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### Summary

- Through the first half (1H) of the year, economic growth slowed down to 4% year-over-year (yoy); however, expected good agricultural performance may improve the overall growth performance.
- In January-May, the consolidated budget registered a surplus of 2.85% of GDP on the back of improved tax enforcement and tax administration.
- The government endorsed the list of enterprises to be privatized in 2005. A number of strategic enterprises, including "Ukrtelekom," may stimulate FDI inflow to the country despite the as yet unresolved Kryvorizhstal issue.
- Total public debt declined due to the government's prudent debt management policy.
- January-May's merchandise trade surplus narrowed to \$800 million, 63% less than over the same period last year.
- Approving half of the laws necessary for WTO entry, Ukraine may still join the organization in 2005.

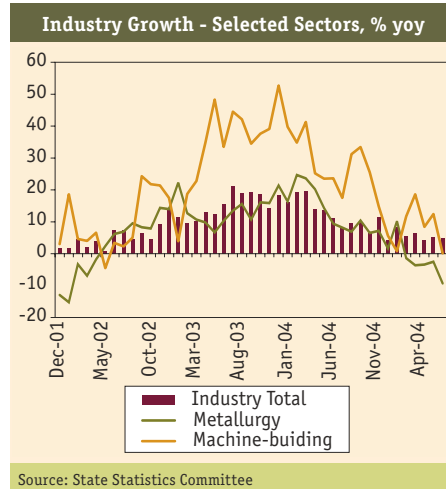
### Economic Growth



Sharp deceleration of economic growth in Ukraine, observed since the beginning of 2005, continued in June. Over the month, real GDP growth slowed to 1.1% yoy compared with a 3.6% yoy increase just one month ago. Over the first half of the year, cumulative real GDP growth made up a modest 4% yoy compared to the impressive 12.7% in the corresponding period last year. Deceleration was reported in all sectors except for agriculture and utilities. Value added in agriculture increased by 7% yoy in January-June compared to a 1.5% yoy decline in 1H 2004. Despite expectations of a fairly good harvest, agriculture may show moderate performance in 2005 due to a high base effect caused by the outstanding crop last year. Over January-June, utilities continued expanding at a robust pace benefiting from high world energy prices. Utilities registered 4% yoy growth over the period compared to an almost 3% yoy decline in 1H 2004. On the downside, construction has been stagnating since the beginning of the year. Value added in the sector declined by 7.7% yoy over January-June on the back of explosive 30.3% yoy growth in the respective period a year before. Over the period, value added

growth in wholesale and retail trade contracted by a cumulative 2.5% yoy, for the first time during the last five years. However, taking into account the robust growth of disposable household income (up 26% yoy), domestic trade dynamics may recover in the near future.

In June, industrial growth demonstrated an almost 1% yoy decline. As a result, cumulative growth slowed to 5% yoy compared to 6.2% yoy at the end of June. Deceleration may be attributed to weakening export opportunities for metallurgy and a high base effect. Soaring commodity prices in recent years were primarily caused by buoyant Chinese demand for metal. Now, as China has introduced new domestic capacities for production of steel and has become a net exporter rather than a net importer, steel prices are likely to continue to fall. Due to production specifications this will have a contagion effect on other commodity prices. In Ukraine, metallurgy accounts for more than 20% of the country's total industrial output and about 45% of merchandise exports. For six months of the year, metallurgical output contracted by 1.8% yoy. In June alone, metallurgy reported a 9.3% yoy decline in output. In addition to external factors, metal production this year is affected by higher production costs (iron ore prices grew by about 50% since the beginning of the year, more expensive railroad transportation and energy resources) and lower domestic demand (due to stagnation in construction). The downward world price trend for metals may reverse by the end of the year due to diminishing stocks of metal products in Europe and production cuts announced by a number of steel giants. However, with largely outdated production capacities in the sector, higher demand for quality and strong domestic currency, Ukrainian metallurgy may keep losing its competitiveness in the medium term unless considerable investments come into the sector.

