UKRAINE
Macro

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The Ukrainian Economy 2006

So Far, So Good

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Content

Summary

Gas shock: more bark than bite. Ukraine was able to accommodate higher gas prices, at least in 1H06, proving several international organizations and their forecasts of impending doom wrong. None of the consequences associated with the gas price hike had a significant destructive impact on the economy. Exports continued their steady growth, steel and chemical producers were able to tolerate higher gas prices without cutting production and helped the industrial sector rebound strongly (5.4% over 8M06), investment activity recovered (12.2% in 1H06) and inflation was kept in relative check (3.8% during 8M06). In general, during the first eight months of the year Ukraine's GDP demonstrated an encouraging 5.7% yoy growth rate.

New industry leaders; domestic demand turning into a driving force. The cool-down on global steel markets combined with the gas price hike put the pinch on the traditional backbone of the national economy, the steel and chemical sectors, leaving new sectors pick up the reigns. Machine-building and food processing led the way demonstrating sound growth during 8M06 (+12.3% and 7.7% yoy). The share of the two growth leaders in total industry production is now on par with chemicals and metallurgy. Previously Ukraine's industry was driven by its export-oriented sectors, steel and chemicals, thanks to cheap gas and strong external demand, however, domestic demand is increasingly becoming a pillar of growth for the economy. Estimated domestic consumption growth reached a remarkable rate of 15% over 1H06.

Inflation headache has eased. The gas price hike was passed to consumer prices in the form of a 25% increase in gas and electricity tariffs for households, with a four month lag. The cumulative CPI growth rate for the first half of the year, 2.9%, was less than half of what it was in 1H05. We believe that the 85% increase in gas tariffs that followed will still have a limited impact on consumer prices, due to the insignificant share of payments for residential gas in consumer spending on the one side and the ability of exporters to forward part of the burden to consumers outside Ukraine. Our forecast for the end-of the-year CPI rate is at 11%.

Current accounts improving, FX reserves ample. Although imports in 1H06 continued to dominate, export dynamics showed steady improvement. After a year of falling, exports started recovering, up from a 6.3% yoy drop in January to 2.1% yoy growth for 1H06. The current account deficit is back in the black and we expect it be at zero by the end of the year, assuming that favorable market conditions persist in the short term. Foreign currency is flowing into the country which helped the National Bank bring its reserves to USD 19.1 bln, as of October 1, close to their historical peak of USD 19.4 bln from last year.

Budget hits 1H06 targets, government resumes debt raising. In 1H06 budget execution stayed within the parameters set out by the government. However, we expect the 1H06 deficit of USD 0.6 bln (1.5% of GDP) to widen to USD 2.6 bln or 2.4% of GDP by the year end, mainly due to higher portion of social distributions scheduled for 2H06. In the fall the government resumed debt raising on the local market (though in modest amounts). In addition to the CHF 384 mln Eurobond placement in August, the government is also likely to embark on another issuance this year, especially given the fact that privatization revenues (the government planned on USD 420 mln) have proven to be an unreliable source of deficit financing this year.

Basic Macro Indicators Estimates

	2006E, old	2006E, new	2007E
GDP real growth, %	3.5	6.5	6.5
Industrial output growth	4.0	6.0	6.5
Capital Investments Growth, %	8.0	15.0	17.0
CPI (eop), %	10.0	11.0	9.0
Current Account Balance, % GDP	-1.0	0.0	-1.0

The Ukrainian economy – some like it hot

When Russia briefly reduced its gas exports in the first days of 2006 to force Ukraine to pay higher prices, it signaled the end of an era. Ukraine faced a crucial test: could it compete in the global economy without cheap energy?

The gas price increase that Ukraine accepted in January 2006 – up to USD 95/tcm at the Russia-Ukraine border from an average of USD 64.8/tcm in 2005, a 47% increase – seemed like a heavy blow for an already shaky economy. Slack demand for steel and other factors had already brought real GDP growth down to just 2.6% in 2005. Most economists lowered their 2006 GDP growth forecasts to 2% or less. We were more bullish, predicting 3.5% growth.

Indeed, the economy proved to have a sufficient safety net to allow it to adjust to a new gas price level, supported by the recovery of the world steel markets, growing investment activity and household consumption. While the first quarter (2.4% yoy GDP growth) met our expectations, monthly GDP progress thereafter exceeded everyone's predictions: 8.5% yoy in May, 9.3% in June, 7.7% in July and 7.1% in August.

Sorting it all out

All other things being equal, higher gas prices would not have led to the deterioration of real GDP growth, as price effects are excluded from real GDP calculations. Moreover, even nominal GDP suffered only 1-3 per cent, according to our estimates.

The trouble, brought on by the nominal increase in gas imports, was successfully offset by other GDP components

GDP = Household Consumption
+ Government Consumption
+ Investments
+ Export - Import

The immediate effect on GDP was due to increased nominal imports. Though the volumes of imported gas stayed the same, actual nominal gas imports in monetary terms increased 17% yoy in 1H06. This increase was mild because this year's gas imports have not been paid for in full or were prepaid last year. Given the 6.5% share of gas import in GDP, the direct impact of higher gas prices subtracted only one percentage from nominal GDP growth in 1H06 (which was +20% yoy). However, we expect the annual growth rate of gas imports to catch up and reach 46.6%, assuming that gas consumption is at about the 2005 level. This will steal an estimated 3% from nominal GDP growth in 2006.

Other GDP Components Conterbalance…

Exports Improving. Spurred by rebounding world markets, the steel and chemical markets in particular, export dynamics have improved since the start of the year. After dropping by 6.3% yoy in January, exports turned around and posted 4.8% yoy growth after the first seven months of the year.

Consumption Remains Robust. The boom in consumer lending shows no signs of slowing down (up 73.6% ytd as of Sep, 1); pushing up growth in real disposable incomes (up 19.5% yoy in 8m06). Estimated growth in household consumption reached a solid 16% yoy.

Investment Recovers. Investment activity revived after a bumpy 2005, spurred by the need to implement energy-saving technologies, and facilitated by a more stable political climate. Fixed capital investments into the Ukrainian economy grew 12.2% yoy in 1H06, a sharp contrast to 1.9% in 2005.

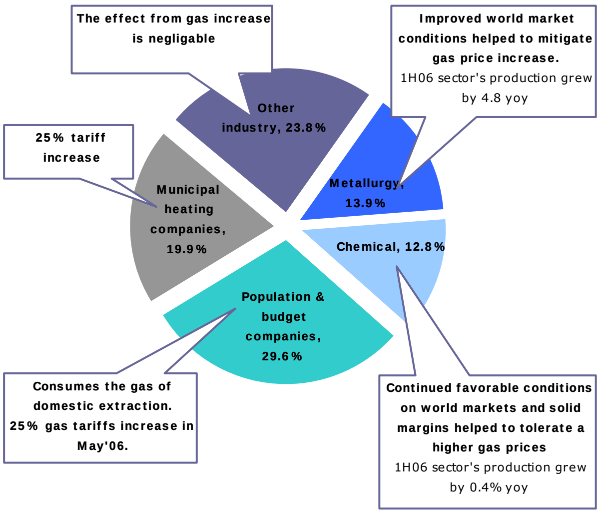
The price shock was successfully dissipated in the national economic system

Breaking the population of gas habits slowly. 29% of the gas consumed in Ukraine is extracted locally and all domestic gas is supplied exclusively to residential and budget/social sectors. The cost of locally extracted gas (USD 40 per 1000 m^3) is much lower than imports. Households used to pay roughly half this sum, with the rest covered by the budget and indirectly in - the form of higher tariffs – by industry consumers. The population saw two hikes in gas tariffs this year: +25% in May and +85% in July. The latter increase was overturned by the court. However, we believe, it will ultimately take place, although the size of the increase will probably be smaller.

