

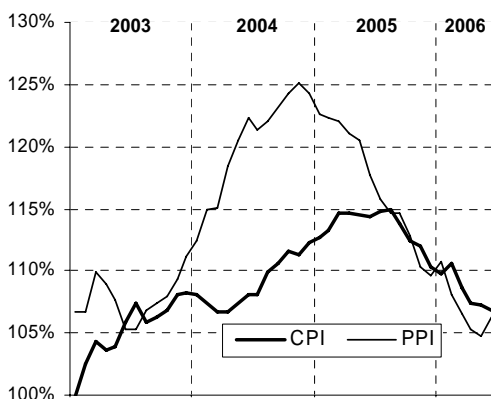


CMP/CASE UKRAINE
UKRAINE: SECOND QUARTER 2006 MACROECONOMIC AND
FINANCIAL SECTOR DEVELOPMENTS

1. REAL ECONOMY

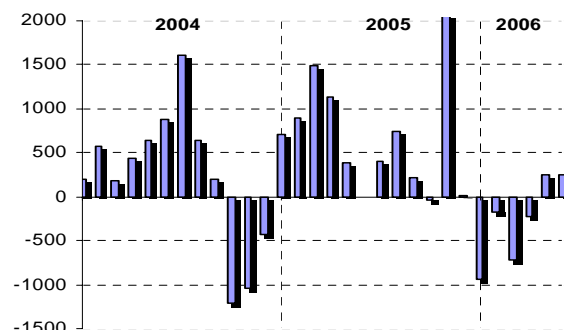
- In the second quarter the economy performed much better than most experts expected - GDP grew an annual 6.6%. We explain the observed growth by increase in the external demand for metals and growing investments demand. High energy costs spurred enterprise investments in energy saving with the subsequent 6.9% (yoy) of gross capital accumulation growth. Private consumption expanded by almost 20% because of growing household revenues.
- CPI inflation declined from 8.6% yoy in March to 6.8% yoy in June. Falling food prices, led to the improvement in the CPI (Figure 1.1).
- At the same time, prices of services showed a 15.3% rate of annual increase in March, and 17.6% in June, due to increased public utility prices and prices for railway passenger transportation. The government increased retail gas prices in May and July, by 25% and 85% respectively, electricity prices in May - by 25%, and, in June, prices for railway transportation - by 43%.
- The PPI inflation rate showed a moderate increase (6.3% yoy in June and 6.5% yoy in March) after a steady decline since late 2004 (Figure 1.1).
- Compared to large scale interventions in 2005, in 2006Q2 the forex market remained fairly balanced (Figure 1.2). The NBU spent USD 0.3 billion of its hard currency reserves to keep UAH/USD rate stable at 5.05. An inflow of foreign exchange to the economy was due to an improved current account as well as higher foreign investments (mainly through FDI) and credits from non-resident (see below). The cash market also became more balanced - demand exceeded supply by only USD 211 million (USD 1.7 billion in 2006Q1). And June even recorded some USD 63 million of excessive foreign exchange supply on the market, reflecting both seasonal factors and a dramatic fall in personal savings starting May 2006¹.

Figure 1.1. CPI and PPI in 2003-2006, %, yoy



Source: State Statistics Committee of Ukraine

Figure 1.2. NBU interventions in 2004-2006, USD mln.



Source: The NBU

¹ In May, personal savings dropped to some trivial number, while spending on goods and services exceeded 90% for the first time since March 2005