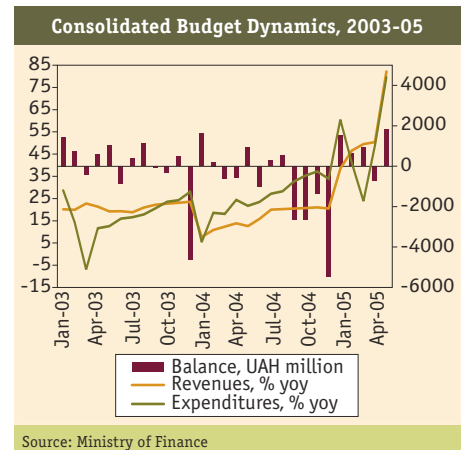


Chemicals, machine building, food and wood processing were the major contributors to industrial output growth during 1H 2005. Strong external demand supported 13% yoy growth in chemicals. Encouraged by robust growth of household incomes, food processing

output advanced by 14% yoy over the period. Enjoying buoyant domestic demand, wood producers expanded their production by a remarkable 20.6% yoy. Machine building kept decelerating as the sector's production advanced by only 0.1% yoy in June. Over the first half of the year, it demonstrated moderate 9.1% yoy growth in contrast to almost 34% yoy expansion in the respective period last year. Following a gasoline crisis over April-May (when the country experienced a shortage of gasoline stemming from government efforts to administratively prevent an abrupt increase of petroleum prices), the situation began to improve in June. Oil refineries' output grew by an encouraging 8.6% month-over-month (mom); however, it was almost 11% lower than in June 2004. Consequently, oil-refining production contracted by a cumulative 5.6% yoy over 1H 2005.

Considering the growth slowdown in the first half of the year, the government lowered the GDP forecast for 2005 by 0.2 percentage points (pps) to 8% yoy. However, it is unlikely that economic growth will reach the expected level. Taking into account worsening external conditions, the GDP growth of 6-7% forecasted by international organizations and independent analysts looks more realistic.

### Fiscal Policy



Supported by improved tax enforcement and tax administration, the cumulative consolidated budget surplus exceeded UAH 4 billion (\$793 million) at the end of May, which is equivalent to 2.85% of period GDP. In real terms, consolidated budget revenues went up by an impressive 40% yoy to reach UAH 47.8 billion (\$9.5 billion). Tax revenue collection has been successful so far, as proceeds from corporate tax and import duties increased 52.1% yoy and 61.5% yoy in real terms respectively. The largest increase in receipts was registered for value added tax. Over January-May, value added tax receipts were almost twice as high in real terms as in the corresponding period last year. However, the figure should be treated with some caution due to accumulation of the VAT refund arrears in the amount of UAH 3.1 billion (almost \$609 million) as of July 1st. Moreover, preliminary

State Treasury data indicates the failure of fiscal authorities to collect targeted tax revenues in June. In addition, generous social payments stimulated a 34% yoy real increase in expenditures to UAH 43.7 billion (\$8.6 billion). Over the period, social expenditures, accounting for almost 82% of total budget expenditures, soared by almost 60% yoy in real terms. Furthermore, due to coming parliamentary elections in the spring of next year, the government keeps increasing social payments (starting July 1st, the government raised the minimum wage to UAH 310, up by 7%). Thus, the targeted deficit of 1.86% of GDP remains quite a challenging task.

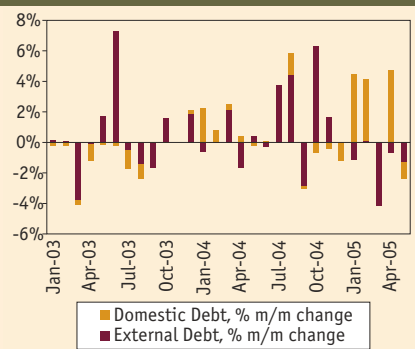
The need to finance debt obligations and substantial social expenditures motivates the government to look for extra budget resources. At the beginning of July, the parliament endorsed amendments to the Budget Law, stipulating an increase in state budget revenues by UAH 372.2 million. Additional budget revenues will be received thanks to a 83% increase in the rent for the oil and gas condensate extracted in Ukraine and a 1.5 pps increase in the obligatory state pension insurance deductions on cellular communication services.

