Ukraine Macroeconomic Situation

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Olga Pogarska, Edilberto L. Segura

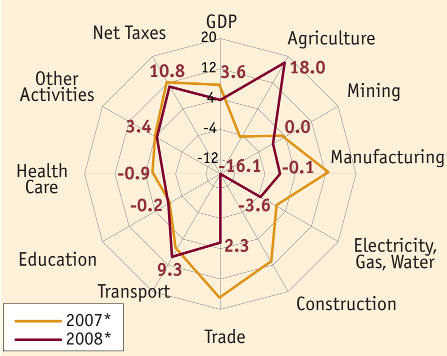
Summary

- According to preliminary data, Ukraine's real GDP grew by 3.6% yoy over January-November 2008. Given the sharp deterioration of real sector performance during October-November, unfavorable prospects for the global economy and domestic financial turmoil, we now expect GDP to grow by 2.0% yoy in 2008 and to contract by about 3.0% yoy in 2009 with still significant downside risks.
- Ukraine's fiscal position remained strong during January-October 2008 as the consolidated budget was in surplus of 0.9% of period GDP. As a result of budget amendments at the beginning of December, the targeted budget deficit was raised to 2.5% of GDP.
- In late December, the Ukrainian parliament approved the 2009 budget with a planned deficit of 3% of GDP contrary to the IMF commitment to have a balanced budget in 2009. Additionally, there are a number of other issues suggesting that 2009 will be quite a challenging fiscal year for Ukraine.
- Consumer inflation is estimated to be around 22% yoy in 2008 and about 15% in 2009.
- The reversal of international capital flows and worsening macroeconomic fundamentals caused the Ukrainian Hryvnia to depreciate. These pressures, amid the lack of transparency and coordination among monetary and government authorities, transformed into a full-scale currency crisis. As a result, the Ukrainian Hryvnia lost more than 50% of its value with respect to the US Dollar in 2008.
- Our estimates of Ukraine's net external financing needs indicate that although 2009 will be a difficult year for the country, the situation still looks manageable.
- Ukraine failed to agree with Russia on a new gas contract for 2009. The new gas dispute may have both positive and negative consequences for Ukraine.

Economic Growth

Economic conditions in Ukraine have been deteriorating more sharply and earlier than we expected. Hit by the combined shock of rising risk-aversion on the global financial market amid growing worries over the health of the Ukrainian banking system, falling world commodity prices and domestic policy tightening, Ukraine's gross domestic product shrank by 2.1% yoy in October and 14.4% yoy in November. This brought cumulative January-November GDP growth to 3.6% yoy, down from 6.9% yoy in January-September. Significant contributors to a steep deterioration in overall growth were industry, domestic trade and construction, the sectors that used to be engines of growth in previous years. The value added growth in these sectors eased to -0.5% yoy, 2.3% yoy and -12.7% yoy in January-November, down from 5% yoy, 9.4% yoy and -16.1% yoy respectively in the first nine months of the year. In November, only agriculture and transportation/ communication sectors still reported vigorous value added growth, advancing by 18.0% yoy and 9.3% yoy respectively. At the same time, November's performance in these sectors was slightly worse than in the preceding month (over the first ten months of the year, value added grew by 18.3% yoy and 10.4% yoy respectively).

