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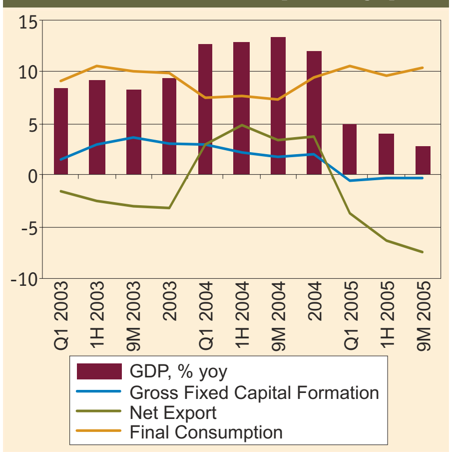
Summary

- Despite early concerns about Ukraine's economic situation in 2005, the country ended the year with a relatively good performance overall.
- In 2005, gross domestic product (GDP) grew by 2.4% year-over-year (yoy); the deceleration from the previous year was primarily due to a high base effect, unfavorable external conditions and a reduction in public investments.
- Fiscal performance in 2005 was better than expected at the beginning of the year. Despite sizable increases in fiscal expenditures, the record high growth of budget revenues allowed for a year-end fiscal budget with a reasonable 2% of GDP deficit, in accordance with IMF recommendations.
- Year-end consumer inflation decelerated to 10.3% yoy, lower than initially expected.
- Despite the deteriorating merchandise foreign trade balance, the current account showed a reasonable 2.7% of GDP surplus due to strong services foreign trade.
- The impact of the recent gas price increase on the Ukrainian economy, though significant, will not be as damaging as initially projected.
- International rating agencies kept Ukraine's ratings unchanged but expressed some concerns.

Economic Growth

Contributions to GDP Growth, percentage points

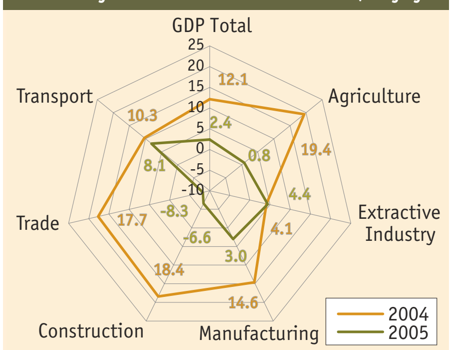


Source: State Statistics Committee, The Bleyzer Foundation

According to preliminary data, GDP grew by 2.4% yoy in 2005, underpinned by strong private consumption growth. For the first nine months of 2005, private consumption increased by a real 17% yoy (up from 15.7% yoy in the respective period last year), stimulated by sizable social payments and easier access to bank credits. At the same time, robust domestic demand stimulated imports, which increased by a real 3.3% yoy over the period, while exports declined sharply by 10.5% yoy negatively affected by April's national currency appreciation and unfavorable external conditions. Political turbulence at the end of 2004/beginning of 2005 and several controversial measures by the new government (such as re-privatization, attempts to introduce price regulations) may have affected investor sentiment and caused a temporary delay in investment projects. However, we believe that the decline in gross fixed capital formation by a real 1% yoy during the first nine months of the year was primarily due to a cut in public investments. In 2004, investments in fixed capital financed from state and local budgets almost doubled in nominal terms compared to the previous year[1], representing a very high base for comparison. The revision of the state budget at the beginning of 2005 envisaging a further increase in social payments and large profit deductions by state-owned enterprises[2] may have resulted in sharp decline of public investments. Thus, unfavorable external conditions, a high base effect and sluggish investment activity were the major reasons of the GDP growth deceleration in 2005.

On the supply side, 2005 GDP growth was driven by fairly good performance in the transportation sector, the extractive industry and manufacturing. During December, growth in these sectors accelerated, bringing the cumulative growth rates to 8.1%, 4.4% and 3% yoy, respectively. The decline in wholesale trade and construction and a considerable slowdown in the industrial sector were responsible for economic growth deceleration in 2005. In particular, value added in wholesale and retail trade (accounting for about 12% of GDP) declined by 8.3% yoy according to preliminary data. Poor wholesale trade performance may be attributed to deceleration in domestically-oriented industries, a reduction in the number of trade mediators and a decline in exports. Construction reported a 6.6% yoy decline in value added, affected by sluggish investment activity. Despite a good harvest this year, value added in agriculture grew by 0.8% yoy in 2005. The deceleration compared to the previous year may be attributed to a high base effect and negative developments in cattle breeding during 2005 (reduction in cattle stock and milk production.)

