

Ukrainian Odyssey: Economy 2006 and Investment Climate

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PART ONE: Economy 2006

Overview

Between 2000 and 2005, Ukraine enjoyed excellent macroeconomic performance. In 2005, the economy decelerated, showing a low GDP growth rate of 2.6%. This deceleration was due to unfavorable external conditions and sluggish investment activity, and occurred despite buoyant domestic consumption, which expanded by 12.7% year-over-year (yoy). Nevertheless, over the last six years on average, Ukraine's economic performance compares favorably to other emerging European economies. In particular, the average real GDP growth for 2000–2005 reached 7.4% yoy, considerably above the average 5% growth in the region. For six years in a row, Ukraine reported current account surpluses of about 5% of GDP on average for the period.

Due to the relatively high degree of concentration of Ukraine's merchandise foreign trade in a few commodities, Ukraine proved to be quite vulnerable to the changes in external demand for basic export goods (e.g., mineral and metallurgical products) in 2005. On the back of declining world prices for steel, rising energy prices, and declining foreign demand for Ukraine's machinery and equipment, Ukraine's export growth deteriorated while imports continued to grow at a relatively high rate. Although the merchandise trade balance turned into a deficit of \$1.85 billion, the overall trade balance remained positive reaching \$1.4 billion thanks to strong foreign trade of services.

The slowdown in investment activities in 2005 is attributed to political and policy uncertainties and a change in the orientation of fiscal policy towards social expenditures. Unanticipated changes in tax legislation (introduced by an amended 2005 state budget) and re-privatization talks affected investor sentiment. At the same time, expansionary social policy caused reallocation of budget resources, restraining the investment potential of the state, which played an important role in economic growth in the previous two years.

In 2006, the Ukrainian economy is expected to grow at a rate similar to 2005, despite a number of adverse external shocks. The most significant negative shock is the recent increase in imported gas prices. Nevertheless, private consumption will remain the key driving force of GDP growth in 2006. Investment activity is likely to start rebounding in the second half of 2006, soon after the political uncertainty associated with parliamentary elections diminishes, while real growth of imports will continue to surpass real growth of exports. In the medium-term, investments

in energy-saving technologies (stimulated by an adverse external shock) will lead to diversification of the economy and raise the competitiveness of Ukraine's producers on world markets, thereby building a sound base for sustainable economic growth. Beyond 2006, GDP growth is expected to be around 5% per annum.

The fiscal situation at the beginning of 2005 raised concerns due to the substantial increases in social spending made in the run-up to the presidential elections. These increase in expenditures was not foreseen either in the 2004 or 2005 budgets. Moreover, the new government not only preserved all social liabilities made in 2004 but continued to raise pensions and other social benefits. However, by eliminating tax exemptions and privileges, eliminating the free economic zones, improving customs collections (thanks to an anti-smuggling campaign) and stronger tax administration, the government was able to control the consolidated fiscal deficit in 2005 to 1.8% of GDP, a level below the target and in accordance with IMF recommendations.

In 2005, monetary policy was aimed at lessening inflationary pressures generated by sizable foreign exchange interventions and vigorous consumer spending growth. Although moderate tightening of monetary policy did contribute to deceleration of inflation, inflation remained in double digits as prices were primarily driven by non-monetary factors. However, the 2005 inflation rate of 10.3% is acceptable given the economic shock suffered by the country.

During 2005, the NBU continued to pursue de facto fixed exchange rate policy targeting. However, increasing inflationary pressures prompted the NBU to appreciate the hryvnia exchange rate against the US dollar by 4.8% in spring 2005. Since then, the exchange rate has been stable at 5.05 UAH/\$. This allowed the NBU to further accumulate reserves with a lower inflationary impact. Gross international reserves surged to a record high \$19.4 billion, or about 5 months of imports.

In 2005, the banking system quickly recovered from the short period of liquidity shortage at the end of 2004. Despite tightening measures by the central bank, there was excess liquidity in the banking system, fueled by robust growth of deposits, central bank interventions on the forex market, and intensified commercial bank borrowings from abroad. This allowed commercial banks to further boost lending

and reduce the cost of loans. At the same time, the high rates of commercial lending growth raise concerns regarding the increasing exposure of the Ukrainian banking sector to various risks — credit, foreign exchange and interest rate. In fact, the level of non-performing assets is already high. Being aware of these risks, the NBU has been taking steps to improve the banking sector's performance and stability by strengthening its regulatory and supervisory framework and encouraging commercial banks to improve their risk management.

Despite deteriorating external conditions, Ukraine's current account balance generated a healthy surplus of \$2.5 billion or 3.1% of GDP in 2005. A considerable surplus in foreign trade of services more than compensated for the small merchandise foreign trade deficit. The financial account also showed remarkable improvement in 2005 compared to the previous year. This improvement was due to record high growth of net foreign direct investment (FDI) as well as an intensification of private borrowings from abroad. In 2005, net inflow of FDI in Ukraine reached \$7.3 billion, which almost equals the total amount of FDI attracted since independence. This impressive inflow of foreign direct investments was achieved primarily thanks to two large privatization deals. Nevertheless, it shows positive changes in the country's image.

During 2005, the total amount of public and publicly guaranteed debt decreased by about 4% to \$15.47 billion. This decrease was mainly due to the country's strategy of limited borrowing and thoughtful public debt management. The ratio of public debt to GDP declined from 24.8% in 2004 to less than 19% in 2005, a fairly moderate level by international standards.

Despite a few controversial economic policy measures taken in 2005, Ukraine continued to make progress in improving its investment climate. In particular, the government authorities undertook the following reforms and measures during 2005:

- Most tax privileges and exemptions, including free economic zones, were eliminated by the amendments to the 2005 Budget Law;
- The government tried to reduce the number of business-related regulations, reviewing a large number of existing regulations and eliminating those that were declared damaging for further business development;
- A number of efforts were made to simplify business registration, licensing and permits;
- An obligatory analysis of the impact of the draft laws on business activities if they are adopted was introduced;

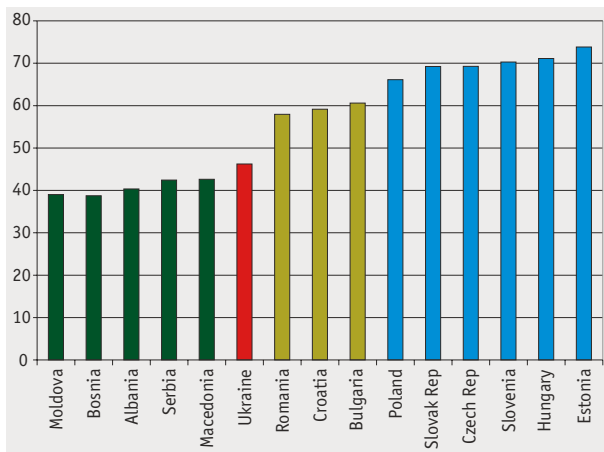
- The legislative framework for intellectual property rights protection, insurance, financial intermediation, stock market, judiciary and others was improved; efforts were made to bring legislation to western standards;
- The government initiated the development of a strategy for carrying out comprehensive judiciary reform, and tried to tackle the problem of underfinancing;
- Although the "re-privatization" program triggered much concern among businesses, especially foreign investors, the disputed privatization deals were contested in courts and the re-sale was limited to the successful Kryvorizhstal sale, which brought in \$4.8 billion;
- Substantial progress has been made in liberalizing cross-border movements of goods and capital. In particular, tariff rates on about 90% of overall Ukraine's imports were reduced, the highly prohibitive central bank resolution regarding foreign investments was substituted with a much softer regulation, and the 50% surrender requirement was abolished. Additionally, Ukraine advanced in its WTO bilateral negotiations and adopted several laws important in view of WTO accession; it has also finalized long negotiated steel and textile agreements with the EU;
- In the context of financial sector liberalization, the procedures for foreign investing in and divesting from Ukraine by non-residents were liberalized, as was interbank trading;
- Steps were taken to reduce corruption and the size of the shadow economy. In particular, the extensive anti-smuggling campaign for customs and a number of legislative initiatives designed to tackle corruption were launched. Ukraine intensified its participation in global and regional anti-corruption organizations and initiatives;
- The peaceful struggle of Ukrainians for freedom and democracy expressed during the Orange Revolution, the orientation of Ukraine's foreign policy towards the EU and the adherence of domestic policies to democratic values have substantially improved the country's image.

However, progress in many other areas affecting the business environment was rather slow compared to other emerging European countries. In particular, there is considerable room for improvement in public governance, corporate governance, the legal and judiciary system, business regulation, reducing the cost of operating businesses, combating corruption and others. There is also the risk that

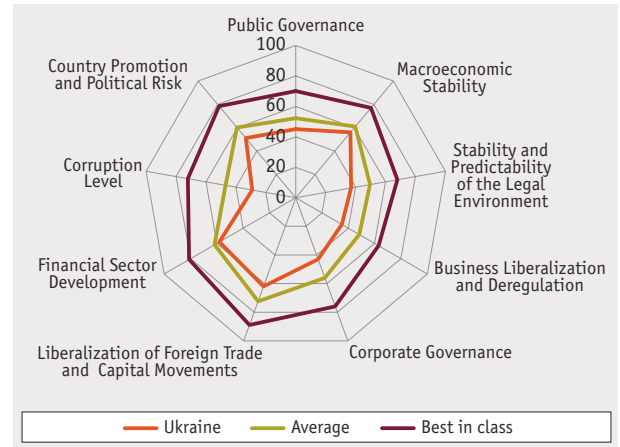
macroeconomic stability can be undermined by the socially-oriented fiscal policy, that potential banking sector problems may emerge, that more external shocks may appear, and that political instability may continue beyond mid-2006 due to disagreements on constitutional reform and the results of the parliamentary elections of March 2006.

Nevertheless, a review of the investment climate in Ukraine compared to the business environments in neighboring countries shows that Ukraine (marked red) is relatively well-placed. Although its investment climate is not as strong as those of the countries that recently joined the EU (marked blue) or those acceding to it in the near future (marked olive green), it compared well with other countries in the new EU frontier (marked dark green). This is shown in the chart below.

SigmaBleyzer's Investment Climate



SigmaBleyzer's Nonagon: Ukraine

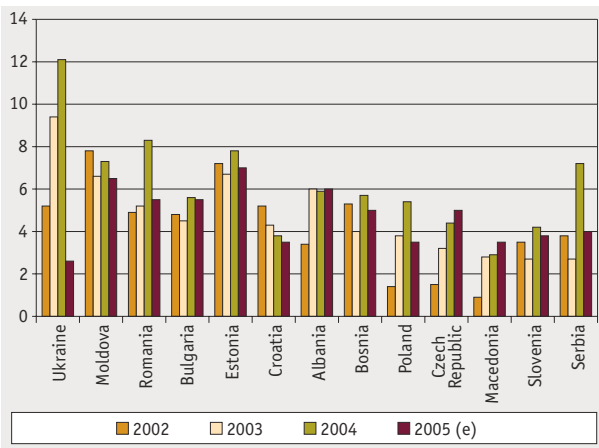


Subsequent sections of Part One present the results of Ukraine's economic development in 2005 and discuss the future prospects for 2006. Further sections in Part Two discuss the investment climate and propose specific policy recommendations to improve it. The evolution of the key economic indicators for 2000–2005 and projections for 2006 are provided in the appendix.

1. The Real Economy

After five years of significant economic growth, the Ukrainian economy decelerated in 2005 showing a low GDP growth rate of 2.6%. As discussed below, this deceleration was mainly due to poor export performance and a reduced level of investments, despite the fact that domestic consumption expanded vigorously. In 2004, real GDP growth exceeded expectations, posting a record high growth rate of 12.1%. Such remarkable growth propelled the country to the top position among other transition economies. By real GDP growth, Ukraine outperformed not only all transition countries in 2004, but was among the top economies in the world. Despite the deceleration in 2005, the average economic growth in the last five years placed Ukraine as one of the most quickly growing economies in the region. Over the five years ending December 2005, average real GDP growth in Ukraine reached 7.7%, which is far above the 5% average for Central and Eastern European Countries and is in line with the 7.9% average for CIS countries.

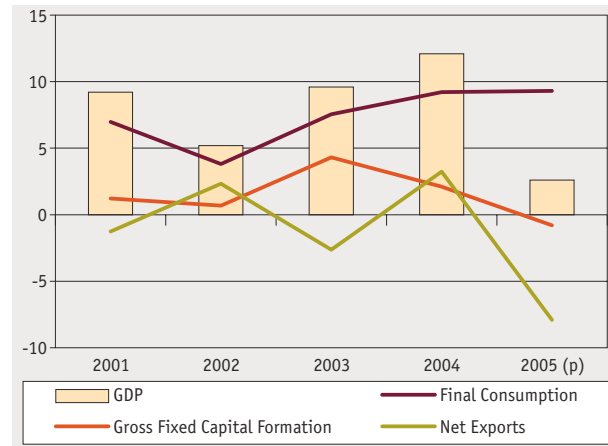
Real GDP Growth in Ukraine and Selected Transition Economies, %



Source: EBRD, State Statistics Committee

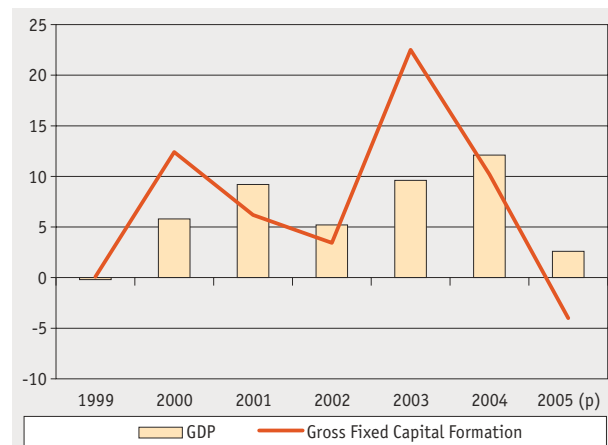
On the demand side, stable expansion of final consumption was the major driving force of the economic growth achieved over the entire period from 2001 to 2005. In real terms, final consumption increased by 12.2% yoy in 2004 and posted an even higher growth rate of 12.7% yoy in 2005. Consumption by households, which accounts for more than two-thirds of final consumption, posted 15.1% yoy and 15.9% yoy increases in 2004 and 2005 respectively. The stable rise in households' consumption was backed by a rapid increase in real household income, partially fuelled by an increase in social transfers and growth in the minimum wage. Growing spending on individual services, like health care and education, supported an increase in state consumption, which constituted 5.4% yoy in 2004 and 4.1% yoy in 2005.

Contributions to GDP Growth by Expenditures, % yoy



Source: State Statistics Committee

Real Growth of Gross Fixed Capital Formation and GDP, % yoy

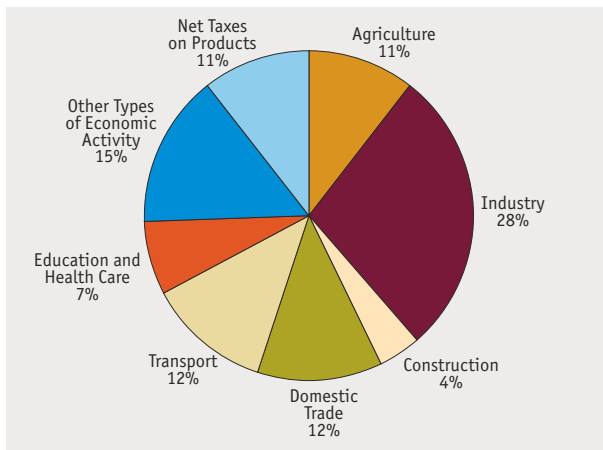


Source: State Statistics Committee

Investment demand played an important role in economic growth in 2003 and 2004, as noted in the chart above. Gross fixed capital formation contributed about 50% of the GDP growth achieved in 2003 and about 20% of the growth in 2004. Several large projects (in particular, in infrastructure) financed by the state were an essential source of investment growth in these years. However, investment activity was sluggish throughout 2005 with gross fixed capital formation posting a 4.0 % decrease, contributing to the slowdown of economic growth. This was due to political and policy uncertainties and a change in the orientation of fiscal policy towards social expenditures. Unanticipated changes in tax legislation, introduced by an amended 2005 state budget, and re-privatization talks affected investor sentiment, while expansionary social policy caused reallocation of budget resources, restraining the investment potential of the state.

Net exports of goods and services have been the most volatile component of GDP over the last few years. Fuelled by rapid expansion of external demand, especially for metallurgical and chemical products and machinery, exports of goods and services accelerated to 13.8% yoy in real terms in 2004, up from 10.3% in 2003. On the other hand, growth of imports declined almost two times to 8.6% yoy in 2004. Accordingly, accelerating exports and decelerating imports was another factor explaining the outstanding economic performance in 2004. As external conditions reversed in 2005, exports declined sharply by 13.6% yoy in real terms. Backed by sluggish investment activity, imports slowed as well, but at a much slower pace than exports. In real terms, imports of goods and services posted a slight decrease of 0.8% yoy in 2005. Such a radical change in external conditions was the major cause of decelerating GDP growth in 2005.

GDP Structure by Sectors in 2004



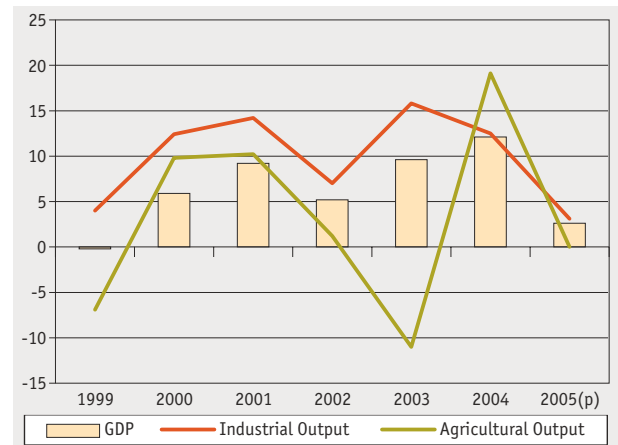
Source: State Statistics Committee

By sector breakdown, industry, agriculture and transportation services were the key drivers of GDP growth over the last few years. Altogether, these sectors explained over 60% of the GDP increase in 2005. Real industrial output went up by 3.1% yoy in 2005, driven by manufacturing industries' performance. Backed by robust domestic consumption demand, output in food and food-processing sped up to 13.7% yoy in 2005. The chemical industry also showed a high 10% yoy increase in output thanks to favorable external conditions. At the same time, metallurgy performed quite poorly in the second half of the year following the reduction of world metal prices. Growth of machinery and equipment production also decelerated somewhat, reflecting reduction of exports of these products and contracting investment demand inside the economy, but remained at a decent 7.1% yoy.

Thanks to favorable weather conditions, the agricultural sector performed strongly two years in a row. Performance of the sector was driven mostly by harvest of

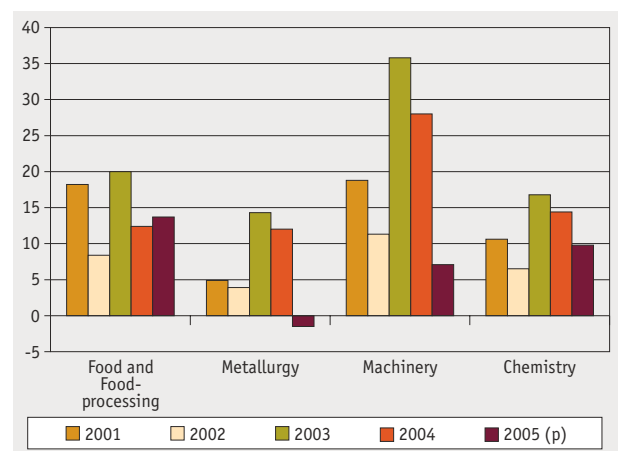
wheat and other cereals. Favorable weather conditions allowed for a good wheat harvest of 18.7 million tons in 2005, which is about 7% higher than the year before. But due to a high statistical base effect and lower harvest of other agricultural plants, agricultural output reported zero growth in 2005 compared to 19.1% yoy in 2004, which followed a year of poor farming yield.

Growth of Industry, Agriculture and Real GDP, % yoy



Source: State Statistics Committee

Output Growth in Selected Industries, % yoy



Source: State Statistics Committee

In 2005, the service sector decelerated slightly compared to 2004, mainly due to reduction of value added in wholesale trade. Poor performance of the wholesale trade sector mirrored slowing exports and sluggish investment activity. As a result, growth of value added in domestic trade declined by 8.3% yoy. However, other types of services posted stable growth of value added, partially compensating for the reduction in domestic trade. In particular, the transport sector showed a 7.4% yoy increase in value added, contributing around 30% to economic growth. Overall, the service sector occupies about 48% of Ukraine's GDP and remains relatively low compared to other transition economies, where services hold more than 55% of GDP (i.e., Bulgaria,

Poland, Czech Republic). But the existence of the weak service sector indicates a high potential for its future expansion.

Future Prospects

In 2006, the Ukrainian economy is expected to grow at a rate of 2.5% (comparable to the rate achieved in 2005) despite a number of adverse external shocks. The most significant effect on the pace of economic growth in 2006 is the recent increase in gas prices. Higher production costs should worsen the performance of several energy-intensive industries, like metallurgy, chemistry, and (to a lesser extent) machinery. However, the possible reduction in output of these industries is expected to be compensated by strong growth of food-processing as well as service sectors primarily oriented toward domestic consumers. Among services, wholesale trade is likely to restore its growth rate following a year of reduction. Along with robust growth of retail trade backed by continuing expansion of private consumption, the rebound of wholesale trade will drive the growth of domestic trade to comfortable levels. The 2006 agricultural harvest is likely to be lower than in the two previous years due to the extremely cold winter that harmed part of the winter crops. This will generate a modest decline in agricultural output. On the contrary, the construction sector is likely to restore its growth rates reflecting the intensification of investment activity in the second half of 2006.

On the demand side, private consumption will remain the key driving force of GDP growth in 2006. Expansion of household consumption demand will be supported by a continuing increase in the real income of the population. However, the growth rate of disposable income is expected to decelerate somewhat in real terms partially due to less ambitious increases in social transfers and minimum wages in the 2006 budget as well as the relatively high

inflation rate. State consumption is likely to grow at reasonable rates, thus contributing to GDP growth.

