSC). As a result, cumulative GDP showed a 4% yoy increase, which is comparable to last year's figure for the respective period. On the demand side, the growth was supported by strong domestic demand, underpinned by robust growth of real wages and social security payments. In particular, real households' disposable income grew by 21.4% yoy for the first four months of the year. Moreover, there are signs of rebounding investment demand, which is reflected in booming machine-building and construction. According to the SSC, investments in fixed capital increased by 15.9% yoy in nominal terms for the first quarter of 2006. More than 50% of these funds were spent to acquire machines and equipment for new facilities and technical modernization of the existing ones. Increasing investment will help Ukraine to materialize its medium-term growth opportunities and bring the growth pace back to the regional-average 5% yoy.

On the supply side, economic growth was primarily driven by the service sector. Value added in transport and domestic trade, cumulatively accounting for about 23.5% in total GDP, advanced by 6.7% yoy and 7.3% yoy over January-May, up from 4.2% yoy and 6% yoy over January-April respectively. Following more than a year of contraction, construction strongly rebounded at 8.2% yoy over January-May. To a great extent, the growth acceleration in these sectors is linked to a recovery in manufacturing, which had contracted due to the sector's adjustment to higher prices of gas and other inputs (such as crude oil).

Just in May the growth of industrial output resumed at an impressive 10% yoy, bringing the cumulative growth to 2.4% yoy (up from a meager 0.4% yoy over January-April). The rebound occurred primarily thanks to growth acceleration in machine-building, metallurgy and food processing (up by 17% yoy, 12.4% yoy, and 9.8% yoy respectively in May), driven by stronger investment demand, favorable external conditions (international prices on steel were on the upward trend since February and accelerated during April-May), and positive developments in private consumption. As a result, these industries reported a 11.5% yoy, 1.7% yoy, and 7.3% yoy cumulative increase in their output respectively. On the downside, coke and oil-refining continued to decline, reporting a 15.1% yoy decrease in output for January-May. However, its performance has been gradually improving.

Growth of Industrial Output and Selected Industries, 2005–06,% yoy cumulative



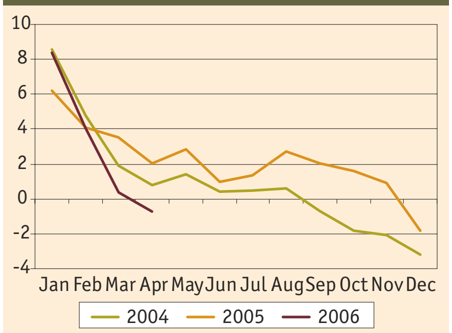
Source: State Statistics Committee

The Ministry of Economy forecasts real GDP growth at a reasonable 2.8% yoy in 2006. However, taking into account recent real sector improvements, the original estimate of GDP growth may be exceeded with GDP growing by 3%-4% in 2006, given that the price on imported gas will not increase significantly in the second half of the year.

Fiscal Policy

Stronger than expected economic growth over the last few months allowed the government to fulfill its financial targets. According to preliminary data of the State Treasury of Ukraine, revenues of the general fund of the central budget for January-May were 1.8% above target, with tax revenues exceeding the target by 1.1%. At the same time, the execution rate of major taxes continued the pattern observed since the beginning of the year. In particular, the enterprise profit tax (EPT) receipts were almost 17.3% below target, reflecting deterioration of enterprises' performance. Moreover, deterioration of foreign trade resulted in lower than planned receipts from export/import duties. However, they were more than compensated for by over-execution of the value-added tax receipts planned for this period by 17.2%.