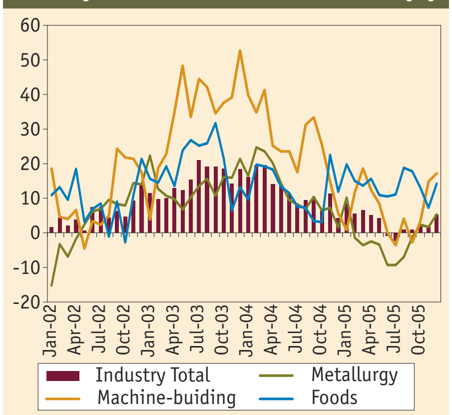
Industry Growth — Selected Sectors, % yoy



Source: State Statistics Committee

In December, industrial output growth accelerated to 5.3% yoy, bringing the cumulative growth to 3.1% yoy. The deceleration from an impressive 12.5% yoy in 2004 was due to the slowdown in manufacturing to 3% yoy in 2005 (down from 14.6% yoy last year.) The main industries that drove down manufacturing production were metallurgy and machine-building. In October, metallurgical production rebounded and accelerated to 5.3% yoy in December, which may be attributed to considerable deceleration in the decline of world steel prices in the last four months of the year. However, this was not enough to compensate for considerable deterioration in the previous months; thus for the whole year metallurgy reported a 1.5% yoy decline in output. Machine-building production continued to pick up, expanding by 17.2% yoy in December. Considerable acceleration in the last two months of the year may be attributed to revived external demand for aerospace and military machine-building products. Cumulatively, however, machine-building production decelerated to 7.1% yoy in 2005, down from the explosive 28% yoy in 2004. On the upside, benefiting from strong domestic and external demand, food processing advanced by 13.7% yoy in 2005, up from 12.4% yoy in 2004.

Industry Growth — Selected Industries, % yoy



Source: State Statistics Committee

According to the agreement between Ukraine and Russia on January 4th 2006, the new price of imported 34 billion m3 gas to Ukraine will be $95 per 1000 m3 at the Russian-Ukrainian border as of the beginning of 2006. This is a significant increase from $50 per 1000 m3 for Russian gas in 2005. At the same time, it will be partially covered by a 47% increase in the transit fee to $1.6 per 1000 m3 100 km. In 2006, Ukraine also plans to get about 22 billion m3 of Turkmen gas under a separate contract at an average price of $55 per 1,000 m3, which means approximately $90 per 1,000 m3 at the Ukrainian border. Since the cost of Turkmen gas was about $65 per 1,000 m3 at the Ukrainian border in 2005, the average price increase of total imported gas is estimated at about 42% yoy. As a result of our analysis, the impact of the gas price increase on the Ukrainian economy, though significant, will not be as damag-

[1] As a result, the share of fixed capital investments financed from state and local budgets increased from about 11% in 2003 to more than 15% in 2004.
[2] According to State Statistics Committee, more than 30% of total fixed capital investments were carried out by state-owned enterprises.

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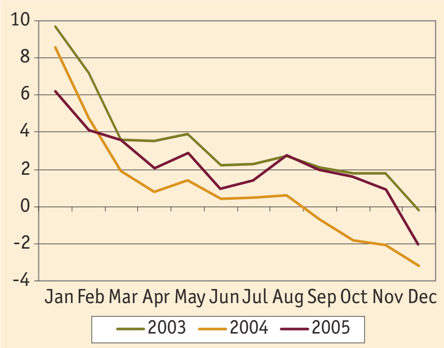
ing as initially projected. In particular, we believe that GDP growth in 2006 will be negatively affected by 2-3 percentage points from the originally forecasted rate of 5% yoy, thus remaining similar to the 2005 rate of 2.5% yoy. In the medium term, however, the overall economy may be boosted by increased investments in energy saving technologies and faster adjustment of tariffs to cost-recovery levels.

Fiscal Policy

Despite the economic growth slowdown in 2005 and sizable increases in fiscal expenditures, the consolidated budget posted a moderate deficit of UAH 7.74 billion (about $1.5 billion) according to preliminary data released by the Ministry of Finance, which is equivalent to less than 2% of estimated full-year GDP. Favorable budget performance was achieved thanks to the record high growth in budget expenditures backed by elimination of a number of tax privileges and exemptions.