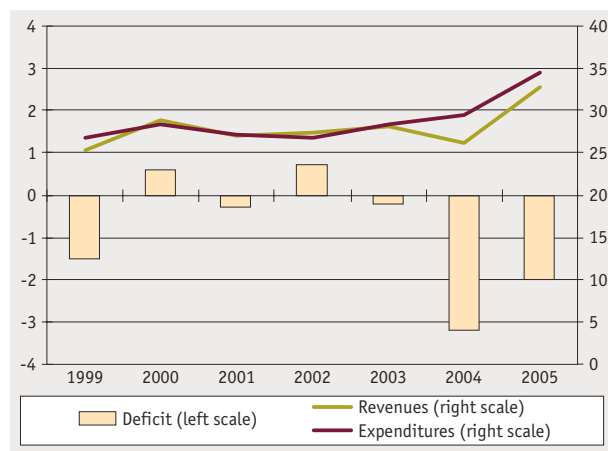
Investment activity is likely to start rebounding in the second half of 2006, soon after the political uncertainty associated with parliamentary election diminishes. The increased needs of many large enterprises for new energy-saving technologies following the gas price hikes will give additional impetus to the accumulation of fixed capital. Although no drastic increases in investment are expected in 2006 due to anticipated modest progress in core large-scale reforms, the gross fixed capital formation is expected to expand at a sufficiently high level.

Real growth of imports will continue to surpass real growth of exports in 2006. Imports will be stimulated by robust internal demand for consumption goods, liberalization of tariff barriers as well as restoration of demand for investment goods in the second half of 2006. New conditions of gas imports will have no direct effect on merchandise imports as physical volumes of imported gas are contracted to stay approximately the same. At the same time, real exports are likely to exhibit only a trivial increase due to the reaction of major export-oriented industries to the gas price shock, the certain decrease of world metals prices expected in 2006 as well as lower external demand caused by a slowdown of world economic growth.

Although Ukraine's GDP will grow in 2006 at a modest rate of 2.5%, the rate of growth should pick up to about 5% per year in the following years. In 2006, Ukraine will suffer worsening external conditions and a painful adjustment to new gas prices. But these adverse external shocks will have a positive effect on the Ukrainian economy in the medium-run, as investments in energy-saving technologies will reduce dependence by the industrial sector on one type of energy and raise the competitiveness of Ukraine's producers on world markets, thereby building a sound base for sustainable economic growth.

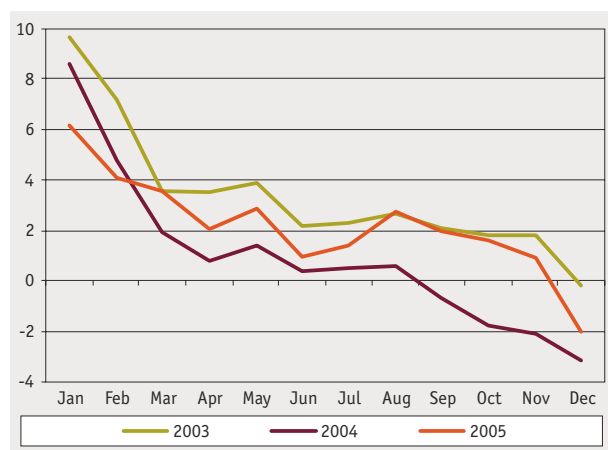
2. Fiscal Policy

Consolidated Budget Parameters, % of GDP



Source: Ministry of Finance, NBU

Consolidated Budget Balance Developments, % period GDP, 2003–2005



Source: Ministry of Finance

In 2005, fiscal policy was expansionary due to large increases in pension payments and other social benefits approved by the government. The initial increases in social benefits were decided by the previous government in the fall of 2004 in the run-up to the presidential elections. In particular, the former government decided to provide a pension supplement to each person who received pensions below the subsistence level in the amount needed to reach the subsistence level, effective in September 2004. According to rough estimates, about 11 million people were eligible for the targeted supplement. This decision changed the outlook for the fiscal budget for the rest of 2004 and the next few years. As a result, the 2004 consolidated fiscal balance sharply deteriorated to 3.2% of GDP instead of the planned 1.75% of GDP. Including extra-budgetary funds (such as the pension fund), the consolidated public sector deficit reached 4.4% of GDP in 2004. In the

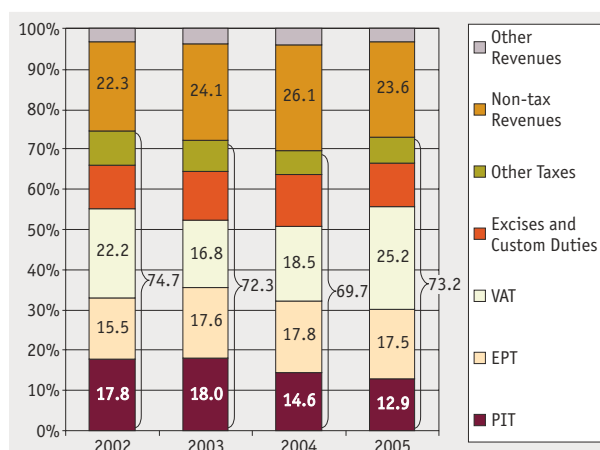
first half of 2005, the new government not only preserved all social liabilities made in 2004, but continued to raise further pensions and other social benefits.

The original 2005 fiscal budget envisaged a deficit of 2.1% of GDP. However, the large social liabilities incurred in early 2005 and a cooling economy posed considerable challenges for the government to maintain the 2005 budget deficit at a reasonable level. In fact, early estimates suggested that the fiscal deficit could have reached almost 5% of GDP if the government had not undertaken strong measures to increase revenues. These increases in revenues were achieved by eliminating tax exemptions and privileges, eliminating the free economic zones and improving customs collections (thanks to the anti-smuggling campaign). On this basis, the government was able to control the consolidated fiscal deficit in 2005 to a moderate 1.8% of GDP deficit, in accordance with IMF recommendations.

Fiscal Revenues

In 2005, fiscal revenues grew substantially by 48% yoy in nominal terms, despite an economic growth slowdown and a worsening merchandise foreign trade performance. The 2005 growth in fiscal revenues was more than twice that achieved in the previous year, when fiscal revenues grew by a nominal 20.5% yoy and were supported by remarkable macroeconomic performance (impressive 12.1% yoy GDP growth, a large foreign trade surplus, etc.) Such remarkable growth is primarily attributed to the government's efforts to increase the tax base and improve tax administration.

Consolidated Budget Revenues, % of total



Source: Ministry of Finance, NBU, The Bleyzer Foundation

As in the previous year, the proceeds from enterprise profit tax (EPT) and personal income tax (PIT) were affected by tax reforms introduced at the beginning of 2004. In particular, the EPT rate was reduced to 25% down from 30%, while the previous progressive scale for the PIT (10–40%) was replaced by a 13% flat rate.

The EPT rate reduction had a positive effect on broadening the tax base, as it encouraged legalization of shadow profits. In addition, the tax base was further expanded by the elimination of privileges and exemptions contained in the Law "On Enterprise Profit Tax" in accordance with the amended 2005 State Budget Law. As a result, EPT receipts grew by about 45.2% yoy in nominal terms in 2005, twice as high as in the previous year. Although the share of profitable enterprises declined slightly in 2005 compared to the previous year, the higher growth rate of EPT proceeds was achieved thanks to the measures to expand the tax base.

PIT performance in 2005 was also better. PIT receipts increased by a nominal 30% yoy in 2005, considerably outperforming the nominal 2.3% yoy decline in 2004. However, this performance should be partially attributed to a low base effect and faster nominal growth of household disposable income in 2005 compared to 2004 (36.4% yoy versus 27% yoy respectively). Nevertheless, the share of PIT in total budget revenues continued to decline to about 13% versus 14.6% in 2004 and 18% in 2003. Though PIT receipts grew by more than 30% yoy in nominal terms, one would expect much higher growth if one takes into account the 36.4% yoy nominal increase in household disposable income. This suggests that the expectations of further formalization (or de-shadowing) of population income did not materialize. This may be attributed to the fact that the high payroll tax was left unchanged. Realizing that the introduction of a flat tax rate in 2004 per se was insufficient for the de-shadowing of the population's income, the new government started an extensive media campaign advocating legalization of income. However, until the root of this problem — a high payroll tax — is properly addressed, the relevance of this tax source will continue to decline.

In 2005, proceeds from value-added tax (VAT), netted for VAT refunds to businesses, were the largest contributors to the growth of tax revenues. In 2004, almost 33% yoy of the nominal increase in VAT proceeds was due to outstanding real sector performance, robust imports and elimination of a number of VAT exemptions at the beginning of the year. Nevertheless, even after the elimination of these exemptions, remaining VAT exemptions were estimated

by the IMF at about 1% of GDP. Inefficiencies in regulations and procedures allowed many businesses to submit fraudulent refund claims to the government, while the authorities' measures to address the issue were only partially successful.

At the beginning of 2005, the problem with accumulation of VAT refund arrears became very acute. Following an audit carried out by the State Tax Administration (STA), VAT refund arrears were estimated at about UAH 3.5 billion (about \$660 million) at the end of 2004, although the actual claims were much higher. Due to execution of this large-scale audit of VAT refund claims initiated in early 2005, the clearance of VAT refund arrears was temporarily suspended. This resulted in rapid accumulation of arrears and over-performance of VAT revenues. Following the adoption of the amendments to the 2005 State Budget at the end of March 2005, a number of tax privileges for specific enterprises and industries, as well as free economic zones, were abolished. A lot of VAT privileges and exemptions were eliminated (including those for imported goods to free economic zones), while the tax rate was kept unchanged¹. In addition, VAT administration was considerably toughened. As a result, VAT proceeds more than doubled in nominal terms compared to 2004. Although this figure is somewhat exaggerated due to VAT refund arrears, the scale of improvement signifies the progress in tax administration and tax base broadening.

Fiscal Expenditures

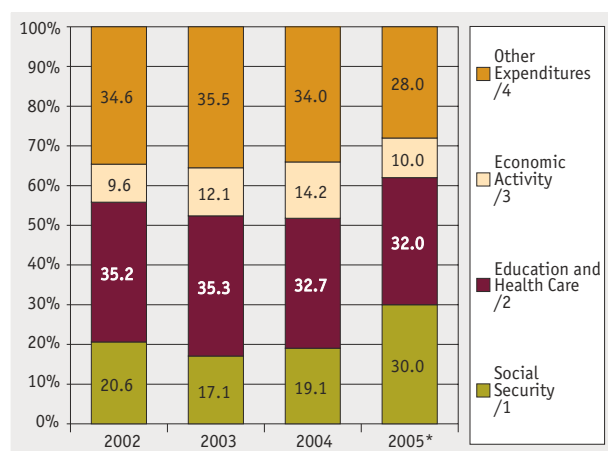
During the first eight months of 2004, fiscal expenditures were managed prudently, in line with the previous years' strategy, when most controllable fiscal expenditures were under-executed until the end of the year to avoid the threat of excessive deficit financing. However, in the last four months of 2004 and in 2005, the execution of fiscal expenditures was more challenging due to the considerable fiscal relaxation in autumn 2004 and the loose fiscal policy in 2005. In particular, the introduction of pension supplements, which actually meant an increase in minimum pension by about 118.5% to UAH 284 (\$54), resulted in an unprecedented increase in social liabilities. As a result, only in the month of September 2004, the fiscal balance ran a deficit of about 1% of GDP, while the year-end fiscal deficit constituted 3.2% of GDP. According to IMF methodology, the overall fiscal deficit, including the deficits of pension and other state funds, was even higher at 4.4% of GDP.

At the beginning of 2005, the minimum pension was raised further by another 17% to UAH 332 (\$63).

¹ During 2004, the government several times expressed intentions to reduce the VAT rate to 17%, down from the current 20%; however, they were not implemented.

However, neither this increase nor the previous ones were envisaged in the 2005 State Budget Law, thus increasing the implicit fiscal deficit to about 5% of GDP. The need to finance all social security payments, including pension outlays promised by the previous government and social programs announced by the new president during the election campaign was the main reason for amending the 2005 budget in March 2005. Thus, the amended 2005 budget envisaged an increase in the minimum wage by 40%, an increase in the average pension by 28% yoy² and the other social benefits (such as benefits for childbirth, disability, etc.)

Consolidated Budget Expenditures, % of total



* Preliminary data

/1 The 2004 indicator for social care and protection expenditures is underestimated since pension supplements introduced in September 2004 were not included in the consolidated budget statistics for that year.

/2 About 60% of this item's expenditures are allocated for education.
/3 Comprised of the fuel and energy sector, industry, construction, agriculture, transport and communications.

/4 State administration, law enforcement and defense account for the majority of other expenditures.

Source: Ministry of Finance, NBU, The Bleyzer Foundation

The ratio of budget expenditures to GDP grew from 29.7% of GDP in 2004 to 33.8% of GDP in 2005, the highest level since 1998, the lion's share of which was directed at financing social programs. These generous social expenditures severely crowded out expenditures for public economic activities and other areas such as state administration, law enforcement and defense. In particular, the government financing of economic activity (except for agriculture) declined by about 30% yoy in nominal terms in 2005. A number of important areas in which government involvement is necessary (due to the presence of externalities, or public goods such as in infrastructure, law enforcement, defense, etc.) were underfinanced.

² September 2004's hike of pensions resulted in the situation when about 80% of all pensioners received the same pension, which was equal to the subsistence minimum level of UAH 284, irrespective of their contribution history. Hence, pension differentiation measures were required to restore the link between benefits and contributions, one of the basic rules of the pension reform that took effect at the beginning of 2004.

³ In particular, since the beginning of 2006 pension insurance contribution was reduced by 0.5 pp to 31.8%, unemployment insurance contribution was reduced by 0.3 pp to 1.3%, contributions in case of accidental disability were reduced by 0.2 pp.

Future Prospects

At the end of December 2005, the Parliament adopted the 2006 State Budget with targeted budget revenues of UAH 125 billion (\$24.8 billion) and expenditures of UAH 137.1 billion (\$27.1 billion). The approved targeted deficit was UAH 12.9 billion (\$2.5 billion), or about 2.6% of GDP. The execution of these budget parameters will be a challenging task since the budget was developed on the basis of overly optimistic macroeconomic assumptions (in particular, a high 7% yoy real economic growth). Moreover, the budget was developed keeping the price of imported gas from Russia and Turkmenistan unchanged from the 2005 level. The increase in gas prices will affect the fiscal budget situation, adding to the fiscal pressures already in place due to large social liabilities. In addition, if the government decides to continue to subsidize households via low utility tariffs and support affected industries, the consolidated fiscal deficit may well exceed the 3% of GDP threshold considered sustainable by international organizations. At the same time, we believe the government has enough expenditure control tools to keep the budget deficit under control. In fact, due to the consolidation of all budget funds and expenditures in a unified treasury account, the government may efficiently manage the fiscal balance through tight control over expenditures. We therefore anticipate that the fiscal deficit will be maintained at about or below 3% of GDP in 2006.

Due to the recurrent nature of the social liabilities taken during 2004–2005, the share of budget expenditures directed at financing social programs will remain high in the future, but is unlikely to increase further. Although the 2006 budget envisages further increases in minimum wages, pensions, and other social outlays, the increase will be rather moderate, mostly adjusting for inflation. As a result, the consumption component of the 2006 budget expenditures will decline slightly from 80% in 2005 to about 76% in 2006. It is very likely, however, that the budget will be amended shortly after March's parliamentary elections. There is a general view that future budgets should focus more on economic development and investment needs.

The 2006 budget envisages a small reduction in several tax rates, such as a 1 percentage point (pp) cut in the payroll tax rate³ and a 0.2 pp reduction in the pension duty on foreign exchange sales to 1.3% (the duty was introduced in 1998–1999 to narrow the shortage of pension fund revenues). Such a modest decrease does not do much to ease the tax pressure

for businesses. Due to the recent parliamentary elections, the long-awaited comprehensive tax reform is unlikely to commence before 2007. On a positive note, the 2006 budget envisaged fewer adjustments to tax legislation and the business environment than the 2005 budget. In 2005, the slow adjustment of the economy to the significant changes in the business environment immediately implied by the amendments to the 2005 Budget Law also contributed to economic growth slowdown.

The pension fund situation remains rather difficult. In 2005, the pension fund reported a deficit equivalent to about 3.5% of GDP, which was entirely financed from the consolidated budget. In 2006, the deficit is forecasted to decline slightly to about 2.1% of GDP, mostly due to a moderate increase in pension outlays in 2006 and a reasonable increase in wages. The high pension fund deficits during 2004–2006, and most likely in the next few years,

suggest that there is an urgent need for accelerating implementation of pension reform in Ukraine.

The fiscal deficits of 2004 and 2005 were largely financed by out-performing privatization receipts. However, being non-recurrent fiscal receipts, privatization revenues can not be regarded as a reliable source of fiscal deficit financing for future periods, especially when the deficit stems from recurrent social security and wage bills. Thus, to bring government expenditures more in line with revenues, a number of policy measures are required. In particular, fiscal deficits can be brought under control through comprehensive public administration reform and a number of bold political measures directed at rebalancing the pension fund. In order to increase fiscal revenues on a sustainable basis, the government will also need to undertake major economic reforms to accelerate investments and economic growth, as explained in Part Two of this report.

3. Monetary and Exchange Rate Policies

Due to the growing inflationary pressures experienced during 2004, the NBU moderately tightened its monetary policy in early 2005. Nevertheless, inflation accelerated to double digits in 2004–2005 (12.3% and 10.3%, respectively) and was primarily driven by non-monetary factors (a number of supply-side shocks, loose fiscal policy, etc.). Monetary tightening, however, did not significantly affect the liquidity position of the banking sector or its potential to disburse loans to the private sector. Except for a short period of liquidity shortage at the end of 2004, there was excess liquidity in the banking system, fueled by robust growth of deposits and central bank interventions on the forex market, which allowed commercial banks to further boost their lending and reduce the cost of loans.

During most of 2004–2005, the NBU maintained a de facto targeting of the hryvnia exchange rate against the US dollar. However, increasing inflationary pressures in 2005 forced the NBU to appreciate the UAH/\$ exchange rate by 4.8% to 5.05 UAH/\$ in spring 2005. During 2004–2005, the central bank took a number of steps towards liberalization of the foreign exchange market. These matters are discussed in greater detail below.

Money Supply

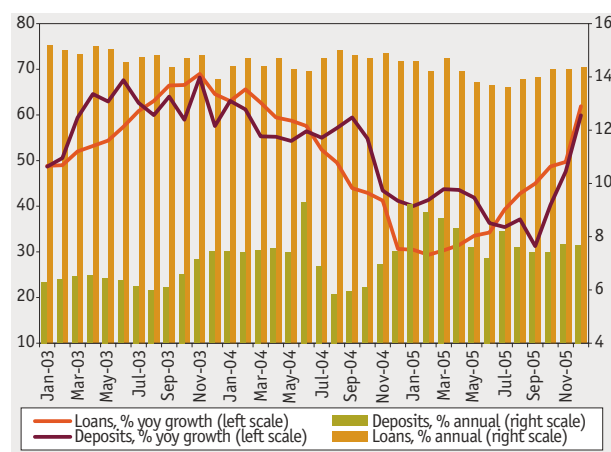
In 2005, monetary policy did not change substantially from the previous year. As in previous years, monetary policy was affected by sizable foreign exchange interventions (which led to rapid expansion of deposits and bank loans to the private sector). During January–October, the average growth rates of the monetary base and money supply were 35.5% and 36.4% yoy, respectively, which is similar to the rates achieved in 2004 (34% and 32% 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 considerable fiscal loosening at the end of 2005.

During the first part of 2004, the monetary conditions were rather loose with the money supply growing at a high rate of 45% yoy. This growth was caused by considerable NBU interventions on the foreign exchange market to maintain a de facto peg of the hryvnia exchange rate. At the same time, such rapid money growth was not fully reflected in the inflation rate, as it was accompanied by fast expansion in money demand stemming from remarkable economic growth. As a result of sharp and unanticipated fiscal loosening in the run-up to the

presidential elections, the growth of money supply soared to 50.6% yoy in September. However, inflationary expectations and political uncertainty due to presidential elections led to an upsurge of demand for cash foreign exchange shortly thereafter. As a result, money supply growth dropped to 32.4% yoy in December 2004.

Responding to high inflationary pressures, the NBU started a moderate tightening of its monetary stance in 2005. In particular, the NBU tightened reserve requirements to commercial banks, increased its refinancing rate to 9.5%, and intensified sterilization operations. To curb rapid expansion of bank credit to the private sector, which contributed to rising inflationary pressure, the central bank tightened reserve requirements to commercial banks. However, these measures did not significantly affect credit activity in the country. In 2005, 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) due to a high base effect. As the banking sector recovered from the near liquidity crisis at the end of 2004 (due to massive withdrawals of deposits), the cost of bank lending started to decline and reached 13.6% per annum in July. However, a number of restrictive NBU measures, introduced during August–September, resulted in a gradual increase in lending rates to 14.3% per annum in December. At the same time, the weighted average bank lending rate declined to 14.2% per annum, down from 14.5% in 2004.

Loan and Deposit Growth and Interest Rate Dynamics

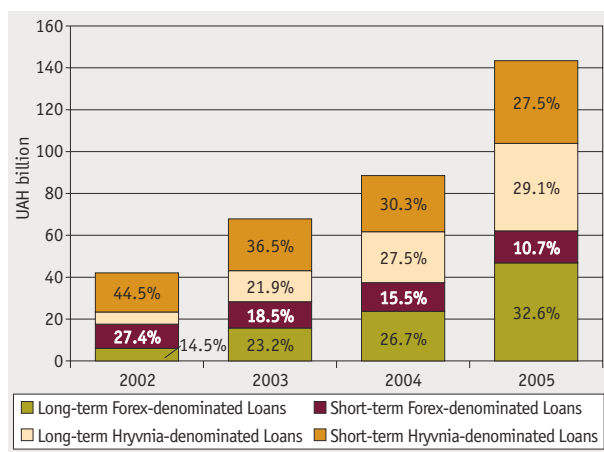


Source: NBU

High deposit growth, strong money demand and increasing commercial bank borrowing from abroad were the driving forces of lending expansion. Although deposit rates declined from 9.2% at the beginning of the year to 7.7% at the end of 2005 and were

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. During the respective months last year, the stock of household deposits at commercial banks shrunk by 8% in two months as people massively withdrew their hryvnia-denominated deposits and converted them into foreign currency-denominated deposits (up 1% over the same period) or cash for foreign exchange. In this way, people responded to political uncertainty related to the Orange Revolution.