Despite these sizeable increases, significant implementation lag, as well as a negligible share of payments for the gas consumed in household expenditures (~1.5%) resulted in a relatively comfortable transition for the population – it was able to successfully absorb this hike without changing their consumer behavior.

As the recent increases in gas tariffs brought the gas price paid by households to a cost-covering level, the likelihood of further tariff adjustments is unlikely, due to the social sensitivity surrounding the issue.

How the Gas Price Increase Was Divided*



** Percentages indicate the sector's share of gas consumption*
Source: Naftogaz, Concorde Capital

A bitter pill for two major industries

The chemical industry (Nitrogen fertilizers) and metallurgy together account for 1/3 of Ukraine's industrial output. As these two industries depend on global markets, they saw their margins squeezed. Still, at the current gas price level, both industries were able to accommodate a 46% gas price hike without a cutting production or export volumes – and have kept their business afloat.

The bulk of the economy will simply factor higher gas prices into their cost structure, in many cases even without passing the additional cost on to the consumer, due to the relatively low portion of gas in the cost structure of most businesses.

Second Increase Looming

We are expecting an increase in the import price to USD 130-140/tcm, up another 37-47%, but this time without any increase in the transit fees that Ukraine collects from Russia. The new, Russia-friendly government has already succeeded in negotiating a delay in the price increase until January 2007.

A gas price increase to USD 135/tcm would represent an additional USD 2.2 bln in annual costs for the Ukrainian economy, on top of the estimated USD 1.4 bln a year cost of the January 2006 gas price increase.

Ukraine should be able to absorb the increase so long as steel prices remain high. According to preliminary data, current accounts ran a USD 350 mln monthly surplus in July a sharp turnaround from the USD 782 mln deficit accumulated in the first half of the year. A turnaround on that scale, if maintained, would put the full year current account into surplus in 2006 and possibly keep it there in 2007 despite the gas price increase. However, until we see the final data for 3Q06 we will remain conservative, forecasting a current account balance of zero in 2006 and a USD 2.4 bln deficit in 2007.

The steel industry will face tighter margins, and funding technology upgrades including the conversion of blast furnaces from gas to pulverized coal injection will require more outside financing. In the medium term, world supply is expected to catch up with demand and lead to heightened competition. Until the effects of modernization materialize, competitiveness of Ukrainian steel industry will be supported by its labor cost advantage and self-sufficiency in raw materials - coal and iron ore.

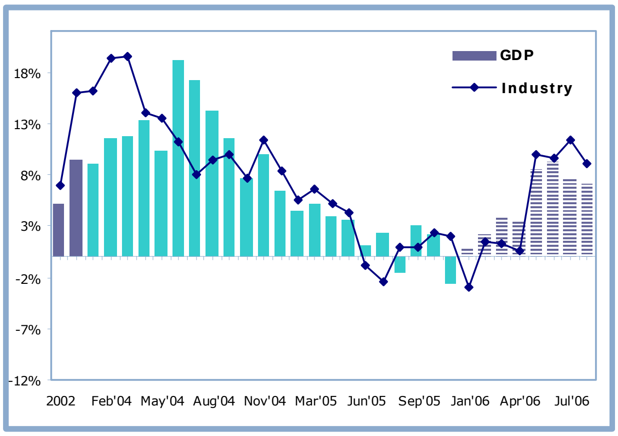
The biggest question is the Nitrogen fertilizer industry. How it handles the price increase remains to be seen. Ukrainian producers are considerably less efficient than their developed-market peers, and after a gas prices are raised they will be paying considerably more for gas than their Russian peers. We believe the Ukrainian plants will struggle to break even after the second gas price increase. To survive in the long run, they need to embark on large-scale investment programs, with the government's support… or to be taken over by Russian rivals with the ability to provide them with cheaper gas.

Growth Returns

This year the Ukrainian economy proved that it is not made of 100% steel. During the first four months of 2006, after last year's sharp drop in global demand for steel, Ukraine's smelters experienced a deep decline, however, Ukraine's GDP posted growth of 2.7% yoy in 4M06. The services sector came to the rescue - trade, construction and transport showed strong growth during the period.

It is still too early to ignore importance of the steel-making sector, the acceleration of GDP growth since May was largely attributable to the recovery of the sector following the rapid recovery of world steel markets. The 8M06 GDP growth rate of 5.7% yoy was more than double annual growth for 2005 (+2.6% yoy).

GDP & Industrial Output, % growth yoy



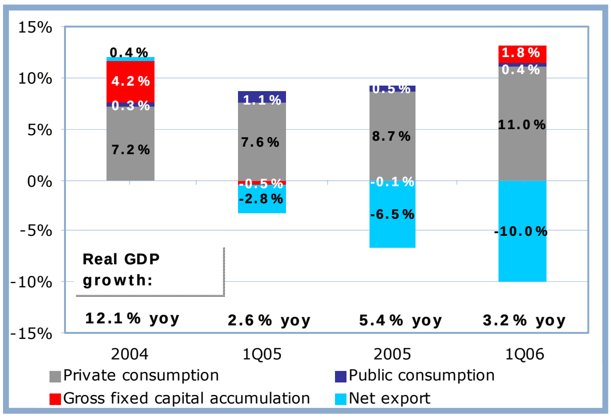
Source: State Statistics Committee

The expansion of the economy since the very beginning of the year, while the foreign trade balance was negative, is due to stronger domestic demand from both the consumption and investment side.

While Ukraine's exports are subject to volatile world trends, the domestic market has undergone steady, rapid growth. Social spending and state-sector wages have increased sharply since September 2004, and consumer lending is booming, with the volume of consumer loans up 73.6% ytd as of Sep, 1. Real disposable incomes grew 19.5% yoy in 8M06, on top of 20.1% growth in 2005 and 16.8% in 2004. Retail trade grew by 27% yoy in 1H06, up from 23% in 2005 and 20% in 2004, and slowed only slightly after the July gas price increase for households, to 25.6% yoy in 8M06.The private consumption contribution to GDP growth, based on the expenditure method of GDP accounting, grew to a record rate of 11% in 1Q06, up from 7.2% in 2004 and 8.7% in 2004.