Consolidated Budget Balance, % of period GDP, 2004–06



Source: Ministry of Finance

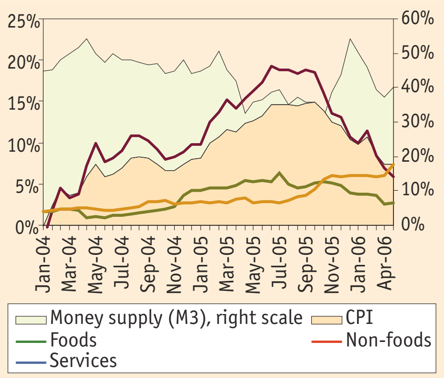
Although expenditures of the general fund of the central budget were almost 7% below the target for January-May, it ran an early deficit. This signals an urgent need for government measures to rationalize public finances to bring expenditures in line with revenues or vice versa, which can be achieved through public administration and pension reforms, and further improvement of tax administration. The consolidated fiscal deficit is not expected to exceed 3% of GDP in 2006, which will be easily financed by the remainder of the funds received from the privatization of Kryvorizhstal and funds received from new privatization as the process is expected to accelerate in the second half of the year.

Since issuance of new domestic debt instruments was suspended in mid-summer of last year, Ukraine's domestic public debt declined by 1.4% since the beginning of the year to reach $3.7 billion at the end of April. Although external public debt increased slightly in April, it has declined by 4.2% since the beginning of the year, constituting $11.2 billion at the end of April. The increase in April is attributable to the strengthening of the euro with respect to the US dollar (as about 15% of total external public debt is denominated in euros). As a result, total public debt constituted $14.9 billion at the end of April. In terms of expected full-year GDP, Ukraine's public debt is among the lowest in peer countries.

Monetary Policy

Consumer price inflation has been rapidly decelerating since February of this year. In particular, CPI declined from 10.7% yoy in February to less than 7.5% yoy in May. The disinflation occurred due to considerable deceleration of monetary aggregates growth, robust growth of food output on the back of limited export opportunities, and moderate growth of prices on imported goods due to a stable exchange rate. To acknowledge the positive developments of consumer prices over recent months, the NBU decided to reduce its discount rate from 9.5% to 8.5% per annum as of June 10th.

Dynamics of Money supply, CPI and Its Major Components, 2004-06, % yoy



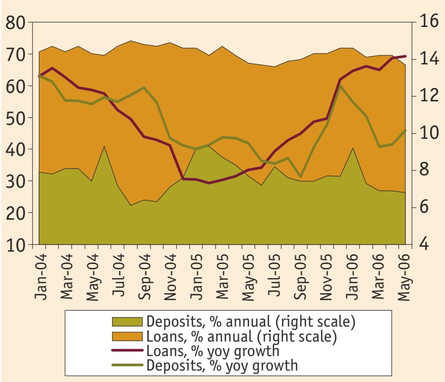
Source: State Statistics Committee

By components, the deceleration of inflation was primarily attributable to the decline in prices on food products, the largest component of the CPI. In May, for the third consecutive month, food prices declined by 0.3% month-over-month (mom), which is explained by overproduction on certain food markets such as milk, dairy and meat products (to a large extent due to Russia's ban on these products imports from Ukraine) and growing competition from certain imported goods (e.g., potatoes, the domestic market for which faces increasing imports from Egypt). As a result, in annual terms food prices decelerated from 11.4% yoy in February to less than 6% yoy in May.

An increase in gasoline prices (which grew by 21.4% yoy in May) resulted in some acceleration of the non-food price index to 2.7% yoy, up from 2.5% yoy a month before. At the same time, the growth of non-food prices remained rather moderate, favored by a stable exchange rate as imported goods constitute the lion's share in this commodity group. Coupled with the small share of non-food products in the consumer basket (about 15%), May's non-food price acceleration had a limited effect on price index dynamics. A similar situation was observed for service tariffs. In May, service tariffs grew by 17.8% yoy, up from 14.6% yoy in April due to a 26.2% and 25% increase in tariffs for gas and electricity, effective since May 1st. However, since services account for just about 20% of the consumer basket, their impact on the whole CPI was outweighed by the decelerating food prices. However, due to the other waves of service tariffs increases (starting June 12th, the cost of passenger railway transportation was raised by about 43%, starting July 1st gas prices for households will be raised by another 85%), consumer price inflation is expected to accelerate to 12% yoy by the end of the year.

