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Summary

- According to revised data, Ukraine showed 2.6% yoy economic growth in 2005.
- Political uncertainties and restrictions on gas consumption imposed on industrial producers resulted in modest GDP growth and industrial output decline at the beginning of 2006.
- In January, the consolidated fiscal surplus reached UAH 2.5 billion (\$0.5 billion) or 8.4% of period GDP.
- Despite considerable fiscal loosening at the end of 2005 and inflationary expectations, annual consumer inflation continued to decelerate and was below 10% in January.
- In 2005, the merchandise trade deficit stood at \$1.8 billion, but was securely covered by the services trade surplus, which reached \$3.2 billion.
- The United States granted Ukraine market economy status and reinstated Ukraine's eligibility for the Generalized System of Preferences.

Economic Growth

According to revised data by the State Statistics Committee of Ukraine (SSC), GDP grew by 2.6% yoy in 2005, fuelled by an impressive 16% yoy increase in private consumption. At the same time, the slowdown from 12.1% yoy growth in 2004 was a reflection of the 4% yoy decline in investments, dampened by political and economic policy uncertainties, and deterioration of the external environment. Unlike in 2004, when growth was supported by a substantial foreign trade surplus, falling international steel prices and growing domestic costs resulted in a large negative contribution of net exports (at around 8 percentage points) in 2005.

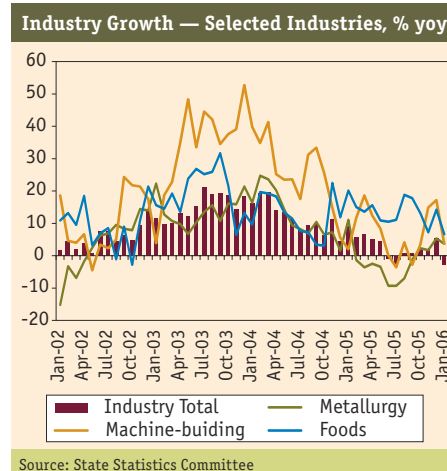


As in 2005, economic growth this year will be primarily driven by private consumption. Moreover, investor confidence is expected to perk up in the second half of the year, thus positively contributing to GDP growth. At the same time, economic growth will be negatively affected by considerably higher energy import prices (particularly natural gas) and forecasted further easing of foreign demand for Ukraine's goods (though not as drastic as in 2005). Considering the structural weakness of Ukraine's economy, GDP

growth is expected to be at a rate similar to 2005's 2.5% yoy.

So far, economic growth in Ukraine has been primarily based on utilization of existing capacities. Moreover, industrial production is very energy intensive and vulnerable to the external environment. Preliminary data suggests that Ukraine's GDP reached only 68.2% of its pre-independence level. To materialize its medium-term growth opportunities and bring the growth rates back to the region-average 5% yoy, Ukraine needs substantial investments to renovate existing and to build new capacities, introduce energy saving technologies, and accelerate market-enhancing institutional reforms.

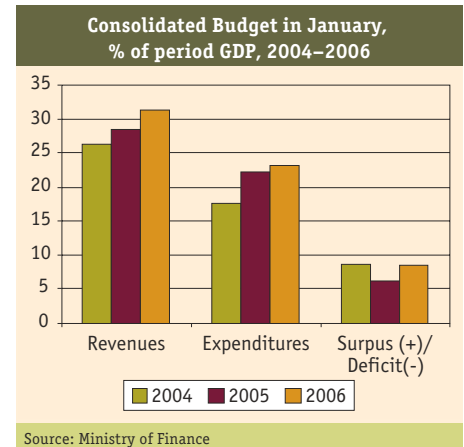
Real sector development at the beginning of 2006 was in line with expectations. Modest 0.9% yoy GDP growth in January was primarily driven by weak industry performance. On the supply side, January's GDP growth was driven by good performance in the transportation sector, utilities and agriculture (value added grew by 6.7% yoy, 13.2% yoy and 4.3% yoy respectively). Following a sharp recession during the second half of 2005, domestic trade recovered at an encouraging 0.7% yoy. However, GDP growth continued to decelerate in January on account of the value-added contraction in manufacturing and construction (down by 4.6% yoy and 8.1% yoy respectively), which together account for about 25% of total GDP. Developments in the manufacturing sector, particularly chemicals and metal processing, whose output declined by 4.7% and 4.2% yoy respectively, were the result of fewer working days, the anticipated sharp increase in gas prices and restrictions on gas consumption. The latter were imposed by the Cabinet of Ministers in January, since Ukraine significantly exceeded its usual gas consumption volumes due to unfavorable weather conditions. As a result, total industrial output declined by almost 3% yoy in January.