Commercial Banks' Loans by Currency and Maturity Structure, 2002–2005



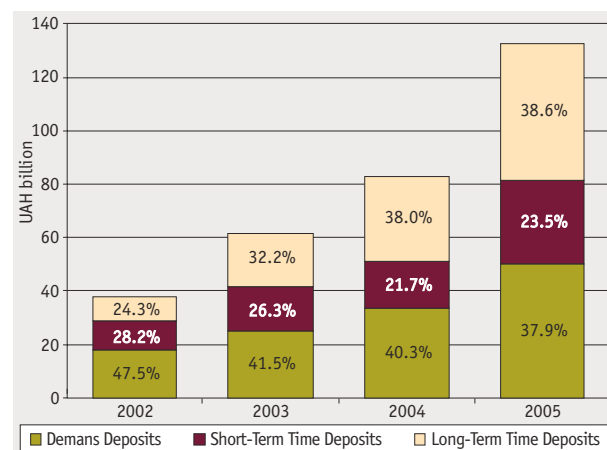
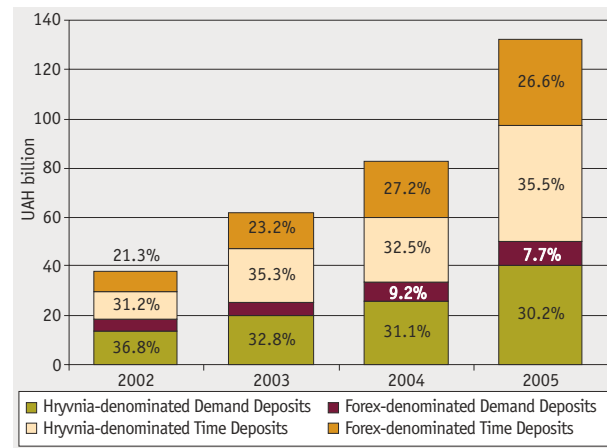
Source: NBU, The Bleyzer Foundation

Based on the NBU data, the ratio of domestic credit-to-GDP⁴ reached an impressive 34.3%, compared to 25.7% in 2004 and 2003. Although high availability of bank credit is important to support the growth of economic activity, such high rates of commercial lending growth raise concerns regarding the banking sector's vulnerability to various risks — credit, foreign exchange and interest rate. The credit risk is related to the quality of banks' credit portfolios. The rapid increase in lending on the back of low capitalization of the Ukrainian banking system, generally weak accounting and reporting standards for legal entities and widespread related-party lending raised concern regarding a possible increase in non-performing loans (NPLs). Indeed, according to IMF estimates, the share of NPLs to total loans increased slightly from 28.3% in 2003 to 30% in 2004. However, it started to decline in 2005 and dropped to about 23% at the end of June 2005. The share of NPLs looks rather high compared to other countries. In part, this may be explained by the more stringent NBU methodology of defining sub-standard loans. Excluding timely serviced

⁴ For the ratio calculation, credit to real sector was used.

substandard loans, the share was 8.9% of total loans in 2004 (up slightly from 8.5% in 2003) and dropped to 6.6% at the end of June 2005.

Commercial Banks' Deposits by Currency and Maturity Structure, 2002–2005



Source: NBU, The Bleyzer Foundation

The other risks stem from the high share of foreign-currency denominated loans and differences in maturity of commercial bank credits and deposits. In particular, the share of commercial banks' foreign currency loans to the economy of Ukraine increased to 42.2% and 43.3% in 2004 and 2005 respectively, up from about 41.7% in 2003. At the same time, the share of foreign currency deposits constituted 36.4% and 34.3% in 2004 and 2005 respectively, slightly up from about 32% in 2003. The increase in the share of foreign currency deposits in 2004 is attributable to the shift in public sentiment before the presidential elections, which resulted in massive withdrawals of deposits (especially hryvnia deposits) or their conversion into foreign currency. In addition, the mismatch between forex-denominated loans and forex-denominated deposits has been growing. Although the mismatch declined in 2004 to

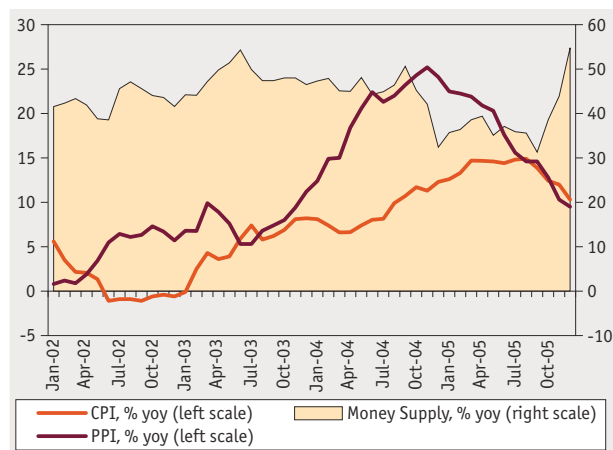
about \$1.4 billion due to forex-denominated deposits developments at the end of 2004, it almost doubled in 2005, exceeding \$3.2 billion.

By maturity, data shows that shares of both long-term deposits and long-term loans have been increasing. However, there was also a growing mismatch between maturities of assets and liabilities as long-term credit grew considerably faster than long-term deposits. In particular, the share of long-term deposits increased to 38% and 38.6% in 2004 and 2005 respectively, up from 32.1% in 2003. At the same time, long-term credit grew from 28.2% of total credit in 2002 to 54.2% and 61.8% in 2004 and 2005 respectively.

Considering the growing banking system exposure to various risks, the NBU has been taking steps to improve banking sector performance and stability by strengthening its regulatory and supervisory framework and encouraging commercial banks to improve their risk management. Although considerable progress was made during 2004–2005, there is still large room for further improvements.

Inflation

Inflation and Money Supply Developments, 2002–2005

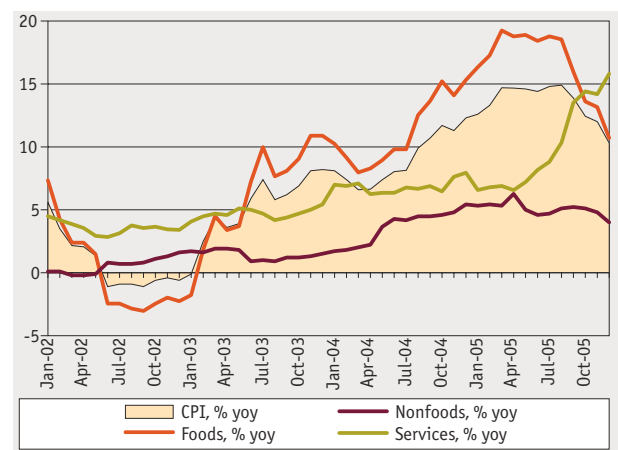


Source: State Statistics Committee, NBU

Following several years of moderate inflation, consumer price index (CPI) growth accelerated to double digits in 2004, for the first time since 2000. Although inflation decelerated slightly to 10.3% yoy in 2005, it remained in double digits. The role of monetary policy in combating inflation was rather limited, as data suggest that consumer price developments were mostly driven by non-monetary factors. In particular, 2005's inflationary pressures were generated by loose fiscal policies in the fall of 2004 and 2005, a number of supply side shocks (such as an increase in world crude oil prices and shortages on meat and sugar markets) and political uncertainties

at the beginning and the end of 2005. Administrative interventions in price setting mechanisms for particular goods were generally inefficient and counter-productive. The deceleration of inflation in the fall of 2005 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 (PPI growth decelerated to 9.5% yoy) and hryvnia appreciation against the US dollar by 4.8% yoy. The appreciation reduced the cost of imported goods and restrained the growth of monetary aggregates.

Consumer Price Inflation by Main Components, 2002–2005



Source: State Statistics Committee

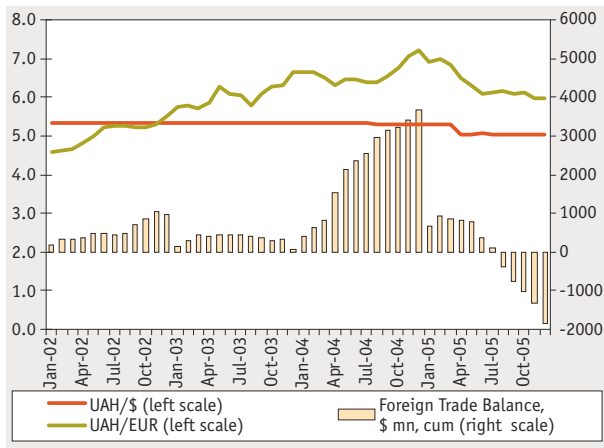
By CPI components, foodstuffs became 10.7% yoy more expensive in 2005. Food prices were affected by expansionary fiscal policy, which encouraged consumption particularly by lower income groups (thus quickly translated into higher demand for foods), and supply side shocks. Despite a 24.5% yoy increase 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.

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. But the increase in the price for imported gas will put pressure on 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. High oil prices in 2005 may also continue to pressure inflation in 2006 as a spill-over

effect on other prices. 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 12–13% yoy at the end of 2006.

Foreign Exchange Market

Nominal Exchange Rates of Hryvnia against US\$ and Euro and Merchandise Trade Balance, 2002–2005



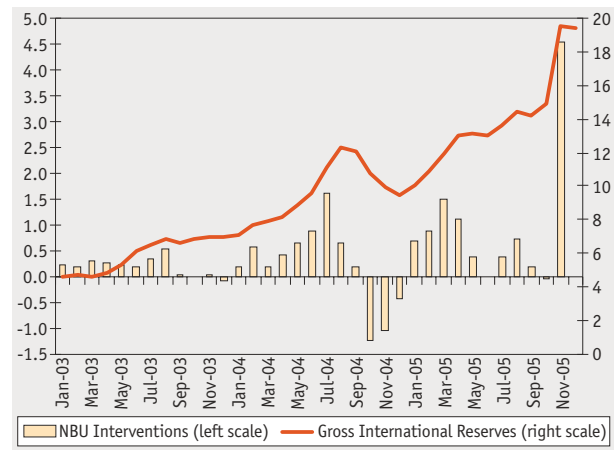
Source: NBU, State Statistics Committee

During 2004/2005, the NBU continued to pursue a de facto fixed exchange rate policy targeting, although officially Ukraine introduced a managed floating exchange rate regime in January 2000. By purchasing large amounts of excess dollars in the economy, the NBU kept the hryvnia exchange rate almost unchanged at around 5.3 UAH/US\$ between 2001 and the beginning of 2005. At the same time, the real effective exchange rate depreciated during 1997–2004 according to IMF estimates (except for 2002) contributing to Ukraine's competitiveness. Strong competitiveness generated large foreign trade and current account surpluses during 2000–2004, which supported GDP growth and helped to replenish the NBU's international reserves. Increasing inflationary pressures prompted a change in monetary policy priorities in 2005. In April, the NBU allowed appreciation of the hryvnia exchange rate against the US dollar by 4.8% year-to-date (ytd), but since then the exchange rate was maintained at 5.05 UAH/\$. This allowed the NBU to further accumulate reserves with a lower inflationary impact.

For most of 2004, exchange rate stability was maintained thanks to NBU purchases of excess foreign exchange. The foreign exchange currency fueled the interbank market due to huge foreign trade surpluses, large FDI and proceeds from Eurobond issues. However, accelerating price growth and political uncertainties in the run-up to the presidential elections changed the situation on the foreign exchange market in the fall

of 2004. The loss in public confidence in the hryvnia's stability was reflected in considerable expansion of demand for cash foreign exchange during September–December. The sudden demand swing caused shortages of cash foreign exchange on the retail market. In an attempt to curb large fluctuations in the cash foreign exchange rate and restore public confidence in hryvnia stability, the NBU introduced a 2% fluctuation band for the cash exchange rate. To support the hryvnia's stability, the NBU sold about \$2 billion of foreign reserves during October–December 2004. As a result, gross international reserves declined to \$9.5 billion at the end of 2004, considerably lower than \$12.1 billion in September 2004, but still 37.4% higher than at the beginning of 2004.

NBU Interventions on the Forex Market and Gross International Reserves, \$ billion, 2003–2005



Source: NBU

As political instability associated with the presidential elections eased and Ukraine's foreign trade position remained strong at the beginning of 2005, the forex market stabilized. Robust inflow of foreign exchange allowed the NBU to replenish its international reserves to the pre-election level at the end of March; it gradually increased to \$14.9 billion at the end of October and surged to a record high \$19.4 billion as a result of a buyout of the money received from the re-sale of Kryvorizhstal. The year-end gross international reserves were equivalent to about 5 months of the successive year's imports coverage, an increase from 2.8 months in 2004.

The central bank made progress in the liberalization of the foreign exchange market. Starting April 1st, the NBU abandoned its regulation requiring the mandatory sale of 50% of export proceeds. This restriction was in effect since the financial crisis of 1998 when the NBU was short of international reserves. As part of the relaxation of the foreign exchange control measure, the NBU liberalized the procedures for foreign investing in Ukraine and divesting from Ukraine by non-resi-

dents.⁵ Starting September 2005, the NBU liberalized interbank foreign exchange trading; commercial banks were allowed to buy and sell foreign currency within the same day, while previously the bank could operate just on one side of the foreign exchange market, and conduct forward foreign exchange operations though with some limitations. At the same time, the NBU introduced restrictions on non-residents' purchases of government securities with maturities of less than one year and a 20% reserve requirement on short-term foreign exchange credit from non-residents. Since the latter measures are not considered binding restrictions, considerable progress was achieved in foreign currency market liberalization. Except for a 1.5% foreign exchange transaction duty to the Pension Fund of Ukraine, which was only marginally reduced to 1.3% at the beginning of 2006, the main impediments for developing foreign exchange markets and instruments were abolished.

Future Prospects

One of the main priorities of monetary authorities in the medium-term is to reduce inflation to single digits. Considering that the NBU expressed a firm intention to maintain the de facto peg in its 2006 Monetary Policy Guidelines, this may be quite a challenging task. The achievement of this objective will also be complicated by the considerable influence of non-monetary factors on inflation and other policy uncertainties (in particular, the stance of fiscal policy, the speed of adjustment of regulated service and utility tariffs to cost-covering levels, the rate of economic growth, world energy and commodity prices, etc.). Based on these factors, it is unlikely that inflation rate will be below 10% in 2006.

Uncertainties related to the March 2006 parliamentary elections, further likely increases in gas prices and looser fiscal policies may result in increasing inflationary pressures and speculative actions in the foreign exchange market. Moreover, the exchange rate may be increasingly under pressure by the changing structure of Ukraine's balance of payments, in particular by the shift of the current account balance into small deficits in 2006. To maintain exchange rate stability, the central bank will continue to intervene on the forex market by selling out its international reserves at least during the first half of 2006. The NBU has a certain degree of capacity for such operations considering the high level of reserves at the end of 2005 (4.9 months of imports). Nevertheless, the NBU may allow greater exchange rate flexibility to avoid an abrupt drop in international reserves and reduce inflationary pressures. More exchange rate flexibility is also seen as a prerequisite for effective functioning of the inflation targeting regime — the ultimate goal of the NBU. However, this regime is unlikely to be introduced in the near future since considerable progress still has to be made in developing the financial infrastructure and strengthening the monetary transmission mechanism in Ukraine.

In 2006, commercial bank lending volumes are expected to continue their growth as commercial banks are extensively expanding their consumer and mortgage crediting operations. Lending rates will decline on the back of greater competition in the sector as the number of foreign banks is growing. Deposit rates may also continue to decline (though gradually, considering forecasted double-digit inflation) due to commercial banks' higher reliance on financial resources attracted on international capital markets.

⁵ In particular, Resolution #482, adopted in mid-October 2004, required the opening of multiple bank accounts and multiple foreign exchange conversions in order to invest in Ukrainian companies or repatriate profits. In August 2005, the NBU adopted Resolution #280, outlining the new regulations for foreign investing in Ukraine.

4. Equity Markets

Despite some slowdown in the country's economic growth, Ukrainian securities markets grew significantly in 2005. During the year, market capitalization more than doubled and reached \$29.17 billion, up from \$11.78 billion in 2004. Therefore, the share of the market capitalization surged from 18.1% in 2004 to 35.2% in 2005. Trading activity also grew significantly. First Trading Securities System (PFTS), which is the main trading platform in Ukraine (holding almost 90% of all organized market transactions), reported that its 2005 volume of trade reached \$2.87 billion. The annual growth of the PFTS volume of trade reached 217% compared with the previous year when total amount of securities trading was \$1.32 billion. However, the volume of trade deals completing on the PFTS to the total level of market capitalization still remains very low. Moreover, it even dropped to 9.8% in 2005 (down from 11.2% in 2004 and 14% in 2003), which suggests the existence of large, unutilized potential of the Ukrainian market.

Capital Market Development

	2003	2004	2005
Market Capitalization, \$ million	4,302	11,778	29,168
Market Capitalization, % to GDP	8.7	18.1	35.2
Volume of Trade on PFTS, \$ million	603	1,320	2,871
Volume of Trade on PFTS, % to market capitalization	14.0%	11.2%	9.8%

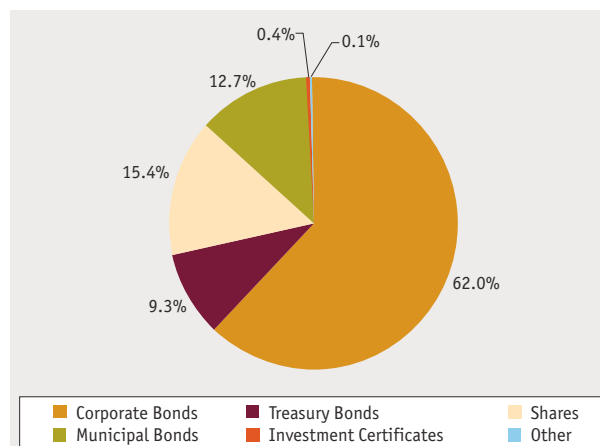
Source: PFTS, The Bleyzer Foundation

The volume of all types of securities traded on the Ukrainian market grew significantly over 2005 with the exception of municipal bonds. However, the composition of trade in securities experienced significant changes, although the leaders still remain the same. As in the previous year those are corporate bonds, treasury bonds, and company stock. The structural breakdown of trade on the PFTS shows that over the last two years the most traded securities were corporate bonds, although their share dropped to 44.7% in 2005 down from 62.0% in the previous year. The decrease in weight of trade in corporate bonds is mainly due to the increasing attractiveness of government securities and stocks, whose shares increased from 9.3% and 15.4% in 2004 to 26.8% and 23.2% in 2005 respectively.

In 2005, the most rapidly growing instruments were government securities, stocks, and investment certificates. The six-fold increase of trade in government securities from \$122 million in 2004 up to \$768 million in 2005 was due to stable demand for this type of security by domestic and foreign investors diversifying their portfolios. An increase in trade of stocks by more than 3 times was backed by (i) a rapidly growing demand for stocks

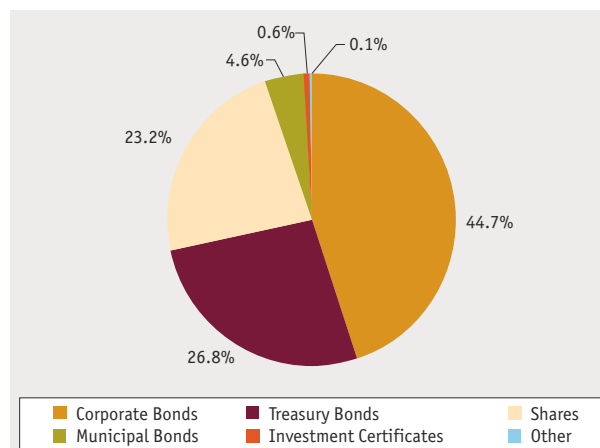
of "second echelon" companies from metallurgical, energy, machinery sectors and retail trade; and (ii) stable demand for traditional "blue chips". The top-5 individual stocks were represented by Lukoil, Alchevsk Metallurgical Plant, UkrNafta (oil company), Bank Aval, and retail trade group "Velyka Kyshenya".

Structure of PFTS Sales in 2004, %



Source: PFTS

Structure of PFTS Sales in 2005, %



Source: PFTS

The 3.2-times increase in trade of investment certificates was mainly due to some improvements in the activity of domestic mutual funds. However, in absolute terms, the volume of this trade still remains very insignificant; it did not exceed \$17 million in 2005 with a total share of 0.6% in the total PFTS' turnover.

Fast development of the Ukrainian equity market is reflected in both domestic and international indexes. The PFTS index increased in 2005 by 35.7% to 352.97 points, up from 260.13 points in 2004 and 85.4 points in 2003. In 2005, the S&P/IFCF-Ukraine index grew by 52.8%,

which is the second best growth in the S&P Eastern Europe Frontier Group after Romania, whose equity market experienced a 61.1% rate of growth.

Overall, although the Ukrainian stock market shows very rapid development, it still remains small. Only a very limited number of financial instruments are currently available. All these indicate a great potential for its further growth and numerous opportunities for investors.

Future Prospects

The Ukrainian equity market is expected to maintain substantial growth in 2006. The growth will be fueled by the intentions of many Ukrainian companies to undertake public offerings, continued privatizations, and improved financial market infrastructure. In 2006, the Ukrainian equity market will

continue to experience some further changes in its structure towards securities issued by relatively new market players from food-processing, retail trade, real estate, banking, and mutual funds. On the other hand, the market desperately needs improved regulations preventing any non-market practices. Passing by the parliament Joint Stock Company Law, which is in line with the existing OECD standards, should fill many gaps in corporate governance legislation and allow the Ukrainian equity market to operate more efficiently.

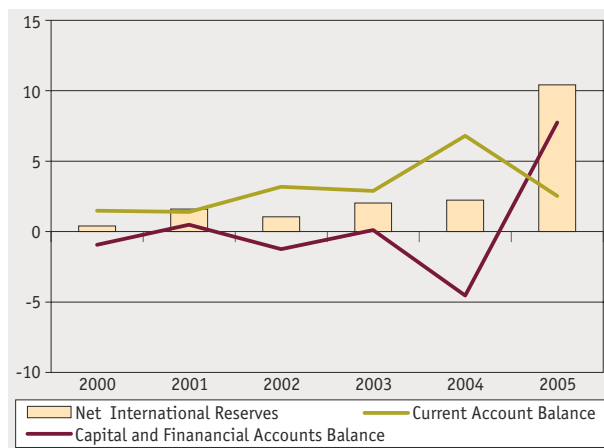
In 2006, the market for government securities will experience moderate growth taking into account the country's parliamentary election and time needed for forming the new Cabinet and main principals of its economic policy. However, in the last quarters of the year the market may receive the new impulse for its development.

5. International Trade and Capital

Throughout the last few years, Ukraine's external position has remained strong. The current account surplus reached record levels in 2004, whereas in 2005 it was the financial account balance that peaked with an impressive surplus, fuelling more than a two-fold increase in foreign exchange reserves. Most Ukrainian exports are still commodities with a low degree of processing, while energy resources dominate imports. At the same time, robust investment demand led to a rising share of high-tech investment goods in Ukrainian imports over the last two years. In 2005, Ukraine managed to attract a record high volume of foreign direct investment primarily thanks to large privatization and M&A deals, but also thanks to positive changes in country image and good macroeconomic environment.

