

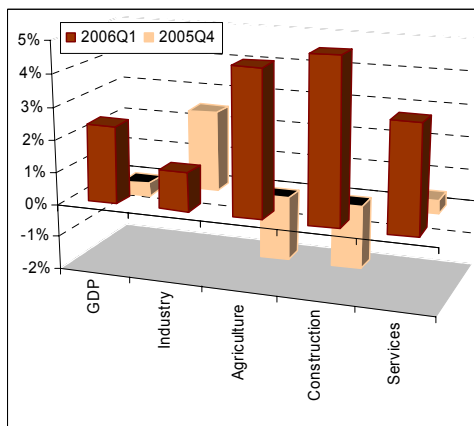


CMP/CASE UKRAINE UKRAINE: FIRST QUARTER 2006 MACROECONOMIC AND FINANCIAL SECTOR DEVELOPMENTS

1. REAL ECONOMY

- Ukraine's GDP grew an estimated 2.4% in the first quarter of 2006, compared to a year earlier.

Figure 1.1. Annual growth rates of GDP and its components, by quarter.

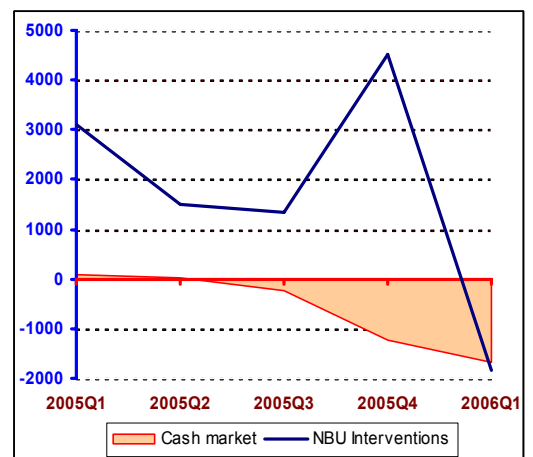


Source: State Statistics Committee of Ukraine

- Growth in agriculture, construction, and services led the recovery in GDP. Industry decelerated in 2006 Q1 due to decline in manufacturing (-0.8%), gasoline price shocks, and weak external demand. (See Figure 1.1)
- Inflation (CPI) showed an 8.6% rate of annual increase in March (compared to 10.3% in December 2005). This slow down can be attributed in part to efforts by the government to hold down prices before the parliamentary elections in March 2006. For example, public utility prices were not raised after the surge in gas prices at the beginning of the year, and new tariffs were not introduced until May 2006. According to the NBU survey of business confidence, inflation expectations in the economy are still high.¹

- During January-March 2006 the NBU spent US \$2.1 bln. from its reserves to maintain UAH/USD rate at the level of 5.05. Strong foreign currency demand originated primarily from the negative trade balance (US \$0.8 bln. in January-March 2006). The NBU is forecasting a positive current account balance for the year 2006², but other analysts (including CASE Ukraine) predict a fall in the current account in the year 2006.
- There was high demand on the cash foreign exchange market (US \$1.7 bln. in 2006 Q1). This trend, which emerged in September 2005, is evidence of fading confidence in the national currency due to uncertainty about the exchange rate, high inflation and, apparently, unease about the political situation.
- The Ministry of Finance reported a decrease in state debt of 3.6% in 2006 Q1, mainly as a result of revenues from the "Kryvorizhstal" privatization.

Figure 1.2. NBU Interventions on the Interbank Forex Market and Net Demand on the Cash Forex Market (US \$ million)



Source: NBU

¹ The survey can be downloaded from www.bank.gov.ua.

² See, for instance, Business International Network, 28.04.2006.

2. CAPITAL MARKETS

2.1. Commercial banks

- During January-March 2006 Ukrainian banks increased their credit portfolios by 10.1% (to US \$33.3 bln.), compared to a 9.1% increase in Q1 2005. In CE3 (e.g., Poland, Hungary, Czech Republic) countries, the average growth rate of bank credit portfolios in 2006 Q1 was 3.8% , while Russian banks expanded credit by 6.4%.
- Credit to households grew by 16.3% in 2006 Q1 compared to 7.4% a year earlier. Credit expansion to corporate borrowers in the first quarter remained unchanged in comparison to a year earlier, at 8.1%. As a result, total domestic credit of Ukrainian commercial banks amounted to almost 40% of GDP at the end of 2006 Q1, an average level that is comparable to Eastern European countries.
- In 2006 Q1 Ukrainian bank deposits rose by only 2.1% (the average figure for the last 5 years in Q1 is 10.7%). In CE3 countries average growth rates of deposits in 2006 Q1 equaled 3.0%, Russia, 9.7%.
- Bank capital increased by 7.1% in 2006 Q1. Starting January 1st, 2007, the NBU is to introduce new minimum capital requirements for commercial banks (increases by 7-14%).
- At the beginning of 2006 dollarization of bank assets and liabilities continued to increase. Specifically, as of the end of March 2006 the share of foreign exchange credits was 44.2% (43.3% end 2005). The share of foreign currency deposits increased from 34.3% to 37.7%. The foreign exchange risk exposure for banks is limited, since the volumes of their liabilities and assets in foreign currency are comparable.
- In 2005 Ukrainian banks borrowed funds in both the domestic and foreign markets. The total external debt of banks almost doubled in 2005 and reached US \$6.2 bln. However, during the first quarter of 2006, Ukrainian banks issued few debt offerings, particularly compared to the CE3 countries. (See Table 2.1)³