2. CAPITAL MARKETS

2.1. Commercial banks

- Ukrainian banks continue expanding their credit portfolios and equity capital. Growth rates of deposits are quite pronounced as well. Bank assets are growing faster than the economy in general and faster than bank assets in comparable countries (Table 1), which is partially explained by Ukraine's lower assets to GDP ratio.
- During April-June, Ukrainian banks increased their credit portfolios by 14.0% (13.6% in 2005Q2). Retail loans remain the key driving force behind the credit expansion - loans to households grew by 26%, while loans to businesses grew by a relatively moderate 10%². Credit portfolios of Eastern European banks (Poland, Hungary and Czech Republic) showed 4.2% growth (yoy) in 2006Q2.
- To support credit expansion, banks kept adding to their book capital, which increased by 8% in the second quarter³, mainly due to increased statutory capital and reserve requirements. That is, banks reinvested their earnings to build capitalization. The Committee on Banking and Finance of the Verkhovna Rada announced the possibility that minimum capital requirements might be raised to EUR 5 mln.
- Securities portfolios of banks declined by 3.5% in 2006Q2. Bank assets increased by 11.7% yoy in 2006Q2 – a bit slower than the credit portfolio.
- Deposit growth remains quite pronounced, 9.6% in 2006Q2 (8.5% in 2005Q2), owing to expanding business deposits. In turn, rising business deposits can be explained by real GDP growth. Growth rates of household deposits, on the contrary, are declining. Since credits have recently been expanding faster than deposits did, we expect stronger demand of Ukrainian banks for external borrowing in the near future.

Table 2.1. Banks assets in the CE3 countries and Ukraine

	Poland		Czech		Hungary		Ukraine	
	bln USD	% to GDP	bln USD	% to GDP	bln USD	% to GDP	bln USD	% to GDP
2004	163,12	65,31	104,68	95,73	86,11	83,96	28,02	40,90
2005	194,37	64,40	119,79	97,62	99,41	93,10	44,16	52,51
1Q2006	199,69	65,40	126,78	98,65	99,09	98,59	46,99	53,63
2Q2006	211,97	70,23	137,56	112,10	103,68	105,03	57,54	68,33

- Dolarization of both credits and deposits is rising steadily. As of the end of June, foreign currency denominated loans reached 45% of credit portfolio, and foreign currency deposits were 40% of total deposits. Thus, the banking system is operating their credit portfolios with an increasing currency mismatch.
- The President submitted to the Verhovna Rada drafts of amended laws “On the NBU” and “On Banks and Banking Activity”. The amendments stipulate:
 - (i) Greater independence of the NBU (office term of the Governor increased from current 5 to 7 years; the Board members would not be allowed to be members of any political party). The draft was rejected.
 - (ii) A ban to register new banks as “closed” joint stock companies. This amendment implies that newly created banks have two options for their legal form – an “open” joint stock company or a legal liability partnership. The draft law passed the first reading.

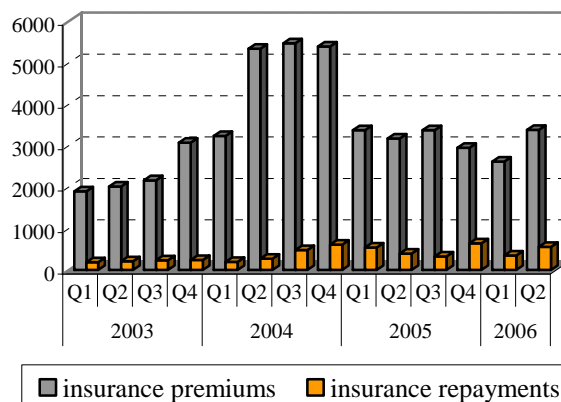
²Household credits currently make about 27% of credit portfolio (5.1% as of the end 2000)

³ By 5% in the second quarter of 2005

2.2. Non-bank financial intermediaries (NBFIs)⁴

- During half-2006, both premiums collected and payments by Ukrainian insurers were smaller compared to a year earlier. Premiums collected dropped by 8.4 %, primarily due to dramatic decline in the volume of financial risk premiums (some 38%). Premiums collected from insurance of financial risks being slightly more than one quarter of the total premiums of all insurance companies (as of end June 2006). Life insurance grew by 31.4% (2Q06 relative to 2Q05), however its share in total premiums collected is only 3%.
- The ratio of payments to premiums collected still remain very low, about 16.4% for 2Q06.
- In 1Q06 net assets of pension funds increased by 56% (to UAH 49.5 million) relative to 1Q05, as a ratio to GDP the number is still trivial 0.01%. Portfolio structure remains stable - assets are allocated into bank deposits and securities, 63.3% and 33.2% respectively.