Balance of Payments

Balance of Payments in 2000–2005, \$ billion



Source: NBU

2005 saw a substantial change in the structure of Ukraine's foreign exchange flows. On the one hand, deterioration of external conditions reversed the merchandise trade balance to a negative figure. This caused a sizable decline in the current account balance, compared to the impressive \$6.8 billion (10.5% of GDP) reached in 2004. Nevertheless, the 2005 current account balance remained positive reaching \$2.5 billion or 3.1% of GDP thanks to a healthy service account surplus. Furthermore, the financial account turned to an exceptionally high surplus estimated at \$7.8 billion or 9.5% of GDP at the end of the year. Such remarkable improvement in the financial account (from \$4.1 billion deficit in 2004) was due to record high growth of net FDI of more than \$7 billion as well as the intensification of private borrowings from abroad. As a result, the stock of net international reserves showed more than a two-fold increase and reached \$19.4 billion by the end of

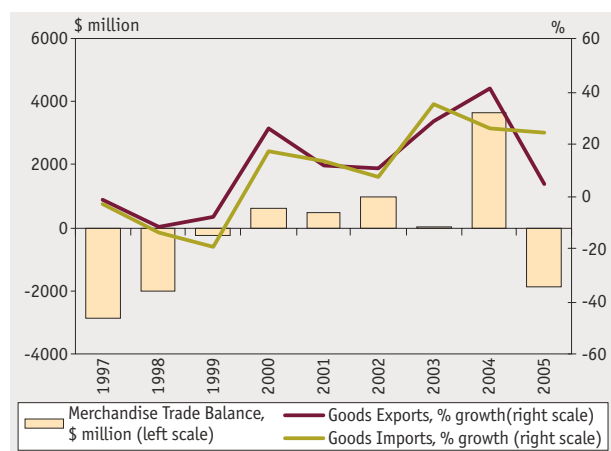
2005, covering 4.9 months of future goods and services imports.

Foreign Trade

Ukraine's cross-border trade flows are, to a large extent, driven by fluctuations in merchandise trade. On the other hand, trade of services constitutes a relatively stable source of trade inflows. Throughout 2005, the overall trade balance was declining steadily driven by a substantial slowdown in goods exports. Due to adverse external shocks, goods exports grew by 4.9% yoy reducing the overall exports growth to 6.4% yoy. At the same time, imports maintained a relatively high growth rate: goods imports went up by 24.6% yoy and total imports increased by 25.7% yoy. Although the resulting merchandise trade balance posted a deficit of \$1.8 billion, the overall trade balance (including merchandise and services) remained positive, reaching \$1.4 billion.

Transport services represent the largest share of service exports (73% in 2005), with gas transit payments from Russia to Europe accounting for a substantial part. Exports of transport services grew by 11% yoy mostly on account of sea and air transportation services. Business services (judicial, accounting, research, etc.) account for another 10% of total service exports. Service imports are more diversified than exports. The three major categories of imported services include transport, state and business services accounting for 22%, 20% and 16% of total service imports respectively.

Merchandise Trade Dynamics in 1997–2005



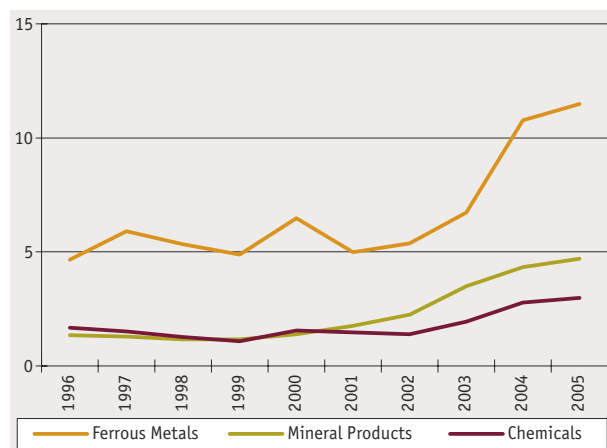
Source: State Statistics Committee

An important characteristic of Ukraine's merchandise trade is the relatively high degree of concentration by commodity type. On the import side, mineral

products represent the largest share of imports (35% of the total). On the export side, the metallurgical sector dominates with a 40% share. Insufficient diversification of commodities causes high dependence of trade flows on external factors. This was evident in the dynamics of exports over the last two years: the surge of goods exports in 2004 and the sharp deceleration in 2005 were primarily caused by changes in external demand for basic exporting commodities, particularly metals.

The low diversification of goods exports and the high dependence on a few commodities is also reflected in the structure of Ukraine's industrial production capacities. Large industrial enterprises built in soviet times were designed to manufacture a few specific products supplied primarily to other parts of the Soviet Union. After the 1991 break-up of production links with former Soviet republics, export-oriented enterprises did not diversify, but successfully managed to access new markets, in particular in Europe and Asia, thereby diversifying export destinations. As a result, Ukraine became an important player on world markets for some commodities. The most prominent success was achieved in steel; in 2004, Ukraine was the seventh largest manufacturer of steel in the world, producing 3.7% of global steel output. By commodity composition, exports remained concentrated on a few types of goods—namely, basic metals, fuels and some types of chemicals. Exports are therefore highly dependent on world prices for a few commodities. Even on metal markets, Ukraine is still considered a price-taker, mostly due to the homogenous nature of products in which Ukrainian exporters specialize.

Exports of Major Commodity Groups, \$ billion



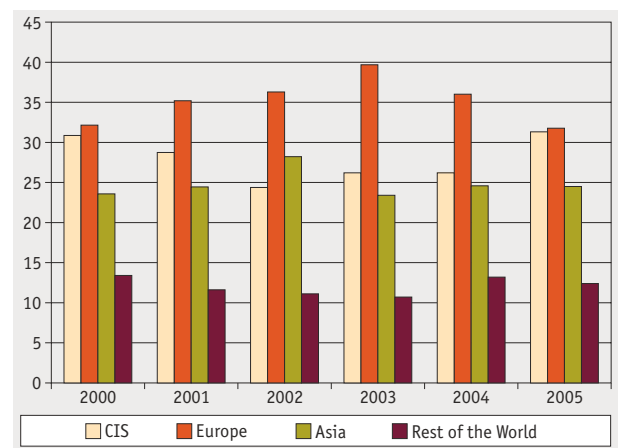
Source: State Statistics Committee

As world metal prices started to decline in mid-2005, exports of Ukrainian metals decelerated as well, but still showed a high 7.6% yoy increase in nominal terms. Outward trade flows were also affected drastically by reductions in exports of machinery and

equipment. This happened due to a drop in demand for Ukrainian products in Europe and the Americas. Despite growing world fuel prices, exports of mineral products also slid down to 9% yoy due to trade restrictions imposed by the government in the first half of 2005 to combat a hike in domestic gasoline prices. However, metals and mineral products exports remained the major contributors to overall goods exports in 2005.

By geographical breakdown, the composition of goods exports underwent substantial changes over the last two years. The share of European countries in Ukraine's merchandise exports was 31.8% in 2005, a significant reduction from the shares of 36.5% in 2004 and 39.7% in 2003. At the same time, CIS countries gained a stronger position in 2005, taking 31.3% of Ukraine's goods, compared to 26.2% in 2004 and 2003. The reduction in the share of Europe in Ukraine's exports destinations is explained mostly by a slowdown of aggregate demand in Europe. Export flows were reoriented to CIS countries, the Americas and Africa.

Geographical Breakdown of Goods Exports, % of total



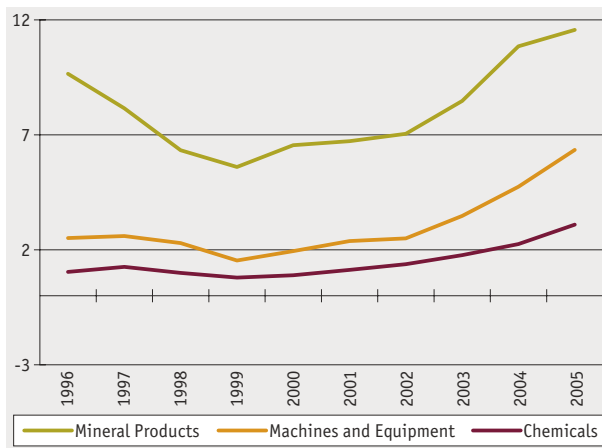
Source: State Statistics Committee

Large increases in merchandise imports in 2005 were caused by the expansion of domestic consumption demand coupled with the real appreciation of the hryvnia. Although the high growth rate of imports contributed to the deterioration of the goods trade balance, there was a positive change in the commodity structure of imported products in favor of investment goods. In particular, imports of machinery and equipment — the second largest import item, representing 15% of goods imports — went up by 33.8% yoy in 2005. This followed 36% yoy growth registered in 2004. Such strong growth rates for investment goods imports indicates that obsolete production capacities of Ukrainian enterprises are gradually being renewed, thereby increasing the efficiency of production. At the same time, imports of mineral products slowed to modest growth rates

of 6.7% yoy due to reduced supply of coal and crude-oil from abroad. The latter was, however, substituted by imports of oil-products that took place due to a reduction of import tariffs on oil products in the first half of 2005.

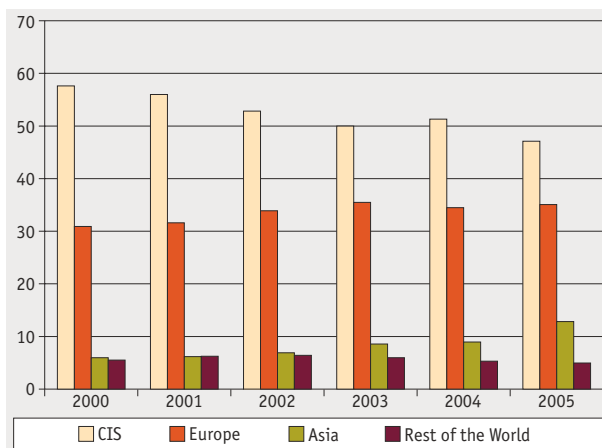
The increases in inward trade flows in 2005 were also caused by the liberalization of tariff barriers agreed upon by Ukraine in light of Ukraine's accession process to the WTO. A significant reduction of import duties on fruits, linen, underwear, footwear, and home equipment took place at the beginning of the year. Imports of textiles demonstrated record 41.7% yoy growth in 2005, compared to a 16.6% yoy rise in 2004. The decreases of import tariffs on a wide range of other products adopted later in 2005 will also trigger increases in merchandise imports in the near future. These increases are likely to happen, both because of an increase in physical volumes of imported goods and because of reduced smuggling.

Imports of Major Commodity Groups, \$ billion



Source: State Statistics Committee

Geographical Breakdown of Goods Imports, % of total



Source: State Statistics Committee

By geographical breakdown, the composition of merchandise imports continued to evolve towards Europe.

Although Ukraine's imports are tied closely with energy materials supplied from the CIS countries (mostly Russia and Turkmenistan), the share of imports originating in this region has been decreasing steadily throughout the last six years. By the end of 2005, the share of CIS countries was reduced to 47.1% compared to 51.3% in 2004 and 58% in 2000.

At the same time, the share of the EU and other European countries in merchandise imports has been on a steady rise, increasing to 35.1% at the end of 2005, up from 34.5% in 2004 and 30.9% in 2000. European countries are the major suppliers of investment goods to Ukraine, whereas imports from the CIS countries consist mainly of energy materials.

Future Prospects

The trends in Ukraine's balance of payments observed in 2005 are likely to continue in the nearest future. In particular, the current account is expected to turn to a modest deficit in 2006, which will be financed by financial account surpluses. The latter will be primarily based on increasing long-term corporate debt as well as a relatively high net inflow of FDI. As a result, gross international reserves are likely to increase moderately in 2006 and stay at rather comfortable levels in terms of imports coverage.

Among the major factors affecting foreign trade dynamics in 2006 will be the recently negotiated increase in prices on imported gas, development of metal prices, and liberalization of import barriers.

At the beginning of 2006, Ukraine and Russia signed an agreement that changed conditions for natural gas supply to Ukraine and transit of Russian gas to Europe through the territory of Ukraine. The agreement made imported gas for Ukraine approximately 42% more expensive in 2006 than in 2005. The major part of imported gas (around 60% of net imports) is consumed by the industrial sector, principally by export-oriented metallurgy and chemistry. Heating suppliers utilize another 25% of net imports, with the rest used for other purposes.

From the international trade standpoint, an increase in gas prices will directly affect the value of imports raising its nominal volumes, and is likely to have a sizeable indirect effect on exports. Higher prices on natural gas will add to production costs of many industrial enterprises, especially in export-oriented chemistry and metallurgy, which use outdated energy-intensive technologies. The costs of producing chemicals, especially chemical fertilizers, will increase sharply due to their high share of natural gas. This will make Ukrainian products less competitive on external markets. In addition to higher costs, the

metallurgical sector will be affected by a moderate reduction in world metal prices anticipated in 2006. After the sharp growth in 2004 and some slowdown in 2005, metal prices are expected to decrease further in 2006, though they should still remain at a relatively high level. Thus, coupled with a lower output price, an abrupt increase in gas prices will adversely affect exports of metals and metal products. However, such an input price shock will stimulate investments in new energy-saving technologies, thereby increasing the competitiveness of the Ukrainian economy in the medium-run.

The substantial liberalization of tariff trade barriers that took place in 2005 will be another factor fuelling imports in 2006. Reduction of import tariffs on a wide range of products adopted in mid-2005 is likely to prompt merchandise imports through increase in physical volumes of imported goods and reduced smuggling.

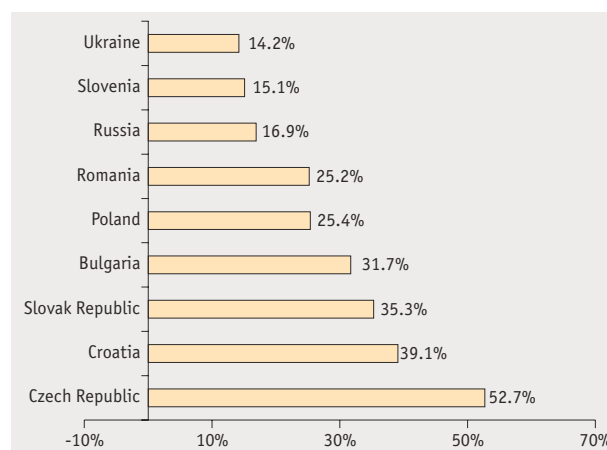
As a result of continuing slowdown of goods exports and acceleration of goods imports, the merchandise trade balance deficit is expected to widen in 2006. The deficit in the goods balance will be somewhat compensated for by a higher surplus in the services trade from an increase in the gas transit fee. However, the overall trade balance is expected to turn to a deficit driving the current account balance below zero.

Foreign Direct Investment

After the 2004 presidential election, Ukraine found itself in an extremely favorable position to attract FDI. A new image of Ukraine as a country striving for democracy and market economy increased the interest of foreign investors in an economy that has a large domestic market, low labor costs, and the potential to make considerable progress in market reforms. Although this positive image has been somewhat breathed on by episodes of state interventions in price setting mechanisms and re-privatizations, the progress that Ukraine made in attracting FDI in 2005 was remarkable.

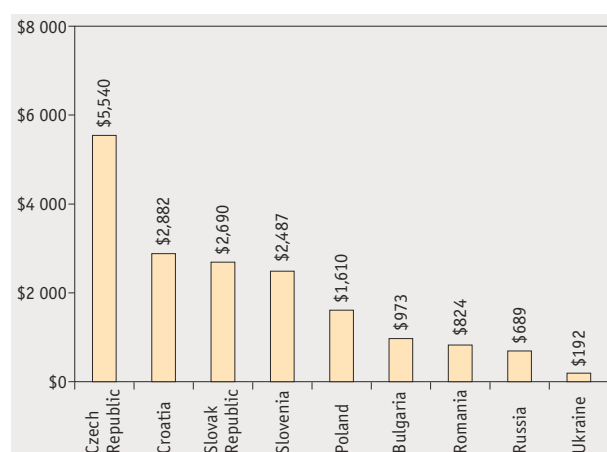
Before 2005, the amount of funds invested in the country by foreigners was small compared with sums received by other countries in the region. From 1991 to 2004 Ukraine managed to attract only \$8,353 million of foreign investment, which translated into 14.2% of 2004 GDP. This figure is far below the levels of FDI attracted by more advanced countries in the region, such as Bulgaria or the Czech Republic. A cross-country comparison of FDI stock per capita also demonstrates that a meager \$192 of FDI per head kept Ukraine far behind even in comparison with its nearest neighbors.

Gross FDI Stock in Selected Transition Economies in 2004, as % of GDP



Source: UNCTAD World Investment Report 2005, WDI database, The Bleyzer Foundation

Gross FDI Stock per Capita in Selected Transition Economies in 2004, \$ million



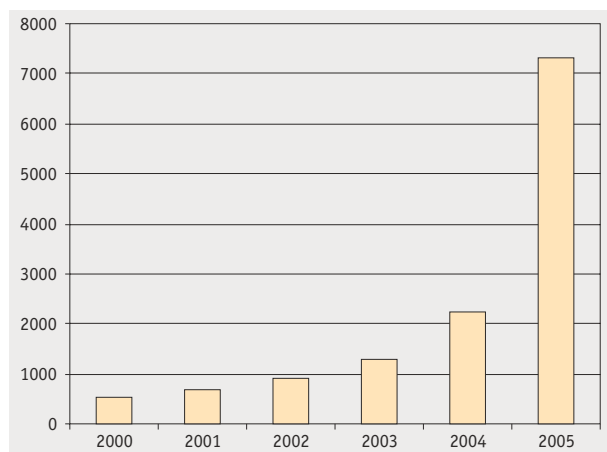
Source: UNCTAD World Investment Report 2005, WDI database, The Bleyzer Foundation

However, despite a limited number of deals, the country attracted large amounts of FDI in 2005. During the year, the net inflow of foreign investment reached \$7.3 billion, which almost equals the total amount of FDI attracted since independence. The bulk of this sum was received thanks to the successful re-privatization of the country's largest metallurgical plant Kryvorizhstal to Mittal Steel, sold for \$4.8 billion. The acquisition of one of the biggest local banks by the Austrian Raiffeisen International Bank brought about \$1 billion of FDI. These acquisitions will bring new know-how and management technologies to Ukrainian metallurgy and banking, thereby increasing the competitiveness of these sectors and the economy as a whole.

Without the two large deals, net inflow of FDI amounted to almost \$2.5 billion in 2005. This is about 10% higher than in 2004, but it is still low as a number of fundamental factors hinder the inflow of FDI. The

unstable and unpredictable legal environment, over-regulation, a complicated tax system, and high level of corruption make it difficult for foreign firms to operate in Ukraine. The Ukrainian government has attempted to carry out some measures to improve the situation; however, the lack of implementation capacity has hindered progress. In fact, reform measures will become effective only if coupled with fundamental public administration and tax system reforms.

Net FDI Flows to Ukraine, \$ million



Source: State Statistics Committee

Regional Structure of FDI

Regional Distribution of FDI Stock

Region / City	As of January 1, 2006, \$ million	% to total FDI
City of Kyiv	\$3 619	32.6%
Dnipropetrovsk Region	\$1,717	15.5%
Kyiv Region	\$591	5.3%
Odesa Region	\$595	5.4%
Donetsk Region	\$586	5.3%
Zaporizhya Region	\$550	4.9%
Kharkiv Region	\$468	4.2%
Republic of Crimea	\$460	4.1%
Total for Listed Regions	\$8,586	77.3%
Other Regions	\$2,523	22.7%
Total FDI*	\$11,109	100.0%

*Excluding most of the amounts received from the sales of the metallurgical plant Kryvorizhstal and Aval Bank.

Source: State Statistics Committee

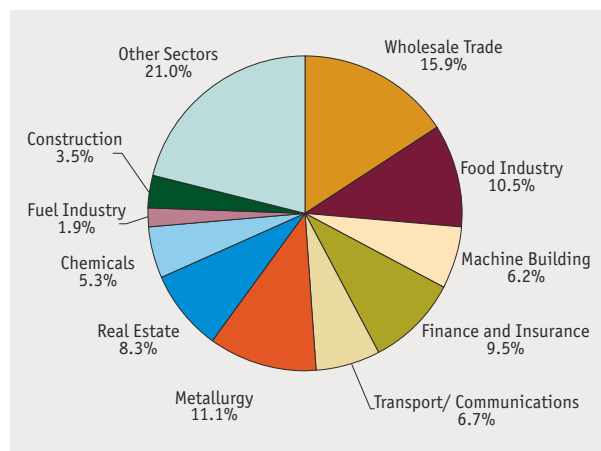
By the end of 2005, around 11,500 Ukrainian enterprises had received funds from abroad in the form of direct foreign investments⁶. By regional breakdown, FDI was concentrated in the country's capital and surrounding region, five regions that have large

industrial capacities, and the Republic of Crimea famous for its health and recreation facilities. Overall, these regions accounted for more than three quarters of total FDI stock.

Traditionally, the food processing industry and domestic wholesale and retail trade have been the most attractive sectors to foreign investors. These sectors are oriented towards domestic consumers and usually give investors a quick return on investment and lower risk compared to other industries. Food processing and wholesale trade account for about one fourth of total FDI. Machine building and communications also received attention from foreign investors due to the high potential for growth.

The financial sector is becoming more attractive to foreign investors after the financial crises in 1998. Thanks to good supervision by the central bank, Ukrainian banks developed from the highly risky and vulnerable institutions to more competitive and healthy financial intermediaries with a wide customer base. Nevertheless, the high level of non-performance loans in the banking sector may continue to limit the interest of foreign investors to a small number of large and secure local banks.

Distribution of FDI Stock by Sector*, \$ million



*Excluding most of the amounts received from the sales of the metallurgical plant Kryvorizhstal and Aval Bank.

Source: State Statistics Committee

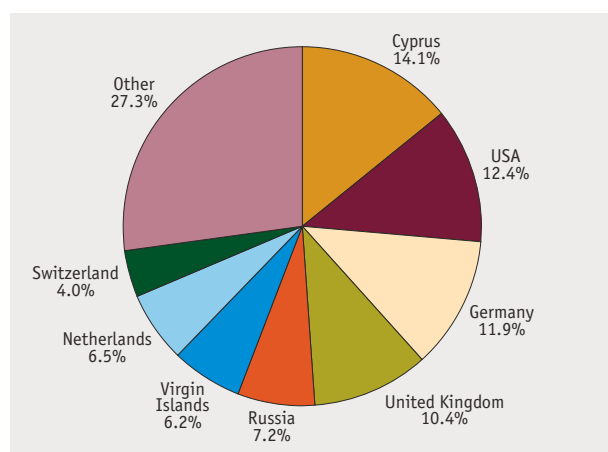
Major Foreign Investors

Overall, 117 countries have invested in the Ukrainian economy. The largest volumes of FDI have come from Cyprus, the US, the United Kingdom, the British Virgin Islands, Germany, the Netherlands, Russia and Switzerland. Together these eight countries contributed more than 70% of the total FDI in Ukraine.

⁶ Here and below we report FDI figures based on the enterprise surveys, which do not account for most of the amounts received from the sales of the metallurgical plant Kryvorizhstal and Aval Bank.

