SigmaBleyzer

THE BLEYZER FOUNDATION

Ukrainian Odyssey: Economy 2004 and Investment Climate

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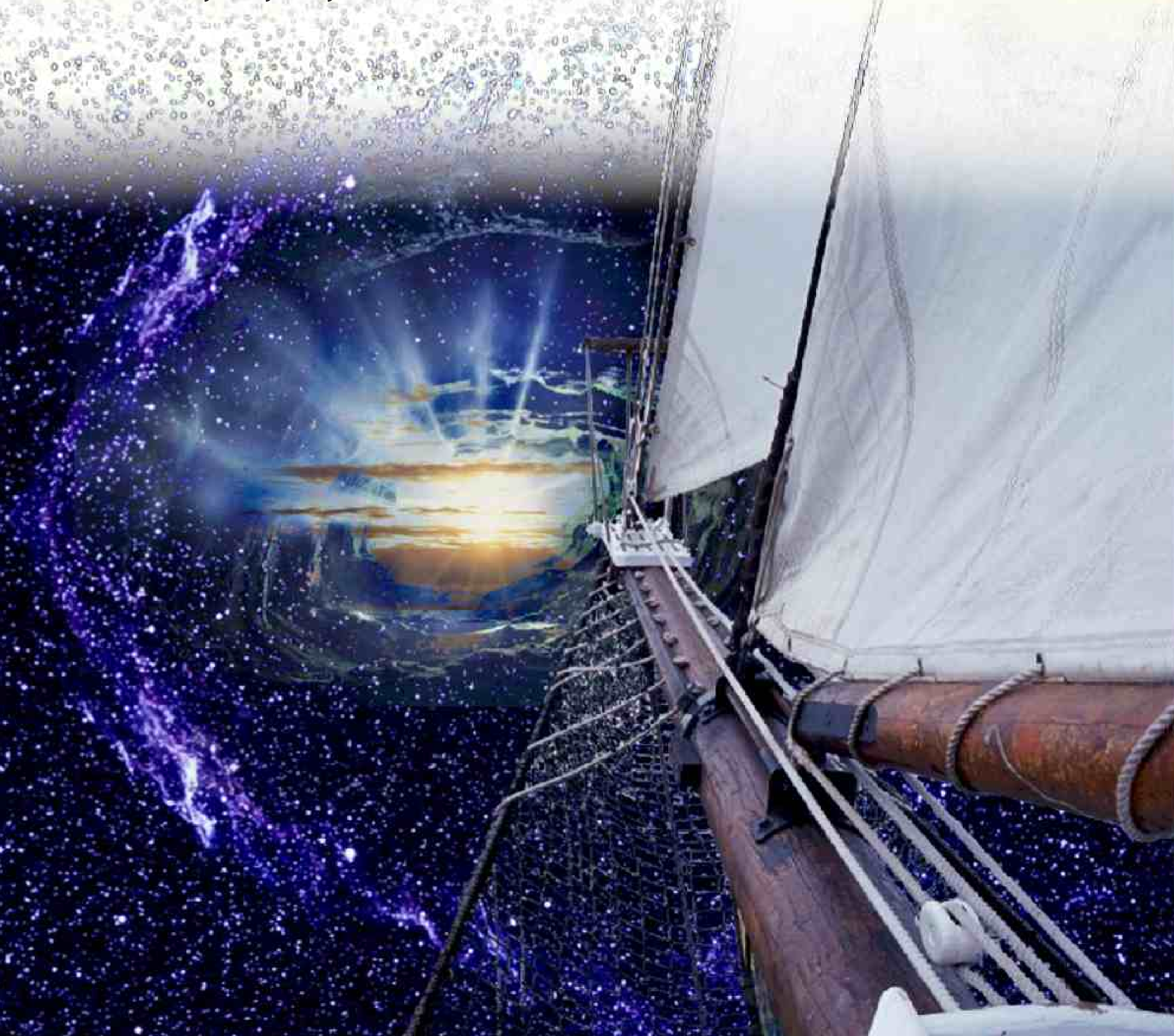

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Part One: Ukrainian Economy 2004

Overview

For the fourth straight year, Ukraine showed some of the best macroeconomic performance in Eastern and Central Europe in 2003. After a slight slowdown in economic growth in 2002, Ukraine's economy demonstrated a remarkable GDP growth rate of 9.4% in 2003, despite huge shortfalls in agriculture. This rate of growth was the highest since Ukraine's independence. Buoyant domestic consumption, a favourable external environment and continuing investment expansion contributed to the country's robust GDP growth, which has continued during the first half of 2004. The major sectors that drove economic growth during 2003 were the processing industry (in particular, metals, machine-building and food processing), construction, transport, and wholesale and retail trade.

Impressive growth of these industrial sectors compensated for the dismal performance of agriculture, which was mainly caused by bad weather. The worst grain crops over the last 50 years caused a severe grain market crisis in 2003 that triggered an acceleration of consumer prices. Annual consumer inflation reached 8.2% compared to 0.6% deflation a year earlier.

The growth in the real money supply in 2003 turned out to be somewhat lower than in 2002, growing at a rate of 38%, compared to 42% the previous year. A dramatic increase in deposits with the local banking system and the NBU's active buyout of massive exports proceeds contributed to high money and credit growth during the year. The gross international reserves of the NBU almost doubled during 2003 to reach a stellar $6.9 billion by year's end. Nevertheless, due to the high availability of foreign exchange from exports, the Ukrainian currency remained stable against the US dollar. Commercial bank deposits grew at a high rate of 63% in 2003. Faced with increasing amounts of deposits and liquidity, commercial bank lending to the private sector also demonstrated a buoyant rate of growth. However, this high growth rate in lending has raised concerns over the quality of the loan portfolios of commercial banks, and therefore the stability of the banking system. The central bank is aware of these risks and maintains particular control of the banking system to minimize the risks associated with its remarkable growth rates in the past few years.

The government maintained prudent fiscal budget discipline throughout the year. 2003 ended with a small 0.2% fiscal budget deficit. The year's fiscal results turned out to be better than expected due to overall economic expansion and improved tax administration, resulting in solid revenues. Fully executed privatisation targets, successful Eurobonds placements, and the finally unlocked adjustment financing from the World Bank also contributed to the solid fiscal state achieved in 2003.

Despite the uncertainties associated with the Presidential elections of 2004, the excellent macroeconomic performance in the country over the last four years as well as the progress in tax reform and the WTO accession progress is sending positive signals to the international investment community. Net Foreign Direct Investment (FDI) inflows have increased significantly in 2003, underlining an improved investor attitude towards the country. Over the year, net FDI reached $1.4 billion, the largest annual inflow since Ukraine's independence. This corresponds to about 3% of Ukraine's GDP.

Ukraine continues to progress in most areas of macroeconomic performance, with good economic growth, sound fiscal policies, low inflation, foreign exchange stability, low external debt, and a good balance of payments. Among the recent achievements of the country are the following:

- An impressive rate of GDP growth of 9.4% in 2003, and 12.7% in January–June 2004.
- Continuing strong real wage growth is translating into an increase of real household incomes, indicating improvements in living standards.
- The central bank's level of international reserves has been expanding rapidly, reaching $8.1 billion in April 2004. This is equivalent to about 11.6 weeks of imports, consistent with IMF guidelines for international reserves.
- A favourable external environment drove foreign trade surpluses, which allowed for the National Bank's international reserves to reach record high levels.
- Since 1999, Ukraine has shown positive current account balances, reaching $2.9 billion in 2003 (6.1% of GDP). The healthy surplus was driven by strong exports and a high level of transfers.
- Sound external debt management reduced public debt as a percentage of GDP from 24% in 2002 to

22% in 2003. As a result, Ukraine regained access to the international debt market. In 2003 and 2004, Ukraine successfully made three Eurobonds placements worth $1.6 billion following an increase in the country's international investment ratings.

- Improvement of the country's international image following the cancellation of FATF sanctions and consecutive exclusion from the black list of non-cooperating countries.

- Commercial bank resources were previously placed in government securities. Today, new lending instruments have emerged, including various consumer lending programs (car loans, housing loans, consumer credit.)

- The government expects to join the WTO in 2005 and has already signed 25 agreements with member countries on market access.

A relatively rapid expansion of capital investments and continuous growth of foreign direct investment inflows in 2003 provide evidence of positive developments in the real sector and the business environment. In order to sustain such remarkable growth over the medium term, the government undertook a number of actions intended to improve the investment climate. Some progress has been made in this direction. Other than those already mentioned, additional recent reforms that have had or will have positive effects on the economy are:

- Starting in 2004, personal income is taxed at a flat 13%, rising to 15% by 2007, replacing the current 10–40% scale.

- Corporate income tax is reduced from 30% to 25% in 2004.

- Ukraine has simplified business registration and licensing and approved a good bankruptcy law.

- The approval of the Land Code was a major cornerstone to privatize land. In addition, parliament approved amendments to the Land Code to allow sale of land to non-residents under joint-ventures with Ukrainians.

- Ukraine has passed a number of Codes and Laws that should further improve the business environment, including the Civil Code, the Commercial Code, the Law on the Judiciary, the Mortgage Law, and others.

- International agencies, including the World Bank, IFC, EBRD and USAID are implementing training and other programs to improve corporate governance. Also, the privatization of remaining state enterprises should further improve corporate governance.

- Improvements in business transparency were supported by reductions in barter trade and non-cash payments for energy.

- The banking sector has improved operations: professional managers are introducing more sophisticated lending and credit practices, lending to micro and small enterprises is increasing, individual consumer loans have appeared, syndication and securitization operations have begun, and banks are beginning to participate in corporate bond issues.

- The Central Bank has also developed modern prudential regulations and has developed a stronger capability to supervise banks.

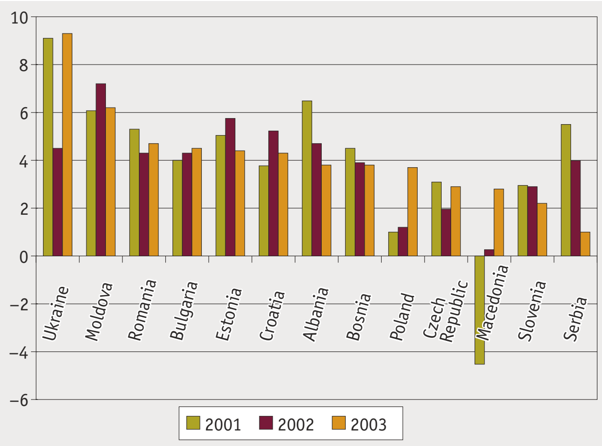
On the other hand, little progress was achieved in improving Ukraine's judicial system, in reducing the number of interventions by government agencies in the activities of businesses, and in improving customs administration. Furthermore, there is a risk that macroeconomic stability could be undermined by potential banking sector problems, external shocks and political instability.

Subsequent sections of the report present the results of Ukraine's economic development for 2003 and discuss the future prospects for 2004. The evolution of the key economic indicators for 1997–2003 and projections for 2004–2005 are provided in the appendix.

1. The Real Economy

The Ukrainian economy performed extremely well in 2003. GDP grew at a remarkably high rate of 9.4%, year-over-year (yoy) which exceeded even the most optimistic expectations. This rate of growth was the highest over the last decade. Moreover, Ukraine was the only country among other European transition economies that was able to achieve such a high growth rate.

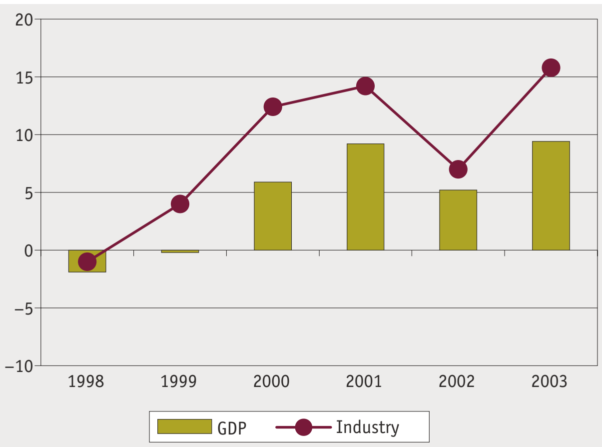
Real GDP Growth in Ukraine and Selected Transition Economies, %



Source: State Statistics Committee

The main source for such remarkable growth was the rapidly growing industrial sector. Although the average rate of industrial growth was around 12% between 2000 and 2003, Ukrainian industry grew at a rate of 15.8% in 2003.

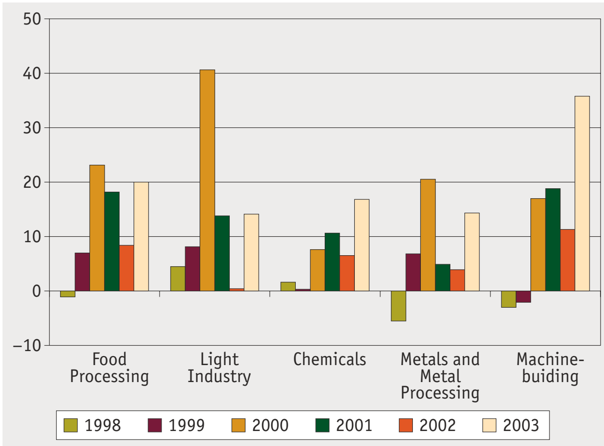
Real GDP and Industry Growth in Ukraine, %



Source: State Statistics Committee

At the product level, machinery, food processing, metallurgy and chemicals were the major contributors to industrial growth in the country. In 2003, the machinery sector was the growth leader, with production increasing by 36%. The solid growth in this sector provides evidence of a positive shift in the structure of industrial production towards higher value-added sectors. In particular, the most remarkable growth within this sector was experienced in the production of transportation machinery; it grew by 46% in 2003. In addition to strong domestic demand for machinery, growth in this sector was also driven by external demand, thus leading to a gradual widening of the export base and lower sensitivity of Ukrainian exports to world prices of raw materials. Due to robust domestic demand, food industry output increased by 20% in 2003 compared with the previous year. Strong external demand remained the main driver of growth in metallurgy and chemicals, which saw output increase by 14.3% and 16.8%, respectively.

Selected Industries Growth, % yoy



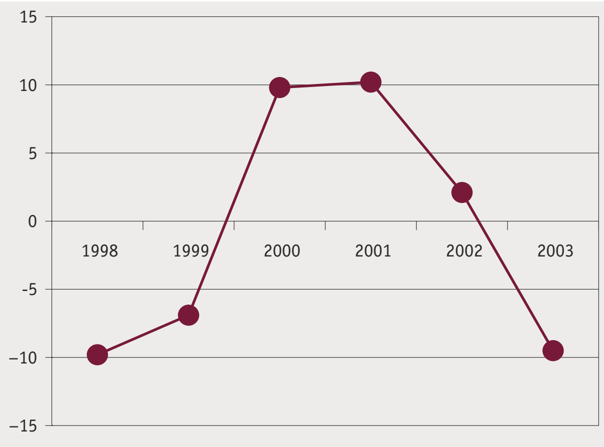
Source: State Statistics Committee

In 2003, the construction sector also demonstrated an impressive growth rate of 23%, an even higher rate than industry. Transportation services grew at a remarkable 12.4%, which is more than double this sector's growth rate in 2002.

The impressive performance of the industrial and construction sectors in 2003 was overshadowed by poor agricultural output. In fact, the agricultural sector posted a 9.5% decline. Bad weather was the major single cause of the worst grain harvest in 50 years. In 2003, only 20.2 million tons of grain was harvested, compared to 38.8 million tons harvested in 2002.