Real GDP and Value Added Growth by Sector in January-November, % yoy



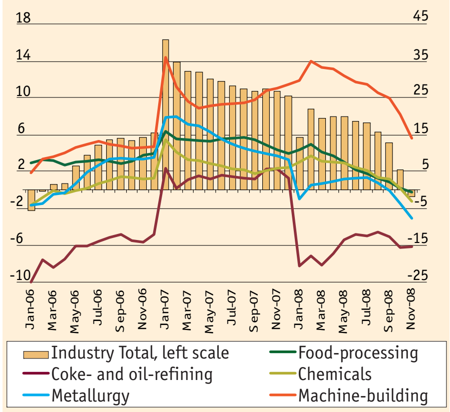
* Operative data

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Industrial performance was disappointing. Industry reported an almost 20% yoy decline in production in October. Moreover, the situation worsened in November as industrial output contracted by 28.6% yoy. Thanks to decent growth in the first nine months of the year, industrial production declined cumulatively by 0.7% yoy over January-November. The deterioration was particularly sharp in export-oriented and consumer-credit-sensitive branches (metallurgy, chemistry and transport vehicles). Abated by high input prices and a continuing fall in world steel and chemical prices, metallurgical and chemical production sank by 35.6% yoy and 19.2% yoy in October and almost 50% yoy and 35% yoy in November respectively. Closely linked to metallurgical performance, the mining industry showed 10% yoy and 60% yoy declines in output in October and November on the back of a 21% yoy and 60% yoy drop in ore extraction respectively.

Higher credit costs and tighter lending standards as well as declining import demand from CIS countries (the main destination for Ukraine's export of machinery and transport equipment) caused an 18% yoy decline in production of vehicles in October and an almost 52% drop in November. The overall production in the machine-building industry declined by about 40% yoy in November, while it grew by 14.6% yoy just two months before. Food processing production continued to fall, declining by 9% yoy in November. Despite a record-high harvest this year, the industry experienced an acute deficit in agricultural raw materials (due to the presence of significant lags, the supply of a number of agricultural products such as meat, milk, etc., continued to be affected by the poor 2007 harvest).

Industrial Output by Selected Branches in 2006-2008, % yoy cumulative



Source: State Statistics Committee

The outlook for the rest of this year and the next one is quite bleak. A number of claims suggest a severe deterioration in the labor market since September. Growing unemployment and pro-cyclical fiscal tightening (in accordance with the IMF program), combined with the ongoing credit squeeze and depreciating national currency signal for more retrenching consumer behavior in the future. As private consumption was the main driver of economic growth over the last five years and accounts for almost 60% of GDP, its downturn will exact a significant toll on economic growth. Moreover, exports (an important source of economic growth accounting for about 50% of GDP) and earnings are likely to experience difficulties in 2009. The benefits from the weaker national currency for Ukrainian exporters may be eroded by the global downturn and low commodity prices.

In addition, a sharp slowdown in both domestic consumption and exports, the rising cost of and more restricted access to capital (both external and internal) will hit the investment plans of corporate enterprises. Indeed, based on State Statistics Committee of Ukraine data, a sharp deceleration in fixed investment growth from 10.4% yoy in 1Q 2008 to just 4.7% yoy over the first nine months suggests that the Ukrainian private sector already cut their investments into fixed capital signifi-

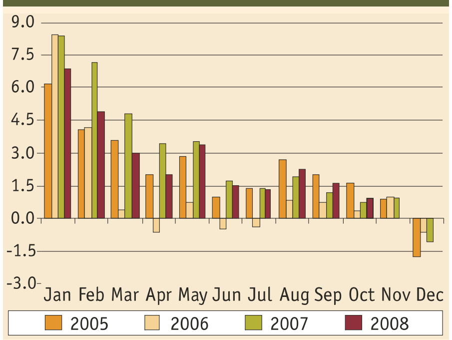
Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

cantly in 3Q 2008. Moreover, this data does not reflect the major financial market turmoil that occurred during October-November. Hence, indicators for the subsequent quarter are likely to notably deteriorate. On a positive note, a fall in domestic demand and energy prices will help to reduce the negative contribution from net exports to GDP through the expected major decline in imports. Considering the above, we now expect GDP to grow by 2.0% yoy in 2008 and to contract by about 3.0% yoy in 2009 with still significant downside risks (natural gas prices, deeper and longer-lasting recession in developed countries and more severe slowdown in Russia, slow authority response in terms of fiscal policy and growing challenges in the real and banking sectors, intensification of political instability related to presidential elections, etc.)