Consolidated Budget Balance, % of period GDP, 2003-05



Source: Ministry of Finance

In 2005, consolidated budget expenditures increased by a nominal 40% yoy to UAH 141.5 billion ($28 billion), the lion's share of which was directed to finance generous social programs. According to the budget amended at the beginning of 2005, the government not only maintained social obligations made in the run-up to the presidential election in the fall 2004 but even increased them. In particular, minimum wage and pension were increased by 40% and 16.5% respectively in 2005, while the average pension was raised by 28% yoy. The other social benefits (such as benefits for childbirth, disability, etc.) were also substantially increased. As a result, budget expenditures represented about 34% of estimated 2005 GDP, up from 29.4% of GDP in 2004.

At the same time, budget revenues increased by an impressive 46.5% yoy to UAH 134 billion ($26.5 billion). In 2004, budget revenues grew by about 21% yoy and were supported by impressive GDP growth at 12.1% yoy. The government estimates regarding a substantial budget revenues increase (which were considered very ambitious at the beginning of the year) materialized due to elimination of a number of tax privileges and exemptions, including those to free economic zones, larger profit transfers by state-owned enterprises, de-shadowing of the economy, advance payments of enterprise profit tax and some accumulation of VAT refund arrears. As a result, consolidated budget revenues as a percent of estimated 2005 GDP increased to a record high 32% (for comparison, the respective ratios were 26.5% and 28.2% of GDP in 2004 and 2003, respectively.)

In 2005, the government financed the fiscal deficit primarily through privatization receipts, which were at a record high level due to the successful privatization of Kryvorizhstal (later renamed Mittal Steel Kryvyj Rih). Although Ukraine issued new debt instruments in 2005, the funds were predominantly directed to reduce the cost of previous borrowings. As a result, the stock of public debt declined by about 4% yoy (8.5% yoy if expressed in national currency) to $15.5 billion at the end of 2005, or about 18.8% of estimated GDP. In particular, external public debt declined to $11.7 billion, or about 14.3% of estimated GDP. At the same time, due to continuing growth of external private debt by more than 66% yoy at the end of September 2005, total external debt advanced by 18.7% since the beginning of the year to $23.3 billion, or 28.5% of estimated full-year GDP. Although this rate is among the lowest in Central and Eastern European countries, rapid growth of external private debt raises concerns.

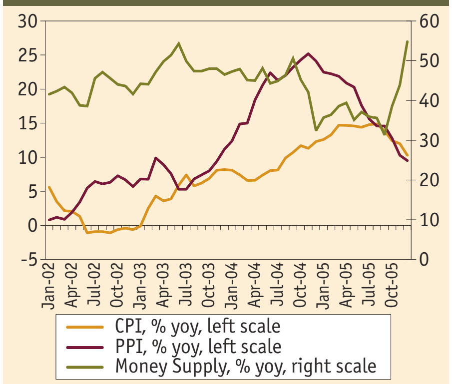
Fiscal outlook for 2006 remains rather uncertain. At the end of December, the parliament adopted the 2006 budget calling for a deficit of about 2.5% of GDP and envisaging further increases in social payments. At the same time, the budget was based on 7% yoy GDP growth (which was considered unrealistic even before the gas dispute) and unchanged prices for imported gas. The increase in gas prices will affect the fiscal situation through lower GDP growth. Considering the likely shortfall of budget revenues and possible larger expenditures on subsidies to households and affected industries, the consolidated fiscal deficit may well exceed the 3% of GDP threshold considered sustainable by international organizations. At the same time, due to consolidation of budget funds in a unified treasury account, the government may efficiently manage the fiscal balance via the tight control over expenditures. Therefore, we believe that the fiscal deficit will be maintained at about 3% of GDP in 2006.

Monetary Policy

In 2005, consumer inflation reached 10.3% yoy, decelerating from 12.3% yoy a year before. At the beginning of 2005, inflationary pressures were generated by considerable fiscal loosening in the fall of 2004 and political uncertainties at the end of 2004/beginning of 2005. During the second and third quarters, inflation was primarily driven by a number of supply side shocks (such as an increase in world crude oil prices, shortages of meat and sugar) and an increase in utility tariffs. Administrative intervention in price setting mechanisms for particular goods was generally inefficient but lessened tensions on the respective markets. The deceleration in the fall should be primarily attributed to a high base effect and absorption of supply side shocks helped by stabilization of world crude oil prices, reduction of import tariffs, etc. Consumer inflation also benefited from the decreasing pressure from producer prices. In 2005, the producer price index (PPI) decelerated to 9.5% yoy, down from 24.2% yoy last year.

