



Analyst's Notebook

Ukraine/Macro
 September 18, 2006

The 2007 Budget: A Lot Like the 2006 Budget

The new government's draft 2007 budget, which was delivered to parliament on Thursday, shows that the change of governments hasn't led to any major change in the state's financial priorities. Like the 2005 and 2006 budgets, the draft 2007 budget is again focused primarily on social spending, but with a slight reduction in the budget burden on the economy, which is positive.

Key Budget Parameters, USD bln

	2006	2007
Consolidated Budget		
Revenues	31.1	35.2
% of GDP	31.6	30.2
Expenditures	34.2	38.5
% of GDP	34.7	33.0
Deficit	3.1	3.3
% of GDP	3.1	2.8
State Budget		
Revenues	24.6	27.5
% of GDP	24.9	23.6
Expenditures	27.1	30.1
% of GDP	27.5	25.8
Deficit	2.5	3.0
% of GDP	2.5	2.6
Public debt of GDP, %	17.6	16.0
Privatization revenues	0.4	2.0
Macro Indicators		
Nominal GDP	98.7	116.5
Real GDP growth, % yoy	5.8	6.5
CPI, %	10.0	7.5
PPI, %	12.5	14.4
Avg. exchange rate, UAH/USD	5.05	5.10

Key Parameters Look Reasonable

The draft sets revenues USD 27.5 bln (up 11.8% from 2006), expenditures at USD 30.1 bln (up 11.1%), and a maximum deficit of USD 2.96 bln (up from USD 2.5 bln).

In its presentation, the government said it expected consolidated revenues at USD 35.2 bln, 13.2% higher than this year's projected figure, consolidated expenditures of USD 38.5 bln, up 12.6%, and a maximum consolidated deficit of USD 3.3 bln.

The lower proportion of GDP distribution through the budget (down from 31.6% in 2006 to 30.2% in 2007) is a positive change, especially after two consecutive years in which the budget burden on the economy increased.

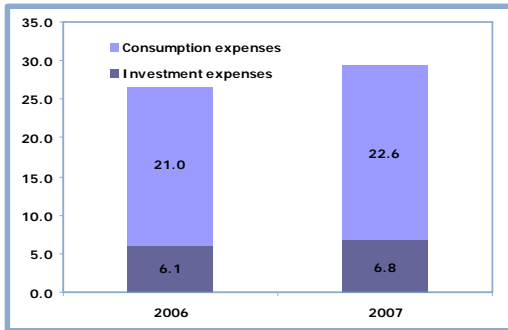
The budget assumes an average exchange rate of 5.1/USD and GDP of USD 116.5 bln. The forecast 2007 GDP growth (+6.5%) is optimistic but almost in line with our projection of 6.0%. However, we think the government's inflation forecast (7.5%) is too optimistic - we expect CPI at 9%.

The main risks to the budget are: the potential for a downturn in global growth which could bring down steel prices (although most forecasters predict they will remain high); the possibility that the upcoming gas price increase will have a greater impact on GDP and/or inflation than this year's price increase had; and uncertainty over whether the government will be able to foster enough growth in foreign and domestic investment to compensate for the expected slower growth of consumption.

Only a Slight Tax Burden Relief

Judging from this draft, 2007 will not see any large-scale tax reform. There are some minor increases and decreases in such things as excise taxes, but no changes in the rates for value added tax, profit tax, personal income tax, or payroll taxes. The main improvement is a reduction in the portion of net income that state-owned companies are obliged to transfer to the budget, from 50% to 15%, which will help Ukrtelecom (UTEL), GenCos and many Oblenergos.

Investment & Consumption Components, USD bln

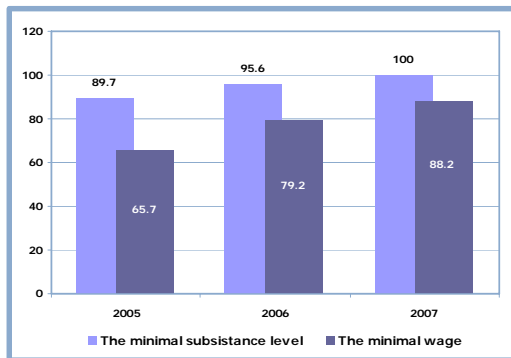


Consumption First, Investment Second

Despite the government's talk about a more investment-oriented budget, the 2007 draft budget actually sharply increases social payments. However, state wages are only slightly higher and less in real terms.

Spending on social payments by the Ministry of Labor and Social Affairs is increased to USD 2.8 bln from USD 1.55 bln in 2006. Budget support for pensions is increased to USD 4.4 bln from USD 3.4 bln (pensions are linked to the official subsistence level, and are funded mainly from payroll taxes through the off-budget Pension Fund). The wage component is increased to USD 4.3 bln from USD 4.1 bln.

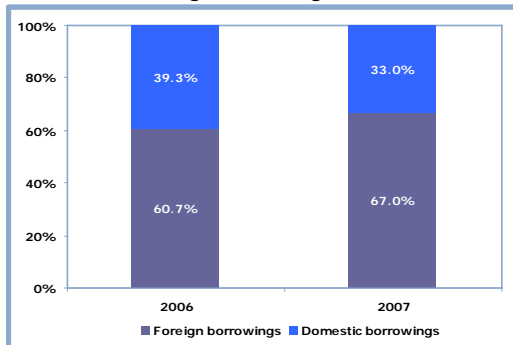
The Minimal Wage & Subsistence Level, USD



There is also an increase in subsidies to farmers to USD 700 mln in 2007 from USD 400 mln and an extra USD 250 mln to cover increased utilities costs (an 85% increase).

These increases add up to USD 2.8 bln. Given that the draft 2007 budget's expenditures are only USD 3 bln greater than the 2006 budget, it seems unlikely that there could be any significant increase in capital expenditures (which is not separately accounted in the budget plan).

Domestic vs Foreign Borrowing



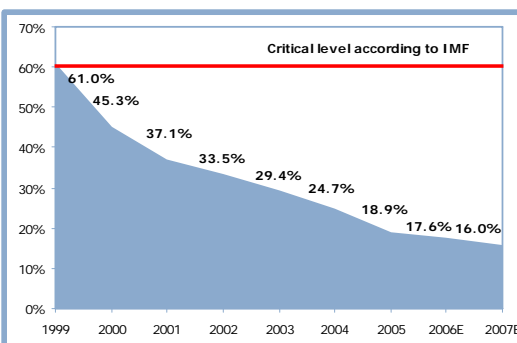
Borrowing on the Rise

Net borrowing will increase more than two times in 2007: from USD 0.4 bln planned in 2006 to USD 1.0 bln in 2007.

The government is more inclined to borrow abroad: the share of debt raised abroad would increase to 67% from just over 60% this year.

However, the debt to GDP ratio would continue to shrink, which could allow the government to raise additional debt for investment projects.

Ukraine's Debt To GDP Ratio



Privatization: Energy Likely, UTEL not

Privatization revenues are set at USD 1.96 bln. So the government is apparently not planning to privatize Ukrtelecom (MCap USD 3.6 bln).

More likely, the government could sell stakes in GenCos, Oblenergos and/or coal mines.

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