Fiscal Policy

Ukraine's fiscal position remained strong during January-October as the consolidated budget was in surplus of UAH 7.4 billion, which is equivalent to 0.9% of period GDP. During the period, consolidated budget revenues grew by 42.5% yoy in nominal terms, underpinned by a 51% yoy increase in tax revenues. According to the State Treasury, revenues to the general fund of the state budget were 6.5% above the targeted amount for January-October. To a significant extent, higher than expected revenues reflected pro-cyclically strong growth in wages and profits during the previous periods, as well as higher inflation (the 2008 budget assumed inflation of 15.9% in 2008 while it is likely to be above 20% this year). Receipts from three major taxes (value added, personal income and corporate profit taxes) ensured almost 65% of total consolidated budget revenues. In addition, the consolidated budget surplus was the result of low expenditure realization. Expenditures from the general fund of the state budget were under-fulfilled by 3% over January-October. The government had to postpone the execution or allow only partial financing of a number of budget programs, except social transfers, facing increasing difficulties in obtaining funds necessary to cover the planned budget gap.

Consolidated Budget Balance, % of period GDP



Source: Ministry of Finance

Despite a favorable fiscal stance over the first ten months of 2008, it is likely to deteriorate rapidly through the rest of the year and next year. Over 2004-2007, consolidated budget expenditures in real terms (CPI deflated) grew by about 20% per annum, almost twice as fast as in the previous four years (2000-2003). At the same time, fiscal deficits were maintained at about 1.5% of GDP on average during these years. Low fiscal deficits were achieved thanks to a notable increase in revenues. Elimination of a number of tax exemptions and privileges since 2005, improvements in tax administration as well as strong growth and very favorable world commodity prices helped to boost fiscal coffers. The sharp slowdown in economic activity, depressed world commodity markets and weak external demand are likely to weigh down fiscal revenues. Already in November, revenues to the general fund of the state budget were notably below target. The Ministry of Finance forecasted that the state budget will be short UAH 7 billion during November-December. At the same time, given the depth of the economic decline in November, the revenue shortfall may be more severe.

The government took a number of steps to cut budget expenditures through the end of the year. In particular, the government froze public sector employees' nominal wages, initially planned to be raised on December 1st in line with the minimum wage increase, and ordered government agencies to cut spending. By securing the IMF stand-by loan at the beginning of November, the government agreed to a significant tightening of fiscal policy. According to the agreement, the 2008 consolidated budget deficit should not exceed UAH 10 billion and should be balanced in 2009. At the same time, budget expenditure tightening may be a significant challenge for Ukraine's government authorities. Fiscal budgets of previous years were heavily biased towards social and other recurrent expenditures, which are difficult to adjust, particularly in an election year. Moreover, facing a sharp decline in business activity and profits, affected industries/sectors producers requested budget support. As a result, fiscal stimuli were granted to the construction sector, agriculture, metallurgy and chemical industry. To sustain the financial performance of the national monopoly "Naftogaz Ukrainy" and State Pension Fund of Ukraine, the government deferred VAT payments for the former and wrote off liabilities of the latter to the state budget (at the beginning of 2008, the Pension Fund of Ukraine was granted a loan of UAH 5 billion to secure timely pension financing).

As a result of amendments to the 2008 budget law approved on December 12th, the budget deficit was raised to UAH 25 billion, or almost 2.6% of GDP, a level that notably exceeds the IMF cap. Moreover, the government has revised the targeted budget deficit financing. Observing significant under-execution of privatization receipts (which accounted for less than 8% of the target at the end of October), tighter credit conditions on external financial markets and rising yields on emerging market securities, the government increased reliance on domestic debt financing. However, government securities remained a rather unattractive investment for commercial banks, despite the fact that the government has raised the proposed yields. As a result, a substantial portion of the government securities issued in 2H 2008 was purchased by the NBU. According to the law on the anti-crisis measures approved at the beginning of November as a necessary step to secure IMF lending, such deals are allowed if the attracted funds are used for commercial banks recapitalization purposes. However, only a quarter of these funds were directed to raise the capital of two state banks (Oshchadbank and Ukreximbank). This may imply NBU financing of the budget deficit, which may hamper recent disinflation progress.

