CONCORDE CAPITAL

Alexander Viktorov
av@concorde.com.ua
+380 44 207 5037
www.concorde.com.ua
Bloomberg: CONR<GO>

Analyst's Notebook

Ukraine/Macro
June 8, 2006

Loosening The Reins

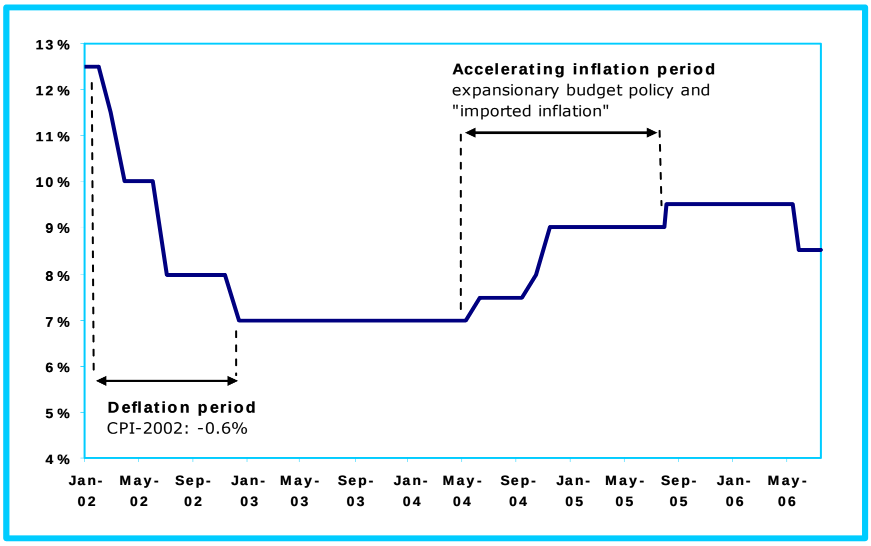
The National Bank Cuts The Discount Rate

On June 7, 2006 the National Bank of Ukraine (NBU) decided to reduce its discount rate by 1% to 8.5% starting on June 10, 2006. After one and a half years of tightening its monetary policy to contain inflation, the NBU has been steadily easing the pressure since the start of the year.

October 2004-Septemeber 2005: Inflation Accelerates, The NBU Clamps Down

The generous social programs implemented in the pre-and-post President Election period overheated consumption demand which caused a sharp surge in consumer prices. CPI accelerated to 6.3% in 4Q04 alone with end-2004 CPI at 12.3% and continued to accelerate in 1Q05 (4.4%). In addition, rapid monetary expansion (the money supply swelled 18% in 4Q05 and 61% in 2005) was another powerful factor to support the high CPI rates during 2004-2005. This growth of monetary indicators was due to a substantial trade balance surplus (USD 7 bln in 2004 and USD 2 bln in 1H05) which provided the country with a strong FX inflow leading to a considerable hryvnya emission during periods when the NBU was purchasing the excessive supply of UHA.

The NBU's Discount Rate



Source: the National Bank

To limit money supply growth and to contain inflation the National Bank started to tighten its monetary policy by raising the discount rate by 0.5% to 7.5% in June, 2004 after five years of steady decline. The following steps were included:

- a series of discount rate increases from 7.5% (June, 2004) to 9.5% (August, 2005);
- A 4.7% hryvnya revaluation to US dollar in April, 2005
- An increase in the volume of mandatory reserves for banks to 100% of the sums of the mandatory reserve that they must keep in their correspondent accounts with the NBU at the start of an operating day;
- excluding cash from the calculation of reserve levels;
- increasing the rate of reserves made by banks under customer current accounts from 7% to 8% and deposit accounts to 6%.

Ukraine's Monetary & Banking Indicators

	2002	2003	2004	5M05	2005	5M06	2006E
CPI (eop)	**-0.6%**	**8.2%**	**12.3%**	**5.7%**	**10.3%**	**2.8%**	**10.0%**
Monetary Base (M0), USD mn	5,767	7,518	10,134	12,266	16,388	15,200	18,846
Monetary Base Growth, % ytd	33.6%	30.4%	34.8%	21.0%	61.7%	-7.3%	15.0%
Money Supply (M3), USD mn	12,179	17,823	23,593	29,286	37,905	41,051	48,139
Money Supply Growth, % ytd	43.0%	46.3%	32.1%	24.1%	60.7%	8.3%	27.0%
Banks' Loan Portfolio Growth, %	45.6%	57.1%	32.3%	10.4%	60.9%	19.1%	50.0%
Banks' Customers' Deposits, %	44.7%	54.9%	35.3%	18.3%	68.1%	11.4%	40.0%
Avg. lending rate, %	20.8	17.5	15.2	14.8	14.6	14.5	14.3
Avg. deposit rate, %	7.4	6.8	7.4	8.3	8.0	7.8	7.5

Source: the National Bank

2006: The NBU Eases Pressure

Despite the increased social payments and a series of price crisis (gasoline, sugar and meat), the government managed to keep inflation from running out of control in 2005. In 2006, despite a severe price shock (the price for imported gas shot up 60%), inflation and monetary expansion have demonstrated moderate growth dynamics. During 5M06, CPI was 2.8% (5.7% last year), the monetary base decreased by 7.3% and the money supply grew by 8.3% (24% in 5M05). The current "non-inflationary" rate of monetary expansion has allowed the NBU to loosen its monetary policy and urge economic growth by supporting the growth of further lending. Since the start of the year the NBU has eased the pressure on banking activity:

- the NBU reduced the volume of mandatory reserves at the start of an operating day for banks by 30 percentage points to 70%;
- cut the rate of reserves made by banks in customers' current accounts from 8% to 6% and deposit accounts from 6% to 4%;

Thus the cut in the NBU's discount rate came as no surprise and was in line with the bank's further loosening of monetary policy.

Despite the NBU's clear shift to more expansionist monetary policy, we are keeping our 2006 basic macro indicator estimates unchanged. At the same time, the NBU's recent moves are likely to facilitate strong growth rates in Ukraine's banking sector. We estimate that total banking loans will rise by ~50% and the overall customer deposit base will increase at ~40% in 2006.