Although Cyprus has become the major foreign investor in Ukraine, funds coming from this offshore zone are likely to originate in other countries. In particular, many Ukrainian firms are known for using the advantages of Cyprian tax legislation. Thus, the rapid increases of investments from Cyprus (by 14.8% in 2004 and by 42% in 2005) suggest that Ukrainian capital that earlier flowed out of the economy is gradually returning. The same seems to be the case for inflows from the Virgin Islands (which grew by 47.9% in 2004 and 18.3% over three quarters of 2005.) Capital coming from off-shore zones was invested mainly in domestic trade, real estate and financial intermediation. In 2004 and 2005, Cyprus also increased its investment in services sectors, such as transport, communication, hotels and restaurants. Investment from the Virgin Islands in machine building grew by four times in 2005.

Major Foreign Investors in Ukraine*, \$ million



*Excluding most of the amounts received from the sales of the metallurgical plant Kryvorizhstal and Aval Bank.
Source: State Statistics Committee

Among non-offshore regions, the US has the leading place among foreign investors operating in Ukraine. Some US multinational companies, such as Coca-Cola, Procter & Gamble, McDonald's, Phillip Morris, Gillette, and others, have propelled the US to the second top position on the list of foreign investors in Ukraine, with their proactive expansion and investment strategy. By the end of 2005, the US share of FDI constituted \$1.37 billion or 12.4%. The largest amount of the US investments went to domestic trade. In 2005, investment in wholesale trade increased by 23.3% yoy driving the share of the sector to 17.6% from 16.5% in 2004. Slightly lower amounts of US funds were invested in food processing. FDI in this industry grew by 12.8% yoy in 2004 and 14% yoy in 2005, preserving the share of the sector at 13%.

The United Kingdom, Germany, the Netherlands and Switzerland were the major foreign investors on European side. Together these four countries

contributed to approximately one-third of total FDI volume. British investors were rather active in the Ukrainian wholesale trade sector, which accounts for 17% of total FDI from the UK. Metallurgical and chemical industries gained much attention from German investors. Around 54% of FDI from Germany went to metallurgy and another 11% to chemicals. At the same time, investments from the Netherlands were highly concentrated in food and food-processing, constituting about one-half of total FDI from this country.

Russian companies were also actively penetrating Ukrainian markets. Investment from Russia grew by 17.8% in 2004 and by 11% in 2005. In previous years, Russian investments in Ukraine were motivated mainly by desire to regain lost markets and re-establish production links that had been formed in the Soviet era. Thus, Russian investors targeted those Ukrainian sectors that were closely linked with Russian industries, like coke and oil refinery. To take a practical example, shortly after Ukraine's independence, Russian oil companies acquired almost all Ukrainian oil-refineries, which in Soviet times were constructed specifically for processing Russian oil. Another object of interest at that time was healthcare complexes in the region of Crimea. However, preferences of Russian investors have gradually moved to industries with high potential for growth. In 2004 and 2005, transport and communication services, wholesale trade, as well hotel and restaurant services were the most attractive sectors for Russian investments.

Future Prospects

Expectations for further increases in foreign direct investment inflow remain quite promising, although the record figure of 2005 is very unlikely to be achieved again. In 2006, net FDI inflow is expected to reach \$2.6 billion. Inflow of FDI is likely to intensify in the second half of 2006, after political uncertainty associated with parliamentary elections and enforcement of constitutional reform abates. A substantial amount of foreign funds is expected to be invested in the banking sector, as negotiations about acquisitions of several large domestic banks were completed at the end of 2005.

Overall, it would be beneficial for Ukraine to attract FDI from as many countries as possible. However, capital from the more advanced economies, like the EU and the US, can bring benefits that are more relevant for the long-term growth and development of the Ukrainian economy. Factors linked to FDI from these economies such as new production, management and marketing technologies, better labor skills, improvement in risk management, etc., make

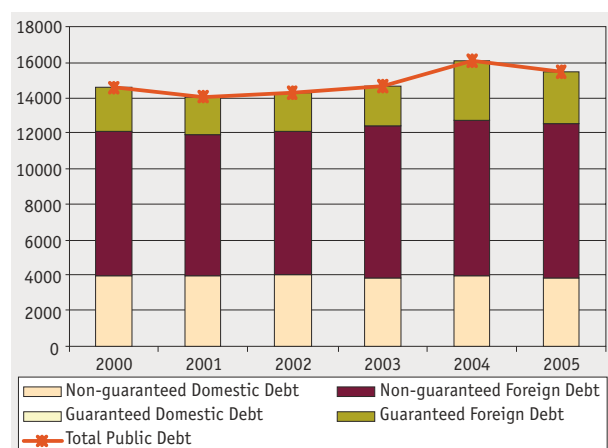
firms more competitive and productive. Thus, Ukraine's progress with WTO membership, granting market economy status by the EU and the US and Ukraine's aspirations towards membership in these organizations will contribute to an increasing

share of capital coming from more advanced economies, thereby strengthening the economic potential of the country.

6. Public Debt and International Lending

Ukraine's public debt position has improved significantly over the last four years and the total amount of public debt as a percentage of GDP has declined significantly. In 2005, the public debt to GDP ratio reached 18.7%, down from 24.8% in 2004, 29% in 2003, and 33.2% in 2002 compared with a peak at about 55% registered in 1999. The existing public debt to GDP ratio is a relatively low ratio among other emerging market economies. During 2005, the total amount of public and publicly guaranteed debt decreased by 3.9% or \$622.6 million to \$15.47 billion. This decrease is mainly due to the country's strategy of limited borrowing. Additional factors attributed to a decrease in the public debt to GDP ratio were significant economic growth over the last few years, strong fiscal discipline and sound external debt management.

Commercial Banks' Deposits by Currency and Maturity Structure, 2002–2005



Source: Ministry of Finance

Ukraine's current level of public debt is moderate by international standards, which means that the risk of the country's insolvency is very low. Strong macroeconomic fundamentals and thoughtful public debt management contributed greatly to reservation of the country's sovereign rating by the major international rating agencies at BB-.

Further improvements in the country's creditworthiness in the coming years will depend on effectiveness of undertaking economic reforms. However, it can be forecasted with a very high level of certainty that public debt repayment and public debt service in 2006 should not be a problem due to the government's prudent fiscal performance and high level of international foreign reserves accumulated by the NBU.

Domestic Debt

During 2005, the country's domestic debt (guaranteed and non-guaranteed) decreased to \$3.8 billion down from \$3.95 billion in the previous year. At the same time, the share of the domestic public and publicly guaranteed debt in the total structure of the country's domestic debt has not been changed and remained at a level of 24.6%.

The decrease in Ukrainian domestic debt is mainly due to the Ministry of Finance strategy towards reduction of cost of borrowing. During the year, the weight of the public direct debt decreased by \$149 million, which represents a decline by 3.8% yoy. The decrease in public direct debt is attributed to exceeding the public domestic debt repayments over public domestic borrowing. In 2005, this overlap was \$286 million. The overlap appeared as a result of the ahead of schedule repayment of the T-Bills issued in 2000, which were owned by the NBU. This repayment was anticipated by the state budget, which empowers the Ministry of Finance to restructure government budget debts. Another factor that supported the decline in the amount of domestic debt was appreciation of the national currency. In 2005, as a result of hryvnia appreciation against the dollar and the euro, domestic debt declined by around \$65 million.

Stock of Official Domestic Debt (end of period), \$ million

	2000	2001	2002	2003	2004	2005
Domestic Government Bonds	1,921.5	2,000.2	2,061.1	1,898.7	2,119.6	1,984.8
Banking Institutions	1,999.2	1,965.5	1,974.0	1,833.9	1,833.9	1,814.8
Other Creditors	0.2	0.2	0.2	0.2	0.2	0.2
Total Domestic Debt	3,921.0	3,965.9	4,035.3	3,732.8	3,953.6	3,799.8

Source: Ministry of Finance

In 2006, Ukraine's domestic debt is likely to increase only marginally by around \$60 million. This is anticipated by the state budget for 2006. The government is planning to borrow around \$0.9 billion on the domestic market, while the expected volume of repayment on past borrowing is projected at \$0.84 billion.

Foreign Debt

Since the 1998 financial crisis, Ukraine's external debt has been declining steadily. The settlement of gas supply-related debt to Russia and the restructuring of

debt to Paris Club members also contributed to the reduction of the stock of external debt. Throughout 2005, Ukraine's foreign debt ratio declined to 14.1% of GDP, down from 18.7% in 2004, and 21.3% in 2003.

Stock of Official External Debt in 2005 (end of period)

	\$ millions	% share of total
Multilateral	4,048.5	34.7
EU	139.5	1.2
EBRD	268.3	2.3
IMF	1,187.5	10.2
WB	2,453.1	21.0
Bilateral	2,385.5	20.4
France	22.7	0.2
Italy	79.3	0.7
Turkmenistan	105.6	0.9
Japan	113.0	1.0
USA	211.2	1.8
Germany	368.1	3.2
Russia	1,485.6	12.7
Debt Owed to Private Creditors	5,240.1	44.9
Foreign commercial banks	1,537.7	13.2
Eurobonds	3,702.4	31.7
Total foreign debt	11,674.0	100.0

Source: Ministry of Finance

During 2005, total external debt (guaranteed and non-guaranteed) went down by \$447 million and reached \$11.7 billion. During the period, the structure of the country's foreign debt has experienced some

changes. In particular, the weight of the direct debt has increased from 72.5% in 2004 to 74.6% in 2005.

One of the major achievements of Ukraine in 2005 in its debt management policy was a very successful Eurobond placement. In October 2005, the Ministry of Finance successfully placed EUR 600 million worth of 10-year Eurobonds with a record low yield to maturity of 4.95% per annum. Moreover, the actual demand for this security was EUR 2 billion higher than it was offered to the market. The extremely high demand for Eurobonds issued by the government in 2005 and their low yields indicate that country's image as a reliable partner was significantly improved.

In 2006, Ukraine's foreign debt should be expected to increase marginally by \$232 million. However, the country's foreign debt to GDP ratio is likely to continue to demonstrate a downward trend and reach around 13% at the end of the year. The 2006 fiscal budget anticipates the total value of borrowing at about \$1.39 billion and the banking system may well absorb this amount. The significant growth of the NBU's liquid international reserves over the last two years provides a solid base for meeting debt obligations. In 2006, Ukraine will repay \$1.16 billion on its past obligations.

PART TWO: Investment Climate

Overview

An emerging country wishing to reach sustainable economic growth should pay attention to increased levels of investments. At the same time, there is growing evidence that although physical and human capital accumulation is crucial for economic growth, their effects became much stronger if combined with increase in the productivity of these factors. In fact, in many countries such as China and Chile, increases in investments explain only part of the rates of economic growth. The rest is explained by increases in total factor productivity that is generated by better management skills, knowledge, information systems, technology and technical change. The increase in total factor productivity can be spurred by welcoming foreign investments, which are an extremely important source of spreading these value-enhancing factors. With the wave of globalisation, FDI inflows help countries with emerging markets to better integrate into the world economy by making them more competitive and by improving their living standards. Thus, the policies and efforts directed at improving the country's investment climate can be seen as an indicator of general progress towards achieving sustainable economic growth.

In order to identify the main factors affecting a country's investment climate, SigmaBleyzer embarked on a comprehensive research effort. The level of FDI was considered to be a good gauge defining the adequacy of a country's investment climate. The study reviewed 100 countries around the world and carried out statistical analyses to identify the policy measures that have the greatest impact on the flow of FDI. It identified the most important measures that a government can take to improve the business environment of a country and attract foreign direct investments.

Through benchmarking, it also identified best practices in economic reforms in a number of successful developing countries. Also, a model was built to predict the flows of foreign direct investments that a country could receive based on the implementation of these key "policy" investment-drivers. Our benchmarking, statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments in the group of over 100 developing countries can be explained by nine economic policy drivers. Furthermore, studies showed that whereas there was a high correlation between the nine policy drivers and the flows of FDI, there was also a low correlation between FDI flows and the "natural characteristics" of a country (e.g., geographical location, country size, population, etc.).

The key investment drivers are presented below in the order of current priority for Ukraine at the current time:

- 1) **Public governance** includes policies and actions to increase the capacity of public administration to implement economic reforms and to improve the efficiency of the system;
- 2) **Macroeconomic stability**, which includes policies and actions that ensure stable domestic prices and foreign exchange, as pre-requisites to minimize economic risks for investors;
- 3) Policies to create a **stable and predictable legal environment** with well-defined "rules of the game" for all businesses, without discrimination or preferential treatment and with capacity to enforce business contracts;
- 4) **Business liberalization and de-regulation policies** to permit firms to operate freely in a competitive environment by removing barriers to market entry, barriers to operations and barriers to exit;
- 5) Policies to develop sound **corporate governance** that would guide the activities of business in the best interest of their shareholders, protecting ownership rights;
- 6) Policies to **liberalize foreign trade and international capital movements** to facilitate the exports and imports of goods and the transfer of capital internationally with a view to increase economic competitiveness and efficiency;
- 7) Policies to **create a healthy financial sector** capable of meeting the financing needs of growing businesses;
- 8) Actions to **minimize corruption** and protect businesses from abuse of power by government officials;
- 9) Actions to minimize the effects of **political uncertainties** on business activities and **promote and inform investors** about business opportunities in the country.

The performance of Ukraine in the respective areas is discussed below.

1. Public Governance

The driver includes policies and actions to improve the capacity of the country's public administration design and implement economic reforms and to modernize and increase the efficiency of the public administration system. The reform of public administration is the key reform that is needed to facilitate and make possible the implementation of all other reforms. If well done, this reform will put the country on a different path, on an accelerated course to faster development and growth.

A second element of Public Governance is the transfer of revenue generating activities that do not involve a "public good" to the private sector. The objective of privatization-related policies is to improve the efficiency of resource use through private ownership, minimize the possibilities of undue market power by the authorities, and concentrate government resources on public goods. Key elements here include sound legislation to ensure a competitive privatization process, an independent agency in charge of privatization, along with private ownership of land.

Public Administration System

Ukraine's current government structure retains many of the problems inherited from the former Soviet Union, which includes a cumbersome decision-making process, a high level of bureaucracy, and unclear division of responsibilities among government agencies. As a result, the existing system of developing, passing and implementing economic policies stifle economic reforms aimed to improve Ukraine's business environment. Therefore, there is a clear need for its reform.

The transition process from the old-soviet-style administration to democratic public governance in Ukraine is rather slow. Starting from the time of gaining independence, Ukrainian governments declared transparency, openness and citizens' involvement as the main priorities of the country's public governance. However, there was always a gap between proclaimed approaches and actual outcomes. During the last couple of years, Ukraine has made some progress in liberalizing the economy and creating an enabling business environment for private sector development. Nevertheless, little progress has been made in creating a similar favorable enabling institutional environment for the public sector. That is, little has been done to provide the "incentives" and "control" systems that would positively influence the behavior of government organizations to achieve a well defined role for the government. The major obstacles include weak central and sub-national governments' capacity in developing and evaluating public policies and poor citizen involvement in policy making and policy implementation.

The limited success of previous governments to implement economic reforms that could improve the country's business environment and investment climate was primarily due to a dysfunctional system of developing, passing and implementing economic policies. A legacy of the communist past, Ukraine's current government structure is plagued with

bureaucracy, vested interests and corruption. Decision-making is quite cumbersome, with unclear responsibilities among government agencies. Even minor decisions require a large number of consultations and approvals. Due to low salaries, public servants are faced with the difficult choice between doing their job impartially and surviving on rather low official salaries, or engaging in corrupt activities. The public sector has become a bottleneck to the country's development, particularly by delaying the implementation of economic reforms.

In Ukraine, the size of the Central Government in terms of numbers of people is relatively small. However, there are an excessive number of central public agencies with poorly defined roles. Moreover, many of these agencies have overlapping responsibilities. This leads to coordination problems and cumbersome decision-making, with multiple consultations. In addition, this situation breeds administrative corruption.

Inadequate control is one of the leading sources of problems in the country's governance. Existing government agencies need a higher level of transparency and control, which will ensure that their actions align with the organization's overall strategic goals. A higher degree of openness should instill public confidence and trust in government institutions. Although over 70% of the budget is now used for "social" purposes, these sectors suffer from large inefficiencies.

Reform Agenda for Public Administration

Without transforming the way government agencies work now, it is likely that the numerous obstacles for investment listed below in this paper will be removed very slowly. On the other hand, if well done, public administration reform will stimulate fast implementation of other reforms, make the public sector less prone to corruption and red-tape, and improve country image; this will put the country on a different path, on an accelerated course to attract investment and faster development and growth. Public administration will become a facilitator rather than an obstacle for implementation of other economic reforms.

The reform of public administration is an undoubtedly ambitious task that will require strong will, a long time and consolidation of various forces. But this is the key reform that is absolutely necessary to facilitate and make possible the implementation of all other economic and social reforms needed to revive investment in the country. Moreover, with

changes to the Constitution that give more chances for the new Cabinet of Ministers to find support in Parliament and to stay in the office longer than its predecessors, it is now a unique time to embark on public administration reform.

The reform of public administration should include the following actions/components:

Redefinition of the Government's Role towards Supporting Private Sector Activities

As a first initial step to reform the public sector, there is a need to clearly define the main objectives and role of the government. The role of the government will not be to compete with the private sector in revenue generating activities, but to support the private sector in these activities. The government role shall be based on the premise that productive and revenue-earning activities will be carried out essentially by the private sector in a free and competitive market environment. The government will deliver essential services that are not normally provided by the private sector, such as: infrastructure services, non-commercial activities in education, health and environment, protection of the poor, market-oriented regulations of trade, communications, labor and other private sector activities, law enforcement, foreign affairs, national security and defense, and similar non-commercial activities.

This clear definition of the role of the government should discourage some of the recent previous government "initiatives" such as the creation of new state enterprises to "complement" the private sector in such markets as oil refining, titanium production, grain distribution, etc. It would also discourage excessive interventions of the government on businesses. Some of these interventions — such as price controls — interfere with free market pricing and destroy business confidence, discouraging investments.

Increase Public Transparency and Access to Government Information

As a second step in the reform of the public sector, the government should quickly make government information more transparent and available to the public, except for national security reasons. This can be achieved by expeditiously passing legislation on Free Access to Government Information on any non-national security matter. Public procurement procedures should also be made more transparent.

Improving information transparency and openness will also be an important weapon to combat corruption, which is a major cause of distortions in public sector behavior. Information disclosure should also aim at building popular support — among businesses, unions, stu-

dents, the press, the civil service — for policy reform and for the role of the Government.

Undertake Functional, Operational and Civil Service Reviews

A comprehensive review of the public sector activities should be performed at the third step. A complete "audit" of all public sector functions, operations and activities should be carried out in order to identify functions or programs that do not service public interests and to detect areas of overlapping responsibilities. Unnecessary or irrelevant functions of the central government should be eliminated; others should be transferred to the private sectors or to local authorities. The review should also analyze day-to-day activities of the state agencies and qualifications of government staff in order to streamline the decision-making procedures, which are currently burdensome and time-consuming, and upgrade the quality of civil service. In general, the comprehensive review can be performed in three stages:

- The main objective of the functional review would be to identify the central government's core functions, roles and responsibilities and allocate resources to priority areas in order to provide effective, affordable government. This will include (i) organizing ministries along "functional" lines rather than by branch or sector, (ii) consolidating and reducing the number of ministries and state agencies to minimize duplication, avoid overlapping responsibilities and introduce a system of clear accountability, (iii) streamlining the current collective process for decision making that requires multiple signatures for most matters by transferring most decision-making power to single line ministries, etc.
- Once the functional reviews have been completed and new organizational set ups established, operational reviews of all ministries and government agencies should be undertaken to simplify their modus operandi, including improvements in internal processes, practices and procedures. The review would eliminate unnecessary regulations and licenses of business activities. In order to increase the effectiveness of the government decision-making process, policy formulation and analysis should be separated from policy implementation.
- Civil service review would aim to upgrade the quality of government staff. This can be achieved through reducing the number of civil servants while increasing the salaries of the remaining staff, introducing effective training programs in order to approach civil servants' qualifications to EU standards and introducing a system of incentives discussed in more details below. These measures

should make civil servants less prone to rent-seeking (corrupt) behavior.

Introduce Effective "Incentives" and "Control" System

The core of the public administration reform is creation of an enabling institutional environment in the public sector based on "incentives" and "control" that would lead public servants to carry out government functions in an effective manner. The "incentives" and "control" system for the public sector shall be designed in the image and likeness of the system that naturally works in the private sector. In the private sector, free prices and free trade allow firms to seek profits, thus creating an incentive for businesses. Control is performed by presence of competition: those that are not improving efficiency and seeking continuous improvements to satisfy their clients will be thrown away from the market through bankruptcy. A similar system shall be introduced in the public sector in the process of implementing a comprehensive public administration reform.

International experience suggests that an effective way to introduce an incentives system is to develop the concept of "programs" (or "projects") accompanied by performance-based budgeting, management and reporting. The most important characteristic of a program is its emphasis on the desired output rather than on the logic of production. Provided the objective of the program as well as actions and resources necessary to achieve this objective are clearly defined, it will be possible to undertake the cost-benefits analysis of the program and to evaluate the rationality of its implementation. Apart from this, it will be possible to define, measure, and monitor performance indicators and assess performance of the agency, department, or team of public servants responsible for its implementation. This will allow introducing the performance-based budgeting, management and reporting as a backbone of public administration functioning.

Within the described framework, *adequate compensation of state servants linked to performance* will be a main ingredient of the *incentive system*. To motivate performance, a key measure will be to link a substantial part of the compensation (about 20%–30% for most staff) to the achievement of objectives of the program or its part. As for now, salaries of civil servants not only fail to reflect individual performance but also are formed in an opaque manner with high emphasis given to bonuses and pay increments as compared to the base salary. Non-monetary incentives should also be enhanced; in particular, the perceived stature and professionalism of government employment should be strengthened by involving employees in setting objectives and

work out programs, and by providing them with sufficient autonomy and accountability to produce the expected outcomes.

To introduce a control mechanism similar to one that operates in the private sector, a set of laws and regulations will be needed. These regulations should allow for the "competitive" environment for public agencies, their behavior, and the way of conducting business. Greater competition can be achieved by establishing more than one government agency providing a service. Competition among providers for the funds will keep them under continuous pressure to seek more efficient and effective ways of reaching the defined objectives. The control mechanism should also include measures to improve information for accountability. Public institutions normally are not subject to the test of the marketplace to evaluate performance and ensure accountability. In the absence of a market test, transparency and openness of information and public processes and performance based on quantitative targets are the best ways to ensure accountability.

Public policy recommendations:

- Clearly redefine the role of the government, which will be based on the premise that productive and revenue-earning activities are essentially carried out by the private sector in a free and competitive market environment, while the government will deliver essential services that are not normally provided by the private sector;
- Increase transparency and accountability of the government by securing public access to government information through passing legislation on a Free Access to Government Information on all non-national security matters;
- Undertake functional, operational and civil service reviews in order to streamline the decision-making procedures of all government agencies;
- Introduce effective "incentives" and "control" system that would lead public servants to carry out government functions in an effective manner.