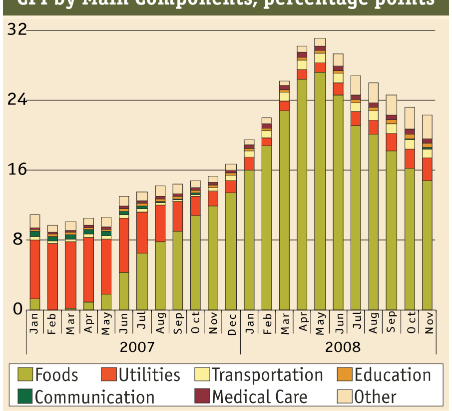
As expected, the government recalled its 2009 budget draft. The revised 2009 budget was presented approved by the parliament on December 25th. Though the government was obliged to prepare a balanced fiscal budget for 2009, the approved budget law envisaged a deficit of UAH 31 billion (about $4 billion), or 3% of forecasted GDP. The targeted deficit, as well as other provisions in the budget law, may delay the recovery of the economy from the current financial crisis as insufficiently tight fiscal policy may slow down the process of leveling out the existing macroeconomic imbalances. Moreover, the government's plan to finance the budget deficit with heavy borrowings on the domestic market will lead to a substantial increase in public debt. Coupled with the high indebtedness of Ukraine's private sector, this means that considerable funds will be diverted from the economy to serve the debt. Furthermore, the budget foresees that the lion's share of domestic securities (UAH 44 billion, $5.8 billion) will be purchased by the National Bank of Ukraine. Though this money is planned to be spent on recapitalization of commercial banks, this is likely to cause double-digit inflation to persist in the next few years. A number of other aspects in the approved budget suggest that 2009 will be a challenging fiscal year.

First, the budget was developed on a quite optimistic macroeconomic forecast (0.4% real GDP growth, 9.5% inflation, UAH/$7-7.5 exchange rate, etc.). Second, the government did not specify the forecasted price of imported natural gas next year. Third, the budget revenue projections were made based on an increase in indirect tax proceeds thanks to a rise in respective tax rates and duties. However, these projections may not be fully realized as the rise in rates may be outweighed by a consumption depression that's deeper than anticipated in the budget. Finally, the significant approved budget deficit, increases in import duties, and violation of some other requirements may cause suspension of the IMF program. At the same time, realizing the detrimental impact of such a scenario to the economy, the Ukrainian government has already sent the request to the IMF authorities to reconsider the program conditions. In addition, positive news in the 2009 budget is the obligation to amend the budget by May 1st 2009.

Monetary Policy

As expected, energy and food prices, the main factors behind rising inflation in the first half of 2008, started to recede during July-August, driving the overall consumer price index growth down. However, this trend was reversed in September due to utility and service (transportation and communication) tariffs adjustment. In addition, a sharp depreciation of the national currency during October-November became a powerful source of inflation during these months, passing through a number of imported commodities, such as fruits, vegetables, clothes and footwear, drugs, etc. As a result, the consumer price index grew by 1.7% month-over-month (mom) in October and 1.5% mom in November, bringing the eleven-month price growth to almost 20%. Despite the fact that the global shock is forecasted to be deflationary for developed countries, the anticipated economic downturn and labor market weaknesses will not bring sufficient inflation relief for Ukraine in 2009. First, the IMF stand-by agreement envisages a quarterly adjustment of utility tariffs for them to reach cost-covering levels by mid-2010. Second and the most important, sharp Hryvnia depreciation in 4Q 2008 and the likely further weakening of the national currency during 2009, though not as substantial as in 2008, will continue to feed inflationary expectations.

