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Analyst's Notebook

Ukraine/Macro
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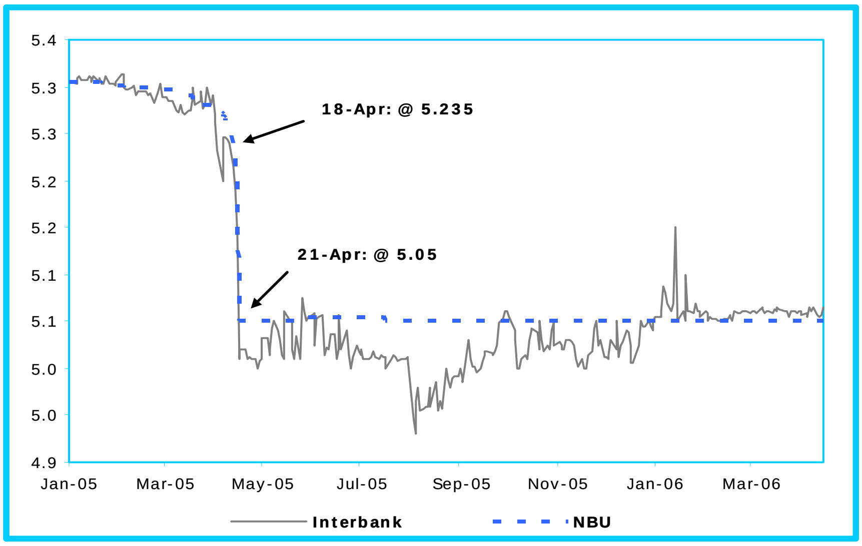
A Year With UAH/USD @ 5.05.

An year ago the rapid appreciation of the hryvna shocked and fascinated many, as the currency, after three-year stay at 5.30-5.33 level, gained from 5.23 to 5.05 against the dollar in only three days, starting on April 18, 2005. While changes in the exchange rate over the previous 12 months had not been more than a hundredth of a decimal point, on April 21 the rate fell 2.7%. The sharp hryvnya strengthening was then used by the National Bank of Ukraine (NBU) as tool to counteract inflation.

UAH / USD Exchange Rate



Source: the National Bank

Since April, 2005 the NBU has kept the UAH/USD exchange rate stable at 5.05. The interbank rate has been floating close to the NBU rate with a slight average deviation of ~0.35%.

Exchange Rate: Up Or Down?

The versatile problems facing the Ukrainian economy have given the NBU reasons to both devaluate and revaluate the national currency. The need to support export-oriented industries drives the devaluation of hryvna, while limiting inflation and minimizing expenses for import requires the further strengthening of the Ukrainian currency. The current amount of international reserves (USD 17.3 bln) provides the NBU with enough flexibility in currency exchange policy regardless of the way it wants to go.

Appreciation: Not Justified

With inflation seemingly under control (CPI ended 2005 at reasonable 10.3% and the growth rate slowed in 1Q06 to 2.7% vs. 4.4% last year), there is currently no reason for the NBU to embark on another round of hryvna revaluation similar to last year:

- *Monetary Expansion Is Under Control.* Last year's rapid monetary expansion (money supply swelled ~55% yoy in 2005) was believed to be one of the main inflation drivers. In this regard, the hryvna's appreciation was supposed to reduce the volume of hryvna emission into economy during NBU buy-out session on the Interbank currency market. During 1Q06 money supply growth slowed substantially to 0.6% YTD (the NBU sold ~USD 1 bln of its reserves to meet rising demands on foreign currency before the Rada elections) compared to 11.4% in 1Q05.

- *Further Revaluation Will Harm Exporters.* Any further hryvna strengthening would be another blow to Ukraine's exporters which are already experiencing rocky times: Ukraine's steel producers are suffering from a fall in external demand for metals, while the chemical industry is experiencing a 2-3 times decline in margins after the recent hike in gas prices. Given the important role of the two sectors in Ukraine's economy (~35% of total industrial output), the NBU would rather use alternative monetary tools to control money supply than undermine the country's export potential.

Despite the moderate growth rates observed in 1Q06, CPI is expected to accelerate later in the year due to increased prices for imported gas, which are to be passed on to consumers primarily via gas and electricity tariffs (up 25% since May 1, 2006). Together with the possible revision of the gas agreement with Russia, which may shift gas prices upwards there is a concern that inflation may accelerate rapidly, far above the expected level. This in its turn may prompt the NBU, once again, to consider further strengthening of the hryvna to ease inflationary pressure.

Depreciation Forces Remain Strong

1) *Adverse Foreign Trade Dynamics.* After the healthy USD 3.7 bln surplus in 2004, the balance of merchandise trade slipped into the red by USD 1.85 bln in 2005, due to falling external demand for metals, hryvna appreciation and liberalization of the import regime. The merchandise deficit is expected to widen to ~USD 6.0 bln stemming the inflow of foreign currency.

Mitigating Factors. Despite the deterioration of the merchandise trade balance, Ukraine is expected to continue to maintain a positive current account balance in 2006 at ~USD1.1 bln (1% of GDP) due to:

- the positive trade balance in services at ~USD 3.5 bln (USD 3.2 bln in 2005), supported mainly by the growth in prices for the transit of Russian gas (services on transportation of energy carriers rendered to Russia account for ~40% of total export of services);
- corporate foreign borrowings via syndicated loans and Eurobonds issuances are expected to grow to USD 3.6 bln (+56% yoy). Ukrainian banks, that notably intensified their efforts to rise foreign debts (USD 1.3 bln), will account for ~70% of these funds;
- Ukrainian government and municipal authorities are expected to make Eurobond placements totaling USD 700-800 mln in 2006;
- the probable privatization of Ukrtelecom (current MCap USD 3.8 bln) and a number of large companies such as the Odesa Portside Plant, Sumykhimprom, Luganskteplovoz will ensure the strong inflow of foreign currency into the country.

1) *As economic growth slows,* the NBU may find itself under pressure from the government side (the make-up of future government is still not clear) to let hryvna devaluate in order to support export-oriented sectors as we have seen in the past. In this case, UAH/USD rate may be shifted gradually to the top section of the currency corridor (5.0-5.2 set for 2006). Although the need to watch out for inflation will be a key factor for any devaluation initiatives.

Opposing Forces To Keep Exchange Rate Stable

We believe that the versatile orientation of the economic factors now in play, will keep the UAH/USD rate stable until the end of the year. Taking into account the NBU's sufficient international reserves, we do not question its ability to keep the rate within the limits of the currency corridor set for 2006: 5.0-5.2. We estimate NBU's official UAH/USD @ 5.05 rate will remain unchanged in 2006, while the interbank rate will hover at 5.05-5.12.

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