Fiscal Policy

In January, consolidated budget revenues increased by a nominal 36% yoy to UAH 9.4 billion (\$1.8 billion), while expenditures grew more modestly by 28% yoy to

UAH 6.9 billion (\$1.4 billion). The resulting fiscal surplus constituted UAH 2.5 billion (\$0.5 billion) or 8.4% of period GDP. The consolidated budget usually runs a surplus at the beginning of the year due to under-execution of expenditures, but reverses to a deficit by the end of the year. In January, the major part of the monthly surplus was accumulated by local budgets, which collected UAH 1.7 billion (\$0.3 billion).

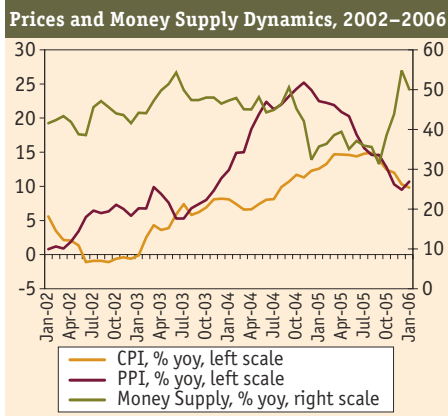


State debt remained virtually unchanged in January. By the end of the month, the stock of total state debt (guaranteed and non-guaranteed) constituted \$15.4 billion, which translates into 16.2% of forecasted full-year GDP. Domestic debt accounts for one-fourth of this amount, while the rest is attributable to external debt. The marginal reduction in domestic debt by 1% month-over-month (mom) is mostly due to repayment of domestic government bonds. The Ministry of Finance has not resumed auctions of domestic securities, which were suspended in July 2005, but plans to return to this practice in the coming months. According to the Minister of Finance, Viktor Pinzenyk, placement of domestic bonds should be renewed in order to give signals to the market. However, Ukraine is not going to increase external borrowings at least in the first quarter of 2006, since the budget is likely to run a substantial surplus over this period. The possibility of new external borrowing in later periods will become clear after revision of the State Budget Law, which is likely to take place right after parliamentary elections in late March. The current version of the State Budget Law envisages a full-year deficit of UAH 13.4 billion (\$2.6 billion), or 2.5% of officially forecasted GDP, which will be financed primarily by "Kryvorizhstal" privatization receipts already accumulated on the Treasury Account.

Monetary Policy

In January, consumer inflation continued to decelerate in spite of considerable fiscal loosening at the end of 2005 and inflationary expectations generated by gas price uncertainty. Annual inflation reached 9.8% yoy, decreasing to single-digits for the first time since August 2004. The favorable development was achieved thanks to moderate monetary tightening. At

the same time, this may be a temporary relief considering expectations of utility and other service tariff increases (e.g., gas, electricity, communication tariffs have been unchanged since mid-2000) and acceleration of producer price inflation. However, due to a high 2005 base, consumer inflation is expected at about 12-13% for 2006.