More importantly, investments have been on the path to way. Real gross fixed capital accumulation increased by an encouraging 8.2% in 1Q06 against a 2.3% drop last year. The rebound was largely due to the stabilization of the political situation. Last year re-privatization uncertainties together with strict and unpredictable policy of the Tymoshenko government led many business groups to postpone investment projects. The need to start the implementation of energy-saving projects, especially topical given the recent price hike on imported gas, was another factor behind improved investment activity.

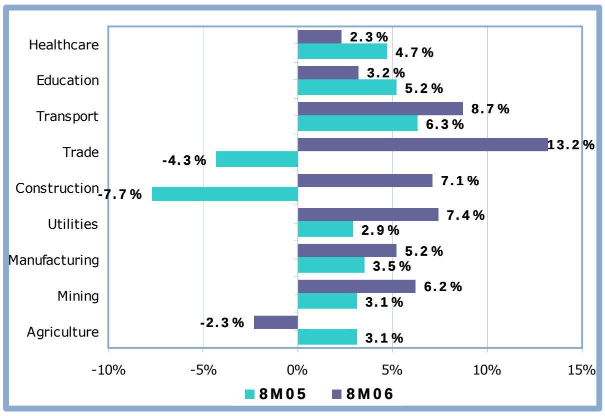
Contribution Of Demand Components To GDP



Source: State Statistic Committee, Concorde Capital

Based on the value added approach, the service and construction sectors were important drivers for 8M06 GDP growth. The growth in trade (+8.6% yoy), transport (+8%), education (1.8%) and construction (6.5%) explains 70% of GDP growth in 8M06.

GDP Dynamics By Sector, % yoy



Source: State Statistics Committee

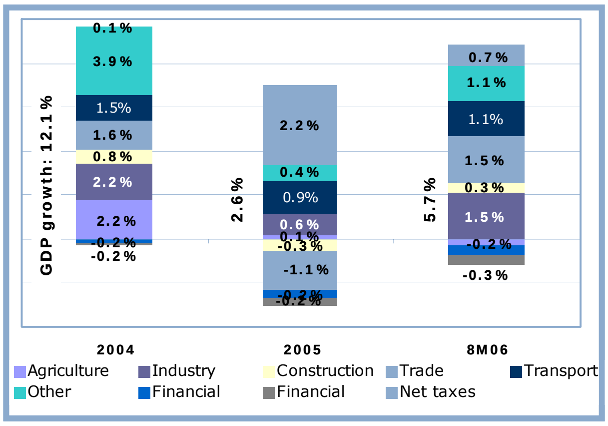
The trade sector, after being a significant retractor last year, this sector turned into a a powerful GDP growth booster in 2006. The recovery in wholesale trade (+9.2% yoy vs. 7.4% decline in 2005) reflected the steadily improving industrial performance. Retail trade continued to flourish (+24.6% yoy) confidently increasing its share in the sector: from 30% in 2005 to 37.7% in 8M06.

Construction also recovered (+7.1% yoy) after a 6.6% fall in 2005, which reflected improved investment activity.

Industry has rebounded strongly since the start of the year. Processing industries grew 5.2% yoy in 8M06 after a 0.4% yoy decline in 4M06. Mining and extraction accelerated from 3.3% yoy growth in 4M06 to 6.2% yoy in 8M06.

Agriculture is a volatile sector, highly subject to good or bad weather. Last year the weather was fine, this year mediocre, and so the sector has gone into decline since June, turning a 4.6% yoy gain in 5M06 into a 2.3% yoy decline in 8M06.

Contribution to GDP Growth By Sector



Source: State Statistic Committee, Economic Ministry

An analysis of contributions to GDP by sector shows that wholesale trade, industry and construction contributed the most to 2006's improved performance over 2005. Trade contributed 1.5 percentage points to growth in 8M06 after subtracting 1.1 points in 2005, industry contributed 1.5 points in 8M06 after contributing 0.6 points in 2005, and construction contributed 0.3 points in 8M06 after subtracting 0.3 points in 2005. The sectors where 8M06 growth lagged behind 2004 the most, when GDP grew by 12.1%, were the "other" category, which added 3.8 points to 2004 growth and only 0.9 in 8M06, as well as agriculture, which added 2.2 points to 2004 growth (because the 2003 harvest was very weak) and subtracted 0.2 points from growth in 8M06.

Industry Rebounds Strongly

Industrial growth rates since May have been quite a surprise for most analysts, most of whom predicted that January's the gas price increase would lead to a prolonged period of weakness, with a possible recession due to the heavy blow to the metals and chemical sectors. Our own initial industrial growth forecast of 3% for 2006 was more optimistic than the consensus, but still turned out to be too low, as we did not foresee the spectacular recovery of world steel prices.

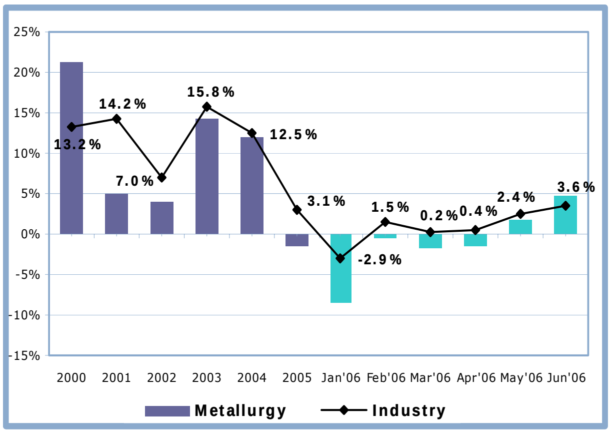
Output contracted by 2.9% yoy in January, when the country faced energy shortages due to the gas price conflict with Russia and severe weather. February-April saw lukewarm growth, with monthly yoy rates ranging from 0.4% to 1.4%. But after the resumption of sufficient gas supplies to steel mills in March followed by the acceleration of the steel price recovery in May, the industry quickly sprang to life. Monthly yoy growth rates jumped up to range from 9.1%-11.4%. Industrial output growth in 8M06 came to 5.4% yoy.

We forecast 6.5% industrial output growth in 2006 and another 6.5% in 2007.

This year's industrial growth dynamics are best understood in two stages:

Bottoming Out in January-April. During 4M06 Ukraine's industrial output grew by a meager 0.4% yoy, marking a further slowdown from the sluggish 3.1% growth recorded in 2005. Metallurgy, which accounts for almost a quarter of Ukraine's industrial output (24.1% in 8M06), reduced output by 1.6% yoy in 4M06 after a 1.5% contraction in 2005. The chemicals sector (5.3% of industrial output), was hit hardest by the January 2006 gas price increase and reduced output by 3.8% yoy in 4M06, after a 7.8% gain in 2005.