CPI by Main Components, percentage points



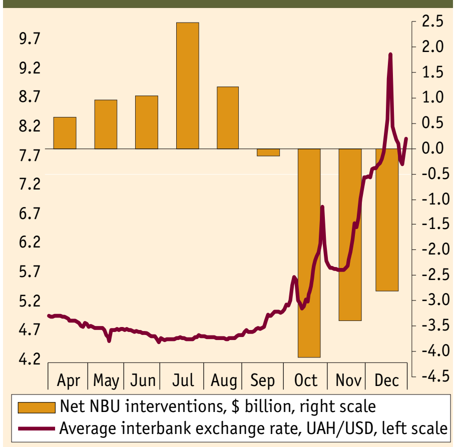
Source: State Statistics Committee, The Bleyzer Foundation

More expensive imports should discourage consumer spending on imports, thus helping to moderate inflation as well as to bring the trade deficit to more sustainable levels. However, while it would be rational behavior to switch to cheaper domestic substitutes, these expectations may not materialize due to a slow domestic supply response. The latter is rooted in structural weaknesses of the Ukrainian economy (heavy reliance on exports on a relatively undiversified commodities, energy-inefficient and import dependent real sector) and inadequate business climate, for years suffering from delays in and piece-meal structural reforms. In addition to sharp upward price correction of imported goods, the currency shock may offset the benefits from lower world energy and raw materials prices. Given the above, we forecast consumer prices to grow by about 15% in 2009. Though inflation will remain in double digits in 2009, this will be a visible deceleration from the 22% price growth estimated for the end of 2008.

The foreign exchange market was extremely volatile during October-December. Similar to other emerging market economies, in the last couple of years Ukraine received large capital inflows, which together with loose domestic fiscal and monetary policies allowed the economy to demonstrate above-region-average economic growth rates. The global financial market turmoil and global economic slowdown has uncovered three major pressure points in Ukraine's economy. First, Ukraine has accumulated $105.5 billion of gross external debt as of the end of September 2008 with private sector debts accounting for about 85% of the total amount. A substantial part of private sector liabilities is due at the end of 2008 and 2009. Second, buoyant domestic demand was increasingly satisfied by imports, causing trade and current account balances to deteriorate. On the back of mounting external financing needs, Ukraine was particularly sensitive to changes in investors' sentiments and access to international finances.

Third, encouraged by a prolonged period of relative exchange rate stability and loose monetary policy, commercial banks have expanded their credit portfolios at a fast pace, including in hard currency (the share of forex-denominated loans in total credits exceeded 50% since the beginning of 2007 despite the NBU measures to discourage commercial banks from issuing credits in foreign currency). Extensive economic literature shows that periods of credit booms are usually followed by a rise in non-performing loans (NPLs). Though official statistics on NPLs was quite favorable so far, it is reported with substantial delays. Now, amid an economic slowdown, growing unemployment and sharp depreciation of the national currency, the Ukrainian banking system is likely to face an increasing number of corporate and private defaults. Already in December, a number of commercial banks started to advertise foreclosure sales on their official websites.

Average UAH/USD interbank exchange rate and NBU interventions



Source: NBU, Finance.ua, The Bleyzer Foundation

Due to the above vulnerabilities, the drying out of international capital flows to Ukraine and worsening macroeconomic fundamentals tilted the balance towards Hryvnia depreciation. At the same time, sizable gross international reserves in the amount of $37.5 billion at the end of September as well as securing $16.4 billion under the IMF stand-by agreement at the beginning of November should have eased the pressures or at least allowed to smooth the process. Instead, during October-December 2008, the Hryvnia lost almost 60% of its value versus the US Dollar with exchange rate interbank market quotations varying from about UAH/USD 5.1 at the beginning of October, ap-

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
4A, Baseyna Street, "Mandarin Plaza", 8th floor
Kyiv 01004, Ukraine
Tel: (380-44) 284-1289 Fax: (380-44) 284-1283
E-mail: kiev.office@sigmableyzer.com.ua