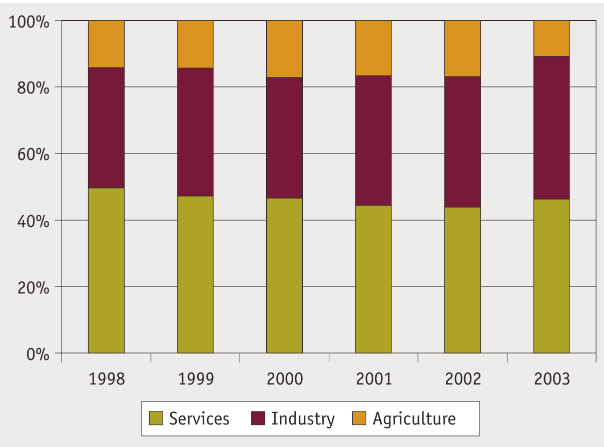
In 2003, the service sector also performed satisfactorily, showing a rate of growth of 5.6%. Despite this performance, the share of services in GDP has been declining over the last six years from 50% in 1998 to its current level of 45% of GDP. The service sector share still remains relatively low compared to other transition economies, where services are not lower than 55% of GDP (i.e., Bulgaria, Poland, Czech Republic). However, the existence of the weak service sector indicates a high potential for future expansion in Ukraine.

Agricultural Output Growth, yoy %



Source: State Statistics Committee

Structure of GDP, %

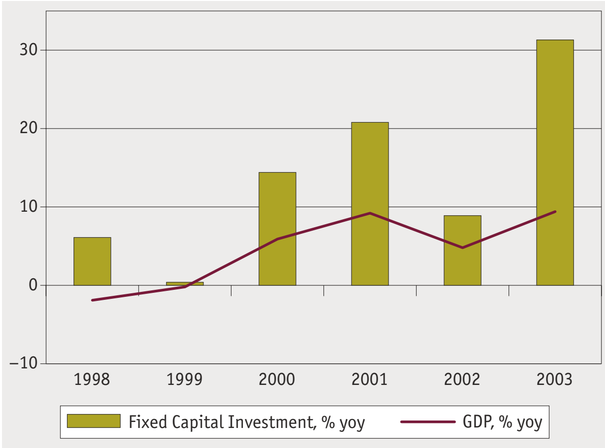


Source: State Statistics Committee

GDP growth in 2003 was driven by two main factors: domestic final consumption and exports, while the investment component was considerably lower. Household consumption increased significantly by 19.7% compared to 2002, primarily as a result of rapid income growth.

In 2003, fixed capital investments grew by almost 31.3%, which is significantly higher than the GDP growth rate. Moreover, this rate of growth in investments is almost three times the rate achieved in 2002. This growth in investments was due in part to a significant increase in the construction sector, machinery and equipment. Such an increase in capital investment gives additional stimulus to the country's economic growth.

Fixed Capital Investment Growth, % yoy



Source: State Statistics Committee

Future Prospects

The significant growth of the Ukrainian economy in 2003 has continued at the beginning of 2004. Real GDP growth in the country jumped to a record high 12.7% yoy from the beginning of the year through June. This accelerating growth rate was stimulated by strong external demand. In addition, the country experienced a significant acceleration of both construction and domestic trade. Between January and June 2004, value-added growth in construction and wholesale and retail trade picked up to new record levels of 32% and 18.2% yoy, respectively. Although some slowdown appeared in some sectors in April, the annual compounded rate of growth of the industrial sector as a whole is at a high 14.7% yoy. In June, the decrease in the rate of growth of machinery and oil-refining was the major reason for deceleration in industry. A drop in the expansion of the machinery sector was due to limits in the technical capacity of production facilities. On the other hand, metallurgical enterprises, enjoying robust external demand, increased their production by almost 16% yoy in January–June 2004, while chemical production surged 17.6% yoy over the same period. Robust growth of domestic consumption led to 14.2% yoy growth in the food processing industry in the same period.

Based on Ukraine's successful economic performance in the first half of 2004, the government revised its full-year GDP growth forecast from 6.0–6.5% to a high 10.5%. The government's ambitious full-year GDP growth expectations may well become reality judging by current real sector performance. In addition, world demand for Ukraine's export commodities is expected to be strong throughout 2004.

2. Fiscal Policy

In 2003, Ukraine continued to exercise a balanced fiscal policy. The country ended the year with a slight fiscal deficit of 0.2% of GDP. Fiscal revenues reached $14.1 billion, or 28.5% of GDP, while fiscal expenditures amounted to $14.2 billion, or 28.6% of GDP.

Fiscal Revenues

The nearly 22% growth of fiscal revenues was achieved with the help of Ukraine's remarkable macroeconomic performance in 2003. However, higher revenues can only be partially explained by excellent macroeconomic results. In fact, 9.4% real GDP growth resulted in only about 3% growth in fiscal revenues in real terms. Other determinants of successful budget execution were an increased tax base and stepped up efforts on tax collection.

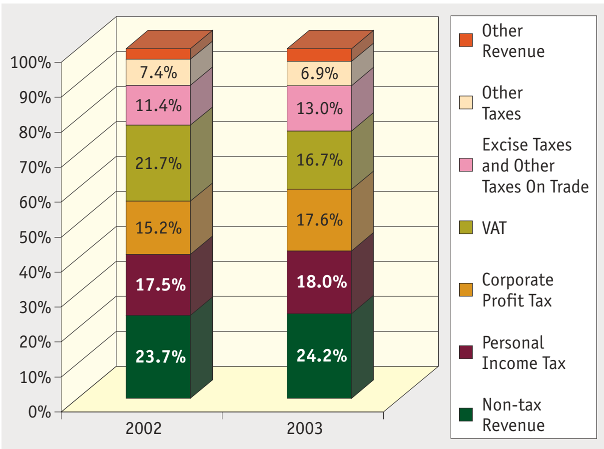
On the other hand, more successful collection of fiscal revenues was adversely affected by a number of factors: about 47% of companies reported losses, thus reducing possible tax receipts. Also, fiscal revenues were plagued by widespread tax privileges. The size of tax exemptions and privileges granted to companies and organizations in 2003 nearly equalled the size of fiscal budget revenues. As in previous years, some of these tax privileges were often politically motivated. For instance, the fiscal cost of VAT exemptions and privileges amounted to about $1 billion in 2003 according to the IMF estimates.

- Tax-related revenues accounted for about 72% of fiscal revenues in 2003, which is in line with last year's number. Out of tax revenues, the share of corporate profit tax and personal income tax accounted for about 18% of fiscal revenues each. The share of both of these taxes has grown compared to previous years due to improved business activities and higher personal incomes in the country.

- The share of net value-added taxes in the structure of fiscal revenues has dropped from about 22% in 2002 to nearly 17% in 2003. However, the actual gross VAT proceeds in 2003 were higher than the year before. The net values were lower because the officially reported number represents a net value of VAT proceeds to the government after considering VAT refunds from the government to businesses. In 2003, the government paid back nearly $2 billion in VAT refunds to exporters, while in 2002 the repayments were minimal. At the same time, even that amount of refunds could have been larger by nearly $1.2 billion that the government did not refund and accumulated as VAT refund arrears. As of January 1, 2004, the level of VAT arrears amounted to $1.54 billion.

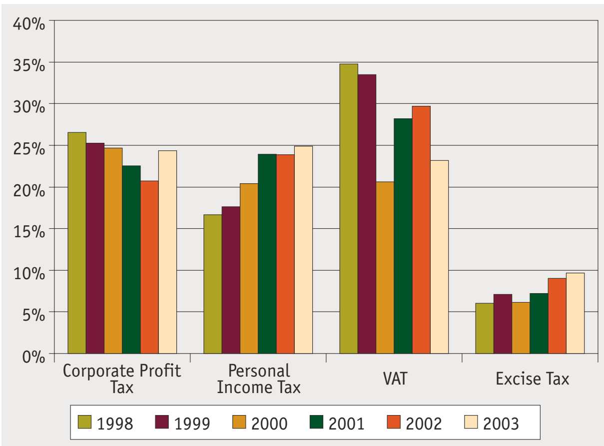
In general, the problem of VAT refunds to exporters has become extremely acute. Due to inefficiencies in regulations and procedures, many businesses can claim VAT refunds from the government for export transactions that never took place. In order to avoid payments on the fraudulent VAT refund claims, the government introduced a cumbersome auditing procedure that slowed down repayments of VAT refunds. This practice resulted in the accumulation of significant arrears, which was the major reason for the IMF to suspend its active financing program in Ukraine. In late 2003, the government designed a mechanism to deal with the situation: it started issuing government bonds to swap for past due VAT refund debts.

Structure of Fiscal Revenues, % of total



Source: Ministry of Finance

Major Tax Proceeds, % of total tax-related revenues



Source: Ministry of Finance

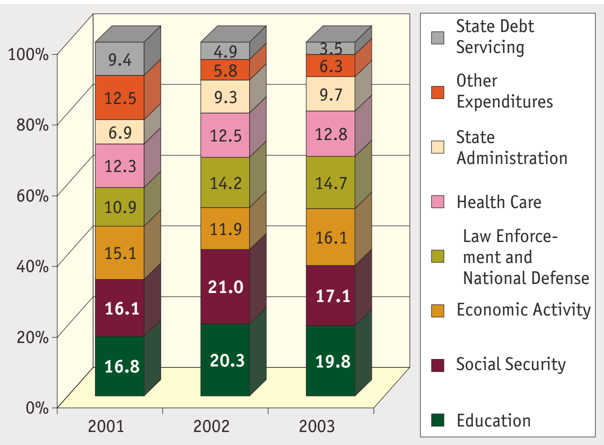
Fiscal Expenditures

Fiscal expenditures have been managed prudently. The government managed to control fiscal expenditures to be consistent with the size of fiscal revenues. As was the case for the past few years, many controllable fiscal expenditures were held off until the end of the year to avoid the threat of excessive deficit financing. Thus, positive fiscal balances were generated throughout the year except for December, when the government spent twice the monthly average to cover outstanding payments. This situation has made it difficult for most government-funded agencies to make planned purchases of goods and services.

Regarding the structure of fiscal expenditures, the most significant changes occurred in the areas of social security and economic activities of the government. Government spending on social security remained almost exactly at the same level in nominal terms as the year before, but declined in relative terms. This resulted in the share of social security expenditures dropping from 21% of total expenditures in 2002 to 17% in 2003. In fact, such a reduction brought social security spending back to its normal levels, since the 2002 fiscal budget stood out due to its high safety net payments.

In 2003, the government spent more financial resources trying to stimulate economic activities in the country. The amounts have grown from 11.9% of total fiscal expenditures in 2002 to 16.1% in 2003. The money went to support companies in different industries, mainly in agriculture, coal production, and transport. The increased involvement of the government in economic activities in the country can be seen as a result of the policy of the current government to have more administrative involvement in some economic activities.

Structure of Consolidated Budget Expenditures, % of total



Source: Ministry of Finance

In its report on the 2003 budget, the Accounting Chamber, the state agency in charge of auditing the process and procedures of fiscal spending, criticized the government for failing to ensure effective use of budget resources. The agency identified numerous incidences of misuse of funds and called for transparent procedures and systemic improvements in fiscal mechanisms.

Future Prospects

The tax reform passed by the parliament in mid-2003 came into force on January 1, 2004. The parliament reduced the corporate tax rate from 30% to 25% and introduced a flat rate of 13% for personal income tax instead of the previously used progressive scale, which ranged from 10% to 40%. The fiscal budget for 2004 was approved by the parliament with the new tax rates in mind. The law on the 2004 state budget establishes fiscal budget with a slight deficit.

The 2004 fiscal budget law introduces new rules calling for increased fiscal discipline and increased revenues. It requires state-owned and stated-controlled companies to transfer a part of their profits to the budget. Also, the new budget law envisages an increase in the fee for banks' non-cash foreign exchange conversion transactions from 1% to 1.5%. At the same time, individuals buying foreign exchange will be exempt from paying the 1% fee — a measure introduced in 1998 in the wake of the financial crisis when the government lacked funds to pay pensions.

In June, the Ukrainian Parliament approved the exchange of VAT refund arrears accumulated through June 1, 2004, into government securities. The total amount of VAT refund arrears subject to restructuring is equal to UAH 1.9 billion ($357 million), out of a total amount of VAT arrears of $1.54 billion equivalent. These "VAT bonds" have 5 years to maturity and a proposed annual return at 20% of par value. The government, however, has decided to indefinitely postpone the issuance of additional VAT bonds. In order to improve VAT administration and eliminate the possibility of claiming VAT refunds for fraudulent exports, the government has prepared regulation introducing special VAT-accounts through which all VAT payments and refunds are to be carried out. However, many issues related to the functioning of VAT accounts were poorly thought-out, and the introduction of the accounts could increase transaction costs for businesses due to the freezing of funds in VAT accounts. As a result, the decision has met strong resistance from industry groups and was postponed indefinitely. An alternative solution to restructure or solve the VAT arrears problem is still needed.

Fiscal budget performance in early 2004 was on track. Both fiscal revenues and expenditures are reaching planned numbers. Despite concerns about likely low levels of tax receipts as a result of the reduced tax rates, both personal income tax and corporate profit tax collection has been adequate. This shows that companies tend to bring their transactions out of the shadow economy when tax rates are reduced. In January–May 2004, the state budget remained in surplus with revenues and expenditures executed within the targeted levels. Receipts of income taxes were slightly above the planned levels, revealing the first positive results of tax reform.

Higher than expected macroeconomic growth and implementation of several large privatization deals encouraged fiscal policy softening and triggered revision of the 2004 budget. Privatization of large metallurgical plant Kryvorizhstal and coal mining complex Pavlogradvuhillia provided the government with extra budget resources allowing the increase of social expenditures to support agricultural producers and to raise minimum wages from UAH 205 to UAH 237 beginning September 1, 2004. Upon the governments' application, the Parliament of Ukraine adopted amendments to the 2004 budget envisaging an increase of state budget revenues by UAH 4.5 billion ($850 million) and expenditures by UAH 8 billion ($1.5 billion). As a result, the state budget deficit is now planned at UAH 7.4 billion ($1.4 billion), which is equivalent to about 2.2% of GDP expected in 2004. The higher budget gap is to be covered by privatization revenues and new borrowing. The annual target for privatization proceeds has been revised from $400 million to $978 million equivalent. The government increased their expected privatization yield after the two previously mentioned privatization deals were closed.. In January–June of 2004, privatisation proceeds reached some $1.2 billion, which is already higher than the revised annual target. So far, the State Property Fund has sold the giant steel mill Kryvorizhstal to the Industrial Metallurgical Union for $804 million. However, this deal has been challenged in court by several bidders that were not permitted to participate in the tender. Also, the State Property Fund hopes to unload 42.9% in the state telecom Ukrtelecom, which would be the largest privatization tender of 2004. The expected revenue for the budget is about $1.0 billion.

3. Monetary Policy

During 2003, Ukraine continued to exercise an expansionary monetary policy. One of the major challenges to the economy was an extremely poor wheat harvest that fuelled sharp price increases. Inflation picked up to 8.2%, higher than the expected base level scenario of about 6%. De facto targeting of the nominal UAH/USD exchange rate led to exchange rate stability between the hryvnia and the dollar throughout the year. However, the Euro/UAH exchange rate depreciated in 2003. The increase in money supply was primarily caused by the unsterilized purchase of foreign exchange by the central bank, which resulted in a significant growth of the central bank's international reserves. Also, the central bank took several steps towards liberalization of the foreign exchange market. These matters are discussed in greater detail below.