Industrial Output & Metal Sector, growth yoy



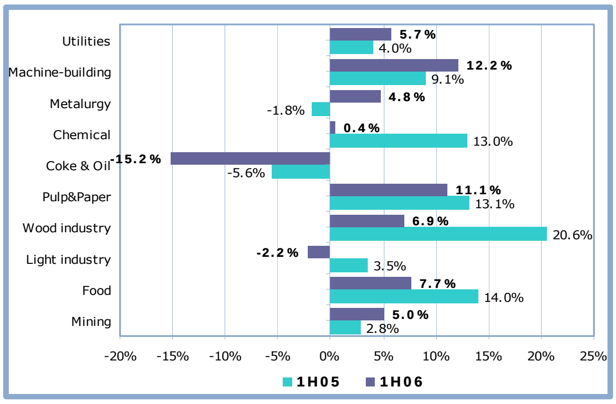
Source: State Statistics Committee

Coke and oil products (9.5% of industrial output), which were down 13.4% in 2005, were down another 18.8% yoy in 4M06. Ukraine's coke industry lost its export markets from mid-2005 as Chinese overproduction flooded world markets, while the elimination of import tariffs on oil products in May 2005 cut the margins of local refineries, prompting them to reduce output and use the down time for equipment upgrades.

On the other hand, ***food processing*** (14.5% of industrial output), which grew by 13.5% in 2005 thanks to increased social payments and rising wages, continued to grow in 4M06, though at a more moderate pace of 6.5% yoy. Most encouragingly, the ***machine building*** sector (12.6% of industrial output), which had recorded 7.1% growth in 2005, picked up speed in 4M06 to 10.1% growth yoy, as industrial investment picked up despite the lull in GDP growth.

Rebounding From May. The strong recovery of world steel prices in May, when prices for slabs, accounting for about half of Ukraine's metal exports, surged by 63% – triggered the recovery of metallurgy, with monthly yoy growth rates jumping to 12.4% in May and a range of 18.9-22% yoy in June-August. The metals sector finished 8M06 up 8.4% yoy. Meanwhile strong growth continued in food processing (7.7% yoy in 8M06) and machine building (12.3%). Recoveries were mounted in chemicals (+0.2% in 8M06) and coke, but oil processing continued to decline (coke and oil products combined were down 12.9% yoy in 8M06).

Industrial Output Growth By Sector, yoy



Source: State Statistics Committee

Consumption Accelerates

Strong growth in household consumption was the **key force that supported growth in 2005** and it will remain one of the most important factors in 2006 and 2007. Since September 2004, when Viktor Yanukovich doubled pensions during his campaign for the presidency, social spending and state-sector wages have been steadily increasing. That, and booming consumer lending have supported continued, rapid consumption growth even when the economy came to a near standstill in late 2005.

The household consumption component in demand-side GDP accounting grew at a record rate of 19.7% yoy in 1Q06 and it is estimated to reach 17% yoy in 1H06 up from 16.6% in 2005 and 13.5% in 2004. We expect the pace of growth to slow only a little over the rest of the year, bringing the increase for the full year to 15.5%. Real disposable income grew by 19.5% in 8M06. Our forecast for full year growth is 18.5%, slightly less than in 2005, mainly because the 2006 state budget was relatively less ambitious in expanding social benefits.

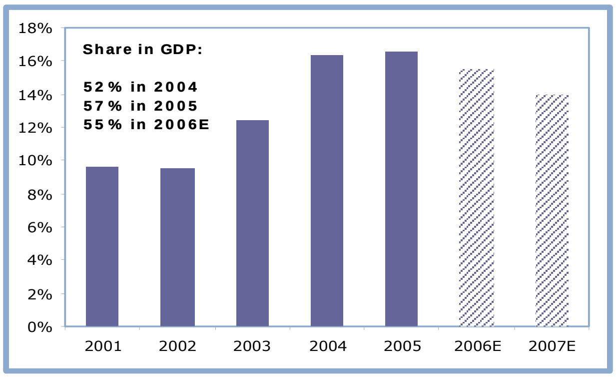
Structure Of Household Revenues & Expenditures

	1H06	1H05
Revenues		
Wages & salaries	44.4%	41.8%
Profit & mixed income	10.0%	9.5%
Property income	2.2%	2.0%
Social benefits	43.4%	46.7%
Expenditures		
Consumption of goods & services	84.7%	84.5%
Property spending	1.6%	0.9%
Taxes	7.4%	6.6%
Non-financial holdings	-1.3%	-0.6%
Financial holdings	7.6%	8.6%

Source: State Statistic Committee

Compared to 2005, the structure of personal incomes changed significantly in 2006 with wages accounting for a larger share versus benefits. In 2005, the volume of social benefit payments exceeded the volume of wages. The 2006 budget is more conservative in benefits, but generous in state-sector wages. The wage increases brought payroll contributions to the Pension Fund closer to payout levels, thus reducing subsidies from the central budget.

Private Consumption Growth, % yoy

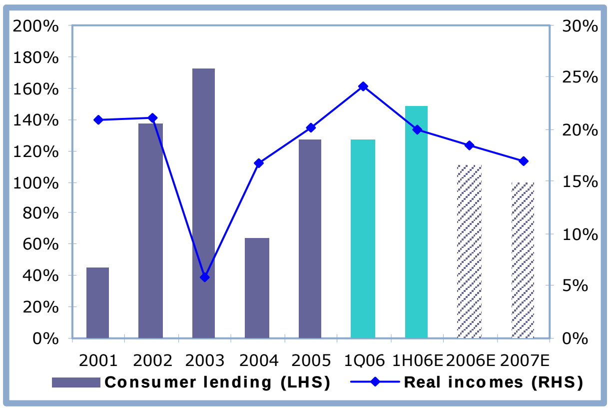


Source: State Statistics Committee

Consumer behavior has hardly changed. Ukrainians still have high propensity to consume, allocating 85% of their resources to the consumption of goods and services. Note however that these figures are skewed because they don't account for the large "shadow economy". Wages, rents and other income are often under-reported and large purchases including homes are often made from unreported savings. Real estate deals are usually reported at below their real values. Also, home renovation, one of the most popular investments, counts in statistics as consumption.

The volume of consumer lending in Ukraine has doubled every year for the past five years (the CAGR for 2001-2005 was 102%). Even so consumer lending remains relatively undeveloped, but it is on its way to becoming an important driving force for consumption growth. The volume of consumer loans as a share of GDP increased from 0.7% in 2001 to 7.8% in 2005. The consumer loan portfolio of Ukrainian banks continued to accelerate in 8M06, growing 73.6% ytd by September 1, up from 63.1% growth recorded in the same period last year. We expect consumer lending to maintain its strong growth and end the year up 110%, at 13.7% of GDP.

Consumption Driving Factors Growth, % yoy



Source: State Statistics Committee, National Bank

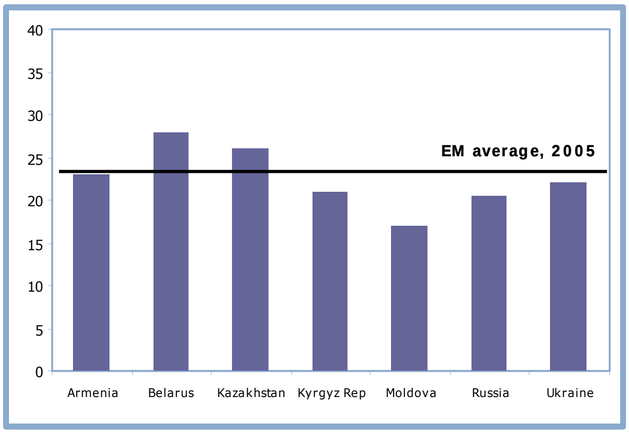
Investment Recovers

Fixed capital investments grew 12.2% yoy in 1H06, real gross fixed capital formation was up 8.2% in 1Q06 and it is estimated to be 10% in 1H06 a big relief after a troublesome 0.3% decline in 2005.