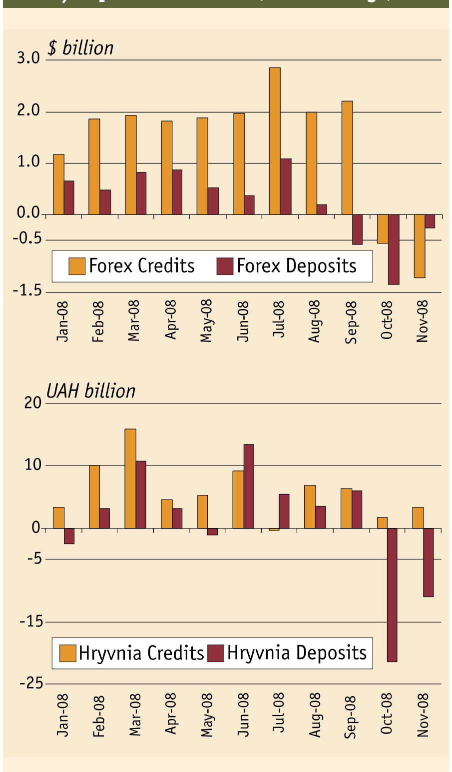
Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (380-57) 714 1180 Fax: (380-57) 714 1188
E-mail: kharkov.office@sigmableyzer.com.ua

proaching UAH/USD 10.0 in mid-December and returning to about UAH/USD 8.0 at the end of the year. The wide fluctuations in the exchange rate may be attributed to the lack of transparency and consistency in the NBU measures to stabilize the market as well as poor coordination between the government and monetary authorities in addressing the financial and economic crisis.

Realizing existing macroeconomic imbalances, the NBU did not resist the exchange rate adjustment towards its new equilibrium level. Limited NBU interventions during September/the first half of October were in line with May's decision to switch to a more flexible exchange rate regime. However, the sporadic nature of these interventions with the surrounding uncertainty regarding the timing, rate and size of the interventions, nontransparent procedure of selecting the banks whose bids were satisfied generated panic and speculative developments on both interbank and cash foreign exchange markets. These intensified the erosion of public confidence towards the NBU policy as well as the banking system as a whole, already injured by liquidity stresses in several commercial banks, which led to the NBU taking control over one of the banks and deposit withdrawals from the banking system. During October-November, Hryvnia-denominated deposits declined by UAH 32.4 billion ($4.8 billion), or 14%. Though the official monetary statistics reported an increase in forex-denominated deposits by 28% during these two months, this growth should be attributed purely to the valuation adjustment that occurred as a result of sharp Hryvnia depreciation versus other currencies. In US Dollar terms, forex-denominated deposits declined by $1.6 billion, or 7.1%.

To calm the forex markets and experiencing strong political pressure to stabilize the markets, the NBU resorted to massive interventions, selling $4.1 billion in October and $3.4 billion in November. Observing rapid depletion of reserves, the NBU tried to stabilize the market by setting technical restrictions on interbank forex markets. However, due to a nontransparent refinancing policy, experiments with the forex-market trading rule (which resembled an intension to set a rigid exchange rate fix), incomplete disclosure of the size and structure of the gross international reserves, and insufficient political autonomy, the NBU failed to raise confidence towards its exchange rate policy and calm the market. Obliged to adhere to IMF restrictions on the size of international reserves, and thus interventions, the NBU had to allow the Hryvnia to depreciate by almost 30% just during the first half of December. However, pressured by political forces, it resumed interventions on a daily basis during the second half of the month, which allowed the NBU to maintain the exchange rate at about UAH/USD 8.0 until the end of the year. Unfortunately, the macroeconomic environment also remains unfavorable in 2009. Hence, we expect further depreciation of the Hryvnia versus the US Dollar.

Commercial Banks' Hryvnia and Forex ($-denominated) Deposits and Credits, stock change, 2008