The Budget Law envisages fiscal deficit financing through new debt issues and privatization receipts. However, the government demonstrated poor privatization performance in the first half of the year. According to government officials, privatization receipts amounted to about UAH 640 million (\$125 million) for the period, below 10% of the targeted level for this year. The slow privatization process is attributed to the ban on the privatization of strategic enterprises imposed in February 2005 and the change of the State Property Fund (SPF) management. Since the ban was lifted in mid-June and the government endorsed the privatization plan for 2005 in mid-July, the privatization process should accelerate. The list consists of 33 enterprises to be privatized in 2005, including Odessa port plant, Severodonetsk nitrogen union, Nikopol pipe plant and a number of hotels. Moreover, later in July the government decided to include the largest telecommunication company "Ukrtelekom" in the 2005 privatization list.

The success of privatization process, however, will crucially depend on the fair and transparent resolution of the Kryvorizhstal deal. Following the decision of the Kyiv Commercial Court of Appeals confirming that the privatization of Kryvorizhstal was carried out illegally, the re-sale of the enterprise was scheduled by the government for October 24th. The government earlier declared that the tender will be carried out in the most efficient and transparent way. However, the very initiation of the re-sale procedure undermines the stated principles, since the case proceedings have not been closed. Allegedly, there are some 30 more enterprises whose privatization may be reconsidered. However, the list of those enterprises has not been published yet.

Considering modest privatization revenues, the government has increased its reliance on new borrowings to finance the budget deficit. At the same time, as the redemption volumes exceed those of newly issued instruments, total public debt declined by 2.2% year-to-date (ytd) to \$15.7 billion. The debt structure has also been changing. The government reduced the share of external debt, while issuing domestic debt instruments. Since the beginning of the year, external public debt fell by 7% ytd to \$11.3 billion, while domestic debt increased by almost 13% ytd to \$4.45 billion. During 1H 2005, the government issued about UAH 6.7 billion of domestic T-bills, exceeding the ceiling of new borrowing on domestic markets for the whole year. According to the amended Budget Law for 2005, borrowing on external and domestic markets is set at UAH 3.23 billion and UAH 6.24 billion, respectively. However, the government has the right to go beyond the limit in case the attracted funds are directed to pay out more expensive earlier obligations. Domestic T-bills issued in 2005 turned out to be attractive debt instruments to non-residents, who hold about 40% of Ukrainian domestic government securities. Although this allowed the government to substantially reduce the cost of its borrowings, the local money market may be vulnerable to the changes in foreign investors' sentiment towards Ukraine.

**Change in Public Debt Structure, 2003-2005**



Source: Ministry of Finance

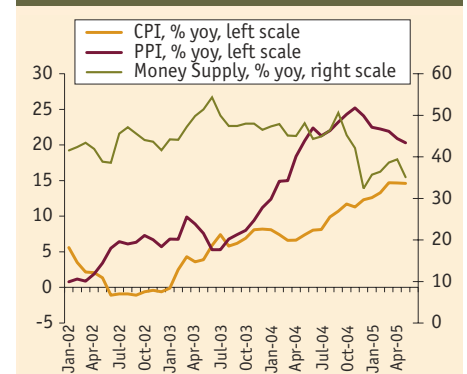
### Monetary Policy

Following the sharp hryvnia appreciation in April, the National Bank of Ukraine (NBU) returned to the policy of targeting exchange rate stability in the following two months. Strong domestic currency, an economic growth slowdown and worsening of foreign trade performance slowed the inflow of foreign exchange into the country. As a result, the NBU reported a negative \$10.5 million balance of its interventions on the forex market in June. For the previous periods, the NBU forex purchases were among the major reasons for mounting inflationary pressure. In addition, stabilization of gasoline prices also helped to contain further acceleration of consumer prices.