For the first time since 1999 growth in gross fixed capital formation slipped into negative territory. The reasons are obvious - sharp reduction in state capital spending as money was diverted to fund pre-election social spending in the fall of 2004; political uncertainty in the wake of the *Orange Revolution*; insecurity over property rights as the new leaders announced their intention to revise some past privatizations, and then argued among themselves for months over how to do that.

The first half of 2006 could hardly be described as politically stable: there was the gas dispute with Russia for a starter, followed by the hard-fought parliamentary elections campaign, and then more than four months of topsy-turvy coalition talks until a government was finally formed in August. However, judging by the recovery of capital investments into the national economy, it was apparently stable enough.

Investment as Share of GDP, 2005



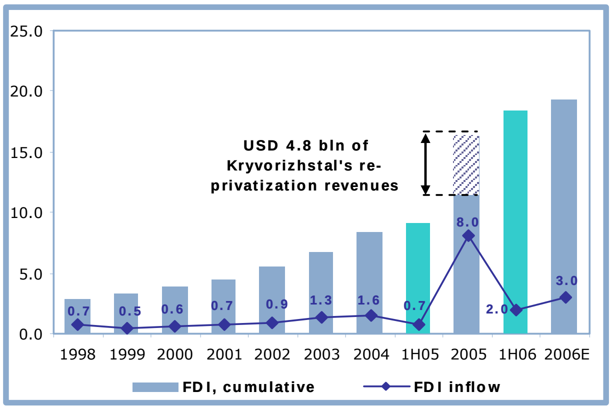
Source: State Statistics Committee, IMF

Investment as a share of GDP, 22% in 2005, was close to the IMF-calculated emerging markets average of 24%. However, Ukraine only surpassed the 20% level in 2004, which pales in comparison to many Asian countries which have been investing around 30% of GDP since the beginning of the 1990s - which ensured their rapid growth during that period.

We think in the mid term Ukraine will continue to increase its share of investments, which will be an important factor driving economic growth in the years ahead. We expect fixed capital investments to continue their recovery in the second half of the year and <u>forecast annual growth in 2006 at 15%</u>, up from 1.9% in 2005.

The highest growth in investment will be observed in sectors oriented towards the domestic consumer market (e.g. food, agriculture, automotive, and retail trade). The need to meet rapid growth in household consumption will push these sectors to expand production capacities. Investment activity will also be stimulated by the need to introduce energy-saving technologies, especially in the chemical and steel sectors, to mitigate the gas price hikes. Also, the increasingly stable political situation will encourage large business groups, especially those involved in the main governing party, the Party of Regions, to make investment commitments which they were reluctant to make last year due to "re-privatization" worries and the criminal investigations that were launched against them.

Foreign Direct Investments, USD bln



Source: State Statistics Committee

We also expect foreign investment and repatriation of capital held abroad to be increasingly important. In 1H06 net FDI was USD 2 bln, 3.3 times greater than 1H05. The main recipients were the financial sector (USD 592 mln), due to recent bank acquisitions, and metallurgy (USD 129 mln). The FDI inflow to metallurgy came mainly from Cyprus, which suggests domestic business groups were returning funds back to the country to finance investment projects in the sector.

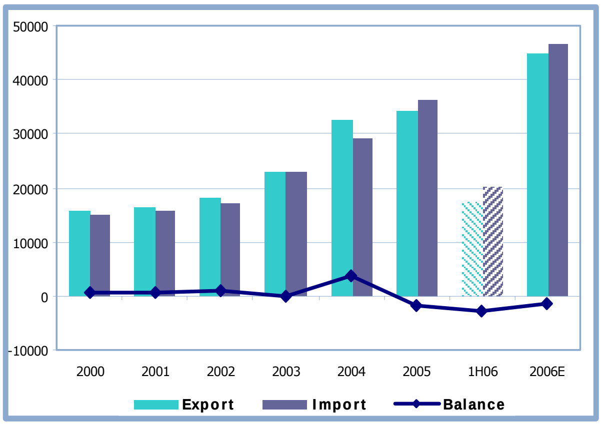
Fixed Capital Investments By Sector

	2004		1H2005		2005		1H2006	
	growth, % yoy	% of GDP	growth, % yoy	% of GDP	growth, % yoy	% of GDP	growth, % yoy	% of GDP
Total	**28.0**	**21.9%**	**8.5**	**17.6%**	**1.9**	**21.9%**	**12.2**	**19.0%**
Agriculture	39.1	1.0%	18.7	0.7%	25.8	1.2%	65.0	1.1%
Industry	24.9	8.1%	7.4	7.1%	4.1	8.2%	11.0	7.4%
Construction	57.6	1.4%	-3.2	0.8%	-15.9	1.2%	0.5	0.8%
Trade	42.2	1.5%	62.0	1.2%	18.0	1.8%	11.7	1.3%
Transport & Communication	28.0	4.3%	11.7	3.7%	-5.6	4.0%	0.7	3.5%
Finance	12.3	0.4%	33.5	0.4%	35.5	0.5%	5.5	0.4%

The Trade Deficit Shrinks

2005: The Time Of Troubles
Merchandise trade ran a deficit of USD 1.85 bln in 2005, against a surplus of USD 3.7 bln in 2004, as growth of imports (up 24.6% in dollar terms) streaked ahead of exports (up 4.8%). Growth in imports was supported by growing consumption and the liberalization of imports in mid-2005. Exports were slowed by a lull in base metal exports (which grew 7.4% in 2005 after a 53.7% increase in 2004) and a contraction of exports of machinery and vehicles (down 6.3% and 18.6% in 2005, after 30.5% and 110% growth in 2004, respectively). Lower world prices and more competition from China reduced Ukraine's niche on world steel markets, while Russia reduced imports of machinery and vehicles due to poor relations with the "Orange" government. Exports decreased in real terms in 2005 by 11.2%, while imports increased 2.1%.