Although the growth of money supply (M3) slightly accelerated to 40.2% yoy in May (up from 37.4% yoy in April), it was still considerable deceleration compared to more than 50% yoy at the beginning of the year. The acceleration may be attributed to faster growth of deposits, whose growth rates increased to almost 46% yoy, up from 41.4% yoy a month before. May's monetary base performance was affected by the following developments — on the one hand, due to an almost balanced forex market in May (as a result of eased political uncertainty after parliamentary elections and a favorable external situation), the NBU started to replenish its foreign reserves. At the end of May, the NBU's gross international reserves constituted $17.7 billion (up from $17.2 billion in April). In addition, the NBU supported commercial banks' liquidity through its refinancing operations in the amount of UAH 1.3 billion ($257 million). On the other hand, the central bank softened reserve requirements in May, which resulted in a decline of commercial banks' funds kept at corresponding accounts with the NBU. The combined effect was that the monetary base declined by 1.6% mom, while the annual rate of growth remained almost unchanged in May compared to the previous month at 24%.

Loan and Deposit Growth and Interest Rate Dynamics



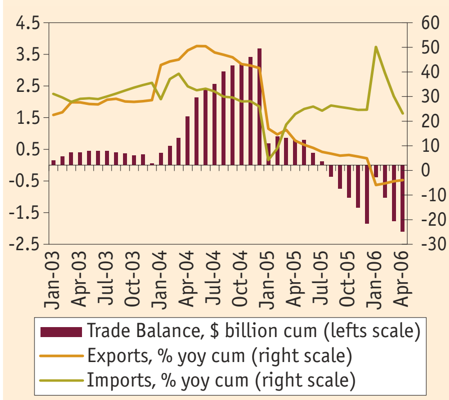
Source: National Bank of Ukraine

May's reduction of reserve requirements coupled with the NBU's refinancing operations helped to ease liquidity tensions in the banking system. Interest rates on interbank credits, the closest indicator of banks' liquidity, declined from 12.5% pa at the end of April to 4.1% pa in mid-May, though they slightly accelerated to about 6% pa by the end of the month. This, coupled with further expansion of deposits, allowed commercial banks to further increase their lending operations while simultaneously reducing their costs. In particular, commercial bank lending grew by 69.2% yoy in May 2006, up from 68.6% yoy in April and 61.5% yoy in December 2005. At the same time, the lending rate declined from 14.2% pa in April to 13.7% pa in May. The increases in bank lending took place both at the retail and corporate levels. Consumer lending growth was driven by growing household incomes and the development of financial innovations for consumers, including credit cards, mortgages, and retail financing. The growth of corporate lending is seen as an additional sign of growing investment demand in the country.

International Trade and Capital

Over January-April, Ukraine's merchandise trade deficit increased to $2.1 billion, as the main export-oriented industries are still adjusting to increased input costs (mostly due to more energy resources) while growing household disposable income and recovering investment demand stimulates the growth of imports. Although Ukraine's merchandise foreign trade balance continued to deteriorate, April revealed some signs of improvement. In particular, the rate of decline in exports diminished to 3.9% yoy over January-April compared to 4.4% yoy over the first quarter, and there were positive changes in the commodity structure of Ukraine's exports and imports. Moreover, an acceleration of world metal prices over April-May, coupled with strong external demand for Ukraine's machinery, equipment and vehicles, may reverse export dynamics. Metals, accounting for about 42% of merchandise exports, reported a slower rate of decline (7.4% yoy over January-April compared to 7.7% yoy over 1Q 2006). Exports of machinery and transport vehicles continue to expand at a strong 13.1% yoy over January-April, with their share in total exports increased to 13.5%, up from 11.4% over the same period last year.