Privatization

Over the 14 years of privatization that started in 1992, Ukraine has managed to privatize (fully or partially) more than 11,000 enterprises. About 67% of all state property was transferred to private ownership through privatization. After completion of mass privatization of small and medium-size enterprises in 1999, the State Property Fund of Ukraine (SPFU), an agency

in charge of privatization in the country, commenced selling large enterprises. This process is still underway with some attractive companies in machine-building, food-processing, transport, and other industries being prepared for transfer to private ownership.

It shall be noted that the legislative base of privatization in Ukraine has for a long time been far from perfect. Since 2000, privatization of state-owned companies has been conducted on the basis of the State Privatization Program for 2000–2002, as later versions of the program failed to pass Parliament. Furthermore, the main document regulating SPFU activity, the Temporary Regulation on SPFU, was adopted as long ago as in 1992 and can be characterized as fairly outdated. In 2005, the Parliament approved the Law on SPFU, which defined the functions and responsibilities of the Fund, but the bill was vetoed by the President, who found that it contradicted the Constitution of Ukraine. There is also some uncertainty on the fate of strategically important enterprises and state monopolies, as the list of enterprises barred from privatization is changed quite sporadically without any specific criteria for examining the importance of the company for the state.

Notwithstanding the deficient legislative framework, the SPFU proved to be quite successful in transferring state enterprises to private ownership. In addition, some positive development in the legislation regulating privatization is expected soon. At the end of 2005, the government drafted a new State Privatization Program for 2005–2007 and made it available for public evaluation, which indicates state authorities' strive for a transparent privatization process.

Ukrainian legislation in this area of private ownership of land is much more up-to-date, although it remains quite prohibitive. In 2001, Parliament passed the Land Code, which provided the legal basis for transactions with land. In addition to acknowledging ownership rights to agricultural land, the Land Code provides for foreign ownership of non-agricultural land and clarifies the rights of foreign investors. However, the development of land relationship is hindered by the latest amendments to the Land Code adopted in 2004 that extend the moratorium on the sale of agricultural land until 2007 and prolong the validity of the regulation that restricts agricultural land ownership by Ukrainian individual or company to 100 hectares until 2015.

A troublesome period in the newest history of Ukraine's privatization was the so-called "re-privatization" process initiated by Ukrainian authorities just after the Orange Revolution. The new government announced plans to reconsider privatization deals for as many as 30 to 3,000 enterprises. It was announced that the results of previous privatization

tenders would be examined in courts. If a court decides that privatization of an enterprise was fraud, the company is to be returned to state ownership and privatized again. Not surprisingly, these plans triggered much concern among businesses, especially among foreign investors.

However, in practice, the "re-privatization" campaign was limited to just two large enterprises that had been previously acquired by local investors on auctions with purposefully restrictive conditions. One of them, the biggest local metallurgical plant Kryvorizhstal, has already been resold to the world's second largest metallurgical company Mittal Steel on a transparent and fair auction. In addition, a clear message was sent to the public that despite popular pressure to continue re-privatization, the government will be seeking to negotiate with the current owners of companies rather than initiate the re-privatization procedure. By conducting an open and transparent resale of Kryvorizhstal, Ukraine restored its reputation and enhanced its attractiveness as a country in which to make investments, whereas the promise to stop re-privatization procedures eliminated much of the remaining fears and increased confidence in Ukraine as a country that strives to respect property rights and obey market-economy rules.

Rather slow progress in reforming corporate and public governance to make these practices compliant with international standards was reflected in a lower rating compared to new EU-member states and countries acceding to the EU. However, Ukraine performs much better than other new EU-frontier countries.

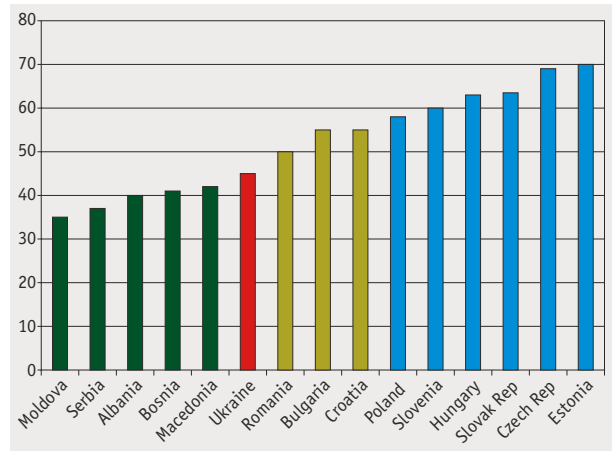
Public policy recommendations:

- Clearly define the policy of the government on "re-privatizations";
- Prepare and adopt a law on the State Property Fund that does not contradict existing legislation to ensure a clearer definition of the Fund's role and to avoid abuses of power;
- Establish adequate procedures to ensure that the further privatization process is transparent and competitive;
- Accelerate the privatization of the remaining state enterprises, particularly the local utility companies and telecommunications monopoly;
- Based on specific criteria, regularly review the list of strategically important companies barred from privatization;
- Develop expeditiously the regulations to facilitate land trade.

The chart below compares public governance in Ukraine with three groups of countries: new EU member states (in blue), which are some of the most successful emerging market countries (Poland, the Czech Republic, Estonia, Hungary, the Slovak Republic, and Slovenia), countries acceding to the EU in 2007–2009 (Romania, Bulgaria and Croatia marked olive green) and other countries that represent the new EU frontier (Albania, Bosnia and Herzegovina, Macedonia, Serbia and Moldova marked dark green). These countries have similar conditions to Ukraine (marked red), and are moving from a planned to a market economy. The chart below indicates that Ukraine has a long way to go in improving its public

governance to levels comparable to those of its more successful neighboring countries.

Public Governance



2. Macroeconomic Stability

The basis for sound macroeconomic performance and sustainable economic growth is macroeconomic stability, which is defined as long-term stability in prices (domestic stability) and foreign exchange rates (external stability). Investors need stable prices and currencies since they are the main elements affecting investment profitability. Stable prices and currency are also needed to minimize business risks and reduce the rate of return required by investors. This will increase the range of projects that could be attractive to international investors. Therefore, to encourage investments and enhance private sector confidence in the country, a major pre-condition is that the economy must be stable, that is, the rates of inflation and currency depreciation should be under control. The determinants of macroeconomic stability are sound fiscal and monetary policies that are achieved through the government's ability to maintain control over the fiscal budget balance, on the one hand, as well as control over the money supply, on the other.

Despite increased political instability on the eve of 2004 presidential and 2006 parliamentary elections, a set of political conflicts and a number of external shocks that hit the Ukrainian economy in 2005, the country managed to preserve macroeconomic stability. The exchange rate of the hryvnia with respect to the US dollar remained very stable with only one exceptional episode of a notable 4.8% appreciation in spring 2005, which was aimed at preventing inflow of hot money in the economy and reducing inflationary pressures. This and other measures have also allowed for maintaining the inflation rate at levels acceptable for a transition economy.

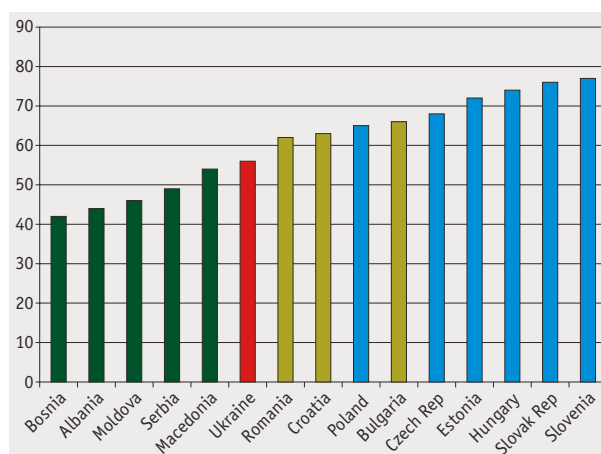
Stability of the exchange rate was supported by continuous central bank interventions in the foreign exchange market coupled with rather strict control over cross-border capital flows. This exchange rate regime of implicitly pegging the Ukrainian hryvnia to the US dollar was adopted in 2000 and has been maintained since. During the turmoil of the 2004 presidential elections, there was strong devaluation pressure on the hryvnia caused by high political uncertainty. However, thanks to the professional and timely steps of the NBU, the stability of the exchange rate was preserved. In April 2005, the NBU undertook an unexpected step and reduced the official exchange rate of the hryvnia from 5.33 UAH/\$ to 5.05 UAH/\$. This unprecedented event in Ukrainian modern economic history prevented the inflow of foreign speculative funds into the domestic government bonds market and helped to contain the growing inflationary pressure. Since then, the NBU has continued to support the exchange rate at the new level through foreign exchange interventions.

Although the constant exchange rate greatly contributed to the stabilization of the Ukrainian economy, the continuation of this policy has been questioned by the international organizations. In particular, the IMF constantly calls on Ukrainian authorities to allow for more flexible management of the exchange rate, which will be one of the prerequisites for adopting an inflation targeting regime.

Over recent years, Ukraine has managed to maintain the inflation rate at a level comfortable for transition economies. However, bringing price growth under better control remains an important issue for local authorities as high growth rates of consumer prices may endanger macroeconomic stability.

In 2004 and 2005, inflation was mainly rooted in fiscal policy that became more expansionary. Increases in social payments coupled with structural imbalances on select agricultural markets caused acceleration of inflation. On a very positive note, monetary policy was provident enough not to reinforce temporary inflationary pressures. Even though the money supply has been growing rather rapidly over recent years (at more than 40% on average), monetary expansion had little effect on inflation, and at the same time accommodated growing demand from the real sector. Moreover, appreciation of hryvnia, although widely criticized by the public, helped to contain inflation. It affected price growth in two ways: directly, through lower prices on imported goods and fuels produced from imported oil, and indirectly, through slowing down money supply growth. However, the National Bank of Ukraine should prepare itself for cautioning inflationary pressure with monetary policy instruments, not through abrupt changes in the exchange rate, which may have large negative side-effects. For this, the NBU needs to develop the necessary monetary policy instruments, improve the inflation forecasting capacities, and strive for better coordination of monetary and fiscal policies inter alia. Structural reforms in the agricultural sector and trade liberalization should also be pursued as key measures for maintaining price stability through balancing domestic markets.

Macroeconomic Stability



The chart shows that macroeconomic stability in Ukraine has a medium rank when compared to

other countries. It is also significantly worse than the ratings achieved by Ukraine in 2000–2004, implying that major efforts are needed to propel the country to more economic stability.

Public policy recommendations:

- Pursue prudent fiscal policy free of political motivations and based on medium-term strategy;
- Pave the way for adopting monetary policy based on inflation-targeting, in particular, by gradually introducing more flexibility to foreign exchange rate policy, developing appropriate monetary instruments, improving inflation forecasting capacities and better coordination of fiscal and monetary policies;
- Accelerate reforms in the agricultural sector to avoid regular occurrence of misbalances at agricultural markets. If made efficient and competitive through reforms, the agricultural sector will not be hurt by lower trade barriers;
- Reduce trade barriers. With the free flow of goods across borders, the temporary disequilibrium in domestic markets will be quickly eliminated without evoking price hikes.

3. Stability and Predictability of the Legal Environment

This driver includes policies and actions to enact and implement stable and predictable laws and regulations that would support and encourage private sector businesses in a free market. It calls not only for a solid legislation and its effective implementation, but also for a transparent judiciary and recognition of international contracts and agreements.

Legislation

After the collapse of the Soviet Union, Ukraine made enormous efforts to create and bring its legislation to the standards of a democratic society and market-based economy. A stable and predictable legal environment and well-functioning judiciary are critical for economic growth, reducing the cost and risk of doing business and attracting foreign direct investments. During the last few years, the Ukrainian legal framework was improved through adoption of a number of fundamental laws, such as the Civil Code, Administrative Proceedings Code, the Law on Mortgages, the Law on the Business Permit System and many others. Good progress has been achieved in improving the legislative framework in the areas of intellectual property rights protection, money laundering, insurance, financial intermediation, stock market, deregulation of business activities and liberalization of foreign trade and others, streamlining and bringing legislation to western standards. The great number of legislative initiatives was developed with assistance from international agencies like the World Bank, IFC, USAID, and others.

Ukraine has passed legislation that allows the country to acknowledge and execute certain decisions of foreign courts (in civil, labor and family cases, as well as particular aspects of criminal cases) and honors decisions of foreign arbitration courts, though their enforcement remains rather difficult. Ukraine is using an International Commercial Arbitration Law that parallels commercial arbitration laws set forth by the United Nations Commission on International Trade Law. Also, Ukraine is a member of the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitration Awards. In 2000, Ukraine ratified the Washington Convention, which provides for the use of the International Center for Settlement of Investment Disputes (ICSID) for resolving investment disputes between investors and the government of Ukraine. Similarly, decisions of the European Court for Human Rights on cases involving Ukrainian citizens are also enforced in the country.

Although Ukraine has made good progress across a broad front of legal and regulatory issues, it still needs to address major areas. The areas of concern are lack of consistency and coherence of legislation, the institutional capacity of Ukrainian authorities and the judiciary to implement the legislation.

Ukrainian codes and laws are riddled with ambiguities, internal conflicts and inconsistencies with other legislative acts. This allows for broad interpretation of the definitions and provisions by regulatory agencies and courts, thus encouraging corruption, increasing uncertainties and costs of doing business in Ukraine.

The most glaring example of **inconsistencies in current legislation** is the conflicting provisions of the Commercial and Civil Codes. Both codes became effective at the beginning of 2004 and constitute the basis for the whole legal system. Although formally the codes should complement each other, in practice they have different approaches to the regulation of business activities (in particular, issues related to regulation of securities, bank accounts, contracts, etc.). Moreover, the Commercial Code has a number of provisions, which are considered to be inconsistent with market economy principles. Although numerous collisions between the codes and subordinate laws were revealed since their enforcement, little improvement has been made so far.

The comprehensive review of the existing legislation in order to eliminate gaps, inconsistencies and ambiguities should be initiated by the government through appointment of a task force of qualified legal experts. The revision may take years given the number of laws passed by the Verkhovna Rada, Resolutions of the Cabinet of Ministers, Presidential Decrees and regulations issued by other state authorities. This process can be more efficient if the task force concentrates on a set of issues that create the largest problem for local and foreign businesses and tackles them first.

The large number of deficiencies in the legislation signifies that Ukraine has serious problems with the **law drafting process**. Although some of the draft laws could be of high quality, as a result of the passing through the parliament the document may change beyond recognition. The changes to the drafts and amendments to the laws often occur as a result of the change in political situation or on the behest of individual or business group interests. Generally, poor law drafting quality may also be explained by the lack of consensus between various groups in the parliament on the fundamentals, such as land and land-related issues, and absence of strategic vision of the country's development. However, the lack of effective, fair and consistent **law implementation** raises even more concerns. In addition to already mentioned inconsistencies inside and between the laws, the enforcement problems arise from little or insufficient attention of the law drafters and members of parliament to assess whether enough re-

sources will be allocated for the proper enforcement and what should be done to fully implement the law. Poor law enforcement is also closely related to the state of the judiciary system in Ukraine.

The Judiciary

Although the Law on the Judiciary provides for judiciary independence, it still remains dependent on and subject to various pressures. The judiciary continues to be criticized for complex and intricate procedures, unpredictability of decisions, inefficiency and corruption. An inefficient judiciary system is considered to be one of the major constraints in improving the investment climate in Ukraine.

One of the reasons for the slow progress in this area is the variance between the workload and the courts' financing. While the workload has been increasing, courts remain persistently under-financed. For example, in 2005 the number of administrative cases increased by about 20% in 2004 compared to 2003 and by about 70% compared to 2000. The increase in workload can be explained by the growing economy, the increased legal culture of the Ukrainian population and businesses. At the same time, even considering the rather substantial increases in budget spending in 2005, the funding of the judiciary system remained fairly low, representing about 2.2% of consolidated budget expenditures during 2003–2005.

Extremely low financing of the courts makes judges vulnerable to demands from different government bodies, from local authorities to law enforcement agencies and utilities suppliers. As a consequence of continued under-financing, courts are largely understaffed. This situation has made the judiciary system desperate for new employees, and has resulted in under-qualified personnel being hired to fill the vacant positions. Also, the judges are often insufficiently qualified to resolve some modern issues in company law, taxation, bankruptcy, and intellectual property. All this affects the quality of justice and undermines public confidence in the judiciary.

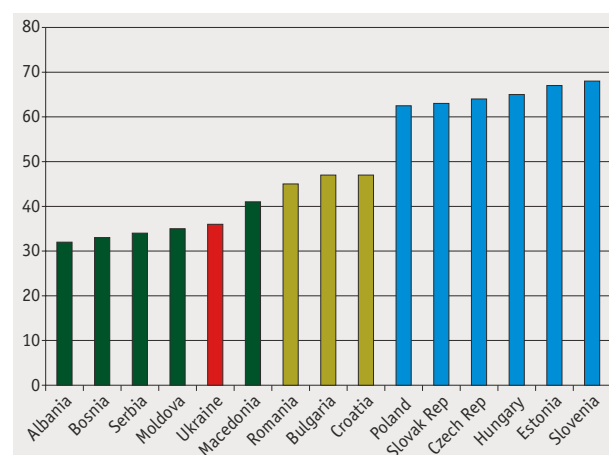
There was a broad understanding in the new government appointed after the 2004 presidential elections of the need for comprehensive judiciary reform. During 2005, the government tried to tackle the problem of the courts' under-financing. In particular, the amended 2005 State Budget envisaged about a 30% increase in budget expenditures to the judiciary system. Court financing in 2006 is expected to be further increased, as foreseen in the 2006 Budget Law. In addition, judges' salaries will be increased almost fourfold in 2006. This may increase courts' independence (particularly financially) and the prestige of the judiciary, and reduce corruption.

During 2005, there was some progress in improving judiciary-related legislation. In particular, the Administrative Procedural Code was adopted in July 2005 and came into effect in September, together with the Civil Procedural Code and the Law on Access to Court Decisions, which was enacted at the end of December. The latter requires court decisions to be posted on official web-sites of judicial authorities, published or disclosed electronically, which may positively affect enforcement of court decisions and increase public confidence in Ukraine's legal system.

The above measures will have a positive impact on the judiciary system development, although they are clearly insufficient to considerably improve the situation in this area. To develop the strategy for carrying out comprehensive judiciary reform, the special Commission on Reforming the Judiciary System was established by the President of Ukraine in May 2005. Many international organizations are actively engaged in reforming the judiciary system and strengthening the rule of law, providing for technical support and access to external technical assistance to the reform process.

Although Ukraine has made good progress in improving the legal framework, considerable efforts should still be made to reform the judiciary system, improve enforcement of laws and court decisions, improve the drafting process and reduce inconsistencies in the existing legislation. Compared to new EU-member states and candidate countries, Ukraine's legal environment is still far behind these countries.

Stability and Predictability of Legal Environment



Public policy recommendations:

- Improve the practice of thorough consideration of any legislative act to be adopted, including their correspondence with existing legislation;

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- Faster development of a strategy on comprehensive judiciary reform and ensure endorsement all legislation necessary for its implementation;
 - Further improve financing of courts to ensure their independence;
 - Improve financial management of the courts' budgets;
 - Enhance hiring, qualifying, and disciplining procedures for judges and court staff employees;
 - Develop comprehensive training programs for judges in contemporary issues, including company law, financial services issues, taxation, bankruptcy, intellectual property, human rights, etc;
 - Encourage creation of free of charge legal advice centers and law school legal clinics;
 - Enhance commercial courts for settling disputes;
 - Develop sound computerized databases for court decisions and legislation that can be accessed by judges across the country.

4. Liberalization and Deregulation of Business Activities

This driver includes government policies and actions that reduce government interventions, enabling private businesses to operate freely and make profits in a competitive environment. Favorable conditions must be created for the three major components of business activities: entry, operations and exit.

In 2005, Ukrainian authorities made noticeable progress in addressing the issue of reforming **the regulatory environment for business**. The government has been working on improving the quality of new laws and legal acts through introduction of the regulatory impact analysis mechanism required for all legal acts. However, building such progressive regulatory practices across state agencies was difficult and slow. The low level of liberalization of business activity, on the one hand, and the over-regulated business environment on the other hand, still remain significant barriers for further improvements in the Ukrainian business climate.

In 2005, the main government efforts related to deregulation of business activity were concentrated in the following areas:

- decreasing the number of existing regulatory acts concerning business activity through the introduction of the "Regulatory Guillotine™" mechanism⁷;
- removing barriers for starting new businesses and operating existing ones.

The recently introduced concept of the Regulatory Guillotine™ is a new one for Ukraine. It was designed to "clean" the existing regulatory environment by reviewing a large number of regulations, and eliminating those that are damaging for further business development. These efforts were undertaken by all government agencies with the participation of the non-governmental institutions. As a result of the first phase of this deregulation initiative, 9,340 regulations were reviewed and around 5,000 were considered inconsistent with the Law on State Regulatory Policy and were amended or repealed by the end of 2005. The same initiative was also undertaken on a local level, which led to the repealing or amending of 1,358 local regulatory acts. Although these efforts were a very positive step towards clearing away the Ukrainian regulatory environment, the results were not as significant as initially expected. The second phase of quick deregulation is a sector-oriented one and should be implemented in 2006. During the second phase, all specific sector irregularities that continue to impede business growth in specific sectors and in the economy as a whole should be identified and eliminated.

⁷ The term and the strategy of "Regulatory Guillotine™" was introduced by Jacobs and Associates and registered as a trade mark.

⁸ World Bank and IFC, Doing Business in 2006. Creating Jobs. Washington DC, 2006.

Duration of Procedure Required to Start Business in 2005

Type of Procedures	Duration (days)
Register for VAT and Income Tax	10
Register with Tax Police	7
Register the Company	3
Make a Company Seal	2
Notify the District Tax Inspectorate	2
Notarize Deeds	1
Open Temporary Bank Account	1
Pay Registration Fee at Savings Bank	1
State Statistics Committee	1
File with Pension Fund	1
File with Employment Fund	1
File with Social Insurance Fund	1
File with Industrial Accidents Fund	1
Approval of Ministry of Internal Affairs of Seal	1
Open a Permanent Bank Account	1
Total	34

Source: World Bank

The simplification of **procedures to open a business** has been a concern of the Ukrainian government over the last couple of years. These efforts are mainly related to the procedures of the new companies' registration. However, the gained results are not sufficient enough and more efforts are required. The actual number of procedures in the country is estimated at as much as 15 and has not been changed starting 2003.⁸ At the same time, the total amount of time needed to fulfill all necessary requirements went down from 40 days in 2003 to 34 days in 2005. With this move, Ukraine was put well above such advanced transition economies as the Czech Republic, Hungary, Estonia, Slovenia and even above some western European countries as Greece, Germany and Spain.