Figure 1.3. Total insurance premiums collected and repayments distributed, 2003-2006, mln UAH



Source: the State Commission for Regulation of Financial Services Markets in Ukraine

2.3. Stock market

- In June, the PFTS, Ukraine's biggest trading platform, received official status as a stock exchange⁵. The new status obliges the PFTS to follow much stricter trading rules, in particular, all transactions will have to be cleared through the depository system. The PFTS also plans to introduce a full order-driven trading system.⁶
- Ukrainian authorities and market participants continue debating a draft law "On Depository Registration of Securities". In June, the draft approved by the Cabinet of Ministers was submitted to the Parliament. Later, the Advisory Council of the State Securities Commission requested the recall of the document. The draft stipulates that the National Depository of Ukraine would serve as an institutional basis for the Central Depository, a future single centralized depository system. The draft also annuls a documentary form of securities and unifies procedures for registering, keeping and clearing securities. Allegedly, the changes should solve the problem of existing double registries. However, the document does not specify how the transition to the new system should be managed and leaves uncertain the future of the existing commercial depository system, the MFS, which services the PFTS transactions.
- In 2006Q2, capitalization of companies trading on the PFTS decreased by 4.5% to USD 36.0 bln. (ratio to GDP of about 40%). The decline in capitalization was driven by falling stock prices – the PFTS index dropped by 11.2% during the quarter (6.7% increase in 2005Q2).
- The decline in the market was influenced by the recent shareholder conflict at Zaporizhstal. Zaporizhstal is a large metallurgical plant (as of January 2006 the 11th biggest company on the PFTS with capitalization of UAH 5 bln which accounts for 2.6% of total market capitalization.) In June, large shareholders decided to merge Zaporizhstal with its affiliated companies through additional issue of stocks. Objecting shareholders were offered a price per share significantly lower than the PFTS ask price before June.⁷ By the end of June Zaporizhtal market capitalization dropped to UAH 2.5 bln. The conflict

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

⁵ Formerly it had the status of the Trade-Information System. The new Law "On Securities and Stock Market" (enacted in May 2006) specifies that only stock exchanges can operate organized security trading

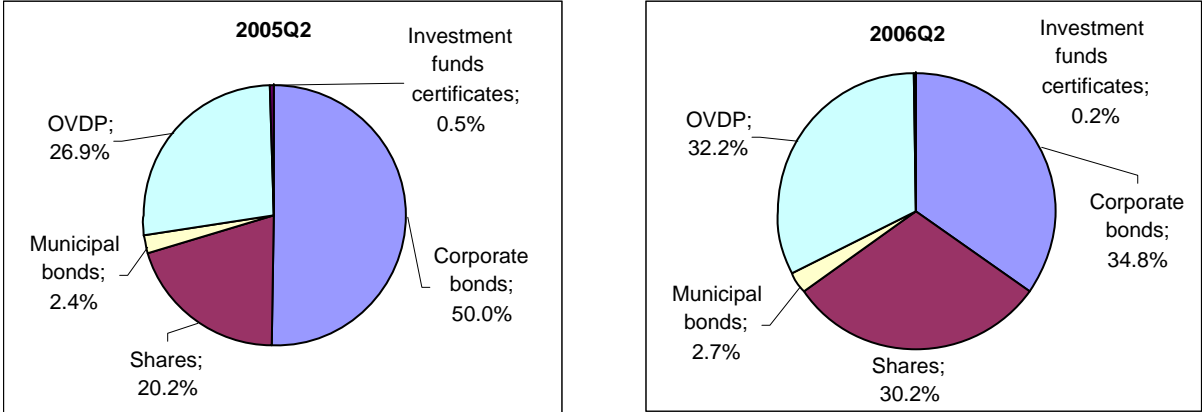
⁶ Now, most trades on the PFTS are done on a quote-driven basis.

⁷ See, for instance, UNIAN, 23.05.2006

received a lot of negative publicity and in July the PFTS stopped trades of Zaporizhtal stocks and temporally excluded them from the PFTS index basket.

- In 2006Q2, PFTS trade volumes reached USD 1.5 bln, three times higher than the same period of 2005. Government and corporate bonds still remain the most tradable instruments accounting for more than 65% of the total market turnover. Trade in shares is increasing and is approaching the trade volumes in government and corporate bonds (Figure 2.1).

Figure 2.1 Structure of trade on the secondary stock market on PFTS in 2005Q2 and 2006Q2



Source: PFTS