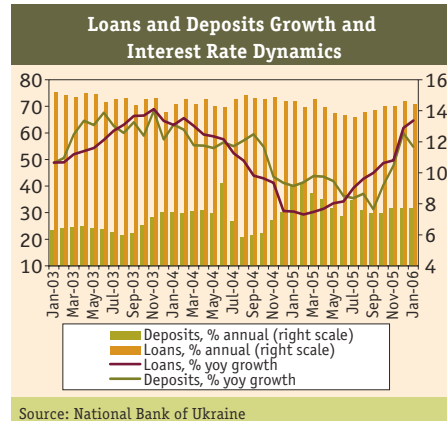


Food price inflation was 10.7% yoy in January, unchanged from the previous month on account of decelerating milk and meat prices (to 13.2% yoy and 16.8% yoy respectively), which compensated for acceleration of sugar and vegetables prices (to 24.8% yoy and 11.7% yoy respectively). Non-food and service prices continued to slow. The non-food price and service tariff indices slid to 3.8% yoy and 14.5% yoy respectively thanks to decelerating medicine prices and transportation tariffs growth. Still, the declining trend of transportation tariffs observed for December 2005-January 2006 should be attributed to a high base affect and is likely to reverse soon after the parliamentary elections.

The NBU's firm intention to maintain exchange rate stability and resolution of the gas price issue calmed the speculative tone of the forex market in January. During February, the average cash exchange rate appreciated slightly to UAH/\$5.11, while the official rate was kept unchanged at UAH/\$5.05 thanks to central bank interventions. At the same time, the scale of the NBU forex market operations was considerably lower in February than in the previous month — about \$180 million vs. almost \$940 million respectively. As a result, international reserves declined to \$18.3 billion at the end of February, but were still 67% yoy higher.

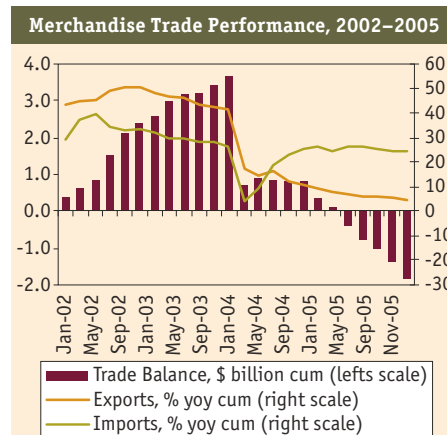
Following considerable acceleration of monetary aggregates growth at the end of 2005, money supply (M3) growth dropped to 50% yoy in January (down from 55% yoy in December). Such deceleration is explained by the surge in demand for cash foreign exchange and the NBU's sale of international reserves and sizable sterilization operations. At the same time, liquidity in the banking system remained rather high thanks to a 55% yoy growth in deposits, underpinned

by growing disposable income (up by a real 22.8% yoy) and rising confidence in the banking sector. In turn, this allowed commercial banks to further expand lending to the real sector, whose growth accelerated to 64.7% yoy in January (up from 62% yoy in December 2005), and decrease the average cost of loans to 14.4% per annum (down from 14.6% per annum.)



International Trade and Capital

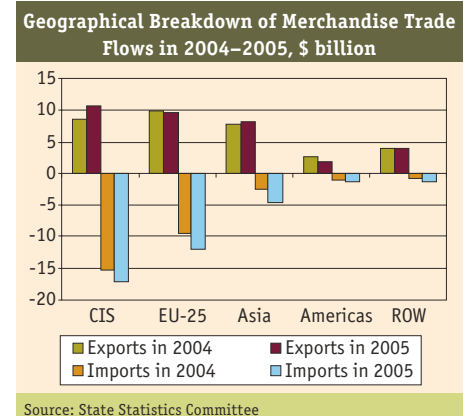
According to the SSC, exports of goods grew by 5% yoy in 2005, while imports rose by 24.6% yoy. The deceleration of exports growth from a remarkable 41.6% yoy in 2004 was primarily due to a reduction in world metal prices and a slowdown of external demand for some Ukrainian products. At the same time, imports were stimulated by continuous expansion of domestic demand and reduction of import tariffs. In addition, both inward and outward trade flows were affected by real appreciation of the hryvnia with respect to the US dollar and the euro, which constituted around 12% and 25% respectively. The resulting merchandise trade deficit was \$1.8 billion in 2005 compared to a surplus of \$3.7 billion reached in 2004.