Closing a business in Ukraine is relatively easy. The duration of the closing procedures for limited liability companies does not exceed 2.9 years, which makes Ukraine compare favorably with other transition countries.

The **system of permission** that existed in Ukraine was a significant barrier for business development. In 2005, there were 61 different types of permits, with the total amount estimated at as much as 1,200. Ukrainian companies needed to spend on average 81 days to obtain all necessary permits for operating their businesses with average payments of around \$202. The existing permission system was regulated by more than 60 laws and by around 100 decrees issued by the Cabinet of Ministers. In addition, many local government bodies had

the right to issue their own permits to operate specific types of businesses in their own regions. The nature of the overregulated and non-unified system that existed in 2005 was due to the fact that 80% of the 2,000 legal acts regulating the procedures for obtaining permissions were issued by different local bodies.

In January 2006, the new Law on Permission System in Economic Activity came into effect. This law introduces clear, unified and transparent procedures for obtaining permissions by private businesses. This law terminates a number of the regulatory acts issued by local bodies as those were inconsistent with the Ukrainian laws. An important innovation related to the functioning of the country's permission system is the introduction of one-stop permissions centers, where entrepreneurs would be able to receive all needed permits.

The existing **system of licensing** is competitive compared with other emerging economies. The average number of procedures through which the Ukrainian company should go in order to obtain requested licenses in 2005 was 18. For instance, in Czech Republic this number is 25, in Poland and Hungary 31. The same refers to the duration of the requested procedures. While Polish companies need to spend around 322 days and Slovakian companies 272 days, in Ukraine all requested procedures will be fulfilled on average in 265 days.⁹

In Ukraine, more than 60 types of business activities are requested to be licensed. Although the overall level of legal support of licensing is on an appropriate level, the major problems in this area are related to unclear procedures while applying for necessary licenses, the large number of required documents to submit, and frequent changes in the respective legislation. All these problems create some misunderstanding among the private businesses.

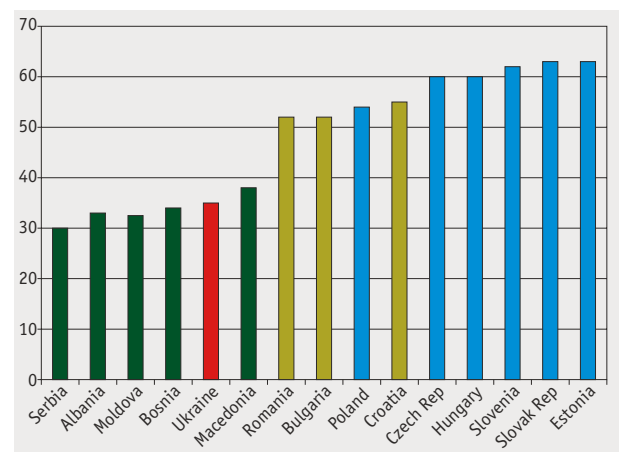
Inspections are serious obstacles for further business development in Ukraine. The annual number of inspections conducted throughout the country by different controlling bodies exceeds 1.5 million. More than 91,000 state workers are constantly working in inspections, which costs the government around UAH 637 million. The majority of Ukrainian businesses believe that the procedures of fulfilling inspections are unclear, complicated, and non-transparent.

Currently, there are around 40 different government controlling bodies in Ukraine. Their list is not stable and has experienced frequent changes. The existing system of inspections does not fulfill its main function of preventing abuses of law and

serves mainly for punitive function. This practice, on the one hand, helps to increase the revenues of government agencies; on the other hand, it negatively affects private businesses. There is a clear need for a new approach to inspections to be developed. It should address several important issues:

- Implementation of EU norms of risk management regarding businesses and specific companies that should be inspected;
- Introduction of the maximum term for inspection;
- Increase transparency in the regulatory environment related to inspections;
- Define and limit the full list of the controlling bodies and type of inspections.

Business Liberalization and Deregulation



Public policy recommendations:

- Clearly define procedures required for starting and closing a business and increase the level of their transparency through the implementation of the public awareness program and development of e-governance programs;
- Increase stability of the existing legal system by avoiding frequent changes in legislation concerning business activity;
- Improve coordination between central and local government bodies on regulatory policy issues by avoiding conflict of interests between different levels of executive power and making clear distinctions in the area of their responsibilities;

⁹ World Bank and IFC, Doing Business in 2006. Creating Jobs. Washington DC, 2006.

- Increase efficiency of the existing registry one-stop-shop offices by staffing them with qualified experts and equipment;
- Secure effective implementation of the second phase of the quick deregulation strategy, the Laws on Principles of State Regulatory Policy, On Permission System in Economic Activity.

5. Corporate Governance

The objective of corporate governance policies is to establish appropriate rules, relationships, systems and processes that would ensure effective distribution of rights and responsibilities among different participants in the company (managers, board members, shareholders and others). This, in turn, helps to improve financial performance of companies and guide their activities in the best interest of their shareholders, protecting ownership rights. Key elements here include disclosure of information about corporations, shareholders' rights protection, equal treatment of all shareholders, and use of transparent accounting practices.

The interest in good corporate governance practices for the economic health of the company and the economy as a whole has been increasing in both developed and emerging markets. The need for corporate governance improvements even in developed economies became obvious following a number of international corporate scandals, including the collapse of Enron, one of the largest US corporations. For emerging markets and transition economies, corporate governance practices are of no less importance than financial indicators. Companies that found domestic financial resources scarce and rather costly have an increasing interest in attracting funds from abroad. The companies that maintain high corporate governance standards have more chances to attract foreign investors and succeed, thus contributing to economic growth in the country.

Since independence, Ukrainian authorities have been actively introducing rules to regulate the creation and functioning of joint stock companies. Although Ukraine is making progress towards developing an effective corporate governance framework, important flaws exist (mainly due to inefficient legislation), allowing for non-disclosure of information, insider dealing, asset stripping, shares dilution and voting fraud, to name a few. Weak corporate governance is one of the reasons for the sluggish stock market development and low level foreign direct investments in Ukraine.¹⁰ The progress made so far in a number of corporate governance areas was primarily driven by Ukraine's aspiration to seek EU membership.

Corporate governance legislation in Ukraine includes the Law on Enterprises, the Law on Securities and the Stock Exchange and the Law on Business Associations. All these laws were enacted in 1991, shortly after independence. Although these laws have been amended several times to bring them closer to EU standards, corporate governance-related legislation in Ukraine still requires considerable improvement.

In particular, although formally the Law on Enterprises requires the equitable treatment of all shareholders, in practice current legislation provides for insufficient protection of minority shareholders, which

allows majority stakeholders to exercise unlimited control over the company with no regard to other owners' needs. One of the most glaring examples of violating corporate governance principles is provision in the State Budget Law requiring profit transfers to the state budget for all enterprises with state-owned equity stakes in the proportional amounts.

Though certain progress has been made in the area of information transparency and disclosure in Ukraine, disclosure rules concerning company information are inadequate. Timely and accurate information regarding a particular enterprise's financial position, ownership, major customers/suppliers, governance is important not only for direct participants but also for market players, potential investors and sometimes the whole society. However, this information is rarely publicly available and can not be found out easily. For instance, the difficulties in the negotiations between Ukraine and Russia during the recent gas dispute were partly related to the lack of transparency of the joint venture RosUkrEnergo (particularly, information on the ownership), the intermediary-monopolist of the natural gas supply to Ukraine.

Although current laws require companies to publish their annual reports in the media, including on specialized web sites, the value of such information for foreign investors may be fairly low considering that information is usually disseminated on an annual basis and based on Ukrainian accounting practices, which are still in the process of adjusting to International Financial Reporting Standards.

Starting 2004, the new Civil and Commercial Codes came into effect, which can be considered an important step towards improving the corporate governance legislative framework. The codes regulate the business entity's set up, operation and termination and embrace better protection of shareholders' rights, including the rights of minority shareholders and greater assurances to investors that international contracts will be honored in Ukraine. At the same time, the codes overlap each other on a number of issues, sometimes providing for conflicting and difficult to interpret regulations. This creates difficulties for the legal application of the codes provisions, undermining the generally positive impact of the codes introduction.

With the aim of improving corporate governance practices in Ukraine and protecting the interests of investors, the State Commission on Securities and

¹⁰ The record high FDI inflow in 2004-2005 is primarily attributed to privatization and re-privatization of the largest Ukrainian metal plant "Kryvorizhstal" and a number of mergers and acquisitions. At the same time, Ukraine's per capita net FDI inflows were among the lowest in the CEE region.

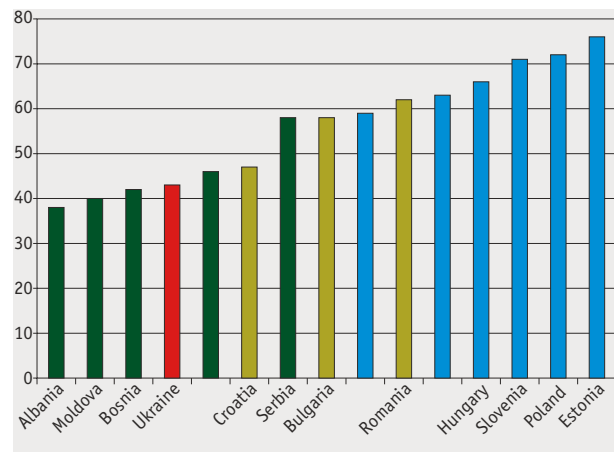
Stock Market developed the Principles of Corporate Governance in Ukraine, which were adopted at the end of 2003. The Principles were developed based on the OECD Principles, though adapted to the legal and economic environment in Ukraine. Since they essentially serve just as guidelines for doing business, their enforcement is rather low in Ukraine. At the same time, there are a growing number of enterprises that develop their own internal corporate governance codes (i.e., the state telecommunication monopoly "Ukrtelecom").

Adoption of a Joint Stock Company Law, complying with international standards, could be a remedy for the existing drawbacks in current corporate governance legislation. The draft law, which encompasses the key rules and regulations necessary for the introduction of sound corporate practices compliant with international standards, was prepared in the late 90s. Since then, the draft has undergone many revisions and amendments; however it was not passed by the parliament. After the recent parliamentary elections, accelerating the adoption of the Joint Stock Company Law will be an important task for the new parliament and government.

In general, the process in improving the level of corporate governance in Ukraine is still primarily driven by various international NGOs and technical assistance providers with the support of the government and increasing participation of corporate entities. The growing number of business entities with participation of foreign capital observed in recent years (either as owner, manager, investor or creditor) may speed up the improvement of corporate governance in Ukraine. This is particularly true for the banking sector. In 2004, there were 19 banks with foreign capital in Ukraine, while this number increased to 23 in 2005 as a result of several mergers and acquisitions. According to the IFC Survey of corporate governance practices in the Ukrainian banking sector carried out in 2004, in general, banks with foreign ownership have better corporate governance practices than banks without any foreign capital. In addition, to expand their resource base, commercial banks more and more frequently apply for borrowing from abroad. To receive long-term and cheap financing from abroad, banks improve their corporate governance practices. These developments, in turn, may shortly translate into other sectors of the economy as the banks may set similar requirements for business entities applying for bank financing.

During 2005, Ukraine made considerable progress in intellectual property rights protection. In connection with WTO accession, Ukraine amended a number of legislative acts regulating copyrights. In particular, Ukrainian laws on manufacturing, export and import of laser-readable discs and respective equipment and raw materials for their manufacturing were brought in line with WTO requirements. In addition, the responsibility for violations in this area was strengthened to criminal. However, enforcement of the current legislation may still lag behind considering the inefficient law enforcement as a whole in the country.

Corporate Governance



Public policy recommendations:

- Accelerate the adoption of the Joint Stock Company Law, complying with international corporate governance standards;
- Speed up the adjustment of Ukrainian accounting standards to international accounting standards;
- Enhance the external and internal audit of company's finances and operations;
- Remove inconsistencies between the Civil and the Commercial Codes by eliminating the Commercial Code and passing some of its provisions to the Civil Code;
- Enact stringent rules for disclosure of the ownership structure of the company, information about company's members of the board, management and their remunerations, related-party transactions and other relevant information;
- Improve the overall law enforcement in the country.

6. Liberalization of Foreign Trade and Capital Movements

This driver includes policies and actions to facilitate the export and import of goods and transfer of capital internationally. This includes the following actions: removal of restrictions to both exports and imports (including non-tariff restrictions), streamlining customs procedures and certification requirements, and liberalizing the foreign exchange regime.

The Euro-Atlantic development strategy for Ukraine, proclaimed by President Yushchenko just after his inauguration in February 2005 and actively implemented by his governments, led to significant developments in the area of foreign trade liberalization. In 2005, Ukrainian authorities undertook much effort in facilitating foreign trade relations, simplifying customs procedures, fighting corruption at customs, bringing local trade legislation in line with the World Trade Organization (WTO) requirements and continuing bilateral negotiations with WTO members.

Although the ambitious goal to join the WTO in 2005 has not been achieved, the progress in this direction was remarkable taking into account the short period of time at the disposal of Ukrainian authorities. Thanks to consolidation of political efforts, the Verkhovna Rada adopted many (though not all) of the radical changes to current legislation required for WTO accession.

The most significant progress was made in liberalization of tariff barriers for imports. In July 2005, the Parliament voted for a set of amendments to the customs tariff that significantly decreased import tariffs on about 90% of Ukraine's imports, including highly-disputable tariffs on agricultural goods. Excisable commodities and textiles were the only two groups for which import tariffs remained unrevised. As a result, the level of overall tariff protection was almost cut in half. The adopted amendments also envisaged a unification of privileged and full-scale tariff rates, which is another important step in trade liberalization. Apart from furthering Ukraine's WTO aspirations, the reduction of import tariffs will promote legalization of shadow imports and discourage corruption, although lower tariffs may stimulate an inflow of goods from abroad, reducing Ukraine's trade balance.

Other essential steps towards WTO membership include elimination of discriminatory treatment of foreign firms in insurance and auditing activities, reduction of export duties on sunflower seeds, adoption of changes to the law on food product safety and others. Yet, several draft laws important to WTO accession, including those that envisage reduction of export duties on live cattle, hide and metal scrap as well as removal of import quotas on sugar, failed to pass the Verkhovna Rada, as their approval would reduce state protection of certain industries hampering vested in-

terests. Still, such politically sensitive issues are likely to be resolved after the Parliament's reshuffle after March 2006.

Another aspect of WTO accession is completion of bilateral negotiations with WTO members regarding access to the market of goods and services. According to the Ministry of Economy, as of January 1, 2006, Ukraine signed 40 bilateral protocols, 10 of which were endorsed in 2005. Overall, 50 WTO members expressed the desire to negotiate access to goods and services with Ukraine. Among the remaining countries, negotiations with Australia are expected to be quite tough due to a strong disagreement between Ukrainian and Australian authorities regarding protection of Ukraine's agricultural market.

Ukraine's bilateral relationship with the US and the EU improved significantly in 2005 and 2006. Recognizing Ukraine's progress in intellectual property rights protection, which for a long time was a stumbling-block in bilateral relations, trade sanctions imposed by the United States on Ukraine in 2002 were lifted. At imposition, the cost of the sanctions (in the form of 100% duty on 23 of Ukraine's export goods) was estimated at \$53 million.

The most prominent achievement in relationship with the EU and the US was their recognition of Ukraine as a market economy. At the end of 2005, EU officials declared that Ukraine has fulfilled all technical requirements for market economy status. The status was officially granted to Ukraine at the beginning of 2006, after completion of all formalities. The US granted Ukraine the status of a market economy in March 2006. Received market economy status will facilitate trade relations, including prompt resolution of existing anti-dumping allegations, thus promoting Ukraine's exports. Furthermore, it will expedite Ukraine's accession to the WTO and may help in advance negotiations on signing a free-trade agreement with the EU and the US.

Ukraine also advanced in finalizing long negotiated agreements with the EU. After several years of negotiations in 2005, Ukraine and the EU signed an agreement on steel trade for 2005 and 2006 that establishes an inversely proportional relationship between quotas for Ukraine's steel exports to the EU and the level of export tariffs on ferrous metal scrap levied by Ukraine. Another agreement lifted the remaining restrictions on trade in textiles and clothing products. The trade relationship with Russia has also undergone some positive changes, despite the upsurge of political tensions between the countries. In particular, Russia and Ukraine agreed on elimination of exemptions from the

bilateral free trade agreement that concern import duties on sugar, confectionaries, tobacco and pure alcohol. Recently however, some other tensions have been developed in trade relations with Russia, particularly regarding livestock and gas.

Although Ukraine's progress in reducing import tariffs was fairly notable, non-tariff barriers remained significant restrictions on international trade. These range from import licensing, standards, and certifications to various sanitary, ecological, veterinary, etc. controls. The Ukrainian government undertook several actions aimed at fighting corruption at customs, reducing customs formalities and accelerating the process of customs considerations through introduction of "one-window" customs procedures. However, comprehensive reform is needed to change the overall system penetrated by corruption and selectivity of the authorities.

Ukraine advanced significantly in liberalizing cross-border capital flows. The most prominent step was in August 2005 when the NBU substituted a highly prohibitive resolution regarding foreign investments with a much softer regulation. The new regulation eliminates the need to open special investment accounts and no longer contains a requirement to convert foreign currency into hryvnia when investing in Ukraine from abroad and repatriating profits. These restrictions were considered as serious impediments for foreign investors as they complicated the transfer of funds and contributed to an increase in operational costs associated with unnecessary currency conversions. It is worth noting that the new regulation still leaves much room for improvement as it is far from being perfect. Further progress in this direction is expected soon when the NBU adopts the amendments aimed at eliminating some inconsistencies in new regulation. In addition, the NBU officials announced that procedures of capital inflow and outflow are going to be simplified in the nearest future. This primarily concerns attraction of foreign banks' deposits and credits by domestic banks.

The NBU has also adopted several measures on liberalizing operations with foreign currencies in the interbank foreign exchange market. Among the most important changes were permission to conduct arbitrage operations with certain foreign currencies, introduction of forward operations and simplification of trading session rules. These measures allow banks to hedge currency risks, as well as to speed up satisfaction of their clients' requests.

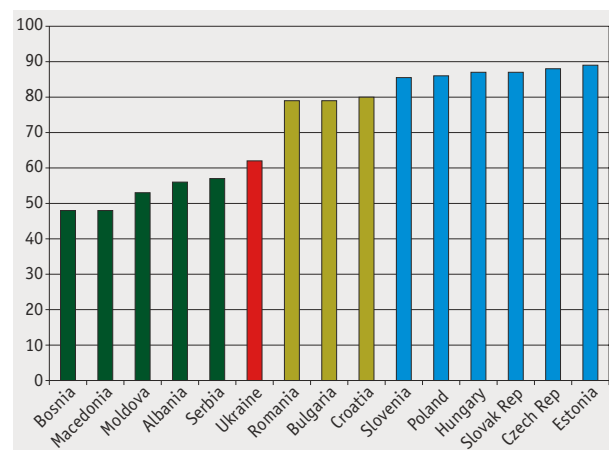
Monetary authorities recognized that liberalization of capital movements will not only help to attract strategic investors, but may provoke speculative capital flows. Striving to discourage hot-money inflows that

could destabilize foreign exchange market and exhaust foreign exchange reserves, the NBU toughened rules of short-term borrowings from abroad. In particular, commercial banks are required to reserve 20% of a foreign loan amount, if the loan is disbursed for less than 180 days. This constraint is designed as a specifically targeted measure, as it increases costs of short-term cross-border capital flows in the form of loans, thus discouraging speculative inflows, but has no effect on long-term strategic investment.

Another change in the foreign exchange market regulation positively affecting foreign trade was the abolishment of the 50% surrender requirement. This restriction was imposed after the financial crisis of 1998 to lift the strong devaluation pressure on the hryvnia. After the foreign exchange market stabilized in 2000, the restriction became fairly redundant. Nevertheless, it was not abolished until recently due to fears that its elimination could destabilize the foreign exchange market. The repeal of the surrender requirement reduces operational costs of exporting enterprises, thus increasing their flexibility in daily operations.

Overall, Ukraine's significant progress with WTO accession and liberalization of cross-border movements of commodities and capital was reflected in the upgrades of country's scores by international organizations, such as the European Bank for Reconstruction and Development and the Economist Intelligence Unit. Nevertheless, the country's rank among other transition economies is still low, due mainly to remaining deficiencies in its customs administration, problems with VAT refunds to exporters, and the fact that Ukraine is still not a member of the WTO. However, it is expected that Ukraine's efforts in WTO accession and further liberalization of capital movements will substantially improve its position among other transition economies.

Liberalization of Foreign Trade and Capital Movements



Public policy recommendations:

- Ensure entry into the WTO as soon as possible; for this, enact pending necessary legislation and sign protocols on mutual market access with the remaining countries in order to pave the way for WTO entry;
- Promote signing free trade agreements with the EU and the US;
- Continue streamlining customs procedures and formalities to ensure prompt consideration and to avoid opportunities for rent-seeking behavior;
- Soften export restrictions; in particular, eliminate corruption and rent-seeking activities in VAT reimbursement and ensure timely and accurate refund of VAT to exporters;
- Eliminate import non-tariff restrictions that often function through licensing, standards and certifications, sluggish performance of government agencies, etc.;
- Ease the system of certification and standardization to acknowledge international standards and certificates for quality, safety, etc.

7. Financial Sector Development

This driver includes policies and actions to develop a healthy financial sector capable of meeting the financing needs of growing businesses. To achieve this, a country needs an independent central bank capable of effective bank supervision, large share of private commercial banks, including foreign ones, functioning lending and deposit markets with liberalized interest rates, along with developed stock market and effective insurance system in place.

Banking Sector

The Ukrainian financial market grew significantly after the 1998 financial-crisis. However, the development of the country's financial market was mainly concentrated in the banking sector. Over 2001–2005, the net assets of the banking sector increased in hryvnia terms by almost five times and reached UAH192 billion (\$38 billion). The size of these net assets is equivalent to around 44% of the country's GDP. However, this number is considerably lower than corresponding indicators in most transition countries where banking assets account for an average of about 60% of GDP.¹¹

Currently there are 163 active commercial banks in Ukraine. Over the last five years, this number has slightly increased from its level in 2001 when the number of active banks was 152. Despite some growth in the number of banks, this figure is well below the historical peak in 1995 when it reached 230 entities. Over the last decade, the decrease in the number of banks was mainly due to improved supervision over commercial banks' activity from the side of the National Bank.¹²

Structure of Banking Sector, 2001–2005

	2001	2002	2003	2004	2005*
Number of Active Banks	152	157	158	160	163
Total Assets (UAH million)	50,785	67,774	105,559	140,332	192,097
Assets as a Share of GDP, %	24.9	30	40.0	41.0	44.0

* As of October 1st, 2005.