Foods, which account for about 65% of the consumer basket, became 10.7% yoy more expensive in 2005. Considerable deceleration in December (down from 13.2% yoy in the month before) was mainly due to a high base effect. Food prices were affected by expansionary fiscal policy, which encouraged consumption particularly by lower income groups (thus shortly translated into higher demand for foods), and supply side shocks. Despite a 24.5% yoy increase in gasoline prices in 2005, the non-food price index was mainly on a declining trend, reporting a 4% yoy increase for the whole year. However, high gasoline prices affected transportation tariffs, which surged by 25.5% yoy. Coupled with a 13.6% yoy increase in the cost of public utilities, service tariffs reported 15.8% growth, almost twice as high as in 2004.

Prices and Money Supply Dynamics, 2001–05



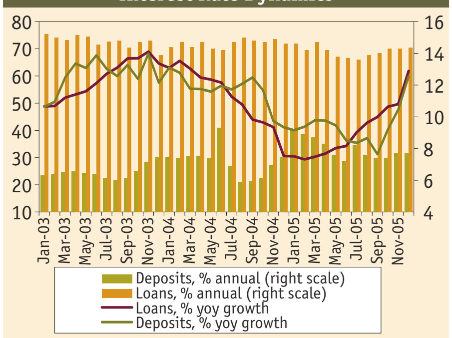
Source: State Statistics Committee, National Bank of Ukraine

Before the gas dispute, the government forecasted inflation to decline to 8.7% yoy in 2006, although international and domestic experts were more cautious, forecasting inflation at about 10% yoy. High oil prices in 2005 may continue to pressure inflation in 2006 as a spillover effect on other prices. The increase in the price for imported gas will also pressure transportation and utility tariffs. Although the decision to raise gas and electricity tariffs for households from the beginning of 2006 was abolished, they will most likely be raised after March's parliament elections. In addition, loose fiscal policy in 2006 will add to inflationary pressures. As a result, we believe consumer inflation will be in the range of 13-14% yoy at the end of 2006.

At the same time, inflation could have been much higher in 2005 if the NBU did not appreciate the national currency by about 4.8% in mid-April 2005. The appreciation reduced the cost of imported goods and restrained the growth of monetary aggregates. At the same time, uncertainties related to the forthcoming parliamentary elections and the gas issue resulted in depreciation pressures at the beginning of 2006. In particular, the cash exchange rate depreciated to an average UAH/$5.15 in mid-January. However, the official exchange rate was kept unchanged at UAH/$5.05, though the central bank had to intervene on the forex market to maintain it by selling about $800 million of its international reserves. Most likely, in order to calm inflationary pressures and the speculative tone of the foreign exchange market, the NBU will maintain exchange rate stability at least during the first half of the year. Nevertheless, to avoid an abrupt drop in international reserves, the exchange rate will be allowed to gradually depreciate to about UAH/$5.2.

In 2005, monetary policy did not change substantially from the previous year. The accommodative monetary policy was aimed at lessening inflationary pressures generated by sizable foreign exchange interventions and vigorous consumption growth (stimulated by rapid expansion of bank loans to the private sector, among other things.) In particular, the NBU tightened reserve requirements to commercial banks several times during the year, increased its refinancing rate to 9.5%, and sterilized commercial bank liquidity in the amount of UAH 17.2 billion ($3.4 billion). During January-October, the average growth rates of the monetary base and money supply were 35.5% and 36.4% yoy, respectively. However, by the end of the year, the growth of the respective aggregates sped up to 53.8% and 54.8% yoy. The acceleration in the last two months of the year may be attributed to the low base effect and considerable fiscal loosening at the end of the year.