Merchandise Trade Flows in 2004–2006



Source: State Statistics Committee

At the same time, the growth rate of imports sharply decelerated to 23.2% yoy over January-April, down from 30.2% yoy registered for 1Q 2006. The decelera-

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

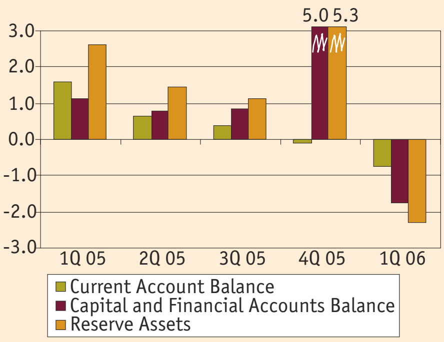
Kyiv Office, Ukraine
21, Pushkinska Street, Suite 40
Kyiv 01004, Ukraine
Tel: (380-44) 244-9487 Fax: (380-44) 244-9488
E-mail: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (380-57) 714 1180 Fax: (380-57) 714 1188
E-mail: kharkov.office@sigmableyzer.com.ua

tion occurred mostly due to the growth slowdown of imports of energy resources, which account for about 34% of total imports. In particular, the growth of imports of mineral products diminished to 17% yoy over January-April (down from 26.6% over 1Q 2006), which may be attributed to lower volumes of gas imports related to the end of the heating season in Ukraine and delays in filling gas underground storage facilities, as well as lower volumes of crude oil imports. The latter were substituted by gasoline imports, since after reducing import tariffs on these commodities in May last year, it became cheaper to import gasoline than to refine imported crude oil domestically. Indeed, imports of gasoline more than doubled over January-April compared to the same period last year. Although in value terms imports of crude oil still reported a 4% yoy increase, it was due to increasing world crude oil prices over February-April and Russia's higher export duty on crude oil over the first four months of 2006 compared to the respective period last year. On a positive note, imports of investment goods, machinery and transportation vehicles grew by about 39% yoy, with their share increased to 36.8%, up from 23.8% over the same period last year.

The widening of the merchandise foreign trade deficit was the primary reason for the negative current account balance of $733 million in 1Q 2006, according to NBU data. Political uncertainty related to March's parliamentary elections resulted in a considerable outflow of short-term capital, which were only partially compensated for by more than a 2.5 times increase in net FDI inflows to $662 million and increased borrowings from abroad. As a result, the financial account (excluding reserve assets) also generated a deficit of $1.7 billion. Although Ukraine is expected to face a current account deficit for 2006 of about $2.8 billion, it will be easily financed by inflows of foreign direct investments (expected at $2.2 billion), by the large size of international reserves (currently at $17.7 billion, covering about 4 months of future imports), and by foreign financing. So far, the current account and financial account deficits have been financed by the NBU's international reserves.

Balance of Payments in 2005–2006



Source: National Bank of Ukraine

Other Developments and Reforms Affecting the Investment Climate

On late June, following three months of negotiations, three political forces — the Block of Yulia Tymoshenko, Our Ukraine and the Socialist Party — formed a coalition. The coalition chose Ms. Tymoshenko as its candidate for Prime Minister. However, this coalition unraveled on July 6th after the Socialists refused to support the Our Ukraine's candidate for Parliament Speaker.

The current political situation is quite fluid. A new majority coalition was formed involving the Party of the Regions, the Socialist Party and the Communist Party. This new coalition elected the head of the Socialist Party, Mr. Oleksander Moroz, as Parliament Speaker and nominated the head of the Party of the Regions, Mr. Yanukovych, as its candidate for Prime Minister. However, negotiations with other political parties are still going on and the ultimate composition of the government is still uncertain. In any event, given the strong competition among political parties, the new government, regardless of its ultimately shape, should be more accountable than in the past.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
21, Pushkinska Street, Suite 40
Kyiv 01004, Ukraine
Tel: (380-44) 244-9487 Fax: (380-44) 244-9488
E-mail: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (380-57) 714 1180 Fax: (380-57) 714 1188
E-mail: kharkov.office@sigmableyzer.com.ua