Money Supply

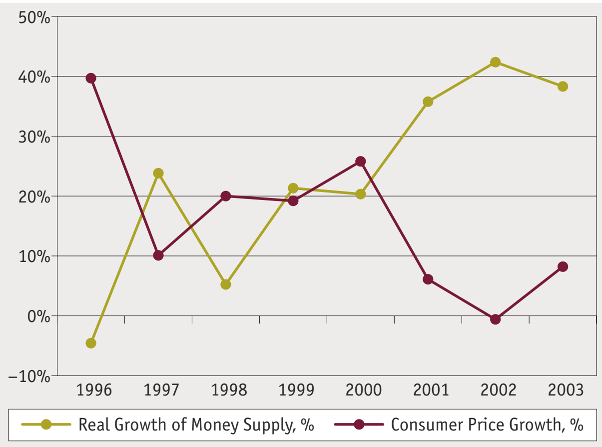
Growth in money supply decelerated slightly in 2003, but remained relatively high at 38%, down from 42% in 2002. Underpinned by large balance of payments surpluses, base money also saw a rapid expansion of 23% in 2003. The growth of base money continued its slowing trend of the last few years (33.6% in 2002 and 37.4% in 2001). Although these increases in money supply were considerable, they were accommodated by increases in money demand brought about by the fourth year of robust macroeconomic growth. Therefore, high money supply growth hardly created inflationary pressure on the economy.

In 2003, the central bank significantly increased financing of the economy through bank refinancing operations. The NBU channelled nearly $5.0 billion to support banks' liquidity, compared to $225 million in 2002, an increase of almost 22 times. Interestingly, a great portion of that amount, nearly $1.9 billion, was disbursed in December alone when the banks were helping budget-funded entities make their fiscal expenditures, as well as lending to companies that were paying their outstanding taxes. A great part of the NBU refinancing went to support agricultural producers who suffered heavy losses due to adverse weather conditions.

The increases in money supply in 2003 were again originated by the central bank's purchases of foreign exchange at the inter-bank market. The abundant supply of foreign exchange came from domestic exporters who were having another year of dramatic growth in sales revenues.

Last year also saw record growth of commercial bank lending, which increased by 64% in 2003, compared to 48% growth in 2002. Such expansion became possible in part by a compensating increase in bank deposits that grew by nearly 63% in 2003. Thus, Ukraine's credit-to-GDP ratio went up from less than 20% in 2002 to 28% in 2003. By this indicator, the level of development of the Ukrainian banking system is comparable with more advanced transition economies of the region. Rapid expansion of commercial lending supported Ukraine's remarkable economic growth as businesses were able to expand their activities and increase investment volumes. However, the low capitalization of the Ukrainian banking sector and the growing mismatch between bank loans and deposits (with the former exceeding the latter by over $1 billion) and their short maturities raise concerns over the stability of the banking system. Due to temporary liquidity shortages that occurred during the year, many banks have suspended their consumer lending programs and stepped up their efforts to increase deposit base. The rapid increases in bank lending also raise concerns about the quality of the current loan portfolios of commercial banks.

Money Supply and Consumer Price Dynamics



Source: National Bank of Ukraine, State Statistics Committee

Inflation

After slight deflation registered in 2002, consumer prices picked up in 2003 primarily due to supply-side factors. As a result of severe weather conditions that destroyed most winter crops in early 2003, Ukraine's agricultural output was only a trace of what the country normally produces. Expectations of poor agricultural output spurred demand for most staple foods in late spring, which drove up prices and often resulted in shortages. The government reacted by introducing price controls, forbidding certain foodstuff exports and imposing other direct administrative measures.

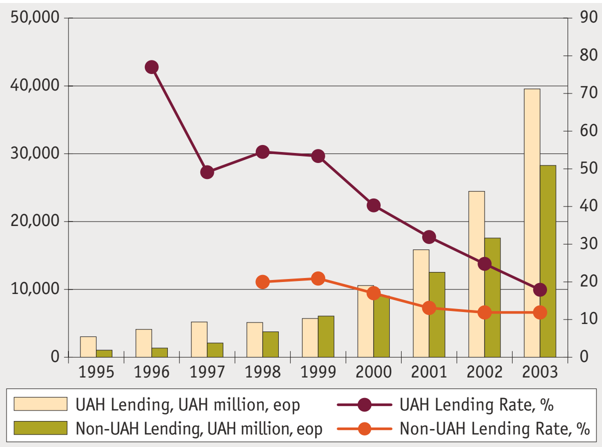
Sharp increases in prices for food items, along with smaller increases in prices for energy and services, led to year-end Consumer Price Index (CPI) growth of 8.2%. In 2003, producer prices (PPI) registered an increase of 11.1% compared to 5.7% in 2002, mainly on due to the increased cost of energy inputs. These large PPI increases could eventually be reflected in greater CPI increases.

Interest Rates

2003 was characterized by relative stability of interest rates. Throughout the year, the central bank maintained its discount rate at 7%, a level it had set in December 2002. However, commercial bank lending rates continue to decline. The rates on hryvnia loans started the year at 18.6% and finished at 17.7%, while lending in foreign currencies (mainly in US dollars) averaged 11.8% at the beginning of 2003 and 10.9% at year-end.

As noted above, lending volumes saw a dramatic expansion in 2003 with a growth of 64% to reach $12.7 billion in total lending. Such a high rate of growth was achieved thanks to robust macroeconomic performance, and was spurred by rapidly increasing deposits and high liquidity of the banking system. Lending in hryvnia and foreign currencies grew at approximately equal rates, while hryvnia lending increased faster than that of foreign currencies in 2002.

Dynamics of Lending Rates and Lending Volumes

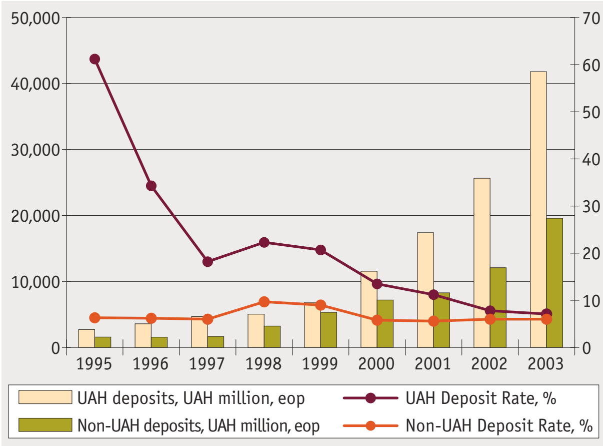


Source: National Bank of Ukraine

Bank deposits also grew at a very fast pace of 63% and reached $11.5 billion at the end of 2003. Such rapid growth was based on rising disposable household income, increased activities of the business sector, and greater confidence in the banking system.

Explosive credit growth took place despite relatively small changes in interest rates, indicating strong demand for financial resources in the country. Both lending and deposit rates have seen further conversion between the rates in hryvnia and in foreign currencies. For deposit rates, such risk differential ranged from 0.3% to 1.6%, while for lending rates, the number varied from 4.6% to 6.8%, which is an improvement compared to similar numbers in 2002.

Dynamics of Deposit Rates and Amount of Bank Deposits



Source: National Bank of Ukraine

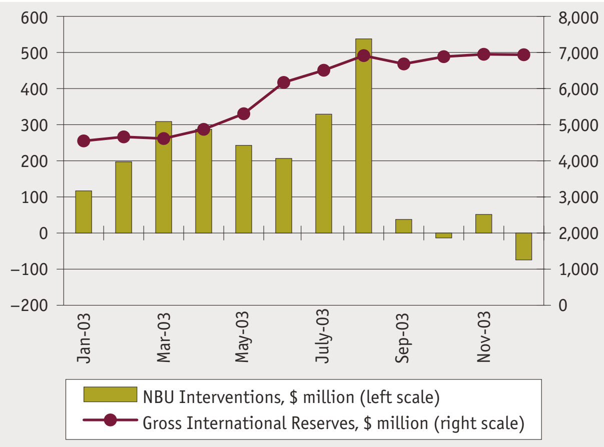
Exchange Rate

In 2003, the central bank continued de facto targeting of the UAH/USD exchange rate. As a result, this exchange rate exhibited remarkable stability with slight nominal appreciation of the hryvnia from 5.3327 UAH/USD to 5.3315 UAH/USD by year-end. This situation was made possible with a nearly constant excess supply of foreign exchange offered by domestic exporters, which are required to sell 50% of their foreign exchange proceeds. The central bank publicly stated its policy of supporting the UAH/USD exchange rate because of its strategic importance for the country's businesses. Therefore, the central bank usually stepped in to balance the market by purchasing the excess supply of foreign exchange. Thanks to the NBU interventions, the hryvnia exchange rate has remained competitive, thus facilitating robust export growth during the year. According to IMF estimates, the annual average real effective exchange rate posted 6.9% depreciation in 2003.

On the other hand, the hryvnia continued to depreciate against the Euro and other major currencies. It lost nearly 18% of its value against the euro, 8% against the British pound, and 10% against the yen. The Russian rouble appreciated against Ukrainian hryvnia that resulted in higher competitiveness of Ukrainian products on the Russian market.

The central bank's operations on the foreign exchange market allowed it to considerably increase its gross international reserves. During 2003, the NBU's gross international reserves rose by 58% from $4.4 billion equivalent to $6.9 billion equivalent. The year-end gross international reserves were equivalent to 11.2 weeks of successive year's imports coverage, an increase from 10.7 weeks in 2002 and 7.8 weeks in 2001.

NBU Interventions and Gross International Reserves, $ million



Source: National Bank of Ukraine

The central bank made reasonable progress in the liberalization of the foreign exchange market. It has allowed banks to make forward transactions on the international markets with the world's most reliable currencies. Also, the central bank allowed banks to purchase foreign exchange on the Ukrainian inter-bank market even if it was unrelated to any of their clients' foreign trade transactions. Also, it has increased the size of the open balance of foreign exchange that a bank is allowed to hold. In an attempt to introduce modern financial instruments, the central bank allowed banks to trade futures contracts on cross-rates of the hryvnia to other currencies.

Future Prospects

With inflationary pressures picking up in the country as evidenced in 2003, the central bank is expected to pay particular attention to internal stability of the hryvnia. For 2004, the government expects consumer price inflation to equal 8%, base money to increase by 26–32%, and money supply to grow by 32–39%.

The central bank expects interest rates to further drop in 2004. Lending rates are expected to fall to 15–16% for lending in hryvnia, and to 8–9% for lending in dollars. Further reduction of the lending rates is doubtful due to the rather high deposit rates that the banks need in order to attract new deposits. Lending volumes are likely to continue their growth in 2004 as the demand for money remains high. Trying to attract big clients and to maintain liquidity, Ukrainian banks are likely to seek financing on the international capital markets as pioneered by Privatbank in late 2003.

The central bank is expected to maintain a de facto fixed exchange rate against the dollar. To achieve this, the central bank will continue to actively engage in the foreign exchange market to maintain dollar exchange rate stability. As evidenced by early 2004 results, the central bank's gross international reserves continued to increase rapidly to reach over $8.9 billion equivalent. However, the NBU is ready to allow more exchange rate flexibility if inflationary pressures and credit risks in the banking sector increase. In 2004, the central bank is likely to maintain particular control of the banking system to minimize the risks associated with its remarkable growth rates in the past few years. In June 2004, the NBU increased its annual discount rate from 7% to 7.5% to prevent the economy from overheating and to balance inflationary pressures. The central bank is not likely to further liberalize the foreign exchange market in 2004, but will likely maintain the requirement to surrender 50% of an exporter's foreign exchange proceeds. Also, the central bank still continues to bar any arbitrage transactions involving the hryvnia.

4. Equity markets

Despite the positive macroeconomic dynamics in the country, growth of Ukraine's equity market has been insignificant in 2003. The organized equity market was dominated by the First Stock-Trading System (a.k.a. PFTS.) About 92% of all organized market transactions took place there, with the remaining made at the seven official stock exchanges. The total volume of sales on the PFTS saw an almost twofold decline over the year and amounted to a low $612 million in 2003. The decline is explained by low volumes of government securities sales compared to previous years. Government securities that held the dominant position in PFTS sales in previous years lost their attractiveness compared to other financial instruments, so the demand for them has been low.

The structure of PFTS sales is given in Table 1.

Table 1: Structure of PFTS Sales in 2003

Equity	Sales Volume, $ million	% of total PFTS	Change, % yoy
Primary Market			
Corporate Bonds	1.4	0.2	−81.7
Options	18.3	3.0	42.4
Shares (IPOs)	6.2	1.0	−19.7
Shares (SPF auctions*)	0.1	0.0	−93.2
Total Primary Market	25.9	4.2	−12.0
Secondary Market			
Treasury Bonds	97.7	16.0	−89.0
Shares	104.7	17.1	−11.2
Corporate Bonds	380.9	62.3	170.8
Promissory Notes	2.5	0.4	—
Total Secondary Market	585.9	95.8	−48.9
Total PFTS	**603.3**	**100.0**	**−48.0**

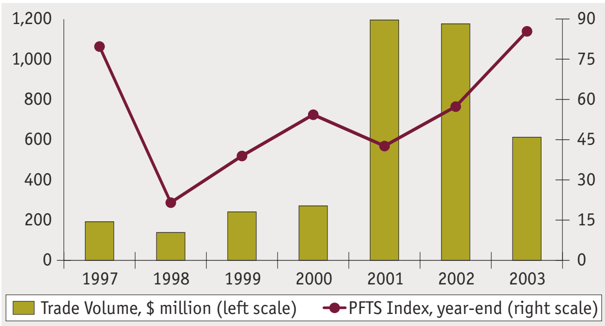
** SPF auctions — auctions held by the State Property Fund where shares of about-to-be-privatized companies are offered.*

Source: PFTS

However, putting aside government securities trading, stock market activity improved in 2003 due to the development of the corporate bond market, which experienced a nearly threefold increase secondary market trading. Trading in corporate bonds surged in 2003 (by nearly three times), becoming a fairly popular instrument of corporate financing for some companies and an attractive investment opportunity for others. Corporate bonds trading constituted the largest part of total trading volume (62% of the total). The high rate of growth of corporate bonds also raises questions about the creditworthiness of some of the bond issuers. Officials are aware of these potential problems and are closely following up on developments.

Trading on the primary equity markets has remained minimal, since blue chip sales were still at extremely low levels during the year. In 2003, the PFTS index increased 48% yoy to 85.4 points, which is the highest level over the last two years. The main drivers of PFTS index growth were all the stocks that formed the PFTS index basket. They include energy distributing companies (Tsentr-Energo, Dnipro-Energo, Zahid-Energo and Kyiv-Energo), local oil extraction monopoly UkrNafta, state telecommunications monopoly Ukrtelecom, large pipe producer Nyzhnyodniprovskyi Pipe Rolling Plant and a few others. The sectoral structure of securities trading has changed little, with shares of oil and gas and energy sector enterprises remaining the most actively traded instruments.

PFTS Trade Volume and Index Dynamics



Source: PFTS

Overall, the Ukrainian stock market remained weak in 2003 despite remarkable real sector performance. During the year, stock market capitalization increased by 9% yoy to $4.76 billion, which is equivalent to 10.6% of GDP. This indicates significant underdevelopment of financial markets in the country.