Loans and Deposits Growth and Interest Rate Dynamics



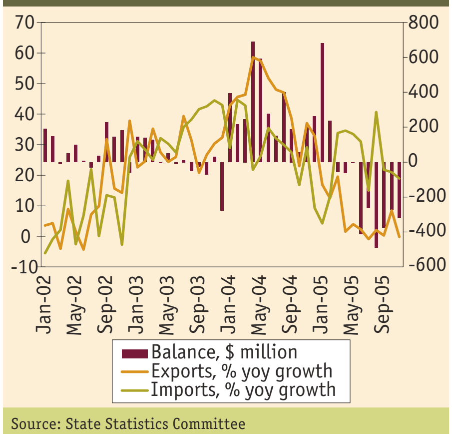
Source: National Bank of Ukraine

Although deposit rates declined from 9.2% at the beginning of the year to 7.7% at the end of 2005 and was well below the average inflation rate, deposits grew at a robust 60% yoy in 2005, underpinned by growing disposable income and growing confidence in the banking sector. Considerable acceleration during November-December (up from average growth of 39% yoy during January-October) was due to a low base effect. Last year, inflation expectations and political uncertainty resulted in massive withdrawals of deposits. At the same time, high deposit growth and strong money demand were the driving forces of lending expansion. Commercial bank loans to the private sector increased by almost 62% yoy, although the growth was more moderate during the year (38.8% yoy on average for January-November). At the same time, a number of restrictive NBU measures, introduced during August-September, resulted in a gradual increase in lending rates to 14.3% in December, up from 13.6% yoy in July.

International Trade and Capital

In November, Ukraine's merchandise foreign trade continued to deteriorate. For the second time this year, exports reported a decline, contracting by 0.2% yoy. At the same time, imports grew by almost 19% yoy. Cumulatively, imports grew much faster than exports (up by 24.6% yoy and 5.6% yoy, respectively). As a result, the cumulative trade deficit reached $1.34 billion at the end of November. Robust growth of imports this year should be attributed to import liberalization (in particular, reduction of a number of import tariffs and simplification of customs procedures), vigorous domestic demand and high world crude oil prices. In addition, the launch of an extensive anti-smuggling campaign aimed at legalizing "grey imports" may also contributed to the growth of imports. At the same time, sharp exports deceleration is associated with weakening of external demand for Ukrainian metallurgical products, higher production costs (mainly due to the increase in cargo transportation tariffs) and national currency appreciation. The mentioned factors eventually resulted in a current account deficit of $200 million in the third quarter of the year, though cumulatively it remained in surplus due to large positive balances generated in the first half of the year. According to preliminary estimates, the current account balance was still positive at about $2.2 billion (or 2.7% of estimated 2005 GDP) at the end of the year, but the surplus was more than three times narrower than last year.

Merchandise Trade Performance, 2002–2005



Source: State Statistics Committee

By product breakdown, the growth of metals exports decelerated to 10.7% yoy for the period, down from more than a 50% yoy increase in 2004. The deceleration was due to declining world steel prices caused by the introduction of China's new metallurgical capacities. At the same time, metals remained the largest contributor to Ukraine's merchandize exports growth as the industry accounted for about 41.5% of total exports. To a large extent, however, the declining trend of exports growth should be attributed to drastic deterioration in exports of machinery and equipment. Since the beginning of the year, exports of these commodities declined by almost 8% yoy in contrast to the impressive 30.4% yoy increase in 2004. On the import side, energy resources (the weightiest item in total merchandise imports) decelerated to 7.2% yoy (down from 8.6% yoy over January-October), thus explaining the declining trend of total imports growth.

The recent increase in imported gas prices will substantially affect Ukraine's foreign trade performance in 2006. The most significant effect the increase will be felt by export-oriented industries such as metallurgy and chemicals, which together account for more than 50% of Ukraine's total exports. Although it is very likely that the profitability of metallurgical companies will decline considerably while the chemical enterprises will find themselves on the edge of profitability, the impact of the gas price increase will be lessened by relatively high international prices on these commodities. In particular, although world steel prices are forecasted to continue to decline in 2006, the trend will be much flatter than in 2005 and world steel prices will be considerably higher than in 2003. World prices for chemical products are forecasted to increase slightly. On the import side, the gas price increase will result in a worsening merchandise foreign trade balance, which will be partially covered by a larger surplus in foreign trade of services due to increased transportation tariffs. Therefore, the current account will run a deficit, though a rather small one at about 1% of forecasted 2006 GDP.

Other Developments and Reforms Affecting the Investment Climate

In mid-January, the major international agencies — Fitch and S&P — affirmed Ukraine's long-term foreign and local currency ratings, though Fitch changed the outlook from Positive to Stable. The major reason for keeping the ratings unchanged in spite of the challenges (related to GDP growth deceleration in 2005, the impact of the imported gas price increase on economic growth and political uncertainties) was low public and external debt ratios, the central bank's high international reserves and the rather modest current account deficit forecasted for 2006.

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