Table 2.1. Debt securities issued by Multilateral Financial Institutions (MFIs)

	Ukraine		Czech Republic		Poland		Hungary*	
	US \$ bln.	% of GDP	US \$ bln.	% of GDP	US \$ bln.	% of GDP	US \$ bln.	% of GDP
2003	n/a	n/a	1.0	1.0%	1.2	0.6%	4.7	5.3%
2004	0.03	0.04%	0.9	0.7%	1.6	0.5%	6.3	5.6%
2005	0.4	0.50%	0.9	0.8%	1.7	0.6%	5.6	5.5%
2006 Q1	0.4	0.47%	0.9	0.7%	2.1	0.7%	5.4	5.4%

* Debt securities issued by MFIs (held by residents)

Source: Web pages of the central banks

- In 2005, according to the Ukrainian National Mortgage Association, the mortgage portfolios of banks tripled, and amounted to UAH 10.6 bln. or 7.4% of the total credit portfolio.

2.2. Non-bank financial intermediaries (NBFIs)⁴

- In 2005 the total assets of non-bank financial institutions accounted for 10% of the assets of all Ukrainian financial intermediaries.
- Insurance companies remain the core of the non-bank financial sector. In 2005 their nominal assets increased by 4.5%, but dropped as a share of GDP. (See Table 2.2)
- There is substantial evidence that domestic enterprises use insurance companies to avoid taxation. As a result, the government placed restrictions on the amount of insurance premiums that could be counted as a legitimate expense in 2005. Subsequently, total insurance premiums received by Ukrainian insurance companies diminished by 31% (down to UAH 12.6 bln.) in comparison with 2004.

³ The NBU prohibition to lend in foreign currency might stimulate banks to issue new Eurobonds.

⁴ Preliminary data on non-bank financial institutions are available only for the year 2005.

Table 2.2. Assets of non-bank financial institutions

	Commercial banks		Insurance companies		Credit unions		Investments funds		Non-State pension funds	
	UAH bln.	% of GDP	UAH bln.	% of GDP	UAH bln.	% of GDP	UAH bln.	% of GDP	UAH bln.	% of GDP
As of 01.01.2005	141.5	41%	20.0	5.8%	0.9	0.3%	0.25*	0.07%	0.03*	0.01%
As of 01.01.2006	223.0	53%	20.9	5.0%	1.9	0.5%	0.23	0.05%	0.05	0.01%

*as of 01.07.2005

Source: State Commission for the Stock Market Regulation in Ukraine

- Insurance payments to customers increased from UAH 1.5 bln. in 2004 to UAH 1.9 bln. in 2005, reflecting a transition to insurance in the classical sense.
- Further changes to the regulation of the insurance sector should be anticipated. Insurance companies currently pay income tax at the rate of 3% of total premiums collected. This tax is a turnover tax in essence. Policymakers have declared their intention to improve taxation of insurers. Specifically, President Yushchenko signed the Decree “About Priority Steps Regarding Investments Sphere” (on April 10, 2006) which obliged regulatory bodies to introduce a general profit tax rate (now 25%) for insurance companies by the end of 2006.