Future Prospects

The Ukrainian equity market is expected maintain relative stability with moderate growth in 2004, taking into account the upcoming presidential elections. Macroeconomic growth, decreasing interest rates and improved market mechanisms should contribute to equity market growth. On the other hand, the market desperately needs improved regulations that will prevent widespread non-market practices and make equities trading less risky and more civilized. Still, the "Law on Joint-Stock Companies (Corporations)" that is being drafted in the parliament aims to fill many gaps in corporate governance legislation and allows for easier stock issues and trading, but it has not yet been adopted.

The corporate bond market will continue its rapid growth and become a valid alternative to bank financing for many companies. Large privatization deals, including the privatization of Kryvorizhstal, Pavlogradvuhillia, Ukrrudprom and Ukrtelecom, should fuel stock market activity in the country.

5. International Trade and Capital

Throughout 2003, Ukraine's external position remained strong, though the current account surplus slightly narrowed. Ukrainian foreign trade has become slightly more diversified in both geographical and commodities breakdowns. Most Ukrainian exports are still commodities with a low degree of processing, while energy resources dominated imports. At the same time, robust investment demand led to a rising share of high-tech investment goods in Ukrainian imports over the last year. Solid macroeconomic development helped bring record growth of net foreign direct investment inflow into the country in 2003.

Balance of Payments

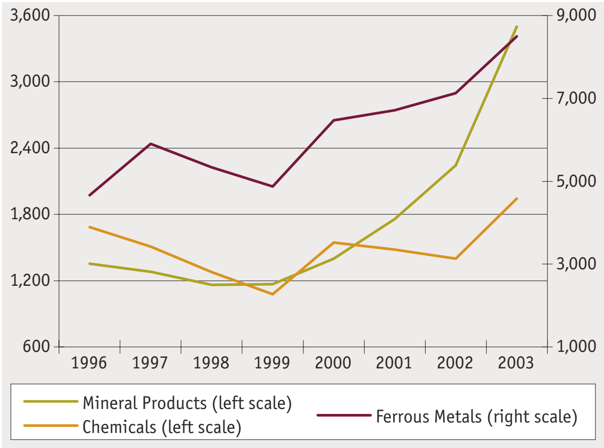
Current account performance remained robust in 2003 despite some deterioration of the goods trade balance. Over the year, the current account surplus narrowed to $2.9 billion after an impressive surplus of $3.2 billion in 2002. This is still at a significant level equivalent to 6.1% of GDP. Net current transfers saw a 14% yoy growth rate, reaching $2.18 billion primarily on account of remittances from Ukrainians working abroad. These foreign exchange inflows also contributed to the positive current account balance in 2003. At the same time, the financial account balance improved significantly, indicating the improved investment climate in the country. In 2003, the financial account posted a $124 million surplus compared to a $1.26 billion deficit in 2002. Record high growth of net foreign direct investment (FDI) inflow and much lower portfolio investment outflow led to the improvement of financial account dynamics. Also, about $1 billion in sovereign Eurobond issues boosted growth of the financial account balance. These matters are discussed below in more detail.

Foreign Trade

In 2003, Ukrainian exports of goods and services rose to almost $29.0 billion, out of which $23 billion were goods. Imports grew to $27.7 billion, including $23 billion of goods. During the year, the foreign trade balance posted a $1.3 billion surplus compared to a $3.5 billion surplus a year ago. Substantial acceleration of goods imports over the year contributed the most to the decline in the foreign trade surplus. At the same time, the services trade surplus increased by 36% yoy, as exports growth significantly outweighed imports expansion.

The remarkably strong merchandise exports growth in 2003 is explained in part by the real depreciation of the hryvnia relative to the major world currencies (especially the euro) and strong external demand for metals and chemicals. The goods structure of Ukraine's foreign trade changed during the year. Raw materials or goods with a low degree of processing still had a relatively high share of total goods exports, indicating the vulnerability of Ukrainian trade to price fluctuations of raw materials on the world markets.

Dynamics of Goods Exports, $ million

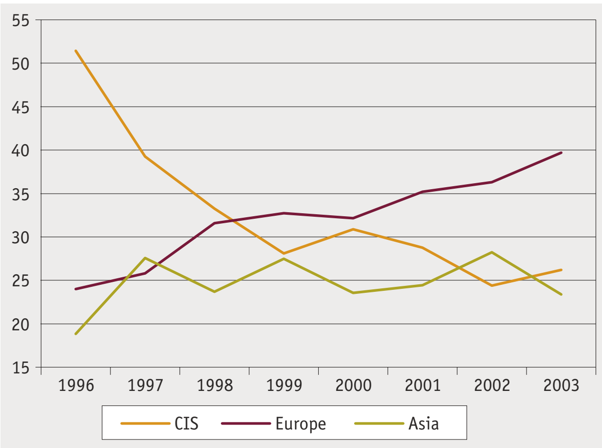


Source: State Statistics Committee

On the positive side, there was a gradual (albeit slow) increase in the share of high-value added goods of total exports. In particular, mechanical machines and transport equipment was the third largest export group in 2003, after ferrous metals and mineral products, accounting for 14.4% of total goods exports. In 2003, the major changes in the composition of exports were attributed to a marked increase in mineral products exports and a sharp reduction of agricultural products exports. In particular, the share of grain exports in total exports dropped from 5.6% in 2002 to 1.7% in 2003 due to the small harvest that caused the crisis on the domestic grain market. At the same time, the share of the country's major export commodity, ferrous metals, declined, while machines and transport equipment exports were on the rise. This reflects a positive trend towards the diversification of Ukrainian exports. Although ferrous metals exports were up 19% yoy to $6.7 billion in 2003, their share of total merchandise exports fell from 39.7% in 2002 to 36.8% in 2003. In contrast, the share of refined oil increased from 9.2% in 2002 to 12% in 2003 following robust expansion of oil-refinery production during the year. The share of chemicals increased in 2003 to 8.4% of total goods exports, after declining for the last three years. The largest share of service exports remains transport services (83% of the total), mainly on account of gas transit from Russia to Europe through Ukrainian territory. Gas transit will continue dominating Ukrainian services trade, taking into account the underutilized capacity of the Ukrainian gas and oil transportation system.

The major changes in the geographical breakdown of exports in 2003 are attributed to the real appreciation of the euro on the international markets and consolidation of the market niche for Ukrainian metals and chemicals in Southeast Asia. Robust growth of exports to Asian countries, especially China, and the trade restrictions imposed on Ukrainian metals by traditional importers of these commodities (like the US and the EU) allowed Ukrainian metal producers to maintain positions in the Asia region. Over 2003, Ukrainian metal exports to Asian countries rose by 6.6% yoy. On the other hand, the share of Asian countries in total exports declined to 23.4%, largely because of the redirection of other trade flows to European countries.

Geographical Breakdown of Goods Exports, % of total



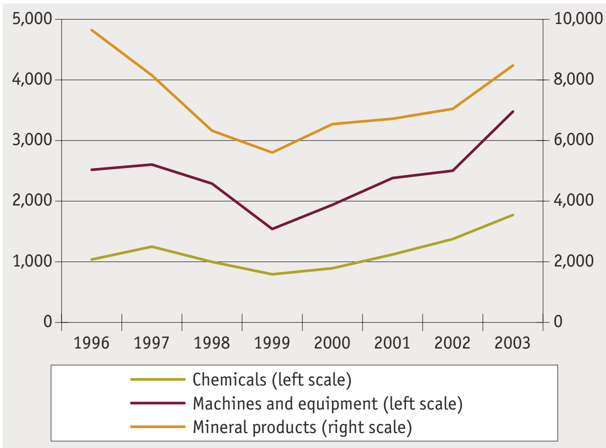
Source: State Statistics Committee

Trade with the EU and other European countries has been increasing over recent years, and the euro's appreciation gave additional impulse to exports growth to the region. In 2003, about 40% of Ukrainian goods were exported to European countries, which compares very favorably with 36% a year ago. Despite a number of trade barriers that remain, Ukrainian exports to the euro zone increased by almost 30% yoy and accounted for 20% of the total in 2003. This expansion was mainly due to higher petroleum and ferrous metals exports during the year. Exports to the 10 EU-acceding countries represented about one third of the total exports to the region.

Despite a sustained declining trend in exports to the CIS, Russia remained the largest importer of Ukrainian products in 2002, accounting for 18.7% of total Ukrainian exports. Solid economic recovery in Russia and other CIS countries in 2002 facilitated growth of Ukrainian exports to this region. In 2003, Russia imported 35% more goods from Ukraine than in the previous year.

Strengthened investment demand from rapidly growing industries seeking to rennovate their outdated capital assets and rapid growth of real household incomes facilitated an increase in merchandise imports in 2003. Over the year, merchandise exports grew at a remarkably high 36% yoy. The composition of goods imports changed in 2003, primarily due to an increase of grain and food products imports. In addition to consumer durables and foodstuff, investment goods (machines, equipment, etc.) were also among the most rapidly growing import items in 2003. In particular, imports of transport equipment (except for private vehicles) and road building machines more than doubled over the year. Imports of machines and equipment also increased 40% yoy in 2003. In total, the above mentioned categories account for about 23.2% of total goods imports, compared to 20.8% in 2002.

Goods Imports, $ million

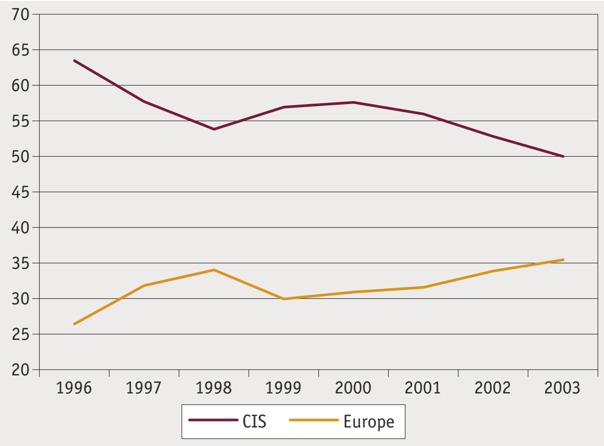


Source: State Statistics Committee

Relatively high rates of growth of investment goods imports indicate that obsolete production capacities are gradually being renewed, thereby increasing efficiency and the potential volume of production. At the same time, the composition of goods imports is still closely tied to energy resources from Russia and Turkmenistan, which account for 37% of total merchandise imports. The major share in services imports belongs to public sector consultancy services, which account for 31% of the total imported services.

The geographical breakdown of imports continued to change only gradually. The main reason for this is the high dependency of the Ukrainian economy on foreign energy resources. The major suppliers of mineral fuels to Ukraine remained Russia and Turkmenistan. As Ukraine's biggest single trading partner, Russia provided 37.6% of Ukraine's total imported goods. Turkmenistan's share of Ukrainian imports made up 7.7%, following Germany, whose share of Ukrainian imports reached 9.8%. Although imports from CIS countries continued their declining trend, about 50% of all goods imports are originated from the CIS region in 2003. At the same time, the share of European goods is on the rise.

Geographical Breakdown of Goods Imports (as % of total)



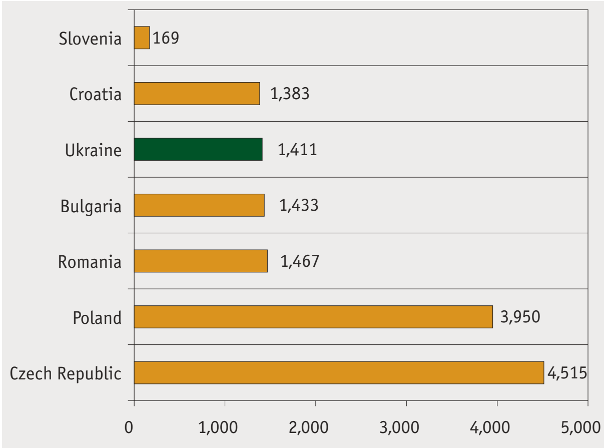
Source: State Statistics Committee

During 2003, the volume of merchandise imports originating in European countries increased to 36% from 34% a year before. It is worth mentioning that European imports could have been much higher provided lower relative price of it. Goods imports of Asian origin continued to penetrate the Ukrainian market in 2003 largely on the account of cheaper consumer goods from China and Japan such as textiles, home appliances, vehicles, computer accessories etc. Over the year, imports from Asian countries grew by almost 70% yoy compared to 21% yoy growth during the previous year.

Foreign Direct Investment

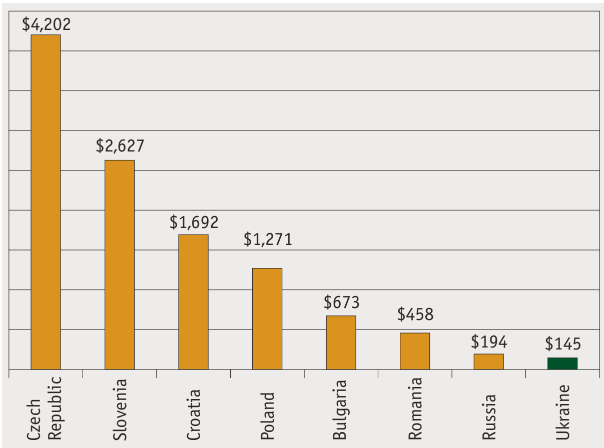
A stable macroeconomic environment and improvements in the business environment were conducive to an increase in FDI inflow in 2003, underlining an improved investor attitude toward the country. Ukraine received the largest amount of net FDI since its independence in 2003. Over the year, foreign investors contributed $1.4 billion of net FDI. This corresponds to about 3% of Ukraine's GDP, which compares very favorably with some other transition economies of the region. Foreign investment inflow has been rising steadily over the last 3 years after the drastic decline in 1999, caused by the financial crisis of 1998 and political uncertainty due to the 1999 presidential elections.

Net FDI Inflow in 2003, $ million



Source: WIIW Research Report # 303 (February 2004), The Bleyzer Foundation calculations

Net FDI per Capita in 2003

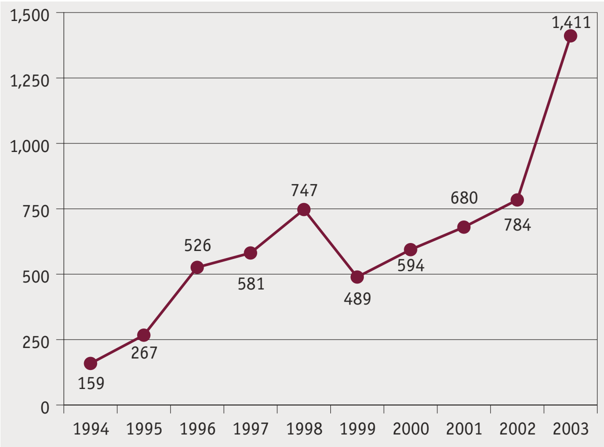


Source: WIIW Research Report # 303 (February 2004), The Bleyzer Foundation calculations

Despite significant progress in attracting FDI, the total volume of FDI in relative terms lags behind Russia and other countries of Eastern and Central Europe. Since independence, Ukraine has only managed to attract a total of $6.9 billion in foreign direct investment, and the highest levels of FDI per capita reached only $145 in 2003. This is extremely low compared to the Czech Republic and Hungary, whose FDI per capita is more than 40 and 20 times Ukrainian FDI, respectively.