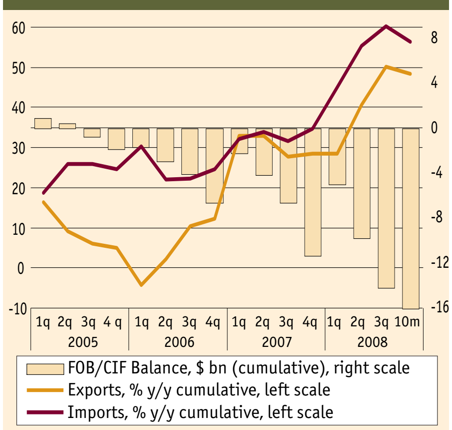
Source: NBU, The Bleyzer Foundation

The sale of gross international reserves, which usually has a sterilization effect, as well as deposit withdrawals affected the liquidity stance in the banking system and growth path of monetary aggregates. At the same time, the NBU supported commercial banks' liquidity by injecting UAH 75 billion ($11 billion) through its refinancing channel during October-November. As a result, monetary aggregates grew by about 1.1% during these two months, which enhanced the deceleration of monetary aggregates growth in annual terms. The above developments as well as the imposition of restrictions on the issuance of foreign currency loans and announced tightening of reserve requirements on foreign-currency denominated loans since the beginning of 2009 resulted in sharp deceleration of credit growth. In particular, in annual terms Hryvnia-denominated credits decelerated from about 80% yoy at the beginning of 2008 to 41% yoy in November. The growth of credits in foreign currency, denominated in US Dollars, declined from about 77% yoy in January 2008 to 43.2% yoy in November. The credit squeeze may be beneficial in terms of curbing consumer demand and thus reducing imports. However, it will be damaging for the credit-dependent in the past economy, which still remains in need of considerable financial resources to renew its outdated production capacities, finance infrastructure and energy-saving projects and fulfill structural reforms. More restricted access to credit resources is among the main reasons behind our forecast of real GDP contraction in 2009.

International Trade and Capital

Seemingly unaffected by international financial turmoil in the first nine months of 2008, Ukraine has started to fully feel its impact since October. September's foreign trade data still demonstrated favorable export performance, as exports grew by 62.7% yoy in value terms that month, bringing the cumulative growth to over 50%. However, deeper data readings showed that more than half of this increase was received thanks to 6.1 times higher exports of agricultural products, while export of metallurgical products and transport equipment notably decelerated. Disappointing data on economic growth in developed countries as well as the deterioration of their growth prospects in the near future caused a sharp decline in world commodity prices. The downturn in world prices for steel and chemical prices coupled with weakening European and emerging countries (particularly Russia, Turkey, etc.) demand have produced a sharp slowdown in Ukraine's exports in October. In particular, exports growth was cut in half in value terms to 30.2% yoy in October. As a result, ten-month export growth

Merchandise Trade Performance



Source: State Statistics Committee

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
4A, Baseyna Street, "Mandarin Plaza", 8th floor
Kyiv 01004, Ukraine
Tel: (380-44) 284-1289 Fax: (380-44) 284-1283
E-mail: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (380-57) 714 1180 Fax: (380-57) 714 1188
E-mail: kharkov.office@sigmableyzer.com.ua

slid to 48.4% yoy. While exports prospects do not look comforting for the coming months, the sharp depreciation of the national currency observed during October-December as well as easing energy prices will help to restore the competitiveness of Ukraine's products on foreign markets.

So far, however, import bills have continued to grow at a fast pace. In September, commodity imports grew at a record-high 73.6% yoy on account of a 95% yoy increase in imports of mineral products, 65% yoy growth in imports of machinery and transport equipment and 77% yoy rise in imports of metallurgical products. In October, however, imports also sharply decelerated, rising by less than 30% yoy. Such rapid deceleration may be attributed to rapid deterioration of industrial production as well as technical restrictions on advanced import payments imposed by the NBU at the beginning of October. Though a few days later the NBU relaxed these restrictions, uncertainty regarding the future import transactions as well as the turmoil on Ukraine's foreign exchange market may have affected importers' and their counterparts' confidence in timely payments. Cumulatively, imports growth decelerated from 60.2% yoy in January-September to 56.5% yoy in January-October. Since import growth notably outpaced exports, Ukraine's FOB/CIF merchandise foreign trade deficit kept increasing and reached $16.1 billion as of the end of October.