2.3. Stock market

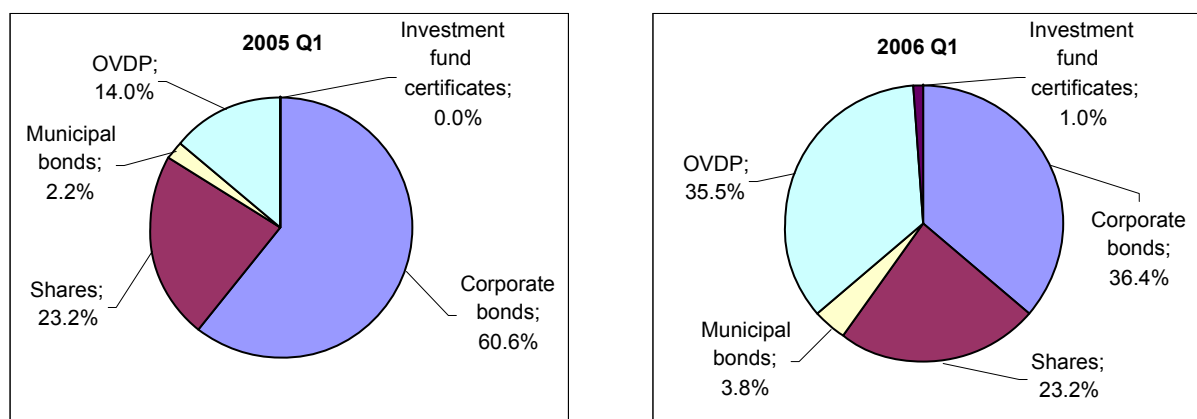
- At the beginning of 2006 two important capital market laws were signed by President Yushchenko. In January the Law “On Mortgage Bonds” was enacted, followed in March by the Law “On Securities and Stock Market”. The former should enable financial institutions to securitize their assets via a pass-through mechanism (i.e. issuing bonds backed by pool of mortgage loans). The latter law requires increased information disclosure by publicly traded companies, and introduces more effective procedures of public and private offering of stocks.
- The cancellation of the Memorandum of Understanding regarding the National Depository of Ukraine (NDU) by the Government was a disappointing development. This opens the possibility that the NDU will become a full-functioning depository and a competitor to MFS. This development has been unanimously criticized by private market participants as a danger to market integrity and transparency.
- In 2006 Q1 trade volumes on Ukraine’s biggest stock exchange, PFTS, were 2.6 times higher than the same period for 2005, reaching US \$1.4 bln. Comparable data for CE3 countries is presented in Table 2.3.

Table 2.3. Selected indicators of stock market performance US \$ (millions)

	Ukraine		Czech Republic		Poland		Hungary	
	2005	2006 Q1	2005	2006 Q1	2005	2006 Q1	2005	2006 Q1
Market Capitalization, end of period, US \$ bln. (% of GDP)	29.2 (35%)	34.6 (40%)	54.4 (45%)	62.9 (50%)	94.9 (32%)	106.1 (35%)	32.7 (32%)	34.7 (35%)
Average daily trade values of shares, US \$ mln.	2.7	5.5	168.9	153.0	233.3	381.6	89.8	116.1
Average daily trade values of bonds, US \$ mln.	8.8	17.8	86.5	137.6	6.7	7.3	5.5	6.8

Source: PFTS, Stock exchange sites of CE3 countries, CASE Ukraine calculations

- Total market capitalization reached US \$34.6 bln. (some 40% of GDP) as of March 31, 2006, which is 18% higher than at the end of 2005.
- The PFTS Stock index grew by 21% in 2006 Q1 (+7.1% during the same period of 2005).

Figure 2.4. Structure of trade on the secondary stock market on PFTS in 2005 Q1 and 2006 Q1

Source: PFTS

- Corporate and government bonds remain the most traded instruments on the PFTS in 2006 Q1 and accounted for almost 72% of the total market turnover.
- The volume of trade in shares remained stable at 23.2%.
- Trading in municipal bonds increased to 3.8% of total volume, compared to 2.2% a year earlier.

3. STATE AND PRIVATE PENSION FUNDS⁵

- In 2005, the State Pension Fund budget reached UAH 65.7 bln, a 75% increase in comparison to 2004. In percentage terms, the budget rose from 10.9% of GDP in 2004 to 15.7% of GDP in 2005. This dramatic increase was caused by an increase in pension benefits introduced by the government at the beginning of 2005.
- In December, 2005 there were 58 private pension funds (PPF), compared to 21 PPFs a year earlier.
- Total assets of PPFs reached UAH 46 mln. at the end of 2005, which was a 40% increase over 2004. Despite this upward trend, PPFs are still a tiny fraction of the NBF market, and especially in comparison to CE3 countries. (See Table 3.1)

Table 3.1. State and Private Pension Funds: Ukraine and CE3 countries

	State Pension Funds	Private Pension Funds	Pension funds members/Labour force
	Expenditures (% of GDP)	Assets (% of GDP)	
Ukraine	15.3%	0.01%	0.3%
Poland	7.4%	9.0%	51.6%
Hungary	9.8%	3.9%	57.7%
Czech Republic	0.6%	4.0%	60.9%

Source: State Commission for Regulation of Financial Services Markets in Ukraine, Statistics offices of respective CE3 countries. Data for Ukraine as of 01.01.2006, for CE3 countries – end 2004.

- The number of participants in PPFs increased by 26.2% and reached 75,000 (0.33% of total labor force).

⁵ State Commission for Regulation of Financial Services Markets in Ukraine, 2005. Full data on State and Private pension funds are only available for the year 2005.