A negative factor in attracting foreign investors is the shortcomings in the privatization process. Although a number of steps are being taken to simplify the privatization process and make it more transparent, the government is still delaying the privatization of infrastructure enterprises. In 2003, the government managed to fulfill its privatization plan for the year following the sale of its stake in a major mobile operator and a large metallurgical enterprise. Privatization proceeds in 2003 reached $400 million, which is considerably higher than the $110 million of privatization yield in 2002. Nevertheless, most of the large privatization deals for 2003 were delayed, in particular, privatization of energy distribution and telecommunication companies.

Dynamics of Net FDI Flows to Ukraine, $ million



Source: National Bank of Ukraine

Regional Structure of FDI

Foreign investment went into 9,442 Ukrainian enterprises during 1991–2003. Almost 80% of total FDI has been invested in the city of Kyiv and the eight most developed regions (out of 25 regions in Ukraine.)

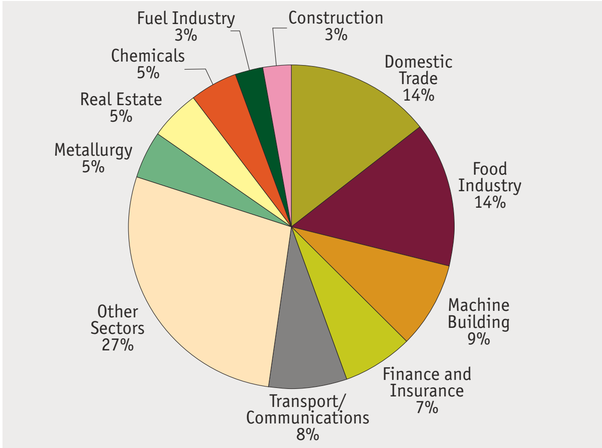
Table 2: Regional Distribution of FDI Stock

Region / City	Jan. 1, 2004, $ million	% to total FDI
City of Kyiv	$2,123	31.9%
Kyiv Region	$474	7.1%
Donetsk Region	$434	6.5%
Zaporizhya Region	$442	6.6%
Dnipropetrovsk Region	$598	9.0%
Odesa Region	$362	5.4%
Lviv Region	$305	4.6%
Kharkiv Region	$268	4.0%
Republic of Crimea	$224	3.4%
Total for Listed Regions	$5,230	78.5%
Other Regions	$1,428	21.5%
Total FDI	$6,658	100.0%

Source: State Statistics Committee

Traditionally, the food processing industry and domestic wholesale and retail trade have been the most attractive to foreign investors. These sectors usually give investors a quick return on investment and lower risk compared to other industries. FDI in food processing and internal wholesalers and retailers represents about one third of the total FDI in Ukraine. Nevertheless, machine building and communications are becoming more attractive to investors due to the high liquidity of its products.

Net FDI by Sector, %



Source: State Statistics Committee

After the financial crisis of 1998, FDI began to flow into the banking sector. Today, the banking sector, along with insurance companies, holds the fifth position in FDI volume. Revival of the Ukrainian economy and the privatization process resulted in an increase in the number of foreign companies operating in Ukraine and, in turn, the development of the banking sector.

Major Foreign Investors

Overall, 114 countries have invested in the Ukrainian economy. The largest volume of FDI has come from the US, Cyprus, the United Kingdom, the Netherlands, Germany, the Virgin Islands, Russia, Switzerland, and Austria. These 9 countries contributed approximately 72% of the total FDI in Ukraine.

The US remains the main foreign investor 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 top of the list of foreign investors in Ukraine with their proactive expansion and investment strategy. As of January 1, 2004, the US share of FDI constituted $1.07 billion or 16.1%. Roughly equal amounts of the US investments (about 15%) went to two sectors-domestic trade and food processing. However, investors were mostly interested in metallurgy in 2003. The US FDI to the metallurgy industry more than doubled in 2003, and its share of total US FDI reached approximately 13%. FDI in the food processing industry, the second largest recipient of American investments, grew by 9.3% during the last year. US investments in agriculture and services related to this sector surged 133% yoy in 2003. At the same time, American investments in financial services and real estate declined.

The relatively large share of investments originating in Cyprus suggests that Ukrainian capital that earlier flowed out of the country is gradually returning. As of January 1, 2004, Cyprus had invested almost $780 million in the Ukrainian economy. The high volume of FDI from Cyprus can be explained by the dozens of offshore companies of Ukrainian origin registered in Cyprus. In contrast to previous years, when Cypriot investments in the domestic wholesale and retail sector grew at a high pace, foreign investors began to withdraw capital from this sector in 2003. During the last year, the highest growth of FDI originating in Cyprus was registered in metals processing and real estate. Cyprus increased its investment in metallurgy and metal processing by almost five times, while investments in real estate and business services grew threefold.

The United Kingdom demonstrated one of the highest FDI growth rates in 2003. FDI from the UK increased by 28.4% yoy in 2003, second only to Germany, which increased its investments by almost 40% yoy. Significant increases in FDI from the UK occurred in the paper and printing industry (where British investments almost doubled during the year), real estate, agriculture, financial services, and machine-building.

Dutch investors, who have been very active in Ukraine since 2000, appeared fourth among the largest foreign investors in 2003. FDI volume from the Netherlands reached only $400 million in 2002 (compared to $367 million in 2000.) While most Dutch capital was invested in food processing (about 60%), Dutch companies increased their investments mostly in wholesale and retail trade, utilities, and wood processing during the last year. At the same time, Germany doubled its investments in machine-building and financial services.

Rapidly developing Russian companies are penetrating the Ukrainian market very actively, despite the couple of years that many Russian investors redirected their capital to their own market. In 2003, Russian FDI in Ukraine grew by almost 17% yoy, compared to just over 2% yoy growth in 2002. In previous years, Russian investors targeted coke and oil-refining industries and health care services, which received about 30% and 21% of the overall Russian FDI to Ukraine, respectively. In 2003, wholesale and retail trade (supermarket trade), real estate and business services, communications, and the food industry were among the most attractive sectors for Russian investments. Russian MTS recently bought the state share of UMC, the largest mobile operator in Ukraine, which was put up for sale in 2003.

Table 3: Major Foreign Investors in Ukraine

Country	FDI as of January 1, 2004, $ million	yoy change, %	Share of Total FDI Stock, %
USA	$1,074.8	20.6%	16.1%
Cyprus	$779.2	15.9%	11.7%
United Kingdom	$686.1	28.4%	10.3%
Netherlands	$463.9	17.1%	7.0%
Germany	$441.4	38.9%	6.6%
Virgin Islands	$381.0	13.1%	5.7%
Russia	$377.6	17.0%	5.7%
Switzerland	$319.5	17.2%	4.8%
Austria	$252.1	19.5%	3.8%

Source: State Statistics Committee

Future Prospects

Ukraine will continue to post significant current account surpluses in 2004–2005, although further strong increases in both consumption and investment-related imports are likely to erode the surplus of trade in goods. According to forecasts, the current account surplus may increase to $3.3 billion in 2004, or 5.6% of GDP. Major risks still exist in Ukraine's dependency on energy imports and its limited ability to diversify its export base in the short and medium term due to extremely high world oil prices. Ukraine could incur trade losses from the EU enlargement in the short term due to the denunciation of free trade agreements between Ukraine and Latvia, Lithuania and Estonia, tougher certification and sanitary requirements for exports to their recently acceding Central European neighbours. According to Ministry of Economy estimates, the total losses to Ukrainian producers in 2004–2005 may reach about $200–250 million annually or less than 1.5% of total goods exports. Judging by current export performance, these losses look insignificant. However, in the medium term, Ukraine is quite likely to benefit from the enlargement as it appears to be the EU's neighbour, as soon as Ukraine manages to re-negotiate a visa regime for its citizens and reduction of non-tariff barriers to trade in some sensitive categories of goods. Also, some technological spillover from the EU is inevitable. One of the major stumbling blocks hindering relations between Ukraine and the EU is that the EU still has not recognized Ukraine as a country with a market economy. Achieving market economy status could significantly improve Ukrainian exporters' position in settlement of trade disputes with EU members. The formal reasons for this were the incidence of administrative price regulation, and an ineffective judiciary system and bankruptcy legislation.

Meanwhile, Ukraine has taken steps to strengthen its links with Russia, its largest single trade partner. Back in September 2003, the presidents of Ukraine, Belarus, Kazakhstan and Russia signed an agreement on the creation of the Common Economic Area (CEA), which was later ratified by the Ukrainian Parliament. The agreement stipulates that the participating states will gradually integrate their trade and economic policies, leading to the eventual creation of a customs union. It is quite doubtful that participating countries will ever reach such a degree of integration as a customs union, but the creation of free-trade area between them may well be implemented. The free-trade agreement with Russia may bring substantial benefits for Ukraine as the Russian market remains highly protected for many sensitive categories of goods (some metal products). In addition, supply of Russian oil and gas may become cheaper for Ukraine as a result. During a series of bilateral negotiations, Russian officials promised to cancel the value-added tax on oil exports to Ukraine beginning in January 2005, which significantly improves the outlook for foreign trade performance.

So far, Ukraine has signed 25 agreements on mutual market access necessary to join the WTO. Ukraine plans to negotiate at least 8 more agreements with other member countries of the WTO through the end of 2004. In particular, Ukraine still has to finish trade negotiations with the USA, Australia, Argentina, Japan, Turkey, Ecuador and Columbia. The government expects that Ukraine will join the WTO by the end of 2004, but it is more likely to occur only in the second half of 2005.

So far in the first half of 2004, merchandise exports grew 51% yoy to $15.5 billion amid an oil price increase, outpacing imports growth of 33%. Imports of goods amounted to $13.1 billion in January–June. Therefore, the surplus in the trade of goods account reached $2.4 billion in the first half of 2004, representing a more than twofold increase over the same period last year. Certainly, an abrupt increase in world oil prices will drive Ukraine's energy imports up, but it can not immediately erode the benefits of growing exports in a favorable external environment for export commodities. Nevertheless, the higher cost of energy inputs will have negative impact on the competitiveness of Ukraine's major export commodities sooner or later, even with the favorable exchange rate policy pursued by the National Bank of Ukraine.

Expectations for foreign direct investment inflow remain quite promising despite the escalation of political risks in anticipation of the 2004 presidential elections. The government expects net FDI inflow at $1.3 billion and $1.5 billion in 2004 and 2005, respectively. To achieve this result, the government is stepping up its efforts to attract investors to Ukraine. In early May of this year, the government announced the creation of the Foreign Investment Agency. The agency will be a state enterprise, in which the state will hold a 51% interest. The State Property Fund (SPF) will act as the founder, later on passing its authority to the Ministry of Economy. An investment promotion agency can be effective in influencing the decision to invest in a country, and its operation may bring substantial increases in FDI inflows provided it operates efficiently. Among the major roles investment promotion agencies usually play are effective dissemination of information about the business environment and opportunities among prospective investors, and coordination of activities aimed at improving the business environment in the country. To ensure effectiveness, the agency must be transparent and trusted by the investment community (including foreign investors already operating in the country), have a business orientation, strong links with the private sector, and simultaneously, be supported at the highest levels of the government.

6. Public Debt and International Lending

The size of Ukraine's public debt has remained constant during the last few years, but has declined significantly as a percentage of GDP. During 2003, total public and publicly guaranteed (PPG) debt increased by 2.4% to $14.5 billion equivalent. The increase is attributed mainly to the additional placement of sovereign Eurobonds on the international debt market. At the same time, the Ukraine's public debt burden continued to decline thanks to rapid GDP growth, strong fiscal discipline, and sound external debt management. In 2003, the total public debt to GDP ratio dropped to 29.4% from 33.5% the previous year, which is a relatively low ratio among emerging markets. The peak of Ukraine's debt burden was registered in 1999 at about 61% of GDP, and significant reduction was achieved afterwards due to successful Paris Club debt restructuring and lower cost of borrowing.

Ukraine's current level of public debt is moderate by international standards; therefore, the risk of the country's insolvency is low. Political instability on the eve of presidential elections is the only factor contributing to the risk of debt servicing problems as perceived by international credit rating agencies. Strong macroeconomic fundamentals and prudent public debt management contributed greatly to the upgrade of Ukraine's sovereign credit rating. Most international credit rating agencies improved the country's rating by several notches in 2003. The major rating agencies confirmed Ukraine's sovereign ratings at B+ with a stable outlook.

The assessment of the country's creditworthiness in the coming years will crucially depend on the ability of the government to accelerate the pace of structural reforms and also on a favorable external environment. Back in 2003, Ukraine entered a period of peak payments on its debt obligations, and the Ukrainian government repaid about $2.1 billion equivalent in direct public debt repayment and service. In 2004, Ukraine has to pay some $2.43 billion equivalent on its internal and external obligations. So far, fiscal performance has been prudent and the NBU continues to accumulate its international reserves, thus public debt repayment and service in 2004 should not be a problem. Given a good public debt situation, Ukraine has access to the private Eurobond market on reasonable terms, and the government will rely on external borrowing to meet its debt obligations over the year.

Domestic Debt

During 2003, domestic debt decreased by 4.2% yoy to $3.85 billion equivalent. To a great extent, the decline is explained by low demand for T-bills offered by the government because of their relatively low return. In contrast to the previous year, the average rate of return on government securities placed in 2003 was equal to 9.75% per annum (down from 11%) thus leaving little profit opportunity given the 8.2% annual inflation. Therefore, the amount of government securities placed on the domestic market turned out to be lower than the amount redeemed in 2003. Over the year, the Ministry of Finance redeemed about $432 million equivalent to domestic creditors, while attraction volume was almost half at $225 million equivalent. The structure of internal debt remained virtually unchanged over the year, as the government's debt to the NBU still accounted for slightly less than 51% of total domestic debt. At of the end of 2003, debt to the NBU amounted to $1.96 billion. Another $1.88 billion is held by commercial banks, the State Pension Fund and the State Deposit Guarantee Fund.

In 2004, Ukraine's domestic debt is likely to go down as payments will constitute $900 million equivalent, while the sale of government securities to domestic creditors is very unlikely to exceed this amount. The expected volumes of borrowing are planned at about $325 million equivalent and the banking system may well absorb this amount, taking into account the higher yield and lower risk associated with government papers compared to other sources of revenue. In January–April 2004, the Ministry of Finance borrowed about $106 million from domestic creditors offering a return of almost 11% per annum, while redemption volumes reached $180 million equivalent.

Foreign Debt

During 2003, total official external debt went up by 4.9% (or $502 million) to $10.7 billion as of December 31st. Throughout the year, Ukraine's foreign debt ratio declined from 24% of GDP to 21.6% of GDP in 2003. Several Eurobond placements made throughout the year contributed most to the external debt increase. Ukraine's sovereign debt held by private creditors increased 24% yoy over the year, on account of the Eurobond placements worth some $1 billion. As a result, the structure of external public debt changed and the shares of debt owed to official creditors declined. At the end of 2003, Ukraine's public debt owed to private creditors reached $3.18 billion equivalent or about 30% of the total external debt. At the same time, Ukraine's debt to the International Monetary Fund (IMF) and the World Bank decreased as these institutions limited their cooperation with Ukraine during the year (see International Programs section.) In 2003, the relative amounts of Ukraine's obligations to the IMF and the World Bank shrunk from 27% and 24% of the total external debt in 2000 to 17% and 21% in 2003, respectively. Still, the major holders of Ukraine's foreign debt at the end of 2003 remained the World Bank, IMF, and Russia; their joint share in Ukraine's external obligations constituted 54% (see Table 4).