Foreign Trade Dynamics, USD mln



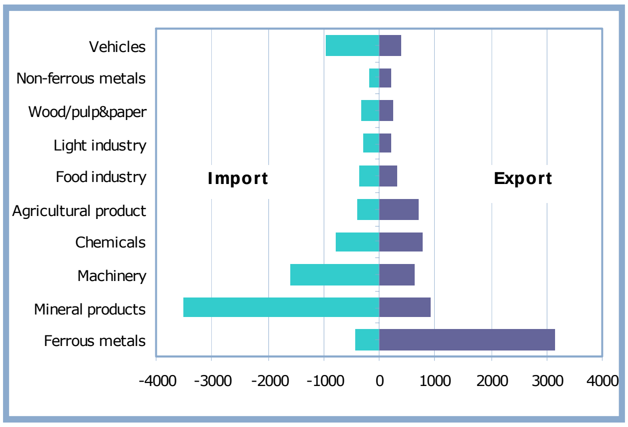
Source: State Statistics Committee

This year imports continued to dominate, but the deficit has steadily recovered since the start of the year. Exports in dollar terms contracted by 6.3% yoy in January and by 3.9% yoy in 4M06, but were up 4.8% yoy in 7M06. The recovery was due mainly to base metals, which contracted by 10.2% yoy in January and by 7.4% yoy in 4M06, but were up 4.6% yoy in 7M06. Growth was also renewed in machinery and vehicle exports (+9.2% and 18.4% yoy, respectively), mainly due to increased supplies to Russia, while chemical producers benefited from favorable world markets, increasing exports 13.5% yoy. Despite the gas price hike, exports of organic chemicals and fertilizers grew yoy in 7M06, by 1.5% and 1.3%, despite declines in 4M06 of 15.7% and 3.3%, respectively.

Merchandise imports grew 23.2% yoy in 7M06, bringing the merchandise trade deficit to USD 3.26 bln, after a USD 118 mln surplus in 7M05, according to trade data. The balance of payments data shows a smaller deficit: USD 2.16 bln in 1H06 compared to USD 2.92 bln in trade data.

The monthly merchandise trade deficits in June and July showed encouraging improvement, coming down to an average of USD 317 mln from an average of USD 525 mln in Jan-May.

Foreign Trade Composition, 1H06, USD mln



Source: State Statistics Committee

Curiously, reported gas import costs only grew 14.1% in dollar terms in 7M06, much lower than expected. Gas imports came to 29.6 bcm of gas in 1H06, which would be USD 2.8 bln at USD 95/tcm. But only USD 2.27 bln in gas imports show up on 1H06 trade statistics, but we don't rule out that there could be some compensatory over-reporting of gas imports over the remainder of the year, which could push import growth up.

The gas price increase's impact on merchandise imports was partly compensated by increased gas transit fees collected from Russia, which pushed the exported services up 22.6% yoy in 1H06, to USD 3.52 bln, according to trade data. Service imports increased 20.8% yoy to USD 1.59 bln, yielding a USD 1.93 bln surplus in services trade in 1H06, up from USD 1.56 bln in 1H05. Service trade in the balance of payments data is very different: USD 4.85 bln in exports, USD 4.27 bln and USD 577 mln surplus. In trade data, the overall 1H06 trade deficit was USD 985 mln, after a USD 1.94 bln surplus in 1H05. In BOP data, the 1H06 trade deficit was USD 1.59 bln after a USD 1.36 bn surplus in 1H06.

As demand for steel and other exports is expected to remain strong for the rest of the year, <u>we estimate export growth in 2006 at 10% yoy, up from our previous forecast of 5% yoy.</u> However, we expect import growth at 18% yoy, stimulated by strong consumer demand, higher gas prices and the growing need for industrial equipment. <u>Look for the 2006 trade deficit (as reported in in trade data) to be just under USD 900 mln and for the the current account balance the end the year at about zero</u> after running a deficit of USD 782 mln in 1H06. According to preliminary data, the current accounts ran a USD 350m surplus in July, which indicates the 2006 CAB could end in surplus.

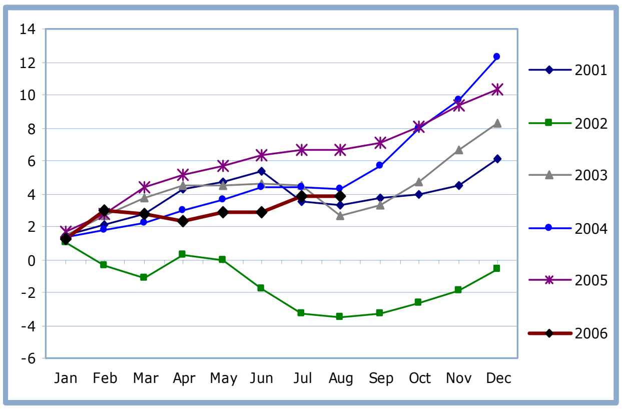
Inflation Eases

Annual consumer price inflation in August was up 7.4% over August 2005, compared to a 14.9% increase in 2004-Aug. 2005. Cumulative inflation in 8M06 was 3.8%, down from 6.7% in 8M05 and 4.3% in 8M04.

Services exerted the main inflationary pressure (17.7% of the CPI basket, 20.3% ytd price growth in 8M06), particularly utilities (6.6% of the basket, up 34.8%). Prices for consumer goods - food, drink and tobacco – actually deflated (64.9% of the basket, -0.4% ytd in 8M06, compared to a 7.7% increase in 8M05). Prices for non-consumer goods grew moderately (17.4% of the basket, +2.1% ytd in 8M06).

Inflation traditionally accelerates during the last months of the year, after the harvest-season the food surplus dwindles, and utility prices are likely to increase as heat providers will need to cover the increased cost of their gas supplies. ***We therefore estimate 2006 CPI at 11%.***

Cumulative Inflation, %



Source: State Statistics Committee

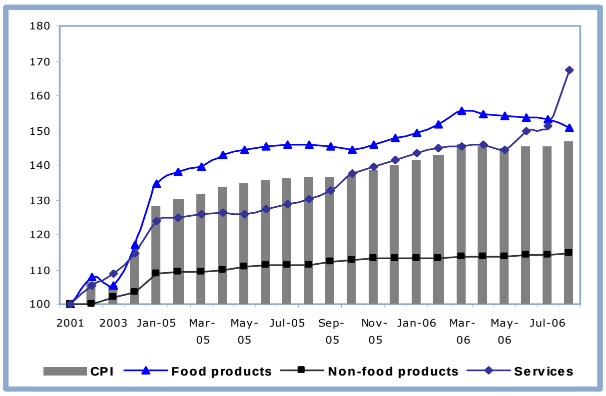
Inflation boosting factors:

1. The higher price for imported gas was passed on to consumer prices through an increase in gas and electricity tariffs for households. Residential gas prices are up 132.5% ytd after successive increases in May and July.

2. Rising oil prices on world markets and Russia's corresponding increases of its crude oil export duties, resulted in a 23.8% ytd increase in gasoline prices in 8M06.

3. Producer price inflation sped up slightly, posting an 8.5% growth rate in 8M06 against 7.3% for the same period last year. We expect full-year 2006 PPI at 13%.