In June, consumer inflation decelerated slightly to 14.4% yoy, down from 14.6% yoy a month before. However, this may be a temporary relief considering

the further increase in social payments and the upward trend of world oil prices. Food prices continued to grow, advancing 0.5% month-over-month in June. In annual terms, however, the growth of the foods price index slowed down to 18.4% yoy. The market for foods seems to suffer from perpetual price upsurges on various products. During 2004, the prices on meat products grew by more than 35% yoy on average each month. Over January-March 2005, monthly growth accelerated to 53.5% yoy on average. As import duties on meat products were reduced, the price trend reversed and reached 36% yoy growth in June. However in April, the market was hit by surging sugar prices. In June, it was 32% more expensive than in the respective month a year ago. Despite state reserve interventions on the market, sugar prices will remain high until the end of September, when sugar manufactured from the new harvest will start flooding the market. At the same time, non-food prices continue to decelerate, reporting a 4.6% yoy increase in June. After the government managed to reach an agreement on the growth of gasoline prices with the major gasoline market players, the growth of gasoline prices kept slowing to 18.2% yoy, down from a 67% yoy increase in April. However, the trend may rebound in the coming months as world oil prices continue to increase, because the agreed level of gasoline prices in Ukraine is conditional on their dynamics. Service tariffs growth accelerated to 8.2% yoy as a lagged effect of the gasoline price increase on transportation tariffs. The producer price index (PPI) continued to decelerate, reaching 17.6% yoy in June. Despite higher-than-expected inflation in 1H 2005, the official inflation target for 2005 was left unchanged at 9.8% yoy.

**Prices and Money Supply Dynamics, 2001-05**



Source: State Statistics Committee, National Bank of Ukraine

The growth of monetary aggregates accelerated in June, which should be attributed to loose fiscal policy. Over the period, money supply (M3) growth sped up to 37.1% yoy, up from 35% yoy in May. In June, cash in circulation advanced 39% yoy responding to increasing social security payments. Growing population income stimulates the growth of deposits. However, the growth has been slowing down since the beginning of the year due to declining deposit rates and high inflation. In June, the average deposit rates de-

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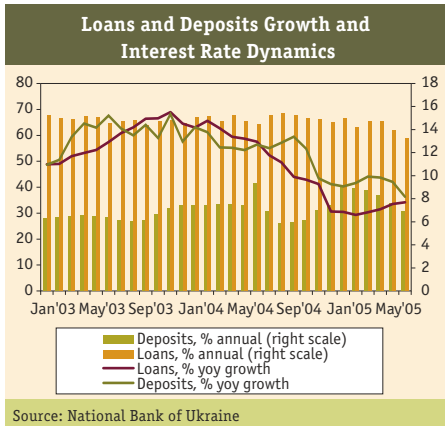
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clined to an annual 6.9%, while inflation was well above that level (14.4% yoy). Despite the tightening of reserve requirements in May, commercial bank lending continued to accelerate reaching 34.2% yoy growth, while the average cost of loans fell to 13.2% annually from 14% in May.

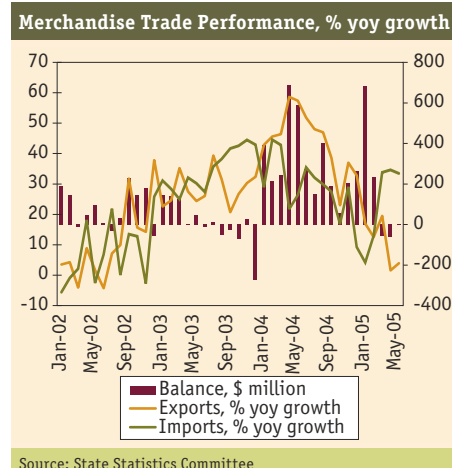


After a sharp revaluation in April, the official hryvnia rate remained virtually unchanged at UAH/USD 5.05 during May-June. At the end of June, the NBU revised its forecast for the main monetary indicators for 2005. The bank lowered the average exchange rate forecast for 2005 to UAH/USD 5.1-5.15. This implies a relatively stable exchange rate for the rest of the year, taking into account that the 1H exchange rate averaged UAH/USD 5.19. In June, gross international reserves declined slightly by about 1% month-over-month (mom), amounting to \$13.1 billion.