Table 4: Stock of Official External Debt in 2003 (end-of-period)

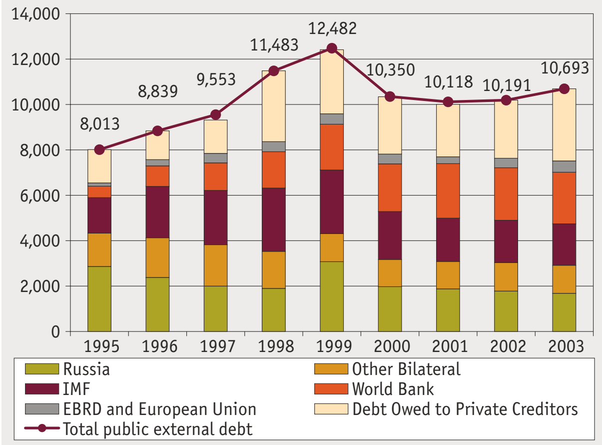
	US$ millions	% yoy change	% share of total
Multilateral	4,599	0.1	43.0
IMF	1,829	−1.9	17.1
WB	2,271	−1.8	21.2
EBRD	209	62.0	2.0
EU	290	1.0	2.7
Bilateral	2,915	−5.5	27.3
Russia	1,681	−5.5	15.7
Turkmenistan	247	−12.4	2.3
Germany	421	9.1	3.9
USA	248	−9.2	2.3
Japan	162	1.9	1.5
Italy	92	−3.2	0.9
Debt Owed to Private Creditors	3,178	24.1	29.7
Eurobonds	2,989	27.2	28.0
1995 "Gazprom bonds"	150	−7.4	1.4
Foreign commercial banks	39	−20.4	0.4
Total Foreign Debt	10,693	4.9	100.0

Source: Ministry of Finance, IMF, World Bank

External debt dynamics over the last eight years show that Ukraine's stock of external debt has been declining since the 1998 financial crisis, reaching about $10.1 billion at the beginning of 2002. Also, settlement of gas supply-related debt to Russia and restructuring of debt to Paris Club members contributed to the reduction of the stock of external debt. Recently, Ukraine regained access to the private Eurobond market on reasonable terms.

The size of external debt owed to private creditors increased in 2003 after the placement of new Eurobonds on the external debt market. Overall, Ukraine owed its Eurobond holders $3.14 billion equivalent at the end of 2003, most of which is denominated in US dollars, while the rest is denominated in Euros. During 2003, Ukraine placed $800 million worth of 10-year Eurobonds early in June and $200 million in October at a record low rate of 7.65%. The yield turned out to be lower than originally expected as a result of strong investor demand. Such an outcome can partly be attributed to higher investor interest in transition economies due to the slowdown of economic growth in the EU and the US. The spread of the $800 Eurobond placement over comparable US treasuries was 204 bps (basis points), indicating their relative attractiveness to foreign investors.

Official External Debt, 1995–2003 ($ million, end-of-period)



Source: Ministry of Finance, IMF, World Bank

During 2003, Ukraine's external obligations were relatively high, but manageable. Total external debt repayment and service amounted to $1.6 billion. Foreign debt service obligations were performed through repayments from the budget, the NBU, and also through the issue of Eurobonds. Also, sustained growth of the NBU reserves during the year supported by strong export performance contributed to timely repayment and servicing of public external debt.

Ukraine's debt service will increase through 2005, when external payments reach a peak of $1.8 billion. This amount is rather high, but robust growth of the NBU's liquid international reserves over the last two years provides a solid base for meeting debt obligations. In 2004, Ukraine has to pay $1.53 billion on its external obligations. To serve this debt, the government expects to obtain funds from multilateral lenders, from new Eurobond placements, from the current account surplus expected in 2004–2005, and from privatization revenues. So far, the government has issued $600 million of Eurobonds at the end of February 2004, in order to take advantage of favourable international debt market conditions. The maturity of the sovereign 2004 Eurobonds is 7 years, and the yield is 6.875%, lower than the previous issues. International rating agencies Fitch and S&P assigned B+ and B ratings to the new placement of Ukraine's Eurobonds, respectively. Overall, the government plans external borrowings of $1.2 billion in 2004 to make all due debt payments during the year, while the rest is to be paid from expected privatization receipts of $400 million (equivalent) by year-end.

International Programs

IMF Program

Ukraine's debt to the IMF amounts to about $1.9 billion and repayments should not put heavy pressures on Ukraine's finances. In 2003, Ukraine obtained no financing from the IMF. This was due to the problems with the value added tax refunds, which were jeopardizing tax compliance, exports, and the overall perception of the rule of law.

The IMF considered further tax reform to be a high priority in 2003–2004. The Fund urged that, as part of this reform, rate reductions should have been linked with a broadening of the tax base and elimination of tax exemptions, and welcomed recent changes in the profit tax as a step in the right direction. The IMF suggested that planned increases in public sector wages should be limited and linked to employment rationalization, with the aim of maintaining a low fiscal deficit in 2004.

In 2003, the IMF also urged that there was a need to strengthen the banking system. High real interest rates and a relatively large share of non-performing loans (about 26%) indicated that credit risk remained pervasive and called into question the sustainability of the recent rapid growth in bank credit. The IMF argued that the NBU's new long-term lending facility might distort the credit market, limit the flexibility of monetary policy, and raise governance issues. The IMF urged the NBU to focus its efforts on more fundamental banking issues, including improving banking supervision, raising capital ratios, and moving to close banks that do not meet prudential requirements.

In March 2004, the IMF approved a Precautionary Stand-By Arrangement for Ukraine of about $605 million for a period of 12 months. This approval was based on the evidence of substantial progress in Ukraine's economic policy in 2003 and the beginning of 2004. The IMF stated that Ukraine has achieved a broad-based and sustained economic recovery. Renewed confidence in macroeconomic stability has contributed to the re-monetization of the economy, a strong balance of payments, the rebuilding of international reserves, and a significant improvement in the economic outlook.

World Bank Program

During 2003, the World Bank had 12 operations under implementation in its portfolio in Ukraine. A series of Programmatic Adjustment Loans (PALs) form the backbone of the World Bank Country Assistance Strategy. PALs are conceived as a sequence of loans. The total amount of loans issued to Ukraine from the World Bank amount to $1.45 billion, with disbursements depending entirely on performance. The PALs aim to increase financial accountability, regulatory framework, property rights, public sector accountability, and social and environmental risk management. PAL I ($250 million) was fully distributed among Ukrainian stakeholders before the end of 2003. PAL II ($250 million) was approved in December 2003, upon which the first tranche of $75 million was distributed. Implementation of the program is ongoing and a second tranche of $175 million will be disbursed in 2004.

The current World Bank project portfolio in Ukraine includes projects aimed to increase efficiency of the country's public sector. These are the Treasury System Project ($16.4 million), which is designed to assist the government in creating an efficient budget management system, the State Tax Service Modernization Project ($40 million), and a Statistical System Modernization Project ($30 million).

In June 2003, the Rural Land Titling and Cadastre Development Project ($195 million) was approved. A new Rural Finance project ($200 million) will be implemented in 2004. This project seeks to develop economically competitive and sustainable rural areas with less incidence of poverty through increased access to financial services by all segments of the rural population. The Bank's program also includes support for the energy sector. The bank provided two loans with a total amount of $315.8 million to the Ukrainian coal sector to increase efficiency in this industry.

Private sector development and financial sector reform have been receiving attention in the Bank's program. Enterprise development adjustment loan I and II (total amount of $610) assisted the government in acceleration and completion of the mass-privatization program and its strengthening.

EBRD Program

The European Bank for Reconstruction and Development's (EBRD) first country strategy for Ukraine was approved in October 1992 and was revised in November 1993. These two documents underlined the need for financing private sector projects, developing the financial sector and rehabilitating existing infrastructure. In June 1997, the Board of Directors approved a new strategy for EBRD's activities in Ukraine, which included the development of the private sector, restructuring the energy sector, strengthening the financial sector, reform of key infrastructure sectors and continued efforts to improve nuclear safety in the context of the EBRD's Energy operation policy.

In its latest country strategy, which was approved by the EBRD Board in September 2002, the EBRD resolved to build on the experience of the previous years and further expand its involvement in Ukraine. The new focus is on promoting private sector business and on using the leverage afforded by priority public sector projects and policy dialogue to improve the investment climate. It was also recognized that maintaining co-ordination with other international financial institutions and with other institutions working on this field in Ukraine remained essential.

The EBRD's latest operational strategy for 2003–2004 includes the following elements:

- encouraging sustained momentum in privatization and commercialization of major utilities.
- encouraging energy efficiency in both the state and private sectors.
- providing funding through the banks to develop the small business sector and at the same time continue to strengthen the banking sector to enable banks to meet the demand for a growing range of banking services from other parts of the economy.
- providing direct financing to the private corporate sector.
- commence funding for the agricultural sector through the provision of working capital.
- continue to implement the EBRD's nuclear safety mandate, both in the administrative role for donor funds on the Chernobyl project initiatives.

The EBRD's portfolio in Ukraine has increased from 5 projects in 1994 to 58 by the end of 2003. These amount to a historical net business volume of EUR 1,279 million. Of this amount, EUR 859 million represented the portfolio (operating assets plus indrawn commitments), of which EUR 614 million were assigned to the private sector and EUR 244 million to the state sector. Operating assets amounted to EUR 524 million at the end of 2003.

The outstanding commitments to Ukraine represent almost 6% of the total of EBRD's commitment to all its countries of operation. In addition, there are technical cooperation activities in Ukraine and these currently include 207 projects with a total value of commitments of almost EUR 47 million. These are mainly related to project preparation and implementation.

Projects in the financial sector account for slightly over 27% of the EBRD's commitment to Ukraine, with much of this represented by loans provided under sovereign guarantee to support the development of small and medium size companies in Ukraine through lending via participating banks. The first of these loans (for EUR 96.2 million) was signed at the end of 1994, and is now fully disbursed. A second credit line (for EUR 70.1 million) was signed at the time of the annual EBRD meeting in Kiev in May 1998, but was only approved by the Rada in early 2000. The energy sector accounts for a further 19% of all commitments. The largest single project in this category is in the power sector; other projects include the development of oil and gas resources, gas transit and energy efficiency. Projects in manufacturing, including agribusiness, account for 32%, transport and shipping 14%, telecommunications 5%, municipal infrastructure 2%, with tourism and property accounting for the remaining 1% of all commitments.

7. Economic Goals and Reforms for the Future

The main priority of Ukraine's economic program for 2004 and 2005 is to maintain the country's recent macroeconomic gains and maintain the current momentum of growth-oriented structural reforms. Given the improved business outlook over the first months of this year, it is quite possible that Ukraine will be able to exceed last year's economic growth. The major tasks of the government in 2004 are:

- to support economic growth
- to control inflation
- to reduce vulnerabilities
- In order to sustain such remarkable economic growth over the medium term, the government should continue its efforts in structural and administrative reforms. The basis for sustainable economic growth and macroeconomic stability lies in the improvements in Ukraine's investment climate. Our studies have indicated that a number of well-defined "policy drivers" have a major impact on the level of investments that the country can achieve.

A review of these "policy drivers" and the investment climate in Ukraine is carried out in Part Two of this report.

Part Two: Investment Climate

Overview

It is widely recognized that foreign direct investment (FDI) plays an important role in worldwide economic development. A large number of developing countries and transition economies have benefited from FDI inflows, which bring not only capital into recipient countries, but also modern technology and know-how. 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.

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. The study concluded that "first generation" reforms-macroeconomic stabilization, achieved through sound fiscal and monetary policies-are essential pre-conditions to creating a favorable business climate and attracting foreign direct investments. But they alone are not sufficient to improve the business environment and ensure increases in international capital inflows. Within this macroeconomic framework, a number of "second generation" reforms are needed. Our benchmarking, statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments in the group of 50 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.)

These key investment drivers were the following, in order of priority:

(i) *Macroeconomic Stability*, which includes policies and actions to ensure sustainable economic stability over the medium term.

(ii) *Business liberalization and de-regulation policies* to permit firms to operate freely by removing barriers to market entry, barriers to operations and barriers to exit.

(iii) 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.

(iv) Policies to develop sound *corporate and public governance* that would protect ownership rights and shareholders, and avoid excesses of power by government agencies.

(v) Policies to *liberalize foreign trade and international capital movements* to facilitate the exports and imports of goods and the transfer of capital internationally.

(vi) Policies to create a healthy financial sector capable of meeting the financing needs of growing businesses.

(vii) Actions to minimize corruption and protect businesses from abuse of power by government officials.

(viii) Actions to minimize the effects of political uncertainties on business activities.

(ix) Actions to promote and inform investors about business opportunities in the country.

The performance of Ukraine regarding the above nine investment drivers is discussed below.

Driver 1: 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.

One of Ukraine's most significant achievements in economic policy-making was taking control of the country's mismanaged fiscal budget system. The country's weak fiscal budget system, characterized by lack of fiscal discipline and politically motivated decisions, was at the root of macroeconomic instability of the 1990's, with fiscal deficits in excess of 5% of GDP. The 1998 financial crisis helped the government realize the need to curb fiscal expenditures. Since then, the authorities have kept the fiscal deficit below 1% of the country's GDP. Additionally, the country established the treasury system to help streamline budget-related payments and ensure transparency in fiscal transactions.

In the fiscal area, a remaining issue is the completion of the tax reform program. This tax program became effective in January 2004, reducing corporate and personal taxes. But the country has yet to act on the proposed reduction of the Value-Added Taxes (VAT), to eliminate a large number of tax exemptions and privileges, and to adopt a single and reasonable social security tax. Another remaining problem in the fiscal area is the completion of the restructuring of the large debts that the government has accumulated on VAT.

The country's monetary authorities managed to curb inflation from two-digit numbers in the mid to late-1990s to 6-8% since 2001. Agriculture was at the root of unexpected price movements in both 2002 and 2003; excellent grain harvest in 2002 put downward pressure on consumer prices, which ended the year with a slight deflation of 0.6%, while poor grain harvest in 2003 fueled price increases to end the year with a CPI of 8.2% year-over-year.

Even though the money supply has been growing rather rapidly over recent years by 20-40% year-over-year, this did not cause sizeable inflation pressures. The money supply was allowed to increase sharply, mainly to accommodate growing demand from the real sector. However, there are indications that inflationary pressures may be developing. In due time, the National Bank of Ukraine should move to a monetary policy based on inflation-targeting. For this, it needs to develop the necessary monetary policy instruments.

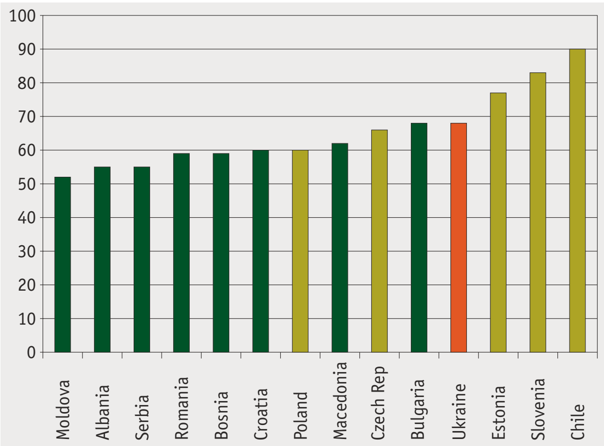
Interest rates continued to fall, making bank loans increasingly more attractive for companies and individuals alike, on the back of further development of the country's banking sector. This has resulted in significant expansion of domestic lending by the banking sector, with loans increasing at rates close to 50% per annum during the last two years. Given these developments, there is a need to enforce strongly prudential supervision to ensure the health of the banking system.