CPI Component Dynamics, % yoy



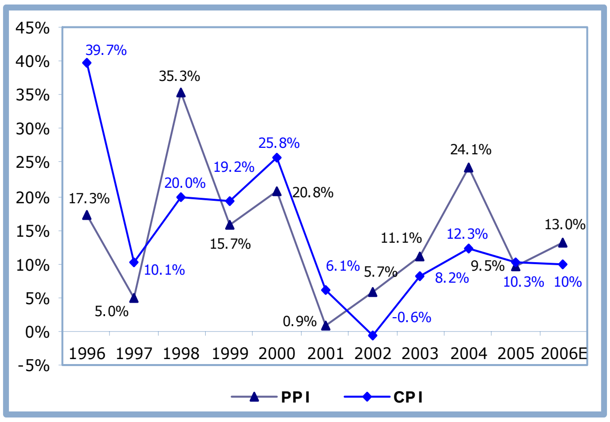
Source: State Statistics Committee

Inflation restraining factors:

1. The higher cost of gas significantly altered the balance of payments and thus the balance of the National Bank's interventions on the foreign exchange market. To defend its *de facto* exchange rate peg, the NBU bought hryvnya worth USD 2.1 bln (net) in 4M06 from the interbank market, resulting in a 5.7% ytd *decrease* in the monetary base in 4M06. After the export upturn the NBU sold hryvnya worth USD 1.3 bln (net) on the interbank market in May-August, but the monetary base was still down -1.1% ytd at September 1, despite steps by the NBU to spur liquidity such as lowering its interest rates and reducing commercial banks' reserve requirements. By comparison, the monetary base grew 27.4% during 8M05.

2. Russia imposed restrictions on meat and dairy imports from Ukraine, causing big drops in Ukraine's exports (meat and related products down 91.6% yoy in 8M06; milk, eggs and honey down 38.3%). That and higher dairy imports (+17.9% yoy, including eggs and honey) boosted domestic supply. As a result, prices for meat and dairy products, which together make 16.9% of the CPI basket, dropped by 6.2% and 7.9%, respectively.

CPI & PPI Dynamics, % yoy



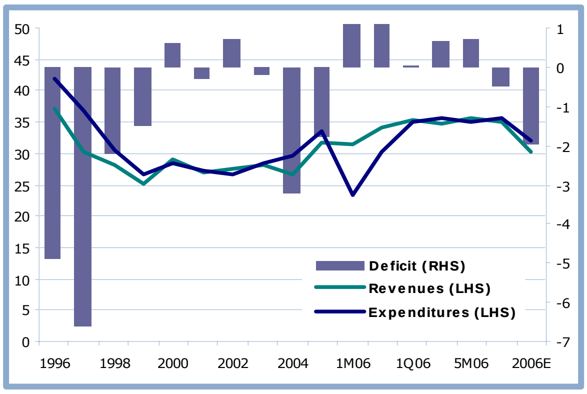
Source: State Statistics Committee

Budget Met, Barely

The 2006 budget was similar to its 2005 predecessor in its strong orientation toward social spending. However, benefit payments rose less quickly in 2006, which allowed for some improvement in the structure of budget expenditures: the share of the budget allocated to investment increased from 19% in 2005 to 22.4% in 2006.

According to the budget law for 2006, revenues are projected at USD 24.6 bln (24.3% of GDP), while expenditures are set at USD 27.1 bln (26.8% of GDP). The deficit is forecast at 2.5% of GDP.

Consolidated Budget Parameters, % of GDP



Source: State Statistics Committee, Finance Ministry

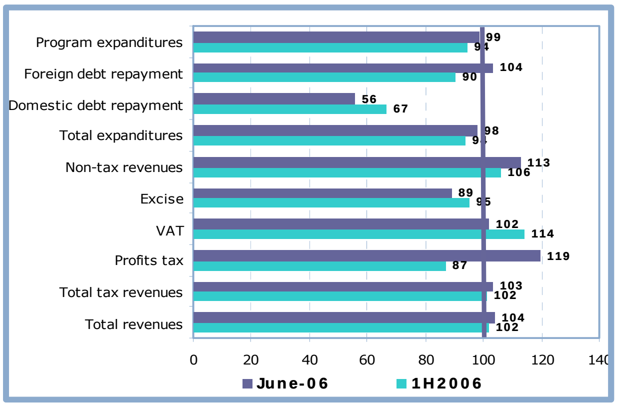
The government struggled in the first part of the year to fulfill the budget as corporate tax revenues fell short. Net corporate profits were down a staggering 59.7% yoy in real terms in 4M06, as the gas price increase, gas shortages and the severe winter took their toll. However, corporate profits have recovered since May in line with faster economic growth: net corporate profits were up 20.8% yoy in May-July, and thus ended 7M06 down a more moderate 13.4% yoy. Corporate profit tax revenues were 13.3% below the period target in 1H06.

The government collected 1.3% more in revenues for the budget's general fund than planned in 8M06, thanks to VAT proceeds that exceeded the target for the period by 14.4%. The high VAT proceeds were due mainly to rapid growth in consumption, but also might have been slightly boosted by delays in paying refunds to exporters. VAT refund delays were significant in the early months of the year.

Total state budget revenues in 1H06 came to 26.6% of the period's GDP, higher than the full-year target of 24.3% of GDP.

State budget expenditures in 1H06 also exceeded the target and came to 28.2% of GDP for the period. The state budget ran a deficit of USD 0.6 bln, or 1.5% of 1H06 GDP.

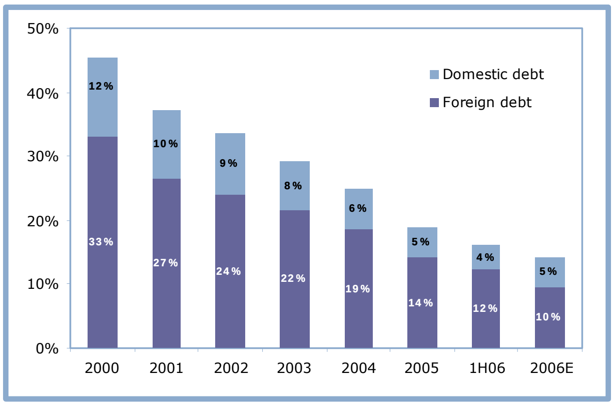
State Budget General Fund, % of Plan



Source: Finance Ministry

State budget expenditures grew more quickly than revenues: expenditures by 29.7% yoy in 1H06, revenues by 19.1% yoy. This was possible thanks mainly to leftovers from from last year's privatization of Kryvorizhstal. About USD 2.9 bln from the sale was assigned to finance the 2006 budget and form a Stabilization Fund. This year's privatization revenues have been very low, just USD 31.7 mln in 1H06, 7.6% of the annual plan.

Ukraine's Debt Breakdown, % of GDP



Source: Finance Ministry

Total public debt was reduced in 1H06 by 4.3% and reached USD 14.8 bln (17% of 2006E GDP). Foreign debt decreased by 4.2%, while domestic debt fell by 5% for the period. Since 1999, the Public Debt To GDP ratio has been steadily decreasing, which gives the country ample capacity to assume new debt for infrastructure programs or to cover the budget deficit. The government recently resumed borrowing on both local and foreign markets, with the renewal this month of local government bond auctions and the placement of a CHF 384 mln Eurobond. We expect the government to continue borrowing in line with the 2006 budget, which authorized USD 0.9 bln and USD 1.4 bln of local and foreign borrowing, respectively.