By product breakdown, merchandise exports continued to be driven by ferrous metals. Despite the weakening external demand and higher production costs (mostly energy and transportation) exports of ferrous

metals posted an increase of 6.7%, explaining almost half of total growth in merchandise exports. Export of chemicals was also on the rise driven by favorable conditions on external markets. Mineral products, which traditionally were one of the major exporting items, posted only a modest increase of 8.9% yoy compared to 23.5% yoy in 2004. The slowdown is primarily attributed to the introduction of seasonal export quotas on oil-products in April 2005. Exports of machinery and transport machines went down by 6.2% yoy and 18.7% yoy mostly because of lower demand for these products in the EU and the Americas.

Although high growth rates of imports contributed to a growing external imbalance, there was a substantial positive change in the commodity structure of imports with investment goods posting a considerable increase in 2005. In particular, imports of machinery grew by 33.8% yoy and were the main contributor to overall merchandise imports growth. Imports of transport equipment also posted a notable 29.1% yoy increase. Another positive tendency is the reduction in mineral products' share of total imports, which went down to 32% from 37.4% in 2004. The slowdown of mineral products imports to 6.7% yoy from 27.9% yoy a year before was mostly due to a lower supply of coal and crude-oil from abroad. The latter was, however, substituted by imports of oil-products. The substitution took place due to the reduction of import tariffs on oil-products, which were cut in May 2005 to combat a hike in domestic gasoline prices.



By geographical breakdown, the largest part of domestically produced commodities in 2005 was supplied to Ukraine's eastern neighbors; exports to CIS countries grew by 25.5% yoy bringing the share of the region in the country's total merchandise exports to 31.3%, up from 26.2% in 2004. At the same time, exports to the EU-25 and the Americas decreased by 6% yoy and 28% yoy respectively due to a lower supply of machinery and transport equipment. At the same time, intensification of inward trade flows was relatively even across countries. Imports from the EU-25 grew by 25.8% yoy, up from 21.8% yoy in 2004. Taking into account that European countries are the major supplier of investment goods to Ukraine, this tendency looks encouraging. At the same time, imports from

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the CIS region advanced at a lower pace, increasing by 12% yoy compared to 32.1% yoy a year before. The slowdown partially mirrors deceleration of mineral products imports.

Although developments of merchandise trade flows signal deterioration in Ukraine's foreign trade sector, the overall external situation remains stable. According to the SSC, the surplus of services foreign trade balance reached \$3.2 billion in 2005, fully compensating for the merchandise trade deficit of \$1.8 billion. Although these figures are preliminary and might be substantially revised, the services surplus will still substantially outweigh the goods deficit according to the NBU officials. Along with the constant inflow of remittances from abroad, this ensures a positive current account balance in 2005.

Other Developments and Reforms Affecting the Investment Climate

At the end of January, the US reinstated the Generalized System of Preferences (GSP) for Ukraine in recognition of the government's efforts to improve the enforcement and protection of intellectual property rights. The GSP program provides preferential duty-free treatment for a wide range of products supplied to the US from designated beneficiary countries and territories. Ukrainian exports that could benefit from reinstatement of GSP the most include certain iron and steel articles, mineral and metal products, electrical and railway products.

In mid-February, the US Commerce Department also designated Ukraine as a market economy starting February 1, 2006. Granting Market Economy Status (MES)

means that the Ukrainian economy develops according to market principles in five areas: (i) the extent of currency convertibility, (ii) bargaining for wage rates, (iii) openness for and protection of foreign investment, (iv) government ownership or control of production, and (v) government control over the allocation of resources. MES will provide greater protection for Ukraine in antidumping investigations, as the US Commerce Department will now use the market information provided by Ukrainian companies in antidumping, while earlier the opinion of local companies did not count.

Both the reinstatement of GSP and granting MES will promote Ukraine's exports to the US and will significantly contribute to the improvement of the country's international image, thereby promoting foreign investment in the country.