The exchange rate of the national currency, the hryvnia, against the US dollar exhibited remarkable stability over the last four years. In fact, the hryvnia appreciated somewhat against the dollar due to strong exports receipts and the weakening dollar. These factors also helped the central bank significantly increase its gross international reserves over the last few years: they have grown from $1.1 billion in 1999 to $7.1 billion in early 2004, which amounts to about 13 weeks of imports coverage. The central bank has committed to maintaining the US dollar peg of the hryvnia in the near future, and is not likely to allow significant fluctuations of the exchange rate. However, over the medium term, the NBU should move to a monetary policy based on inflation targeting, giving more flexibility to the exchange rate.

To maintain the momentum of its recent favorable economic performance, the country needs sizeable investments in its aging production facilities and infrastructure. Some progress has been made, with Gross Domestic Investments growing from about 18% of GDP a few years ago to a current level of 22% of GDP. Ukraine also needs to take actions to accelerate foreign direct investments. It managed to attract $1.4 billion in net foreign direct investments in 2003, which represents a major breakthrough compared to 2002 (a 50% growth.) This reflects the positive impact that the country's impressive macroeconomic performance has had on FDI flows. But this level is still inadequate for a country the size and potential of Ukraine.

The chart bellow compares Ukraine with two groups of countries: one group (in blue) represents the countries that have recently joined the EU (Poland, Slovenia, Estonia, Czech Republic) plus Chile, which is one of the most successful emerging market countries. The next group (in green) represents the countries that constitute the new EU-frontier (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Moldova, Romania, Serbia and Montenegro.) These countries have similar conditions to Ukraine (in red), and moving from a planned to a market economy. The comparative analysis of Ukraine with other transition countries shows that its macroeconomic performance is very good compared to others. Moreover, macroeconomic stability in Ukraine has the highest rank within the group of the new European Union frontier countries.

SigmaBleyzer Driver 1
Macroeconomic Stability



In order to improve macroeconomic stability, Ukraine should adopt the following set of the *public policy recommendations*:

- Complete the restructuring of VAT arrears.
- Complete the Tax Reform Program, including the reduction in VAT, the elimination of tax exemptions and privileges, and the adoption of a single social security tax.
- Develop appropriate monetary instruments to permit a move towards a monetary policy based on inflation-targeting.
- Gradually introduce more flexibility to foreign exchange rate policy by reducing the foreign exchange surrender requirements for exporters.
- Further improve banking supervision, including stronger prudential regulations (capital adequacy, lending to related companies, etc.) to ensure the health of the banking sector.

Driver 2: 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.

Ukraine has made notable progress in improving procedures for registering a new business. However, it is still behind some other transition countries. According to a recent enterprise level survey, Ukraine ranks high among other transition economies in the region with regards to transparency of company registration procedures. According to the survey, starting a business requires 40 days to complete all the procedures, which is less than half of the time needed for similar procedures in the Czech Republic (88 days), and less than in Slovenia (61 days), Bosnia (59 days) Croatia (50 days), Macedonia (48 days), Albania (47 days), Serbia (44 days), and many other developing and mature economies. Overall, registration is perceived as the smallest barrier for businesses, which is confirmed by a great number of new small businesses that have sprung up around the country over recent years.

Ukraine can boast a sound legislative framework that defines specific rules and procedures for company registration. It ranges from the President's decree on deregulation adopted in 1998, to the most recent law on registration scheduled to come into force in July 2004. The latter law introduces a more transparent and rapid registration process in line with requirements of the WTO and the European Union.

"One-stop shop" methods for company registration have been introduced in many regions, which decrease the time and the cost of establishing a new business. As evidenced by the functioning of one of these offices in the Ivano-Frankivsk region, both the cost and time required for registration could be halved. Also, one-stop shop registration provides full access to information on registration procedures, and reduces unofficial payments to zero.

As for the operations side of business activity, the situation remains rather difficult. The interference of government agencies in business activities has continued, even at a higher pace. According to a recent survey on the business environment in Ukraine, obtaining numerous permits is another big impediment to business operations in the country. The permits are required for virtually any area of a company's activity: from land use, to office remodeling or construction, to fire department and police approvals. Obtaining permits is one of the few areas where not only was no improvement registered compared to previous years, but the situation actually deteriorated. According to official estimates, business operations are administered through more than 1,200 permits regulated by 146 legislative acts. About 40% of these permits are considered unjustified and unnecessary. The process of granting permits is often non-transparent, paving the way for red tape and corruption opportunities. To deal with this problem, the authorities are preparing a new law to streamline the procedures.

As identified in the study, despite registered improvements, inspections by all sorts of local authorities remain a significant hurdle to normal business operations. Total length of inspections was decreasing for a number of years, from 27 days per year on average in 2000 to 17 days in 2002. At the same time, an average company was inspected 14 times in 2002, a decrease from 16 times in 1999, and 30 times in 1997. The numbers, although decreasing, clearly indicate room for further improvement.

Inspections are most often performed by tax officials and by the fire department and frequently result in demands for unofficial payments. In an attempt to cope with the problem, the state tax authority recently declared a planned reduction in the number of inspections in 2004. The government is committed to taking more decisive and global measures to improve the situation.

Taxation remains one of the greatest problems for business activities in Ukraine. A large number of taxes, privileged treatment of selected companies, and unclear tax procedures all contribute to a great deal of concern for businesses. Furthermore, these uncertainties encourage corruptive practices and abuses by the Tax Police.

Frequent changes in tax legislation also negatively affect the business environment in the country. According to recent estimates, there were 26 changes to three major tax laws in the 18-month period starting from January 2002. At the same time, attempts to adopt more progressive tax legislation have been stalled for years. However, the parliament made a considerable advance towards completion of the tax reform by passing a few important new laws in 2003. The new legislation reduced the corporate profit rate from 30% to 25%, and introduced a flat rate of 13% for personal income tax instead of the 10%-40% tax brackets. In another law, the parliament reduced VAT from 20% to 17%, but the President vetoed the law. There is a good chance that tax reform will proceed in 2004 to reduce payroll deductions to various social funds, and introduce a clear model of VAT payments.

The situation has improved with the total regulatory costs of doing business, defined as cost of compliance with regulatory requirements and includes both official and unofficial payments, as well as time cost. As a recent survey suggests, company officials had to spend on average about 15% of their time complying with all regulatory requirements ("time cost") in 2002, a big improvement from nearly 32% of their time in 1999. The number fares well even if compared to similar numbers in Bulgaria and Romania, where the "time cost" reached about 22-23% on average in 2002. Similarly, the overall regulatory costs for a business have fallen to $2,248 in 2002 from $3,222 in 1999.

On its way to a market economy, Ukraine has reduced direct subsidization of state-owned enterprises, even though indirect subsidies are believed to exist. Government-endorsed monopolies, tax preferences, selective enforcement of tax laws, and free or below-the-cost inputs from the government are considered the most popular forms of indirect subsidies in Ukraine. These are enjoyed by local companies that can boast strong lobbying support at various levels. However, the government is actively working to reduce such market-distorting practices through measures to fight corruption and to build more transparent governance and legislation. Another incentive for the government's pro-active stance on these issues is Ukraine's commitment to adopt the WTO Subsidies Code required for the country's membership in the organization.

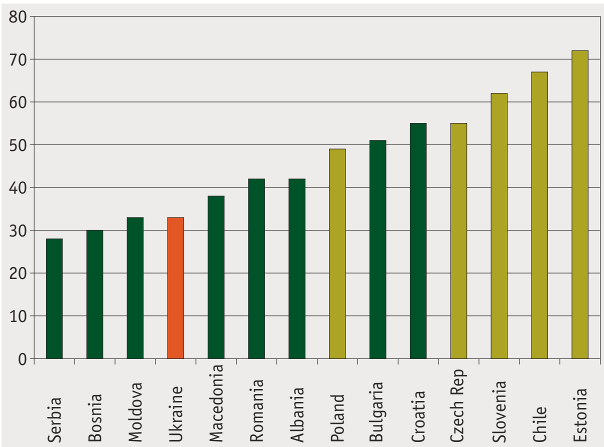
Even though Ukraine abandoned substantial preferences for foreign investors (including tax breaks and privileged tax treatment) that existed until 1996, it did leave some general incentives. Foreign investors enjoy a number of state guarantees, the most crucial one being the unrestricted repatriation of profits. Also, foreign investors are exempt from customs duties for in-kind contribution imported into Ukraine for the company's charter fund.

Ukraine was particularly successful in eliminating barriers to exit, which required the existence of sound legislation. A new bankruptcy law considered to be one of the most progressive in Eastern Europe came into force in January 2000. The law ensures debtor-led reorganization, a meaningful moratorium on payment and collection of pre-existing debt, and a tax forgiveness provision. The new law emphasizes the need to rehabilitate enterprises to restore their operations and satisfaction of creditor's claims; bankruptcy is applied only as a last resort. The existence of a credible threat of bankruptcy is an effective way of ensuring the enforcement of contracts and payment discipline, and therefore essential to the functioning of credit markets.

As a result of implementation of the new bankruptcy regulations, Ukraine significantly improved procedures related to bankruptcy. For example, the time required to close a business was 3 years in 2003. This is well below the similar number registered in other transition economies. For example, closing a business in Czech Republic requires 9.2 years, 7.3 years in Serbia and Montenegro, 5.8 years in Chile, and just less than 4 years in Slovenia, Bulgaria and Albania. Only Poland demonstrated better results at 1.5 years.

In its advance towards a modern market-based economy, Ukraine has made significant progress in liberalization of business activities. However, despite major efforts to liberalize and deregulate the economy, specific problems still remain. Although barriers to entry and exit have been substantially reduced, the cost of doing business remains very high due to the number of permits and licenses that operating firms have to obtain as well as the frequent interference of government agencies in business. The high costs negatively affect the country's rank among other transition economies. The comparison of Ukraine with other economies of the region shows that the total level of its business liberalization and deregulation is still behind many other countries.

SigmaBleyzer Driver 2
Business Liberalization and Deregulation



Public policy recommendations:

- Implement the one-stop-shop system of business registration across the country.
- Simplify the procedure and reduce the cost for operating business.
- Eliminate the incentives of state agencies to carry out excessive government intervention in businesses.
- Make the schedule of inspections available well in advance.
- Simplify and reduce the number of inspections, eliminating ad-hoc inspections.
- Eliminate the current system of Tax Police.
- Develop transparent procedures for the liquidation of companies, including disclosure of information.

Driver 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 solid legislation and its effective implementation, but also for a transparent judiciary and recognition of international contracts and agreements.

After the collapse of the Soviet Union, Ukraine was left with legislation that was totally unfit for the new realities. Development of a democratic society and of a market-based economy required creating new laws and regulations. For the past 12 years of independence, Ukraine succeeded in drafting a significant amount of legislation. The country adopted a new constitution, passed a new criminal code, land code, civil code, commercial code, customs code, election law, family code, and many economic laws. Ukraine can now boast modern legislation in the areas of bankruptcy, money laundering, public procurements, privatization, mortgage, labor regulation, and others. Significant work is being done to improve legislation on company law, the stock market, and leasing, as well as to streamline legislation and bring it up to western standards. Such a great number of legislative initiatives required a lot of effort, and was often done with assistance from international agencies like the World Bank, IFC, USAID, and others.

However, some of the new laws have been amended and changed many times as a result of shifts in the political situation in the country. Such instability of legislation often created a great deal of uncertainty among local and foreign businesses alike. In a notorious example, Ukraine originally granted broad privileges and tax exemptions to joint ventures established with foreign participation. These were fully revoked a few years later with a law that had retroactive force, leaving foreign-owned businesses bewildered and frustrated.

According to a recent survey of the business environment in Ukraine, 69% of respondents cited unstable legislation as a significant barrier to business development. The survey estimated that there were 26 changes in three major taxation laws in 18 months, 6 changes in legislation on licensing in 2002, and 11 changes in customs laws and regulations in 18 months.

Ukraine's legislation ensures equal treatment of domestic and foreign businesses (with some notable exceptions being production of weapons and alcohol, which is open only for local companies.) However, local companies, through their strong political lobbies, are often better positioned in competition with their foreign rivals.

Ukraine has passed legislation that allows the country to acknowledge and execute certain decisions of foreign courts. The law covers foreign court decisions in civil, labor and family cases, as well as particular aspects of criminal cases, and it also honors decisions of foreign arbitration courts. 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. The newly adopted Civil Code also ensures easier enforcement of international contracts in the country.

The main problem with the Ukrainian legal system is not so much the deficient legislation, but law enforcement. Court decisions can be very unpredictable and often politically motivated. Besides, they are often hard to enforce. The task of reforming the judicial system is necessary to improve the situation with law enforcement.

Independence of the judiciary still remains a major stumbling block. Extremely low financing of the courts leaves judges vulnerable to demands from different government bodies, from local authorities and law enforcement agencies, and utilities suppliers. It also makes the court system vulnerable to corruption. The government is trying to tackle the problem in part by increasing government financing of the judiciary, with a registered increase of 2.4 times in 2003 compared to 2000.

As a consequence of continued under-financing, courts are largely understaffed, with over 2,000 vacancies at the end of 2003. 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.

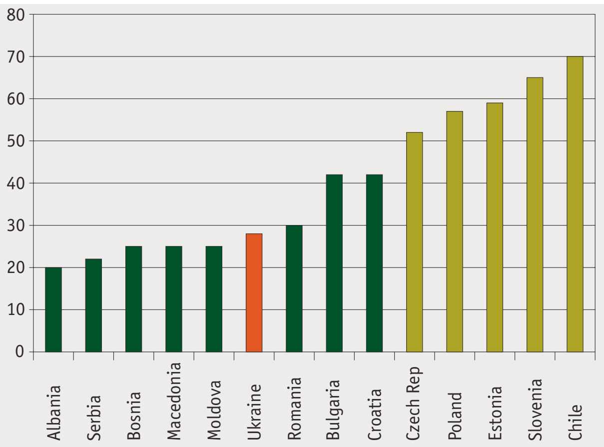
To tackle this problem, the government has emphasized the importance of up-to-date legal education, which has improved significantly over the last few years. Currently, most law schools are offering classes on important new topics not covered before, such as business law, human rights, international treaties, ethics, etc. Major law schools are adopting modern approaches to teaching, including legal clinics, to ensure training of their students to meet international standards.

Many international organizations are working to help Ukraine build a stable legal system. In one instance, a USAID-funded project to support effectiveness and independence of local courts purchased computers for the courts, brought numerous judges to the U.S. for training programs, helped build libraries in the higher courts, and helped develop judicial training centers.

With the adoption of the new law on the judiciary in 2002, the authorities are undertaking wide reform of the judiciary system to enhance its capacity as an independent and reliable system to protect basic freedoms.

Although Ukraine made significant progress in enacting business laws, the legal environment is still behind other successful transition economies because of the inadequacies of the judiciary to implement their laws and enforce business contracts.