The widening foreign trade deficit and higher dividend payments formed a record-high monthly current account deficit of $1.9 billion in October. The ten-month current account gap widened to $10.5 billion, which corresponds to 6.5% of period GDP. Preliminary balance of payments (BoP) data for September-October point to the growing deficit on financial and capital accounts. In particular, monthly FDI inflow decelerated sharply from $1.4 billion on average during May-August to $0.7 billion in September and $0.3 billion in October. Though Ukraine's private sector continued to borrow from abroad, much higher private debt amortization payments as well as other capital outflow led to a decline in NBU foreign exchange reserves.

Our estimates of Ukraine's external financing requirements show that though 2009 will be a difficult year for the country, the situation still looks manageable. We believe that the current account deficit will decline to about 3.5% of GDP thanks to improved competitiveness of Ukraine's exports and a fall in imports, particularly of consumption goods. At the same time, private external debt payments due in 2009 are estimated to increase to $40-45 billion. However, excluding trade-related external liabilities and making assumptions on the Ukrainian subsidiary banks and corporate debt to their parent companies abroad, the overall financing need is estimated at about $20 billion. Given the IMF and other International Financial Institutions (e.g., World Bank, EBRD, etc.) support and moderate FDI inflow, the net external financing gap may stand at about $10 billion, which would mean a reasonable decline in the NBU reserves and further currency depreciation. At the same time, this scenario contains significant downside risks (the price for imported natural gas still remains unknown, the approval of the 2009 state budget law with 3% of GDP deficit risks to lead to IMF program suspension, the deterioration of the global economy may be deeper and longer than forecasted, political instability may intensify due to the upcoming presidential elections, etc.)

Other Developments Affecting Investment Climate

During December 2008, Ukraine failed to agree with Russia on the price of imported natural gas to be paid in 2009. For a number of years, Ukraine paid below-market price for imported natural gas. However, with the cooling of Ukrainian-Russian relations since 2005, Ukrainian piece-meal efforts to reform the energy sector, and the growing international price for mutual gas, Ukraine and Russia were regularly involved in gas disputes, which already resulted in temporary cessation of natural gas supply to Ukraine at the beginning of 2006. At the beginning of October 2008, Ukrainian and Russian Prime Ministers signed a memorandum envisaging a three-year transition towards a "market-based" price for imported gas and removal of the opaque intermediary - RosUkrEnergo. The gas dispute between the two countries intensified in late October, when the Russian state gas monopoly "Gazprom" announced that Ukraine did not timely settle accounts for natural gas deliveries. Though Ukraine paid back the lion's share of its debt to Gazprom by the end of the year, the countries did not agree on the price for imported natural gas. The offered price by Gazprom varies from $450 to $250 per thousand m3 and insisted the transit fee through the territory of Ukraine should remain unchanged. Ukraine considered the price of $201-235 per thousand m3 but wanted to raise the transit fee to $2.0 per thousand m3 per 100 km, up from $1.7 in 2008. The rather narrow difference between the offers suggests some vested interests might be blamed for the failure to reach an agreement. Being the most non-transparent sector in Ukraine, the energy sector gives ample opportunities for rent-seekers.

With the absence of a new contract on gas supply to Ukraine, Russia stopped gas supply to Ukraine on January 1st 2009. As it was in 2006, Russia first reduced gas flows into the Ukrainian pipeline in the amount equal to Ukraine's shipment, while continuing supply to European countries. A few days later, however, accusing Ukraine of stealing gas destined for European consumers, Russia stopped gas flows to Ukraine entirely. While the cutoff of gas supply to the European countries may expedite the gas talks between Ukraine and Russia, the current gas dispute may have far-reaching consequences for Ukraine. On a positive note, it is likely to facilitate transition towards market-based energy prices, which may increase political independence of Ukraine away from Russia's influence. This transition may also stimulate Ukrainian government authorities to proceed with reforms in energy and related sectors (e.g., utility sector). On the other hand, Ukraine, as well as Russia, failed to confirm to the European countries that it is a reliable gas transit country, which damaged its international image. In addition, the current situation may facilitate construction of alternative pipelines that bypass Ukraine.