Source: National Bank of Ukraine

The main concerns over the banking sector development include:

- low capitalization;
- low profitability;
- high concentration;

- high operating costs and interest rate spreads (7.5–8%);
- very rapid credit growth over recent years implying concerns over the quality of the loan portfolio;
- inadequate rules for loan classification and provisioning, which tend to underestimate the level of non-performing assets;
- poor risk allocation as a few large firms receive the lion's share of total credits;
- low transparency and lack of good corporate practices.

The banking sector still remains small with a significant degree of concentration. According to NBU statistics, the top ten banks (two of which are state-owned) accounted for as much as 54% of total banking sector assets, while the top 24 banks own 70% of total assets in October 2005. Moreover, assets of the three largest banks alone totaled over one quarter of this amount while as many as 108 banks hold 12.8% and reported a cumulative number of UAH 23.3 billion of total assets, out of which only UAH 5.5 billion was their own capital. Small and inefficient banks have often survived due to political connections or support from the industrial groups to which they belong.

Being largely under-capitalized, local banks engage in syndications with other local or foreign banks to accommodate the growing needs of businesses. Faced with a shortage of inexpensive resources in the country, Ukrainian banks have started to borrow from European financial markets by taking syndicated loans or issuing Eurobonds. Nevertheless, foreign participation in the banking sector is modest but growing with some of the world's largest banks being very active in Ukraine. These include Raiffeisenbank, Citibank, ING Bank, Credit Suisse First Boston, CalyonBank (seven foreign-owned banks in total). Some other banks have foreign-owned stakes (13 banks). The foreign participation accounts for no more than 20% of total banking sector assets. Entry of foreign banks used to be regulated due to limitations placed on their activities by the Ukrainian legislation, and through heavy lobbying from local banks.¹³

¹¹ IMF data.

¹² National Bank of Ukraine.

¹³ See the Ukrainian Law on Commercial Banks for more details.

The level of capitalization of the Ukrainian banking system remains extremely low despite several years of strong asset growth and steady but insignificant earnings. The current minimum statutory capital requirement of the NBU necessary to obtain a general license for nationwide banking activities is set at EUR 5 million. This minimum capital requirement is even lower for the many smaller institutions that operate only on a limited regional basis. For operating banks, the major current source of capitalization remains retained earnings, which are not increasing at the same pace as loan growth. Furthermore, the low level of capitalization is even more serious given the high level of non-performing loans in the banking sector. According to IMF estimates, the level of non-performing loans is likely to be about 5 to 6 times higher than the "official" level of about 4% of total assets. It is likely that these high levels of non-performing assets will result in the failure of a number of small/medium banks in the near future.

The banking industry in Ukraine is concentrated in the capital city — Kyiv, and several big regional centers. The capital of Ukraine is the wealthiest city in the country with GDP per capita 50% higher than the next wealthiest region in the list. As of January 2005, Kyiv's population and businesses placed 37% of all banking system deposits. The average size of retail deposits of Kyivites is equal to UAH 4,740, which is more than four times that in the Dnipropetrovsk region, the second in the list by the amount of deposits placed with the banking system. Combined deposits of the population and businesses of Dnipropetrovsk and Donetsk region (the highly populated regions of Ukraine) amount to 22% of total deposits placed with the banking system.

More than half of all banks operating in Ukraine are registered in Kyiv. And there are several regions in the country where not even a single bank is registered. As for the number of banking outlets throughout the country, Ukraine is severely under banked. On average, there are slightly more than 3 banking branches per 100,000 people, while the corresponding figure in the eurozone reaches 50 bank outlets. For the new EU members this ratio amounts to 7.

Non-banking Financial Sector

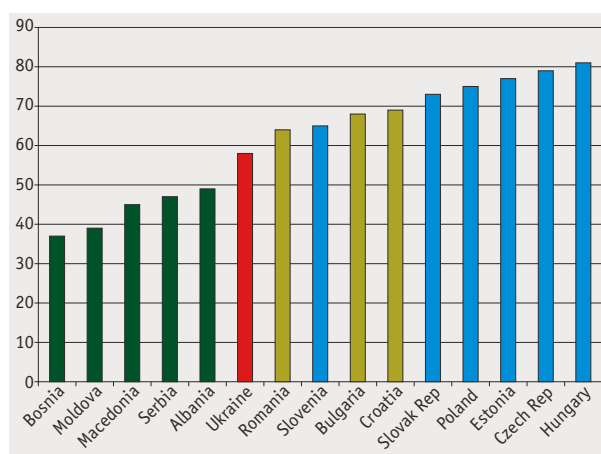
Currently, the Ukrainian non-banking financial sector remains highly underdeveloped and relatively small, which negatively affects the country's overall economic development. The insignificant size of the existing non-banking financial institutions (NBFI) significantly limits their actual involvement into providing local businesses with financial services and financial resources in particular. In contrast, in the most advanced transition economies, NBFI play a

very important role in the countries' development. This role is defined by the importance of such institutions in providing domestic companies with a variety of services and instruments, which are not offered in such broad spectrum by banks. As a result, both financial sector and the economy as a whole receive additional impulses for its own development.

In 2005, the Ukrainian market capitalization experienced significant growth. During the year it increased more than twofold and reached almost \$30 billion or 35.2% of GDP. However, many of the companies listed on PFTS are not liquid. Companies' shares traded on PFTS in 2005 constitute 23% of the total trade on this stock exchange or \$0.65 billion in absolute value. Therefore, the actual market capitalization is substantially lower. Aggregate market capitalization of five companies with the biggest volume of the market capitalization (i.e., Kryvorizhstal, Ukrtelecom, Ukrnafta, Mariupol Metallurgical Plant, and Azovstal) is \$11.15 billion or 13.6% of GDP. Low level of liquidity of the Ukrainian market is a serious obstacle for further NBFi development. Moreover, lack of available financial instruments restrains activity of insurance companies, pension funds and other economic agents. As a result the country's financial market develops rather slow compared to peer countries.

The existing underdevelopment of the equity market reflects insufficient legal support for further financial market development. In particular, the existing weaknesses in corporate governance, including lack of efficiency in information disclosure for publicly listed companies, and delays in passing the Joint Stock Company Law.

Financial Sector Development



Significant efforts of Ukraine undertaken in 2005 substantially improved its financial sector. Although Ukraine performed much better than many other countries in the region, its financial

sector development is still behind many other European emerging markets, in particular EU-member states and candidate-countries. From this point of view, further improvements in Ukraine's financial sector are required.

Public policy recommendations:

- Ensure equal "playing conditions" for domestic and foreign banks by adopting specific amendments to the current law On Banks and Banking Activity, which will allow foreign banks and non-banking institutions to fully operate in Ukraine;
- Provide specific mechanism able to ensure dealing with unsecured debts issued by commercial banks by adopting a special Degree of the National Bank of Ukraine;
- Continue practice of the NBU to ensure stability on the retail financial market by increasing the size of individual deposit insurance by introducing \$1,500-coverage for deposits;
- Encourage stock market transactions to be made on the organized market through better development of the country's depository and registry system by adopting amendments to a Law on Depository System and abolish existing inconsistencies in policies of NBU, Stock Market State Commission, Committee for Regulation Financial Services Market and Securities, and State Depository;
- Support implementation of a modern system of corporate governance by introducing additional requirements to financial market operators in terms of information disclosure in-line with the existing OECD and EU practices/standards;
- Stimulate development of non-banking financial sector by introducing a frame law on non-banking financial institutions, which will incorporate all main principles needed to support this sector growth.

8. Corruption Level

This driver includes policies and actions to minimize corruption and protect businesses from abuse of power by government officials. Key measures here range from creating the legal framework to ensure better enforcement of anticorruption measures to measures to prevent corruption and raise public awareness of the problem.

Corruption remains one of the gravest impediments to the successful development of a competitive market economy in Ukraine. To a large extent, corruption was inherited by Ukraine from the former Soviet Union, characterized by a highly restrictive system of resource allocation. During the Soviet period, the so called "blat", the informal use of personal relationships to get access to scarce goods, services and resources, even the most basic ones, was a vital element of everyday life. One would suggest that after the collapse of the central planning and democratic transformations, the country should have faced a reduction in corruption. In reality, after a short cooling off period that may be attributed to the break-up of former relations, corruption has quickly become a wide-spread phenomenon in Ukraine. The fast spreading of corruption during the early stages of transition may be partly explained by the deep-rooted habit of the population to use corrupt practices as the best way of solving problems. However, the main reason was institutional weakness of the new state. The slow formation of the "new" institutions, compatible with the market economy, when the "old" ones were already disrupted, created a favorable environment for corruption-generating activities. Moreover, the unique situation when both political and economic systems were simultaneously in the process of transforming created unprecedented opportunities for those that happened to be in power. The coalescence of public and private interests in Ukraine became a common phenomenon, undermining the credibility of public institutions.

It is a problem that spreads through nearly all aspects of the country's economic, political and social life. According to Transparency International's 2005 Corruption Perception Index, Ukraine is placed at 107th out of 159 countries surveyed, sharing this position with Belarus, Honduras, Kazakhstan, Palestine, Vietnam and Zimbabwe. There is, however, improvement compared to 122nd position out of 146 countries in 2004. At the same time, Ukraine's corruption rating improved from 2.2 in 2004 to 2.6 in 2005. According to the recent EBRD-World Bank Business Environment and Enterprise Performance Survey, more than 40% of firms indicated that corruption is a problem of doing business in Ukraine and more than 20% of firms identified corruption as a major constraint. This indicator is higher than the average for European and Central Asian countries. At the same time, 2005's indicator is significantly lower than that registered by the similar survey in 2002 (about 52%).

Although corruption at all levels remains a prevalent and persistent problem, there are reasons for optimism. The Orange Revolution has stemmed the tide of outright corruption and reduced the size of the unofficial "shadow" economy. Maintaining macroeconomic stability and fighting corruption were among the key priorities of President Yushchenko's and the new government's programs.

Attempts to develop a legal framework addressing the corruption-related issues began in 1995, and since 1998 are governed by a seven-year presidential strategy — the 'Anti-Corruption Concept for 1998–2005'. The anti-corruption plan is administered by the Coordinating Committee against Corruption, which reports to the President. There is also a committee within the Verkhovna Rada (the Parliament) that deals with organized crime and corruption. Each of the line ministries charged with responsibilities in anti-corruption policies have specialized units to that effect. Ukraine has recently established a specialized unit within the Prosecution service to deal unequivocally with corruption and organized crime.

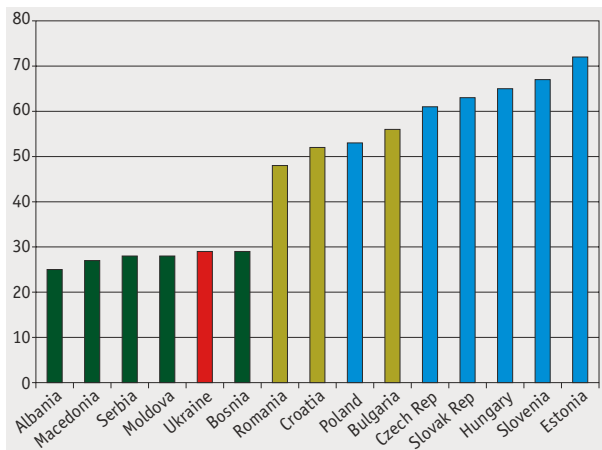
The new government launched an extensive anti-Smuggling campaign — Smuggling-STOP — aimed at reducing the size of the shadow economy and deregulating customs clearance. The campaign proved to be successful as the State Customs Committee collected more customs duties than originally targeted.

In order to tackle corruption, the authorities launched a number of legislative initiatives. In particular, the drafting of the National Program on Combating Corruption was initiated. In November 2005, the Presidential Decree on Priority Actions to De-shadow the Economy and Combat Corruption was issued. At the end of 2005, the President signed a Decree that establishes an inter-agency commission of the National Security and Defense Council of Ukraine for combating corruption.

Over-regulation of the economy and low state officials' salaries provides a breeding ground for corrupt and rent-seeking activities. Bribery remains a basis to affect decision making on different levels. According to the recent WB-EBRD Investment Climate Survey, about 25% of firms reported that unofficial payments are frequent in Ukraine. The 2005's progress in deregulation of business activities (introduction of "one-stop-shop" procedures at customs, regulatory guillotine, elimination of most tax privileges and exemption to name a few) and the increase in wages for public sector servants may also contribute to reducing corruption.

Ukraine participates in global and regional anti-corruption organizations and initiatives. Ukraine was among eighty countries that signed the United Nations' Convention Against Corruption soon after it was adopted in October 2003. In 2005, Ukraine became a member of GRECO— Group of States Against Corruption, shortly after the Verkhovna Rada's ratification of the Civil Law Convention on corruption.

Corruption Level



Despite some progress, Ukraine is still riddled with corruption scandals, casting a shadow on the country's image and damaging foreign investments, public respect to government authorities and the rule of law. Ukraine's level of corruption is substantially higher compared to new EU-member states and candidate countries. That is why it is placed far behind these countries, indicating there is considerable room for improvement in this area.

Public policy recommendations:

- Implement public administration reform to improve transparency of decision-making process and procurement procedures;
- Reduce the ambiguity and discretionarily of government regulations and raise accountability of the public servants for their decisions by introduction of e-governance resources;
- Strengthen the capacities of the internal audit office and make it fully accountable for public;
- Raise accountability of public servants for their decisions.

9. Country Promotion and Political Risk

This driver includes policies and actions to minimize the effects of political uncertainties on business activities and improve its image as perceived by foreign and domestic investor. Key measures include the government's consistent and detailed action plan to improve the country's image, support to current investors in resolving problem issues, ensure the effective functioning of the authorities unimpeded by vested interests, elimination of power abuses by the authorities, and minimizing the risks of civil disturbances that may affect businesses.

Ukraine's "Orange Revolution" became one of the prominent events in recent Ukrainian history. Although the highly strained election process was accompanied by massive gatherings of Ukrainians in major cities, the struggle of Ukrainians for freedom and democracy was peaceful. The peaceful transfer of powers as a result of the revolution made the country well-known on the world stage. Taking advantage of the favorable perception of Ukraine by world community, the government actively started to mend Ukraine's external relations, which were in stagnation for nearly a decade.

The recognition of Ukraine's political and economic achievements by the investor community was reflected in the development of the country's sovereign ratings assigned by leading international rating agencies. Just after the political situation stabilized, Moody's changed its outlook on Ukraine's B1 ratings from developing to stable. More distinctly, Fitch upgraded the country's long-term ratings from B+ to BB- with a stable outlook, which was changed to positive after a while. The improvement in sovereign ratings was also made by Standard & Poor's, which increased long-term ratings from B+ to BB- with a stable outlook.

Although at first the new government made a number of controversial movements (like re-privatization, interventions in markets, elimination of special economic zones, etc.), efforts by the Cabinet of Ministers aimed at correcting the outcomes of these measures in the second half of 2005 were welcomed by world diplomatic circles in general and by foreign investors in particular. The revival of foreign investors' confidence in Ukraine was reflected in high demand for the recent issue of Ukrainian Eurobonds that were placed at a record low annual yield rate of 4.95%. In addition, the U.S. Overseas Private Investment Corporation (OPIC) has recently confirmed its plans to resume investment in Ukraine, after a long-time investment dispute that forced OPIC to stop its operations in the country is resolved. On top of this, approval of market economy status for Ukraine by the EU and the US, abolishment of trade sanctions by the United States and repeal of application of the Jackson-Vanik Amendment by the US point to a warming attitude towards Ukraine and overall improvement in the country's image.

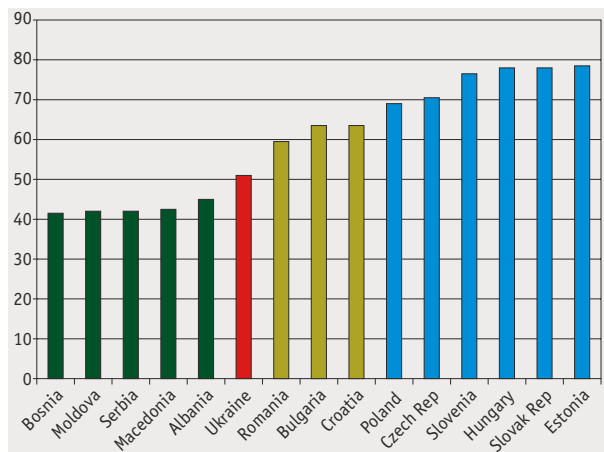
At the same time, the political events during the presidential and parliamentary elections have created tensions in the country. Furthermore, due to Ukraine's location between Russia and the enlarged EU, the country finds itself in the middle of increasing pressures from both sides. In 2005, the new government declared its strategic objective to move towards deeper cooperation with the EU while maintaining good relations with Russia. Ukraine is on the Euro-Atlantic agenda. The perspectives of EU integration play a critical role in the process of increasing stability in the country, fostering economic reforms and ensuring its movement toward a democratic society. At the same time, Ukraine's participation in the initiatives of former Soviet countries has for the most part been formal. Moreover, one of the results of the events during the Orange Revolution was the general cooling of the relationship between Ukraine and Russia.

Currently, Ukraine is on the road of transforming the political system. After March 2006 parliamentary elections, the Law "On Introduction of Amendments to the Constitution of Ukraine" became fully effective. The constitutional reform envisages a shift to a parliamentary-presidential republic, reducing presidential power and giving more authority to the Parliament. In particular, the power of the President of Ukraine is limited to the appointment of the Minister of Defense, the Minister of Foreign Affairs, the Head of the National Bank, and the Prosecutor General with the subsequent approval of the Parliament. The Prime Minister will be selected by a majority coalition in the Parliament and he will be confirmed by the President. However, the President will have the right to dissolve the Parliament if it fails to form a majority coalition within one month of parliamentary elections or if it fails to form the Cabinet of Ministries within 60 days of the Cabinet's resignation. In case of the Parliament's dissolution, the Cabinet of Ministries will also be automatically dismissed. The powers of the Parliament of Ukraine were widened to include the right to approve other Ministers (except those mentioned above) and heads of key state committees by motion of the Prime Minister, without the need for Presidential approval. In case of early termination of the President's powers, the Head of the Parliament (not the Prime Minister) will act as President until the new presidential election. This transfer of power should ensure better cooperation between executive and legislative bodies.

Some political instability, which existed in Ukraine during 2005, led a lowering of its position in the ranking of countries by the level of political risk. This is mostly explained by political and policy uncertainties related to presidential and parliamentary elections,

unexpected changes in the Cabinet of Ministers and, consequently, in the approach of achieving the goals of the government's economic policy. Despite a number of positive outcomes, Ukraine needs to present more evidence of its adherence to democracy and market-economy principles. So far, by the level of country promotion and political risks, Ukraine's position remains lower than those of new EU member states and candidate countries.

Country Promotion and Political Risk



Public policy recommendations:

- Strive for government stability;
- Dissipate the current friction between the East and the West of the country;

- Take measures to eliminate power abuses at different levels of government;
- Ensure stability of the legal environment;
- Compensate losses to investors operating in special economic zones and avoid further radical changes in the rules of game;
- Resolve outstanding investment disputes with foreign investors; ensure fair treatment of foreign investors in courts;
- Use high-level political summits, meetings, conferences, etc. to educate representatives of other countries on Ukraine's achievements in building a strong democracy and a functioning market economy;
- Engage the country's embassies and other missions to disseminate up-to-date information on Ukraine and its business opportunities;
- Continue timely repayment of foreign debt and other international obligations; participate in international programs and initiatives;
- Avoid any government interventions into private business activity and concentrate government efforts only on provision of public goods and services by formulating a clear statement regarding the mission of the government and its goals.

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Appendix

Source		2000	2001	2002	2003	2004	2005*	2006(f)**
GDP								
SSC	GDP nominal (UAH bn)	170.1	204.2	225.8	267.3	345.1	418.5	480.6
	GDP/Capita (US\$)	639	784	883	1,053	1,372	1,740	2,044.1
	Real GDP (% yoy)	5.9	9.2	5.2	9.6	12.1	2.6	2.5***
	Private Consumption (% yoy)	2.5	9.5	9.5	11.2	15.1	15.9	7.1
	Gross Fixed Capital Formation (% yoy)	12.4	6.1	3.4	22.3	10.2	-4.0	3.3
	Agricultural Output (% yoy)	9.8	10.2	1.2	-11.0	19.1	0.0	—
	Industrial Output (% yoy)	12.4	14.2	7.0	15.8	12.5	3.1	—
Public Finance								
MinFin	Consolidated Fiscal Balance (% of GDP)	0.6	-0.3	0.7	-0.2	-3.2	-1.8	-2.6***
	Revenues (% of GDP)	28.9	26.9	27.4	28.2	26.3	32.0	31.5
	Expenditures (% of GDP)	28.3	27.2	26.7	28.4	29.5	33.8	34.1***
Monetary Statistics								
SSC	Consumer Price Index (% yoy, eop)	25.8	6.1	-0.6	8.2	12.3	10.3	12.5
NBU	Monetary Base (% yoy)	40.7	37.4	33.6	30.1	34.1	53.9	30.2
	Money Supply-M3 (% yoy)	46.1	41.9	41.8	46.5	32.4	54.3	31.7
	Average Exchange Rate (UAH/\$)	5.44	5.37	5.33	5.33	5.32	5.12	5.11
	Average Exchange Rate (UAH/Euro)	5.03	4.81	5.03	6.02	6.61	6.39	—
External Sector								
SSC	Merchandise Exports (US\$bn)	14.6	16.3	18.0	23.1	32.7	34.3	—
	Merchandise Imports (US\$bn)	14.0	15.8	17.0	23.0	29.0	36.1	—
	Exports of Goods & Services (US\$bn)	18.1	19.8	22.0	27.3	38.0	40.4	45.5
	Imports of Goods & Services (US\$bn)	15.1	16.9	18.2	24.5	31.1	39.1	49.2
	Net Foreign Direct Investments (US\$bn)	0.52	0.69	0.93	1.30	2.22	7.31	2.60
NBU	Gross International Reserves (US\$bn)	1.48	3.09	4.42	6.94	9.52	19.39	19.9
	Gross International Reserves (months of imports)	1.1	1.7	1.9	2.4	2.8	4.9	—
	Current Account Balance (US\$bn)	1.48	1.40	3.17	2.89	6.80	2.53	-1.0***
Debt								
NBU	Gross External Debt (US\$bn)	—	—	—	14.38	19.65	25.91	—
MinFin	External Public Debt (US\$bn)	10.35	10.12	10.19	10.69	12.15	11.67	—
	Domestic Public Debt (US\$bn)	3.82	3.97	4.01	3.85	3.95	3.80	—

Abbreviations: SSC — State Statistics Committee of Ukraine, NBU — National Bank of Ukraine, MinFin — Ministry of Finance of Ukraine, NBU — National Bank of Ukraine, eop — end of period, (f) — forecast

Notes: * preliminary data;

** Unless specified, forecasted indicators are from Consensus Forecast published by Ministry of Economy of Ukraine as of March 2006;

*** The Bleyzer Foundation forecast.



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