Ukrainian Macro Indicators

	2000	2001	2002	2003	2004	1H2005	2005	1H2006	2006E	2007E
Real Indicators										
GDP real growth, %	5.9	9.2	5.2	9.4	12.1	4.0	2.6	5.0	6.5	6.5
Nominal GDP, USD mn	31,262	38,009	42,393	49,537	65,039	33,426	84,107	40,812	101,045	121,254
Industrial output growth	12.4	14.2	7.0	15.7	12.5	5.0	3.1	3.6	6.5	6.5
Capital Investments Growth, %	14.4	20.8	8.9	31.3	28.0		1.9	12.2	15.0	17.0
CPI (eop), %	25.8	6.1	-0.6	8.2	12.3	6.4	10.3	2.9	11.0	9.0
PPI (eop), %	20.8	0.9	5.7	11.1	24.1	9.2	9.5	5.0	13.0	14.0
Foreign economic activity										
FDI annual, USD mn	593	680	917	1,323	2,253	586	7,328	2,009	3,000	3,500
FDI (Cumulative since 1991), USD mn	3,875	4,555	5,472	6,794	9,047	9,061	16,375	18,384	19,375	22,875
Current Account Balance, % GDP	4.6	3.7	7.5	5.9	10.5	6.8	3.1	-2.1	0	-1.0
Total Exports, USD mn	19,248	19,809	22,012	27,328	37,980	19,695	40,421	20,886	45,691	52609
Export Growth, %	17.9	2.9	11.1	24.2	39.0	10.5	6.4	6.0	13.0	15.1
Total Imports, USD mn	18,166	16,924	18,164	24,409	31,004	17,752	39,052	21,871	46,576	54152
Import Growth, %	19.2	-6.8	7.3	34.4	27.0	28.5	26.0	23.2	19.3	16.3
Trade Balance, USD mn	1,082	2,885	3,848	2,919	6,976	1,943	1,369	-985	-886	-1,543
Debt										
Total Public Debt, USD mn	14,173	14,085	14,202	14,543	16,096	15,733	15,474	14,814	14,253	16,000
Total Public Debt, %GDP	45.3	37.1	33.5	29.4	24.7	47.1	18.4	17.0	14.1	13.2
NBU Reserves, USD mn	1,475	3,089	4,417	6,940	9,525	13,072	19,395	17,586	16,500	16,000
Social indicators										
Population, mn	48.9	48.5	48.0	47.6	47.4	47.2	46.9	46.8	46.6	46.5
Unemployment (ILO)	11.7	11.1	10.1	9.1	8.5	8.5	8.0	8.0	8.0	7.5
Monetary indicators										
Monetary Base (M0), USD mn	2,353	3,623	4,963	6,211	7,681	10,159	11,764	12,732	14,117	17,081
Broad Money (M2), USD mn	5,798	8,411	12,075	17,714	23,494	30,911	37,724	42,208	47,155	58,943
Economy Monetization M2/GDP	19%	22%	28%	36%	36%	92%	45%	49%	47%	49%
Money Supply (M3), USD mn	5,928	8,517	12,179	17,823	23,593	30,123	37,905	42,403	47,381	59,226
Money Supply Growth, %	11.0	43.7	43.0	46.3	32.1	27.7	60.7	9.6	25.0	25.0
UAH/USD (eop)	5.43	5.30	5.33	5.33	5.31	5.05	5.05	5.05	5.05	5.05
UAH/USD (avg)	5.44	5.37	5.33	5.33	5.32	5.17	5.12	5.05	5.05	5.05
State Budget, % GDP										
Revenues	28.9%	26.9%	27.4%	28.5%	26.0%	33.7%	25.3%	26.6%	24.5%	24.0%
Expenses	28.3%	27.2%	26.7%	28.6%	28.9%	32.6%	27.0%	28.2%	26.9%	26.0%
Budget Balance	-0.7%	-0.3%	0.7%	-0.2%	-3.0%	1.0%	-1.8%	-1.5%	-2.4%	-2.0%

Source: State Statistics Committee, Concorde Capital

Economic Indicators: International Comparison

Country	Real GDP			Consumer Prices			Current Account Balance		
	2004	2005	2006E	2004	2005	2006E	2004	2005	2006E
CIS countries									
Ukraine	**12.1**	**2.6**	**5.0**	**9.0**	**13.5**	**13.0**	**10.5**	**2.7**	**1.2**
Russia	7.2	6.4	6.0	10.9	12.6	10.4	9.9	11.3	11.8
Kazakhstan	9.6	9.4	8.0	6.9	7.6	7.5	1.2	1.8	2.3
Belarus	11.4	9.2	5.5	18.1	10.3	10.4	-5.3	1.2	-0.8
Turkmenistan	17.2	9.6	6.5	5.9	10.8	7.9	0.6	2.8	1.4
Armenia	10.1	13.9	7.5	7.0	0.6	3.0	-4.6	-3.3	-3.9
Georgia	6.2	7.7	6.4	5.7	8.3	5.3	-8.3	-7.4	-7.1
Kyrgyz Republic	7.0	-0.6	5.0	4.1	4.3	5.7	-3.4	-8.1	-6.8
Moldova	7.3	7.0	6.0	12.5	11.9	9.4	-2.7	-5.5	-5.2
Tajikistan	10.6	6.7	8.0	7.1	7.1	7.8	-4.0	-3.4	-4.2
Uzbekistan	7.4	7.0	7.2	8.8	21.0	11.3	10.0	10.8	9.6
Baltics									
Estonia	7.8	9.8	7.9	3.0	4.1	3.6	-12.7	-10.5	-10.1
Latvia	8.5	10.2	9.0	6.3	6.7	6.4	-12.9	-12.5	-12.8
Lithuania	7.0	7.3	6.5	1.2	2.6	3.2	-7.7	-7.5	-7.5
Central Europe									
Czech Republic	4.7	6.0	5.5	2.8	1.8	2.8	-6.0	-2.1	-2.3
Hungary	4.6	4.1	4.4	6.7	3.5	2.0	-8.8	-7.9	-8.2
Poland	5.3	3.2	4.2	3.5	2.1	1.3	-4.1	-1.6	-2.5
Slovak Republic	5.5	6.0	6.3	7.5	2.8	3.6	-3.5	-7.2	-6.4
Slovenia	4.2	3.9	4.0	3.6	2.5	2.4	-2.1	-0.9	-0.3
Southern & South-eastern Europe									
Bulgaria	5.7	5.5	5.6	6.1	5.0	7.2	-5.8	-11.8	-10.2
Croatia	3.8	4.1	4.1	2.1	3.3	3.2	-5.6	-6.0	-5.9
Malta	1.0	1.0	1.3	2.7	3.1	2.8	-10.4	-6.7	-6.5
Romania	8.4	4.1	5.2	11.9	9.0	7.9	-8.4	-8.7	-8.3

Source: International Monetary Fund

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