### International Trade and Capital

Following an almost balanced trade of goods account in May, the cumulative surplus remained virtually unchanged at the \$800 million level registered over January-April. January-May's trade surplus was 63% lower than that achieved in the same period last year. Since the beginning of 2005, import growth has been accelerating, eventually exceeding the rate of export expansion in March-May. Over the period, exports grew by a fairly modest 10.4% yoy as compared with the more than 50% yoy growth for the first five months of 2004. Advancing 34% yoy each month during April-May, merchandise imports reported a 25% yoy increase since the beginning of the year. Export growth deceleration over April-May should be attributed to sharp hryvnia appreciation and weakening external demand for Ukrainian metals. Cross border metals sales remained among the largest contributors to the overall growth of goods exports; however, the pace of metals export expansion dropped from 60%

yoy to slightly above 40% yoy. At the same time, growing population income and cheaper domestic credits together with strong national currency will further facilitate imports. Although the first quarter current account reported a surplus 4% higher than in the respective quarter last year, decelerating exports and accelerating imports will result in a narrower current account surplus as compared with the previous year.



The extensive country promotion campaign, which should improve the country's image, and the policy of maximum assistance to foreign investors declared by the Ukrainian top officials should stimulate the inflow of FDI to Ukraine. The first quarter of the year reported rather moderate net FDI inflows of \$235 million, slightly below the level registered over the same period last year. The slowdown is attributed to the drastic change in the country's management and the whole issue of re-privatization. With a stabilized political situation and resolution of privatization disputes, foreign investors' perception of Ukraine's investment climate should improve. To promote and inform foreign investors about business opportunities in the country, the foreign investment promotion agency was created at the beginning of July.

### International Programs

On July 21st, an IMF mission arrived in Ukraine to assess current macroeconomic developments in the country. The mission will primarily focus on current and 2006 fiscal policy issues. Since there is no active lending program, cooperation between Ukraine and the IMF is limited to technical assistance support.

At the beginning of July, the government received a \$172.5 million tranche under the Second Programmatic Adjustment Loan (PAL-2) from the World

Bank. The program aims to facilitate structural reforms in Ukraine, including public administration reform, strengthening fiscal discipline, property rights protection, and social services. In mid-July, the World Bank Board of Directors approved another lending program, the First Development Policy Loan (DPL-1) in the amount of \$251 million of development assistance financing. Earlier in June, the WB approved two loans of \$86 million and \$106 million for investment projects in education and energy sectors, respectively. According to the WB director in Ukraine, Belarus and Moldova, the amount of lending programs issued by the World Bank in 2005-2007 may exceed \$2 billion.

### Other Developments and Reforms Affecting the Investment Climate

On July 6-7th, despite acute opposition protests, the Verkhovna Rada of Ukraine approved seven laws necessary for World Trade Organization (WTO) accession out of the 15 proposed by the Cabinet of Ministers. In particular, critical laws on intellectual property rights and agricultural trade were approved. Moreover, amendments to the law on banks and banking activities allowing non-resident bank branches to operate in Ukraine were approved in the first reading. For WTO entry to be discussed by the WTO's ministerial meeting scheduled for December 2005, all necessary laws should be endorsed by the end of September-mid-October. Due to the Ukrainian parliament's summer vacation, the government intensified negotiations to complete bilateral agreements on joint access to the markets of goods and services. In July, the respective protocols were signed with Norway, Indonesia, and Japan. However, Ukraine still has to sign the respective agreements with 13 countries including the US and Australia. Despite a very comprehensive agenda over a fairly short period of time, Ukraine still has the chance to join the WTO in 2005. Ukraine's active seeking of WTO membership received broad support by the international community, including the World Bank and the European Commission.

In June, the government initiated a number of policy actions intended to further liberalize the Ukrainian economy. Following the abolition of the mandatory sale of 50% profits received from export operations in March, the government lifted the mandatory requirement to register foreign trade contracts in June. The possibility to abolish the 90-day obligatory return of foreign currency receipts and other measures to liberalize the money market are being actively discussed by government authorities.

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