SigmaBleyzer Driver 3
Stability and Predictability of Legal Environment



Public policy recommendations:

- Further improve financing of courts to ensure their independence.
- Increase salaries of judges and court employees to curb corruption.
- Hire additional judges and administrative personnel to reduce the workload and eliminate the backlog of unresolved cases.
- Develop comprehensive training programs for judges in contemporary issues, including company law, financial services, taxation, bankruptcy, intellectual property, human rights, etc.
- Improve legal education; encourage creation of "legal clinics."
- Enhance commercial courts for settling disputes.
- Abolish the practice of backdating any legal decisions.
- Develop sound computerized data bases for court decisions and legislation that can be accessed by judges across the country.
- Set the practice of thorough consideration of any kind of regulations to be adopted, including their correspondence with existing legislation.

Driver 4: Corporate and Public Governance

This driver includes policies and actions aimed at improving the governance of private companies and public administration, to support private sector activities in a free market economy. They include policies related to corporate governance, public administration and privatization.

a. Corporate Governance

The objective of corporate governance policies is to establish appropriate rules that would guide the activities of businesses in the best interest of their shareholders, protecting ownership rights. Key elements here include disclosure of information about corporations, shareholders' rights protection, public reporting requirements, and the use of transparent accounting practices.

The issue of governance of private companies has come to Ukraine together with the country's independence. The authorities have been actively introducing new rules to regulate the creation and operation of joint stock companies. However, the country still suffers from many serious problems in the area of corporate governance, mainly due to inefficient legislation. Loopholes in current legislation allow for the non-disclosure of information, insider trading, asset stripping, shares dilution, and voting fraud, to name a few. Also, the issue of minority shareholders' rights is not sufficiently regulated, which virtually allows majority stake holders to exercise unlimited control over the company with no regard to other owners' needs.

Many of these problems were addressed in the 2002 presidential decree "On Measures for the Development of Corporate Governance in Ukrainian Joint Stock Companies". The document provides for the improvement of the legal foundation, information disclosure, shareholder protection, and company management structure. It also recommends that the judiciary summarize and analyze corporate governance practices in Ukraine in order to support their compliance with international best practices. The newly adopted Civil Code that came into effect on January 1, 2004 ensures better property rights protection and defines clear rules for property relationships (including intellectual property).

A draft law "On Joint Stock Companies" being prepared in the parliament intends to make the 2002 Presidential decree more binding and to eliminate the remaining conflicting issues. This draft law has undergone many revisions and amendments, and its adoption has become a political issue. The adoption of the Joint Stock Companies law is an urgent matter.

In order to increase transparency and accountability of company management, the government has required all state-owned enterprises to submit their annual reports to the State Securities and Stock Market Commission. Also, all joint-stock companies are required to publish their annual reports in the media, including on specialized web sites.

One of the stumbling blocks to faster development of modern corporate governance standards is the lack of understanding among many of the company executives of how these mechanisms are supposed to work. To deal with this problem, the authorities are working to educate company management by organizing training sessions and seminars that cover these issues. In 2004, the State Property Fund plans to enroll about 1,500 company managers in these training courses. Some international financial institutions are also working in this direction.

Over the last few years, Ukraine has made progress on intellectual property rights protection. Partly under pressure from the U.S., the country passed new legislation that establishes a sound legal base for honoring copyrights, and for prosecution of violations in this area. However, enforcement of current legislation still lags behind leaving opportunities for non-competitive behaviors.

In an effort to improve transparency of its business operations, Ukraine introduced new accounting standards. The new rules are based on international accounting principles and are a big step forward from the Soviet-era standards that were previously used. However, some issues must still be addressed for Ukrainian accounting rules to fully comply with international accounting standards (IAS).

Public policy recommendations:

- Adopt the Joint Stock Company Law, according to international standards. The Law should include provisions that would (i) clarify differences between closed and opened companies; (ii) define the role and responsibilities of the board of directors; (iii) introduce cumulative voting; (iv) facilitate the settlement of shareholders disputes; (v) improve protection of minority shareholders; (vi) define the rights and obligations of common and preferred stock shareholders; (vii) define clear requirements on disclosure of information.

- Develop a Corporate Governance Code incorporating world's best practices.

- Adopt and amend securities laws and regulations to develop a functioning stock market and get rid of loopholes in legislation allowing abuses.
- Adjust Ukrainian accounting standards to international accounting standards.
- Clear up collisions of the civil and the commercial codes in different treatment of similar issues with regards to setup and operation of corporations.
- Disclose the nature of ownership of a company's key suppliers and customers.
- Strengthen the power of the Antimonopoly Committee.
- Introduce international disclosure standards into the Ukrainian stock market.

b. Public Governance

The objective of public administration policies is to redefine the role of the government to support the private sector and secure the provision of sound and efficient government services without corruption. Progress in this area is achieved through the implementation of transparent public administration procedures, sound procurement policies, and redefining the roles of government agencies.

Reform of the public administration has been on the agenda ever since Ukraine got its independence. The authorities created new legislation to foster transparency and openness of the executive branch. In a recent joint study of the World Bank and the UK's Department for International Development, Ukraine has been praised for considerable progress in the development of public administration.

However, numerous problems still remain. Public administration is one of the weakest points in the structure of Ukrainian society. A legacy of the communist past, it is ripe with corruption, bureaucracy, and vested interests. 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.

Ukraine has been actively addressing these issues through public administration reforms and initiatives, mainly induced and facilitated by international institutions. Organizations like the World Bank, USAID, and NGOs have completed numerous projects in Ukraine designed to build a transparent and modern civil service system. The projects range from support to local government, to efforts to bring up-to-date models of parliamentary process to the Ukrainian parliament. In a recent example, the World Bank provided Ukraine with a $40 million loan for restructuring and improving the efficiency of the country's tax authorities.

As a part of public administration reform, Ukraine has worked to reduce the number of civil service officers. In a recent effort, the government decided to cut the number of public servants by 10% in 2004. Much has been done to raise the professional level of public servants through their participation in various training sessions and seminars, often held within technical assistance projects. Nevertheless, there is still a lot of work to be done to rationalize the size of the government.

Ukraine has made good progress in implementation of the new Procurement Law designed to meet international standards. The law regulates purchasing activities by all public entities and provides for transparency and accountability in such transactions. Also, a web page for public procurement has been established and includes comprehensive databases on notification, advertising and pre-qualification of bidders, allowing for easier access to information.

In a combined project with the World Bank, the government is introducing an internet-based product that will facilitate public access to official information, and allow the public to perform certain government-related functions online. Also, the government has started a good practice of public consultations on some critical issues like the state budget, personal income tax law, the privatization program and others, providing an opportunity for direct public participation in policy-making.

In general, Ukraine has made significant progress towards the development of a public administration system. However, the agenda for public administration reform is still large. According to the recent European Commission's annual study of civil service capacities in candidate states, with continuous progress, it will take Ukraine up to five years to meet European standards in public administration.

Public policy recommendations:

- Carry out functional reviews of government agencies to clarify their function and consolidate them as appropriate.
- Carry out operational reviews of government agencies to streamline decision-making procedures on all levels of civil service.

- Continue the government's practice of open public consultations on issues critical to the business environment.

- The above measures would allow for a reduction in the number of civil servants. Together with increases in salaries and benefit packages, this should make civil servants less prone to rent-seeking behaviors.

- Raise the professional level of civil servants by organizing training sessions, exchange of knowledge and best practices.

- Continue improving procurement procedures to make them more competitive and transparent.

- Adopt legal regulations and policy statements that deal with problematic issues in the management of state shares on those enterprises in which the state is still a shareholder

c. Privatization

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.

Privatization in Ukraine started in 1992 and was designed to increase the private sector share of the economy, transforming the country from a centrally planned economy to a market economy. Since then, the government has managed to privatize over 91,000 companies, or about 85% of all companies. Mass privatization of small and medium-scale companies was successfully completed by 1999. These enterprises, now in private hands, contributed significantly to the economic recovery. As a result of these privatization activities, as much as 65% of GDP is generated by the private sector today (a percent similar to Slovenia and Romania, but below the 70% in Bulgaria and 75% in Poland.)

The privatization of large enterprises is still underway, with many large industrial companies in the energy, metallurgy and telecommunications sectors slated for privatization. The government is developing a new privatization program through 2006, which plans to continue privatization of strategic enterprises not previously offered for sale.

Over the years, Ukraine has realized the need to find strategic investors to speed up the development of companies, and consequently entire industries. Therefore, industry experience and a good track record have become very important requirements for prospective buyers.

The State Property Fund (SPF), an independent agency in charge of privatization in the country, has managed the process since the start of the campaign. SPF was successful in creating an effective process of changing ownership and a level playing field for both domestic and foreign investors. However, concerns have been raised over the lack of transparency of the privatization process, which has led to power abuses and vested interests. In response to this, the authorities passed a new privatization law that corrected the alleged cases and provided for more open bidding procedures, clearer qualification requirements, and the use of independent financial advisors to help ensure transparency.

Private ownership of land remains an important issue. In 2001, parliament passed the new 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 Land Code prohibits the sale of land until 2005, and restricts the land ownership of any Ukrainian individual or company to no more than 100 hectares until 2010. While the code does not allow foreigners to own agricultural land, a Ukrainian-registered company with foreign participation may purchase and use such land.

Public policy recommendations:

- Pass the law on the State Property Fund to ensure a clearer definition of the Fund's role and to avoid abuses of power.

- Accelerate the privatization of the remaining state enterprises, particularly the local utility companies, the remaining energy distribution companies, and telecommunications monopoly, Ukrtelecom.

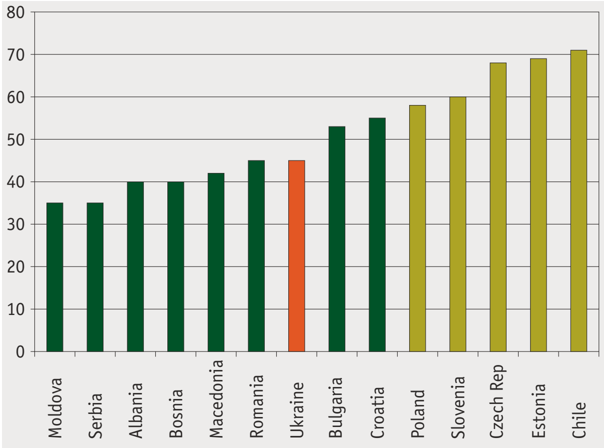
- Establish adequate procedures to ensure that the privatization process is transparent and competitive.

- Based on specific criteria, regularly review the list of strategically important companies barred from privatization.

- Develop expeditiously the regulations to facilitate land trade

International comparisons show that although Ukraine has still to take future measures on corporate and public governance, it performs much better than many other new European Union frontier countries. It is behind the new EU member-countries, in which the level of corporate and public governance has seen adequate compliance to EU requirements.

SigmaBleyzer Driver 4
Corporate and Public Governance



Driver 5: 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.

Since independence, Ukraine has significantly eased its foreign trade regime. From a country abundant with trade restrictions, including multiple export and import tariffs, various licensing requirements and corrupt and unqualified customs authorities, it has developed into an economy that considers foreign trade a powerful engine for its Euro-Atlantic aspirations. However, Ukraine still remains far behind other transition economies and developing countries.

As a result, Ukraine now enjoys an envious balance-of-payments position. Favorable conditions on world markets for Ukraine's traditional exports have also helped the country improve its external position in recent years. One of the major achievements after the collapse of the Soviet Union and the breakup of regional economic ties was its ability to geographically diversify its foreign trade, thus lessening its dependence on trading partners from the former Soviet Union. Europe's share in exports has grown to 40% and continues to rise, while Russia still remains Ukraine's biggest single foreign trade partner, accounting for 19% of all exports and 38% of imports. Also, Ukraine continues to successfully shift the structure of its exports from low value-added commodities like metals and chemicals, towards a greater share of machinery and equipment. As a result, Ukraine now enjoys a sizeable surplus in its current account balance, which amounts to about 5% of GDP.

However, in order to sustain export growth, Ukraine needs to act on three priority actions. First, it needs to become recognized as a Market Economy by the EU and the US. Second, it must join the World Trade Organization. And third, it must sign free trade agreements with the EU, the CIS countries, and the US.

Ukraine should be able to get recognition as a Market Economy by the EU and the US in the near future. This would facilitate trade relations, including prompt resolution of existing anti-dumping allegations.

Ukraine is also striving for WTO membership and is thus fully committed to aligning its foreign trade-related regulations to those of the WTO and the European Union.

In 2000, Ukraine introduced a uniform customs duty that combined seven import fees (customs clearance, sanitary, veterinary, phyto-sanitary, radiation, ecological control, and the road usage fee), thereby significantly increasing transparency of import-related payments. Import duty rates for most goods (except for farming goods, food and excisable items), are established at levels accepted by WTO.

However, most significant restrictions on international trade remain of the non-tariff kind. These can range from import licensing, to standards and certifications, to various sanitary, ecological, veterinary, etc. controls. Even though much progress has been made through creating more transparent regulations and streamlining the procedures, this area remains largely affected by corruption and selectivity of the authorities. Much emphasis in recent efforts to deal with these problems has been put on improving the legislation (to eliminate existing loopholes), proper financing and training of customs officials, and creating clear non-biased practices of cooperation with businesses.

Since 2001, the Ukrainian parliament has passed several new laws on standardization and certification to streamline the process. Ukraine is striving to harmonize its standardization and certification system with international norms, and plans to bring it into conformity with the European Standards System by 2008. The government has established a National Accreditation Body to ensure the use of standards and procedures consistent with the European Cooperation for Accreditation policy.

Ukraine has actually abolished most export controls, leaving only those pertaining to exports of sensitive goods (e.g. weapons, or products that can be used for producing weapons.) However, some export restrictions are still in place, mainly through the mechanism of minimum export prices for certain commodities, sluggish performance of the agencies responsible for issuing required documents, etc. Such non-competitive behavior is being taken very seriously by the authorities that are striving to align Ukraine's foreign trade regulations and practices with those of the EU.

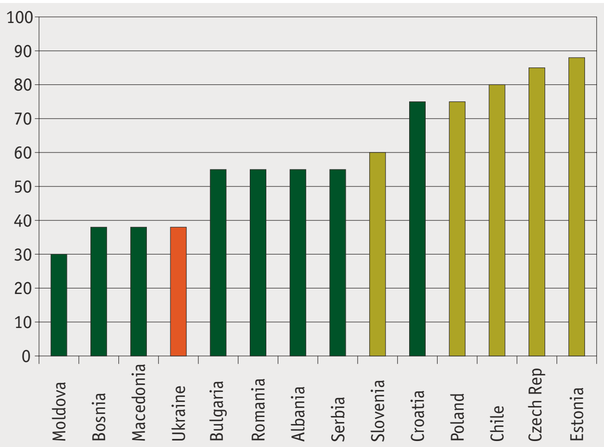
In fact, Ukraine has gone a long way in harmonizing its regulations with those of the WTO, and it is expected to join this organization by mid-2005. In preparation for this event, the country has signed bilateral protocols on mutual market access with more than 20 countries out of 29 required for joining the

WTO, including the EU. Ukraine has entered into free trade agreements with a number of countries, including all of the former Soviet Union countries. Also, Ukraine enjoys most favored nation status, according to the Partnership and Co-Operation Agreement signed with the EU.

Ukraine has recently signed a Common Economic Area agreement with Russia, Belarus and Kazakhstan. Although this agreement is ambitious, its implementation is quite flexible. The first step would be a free trade agreement among these countries, which would be highly beneficial for Ukraine. Further steps (such as common markets and monetary unions), however, are rather controversial and highly unlikely to materialize. Besides, Ukraine intends to become a full member of the Central European Free Trade Agreement (CEFTA) pending the country's membership in the WTO. A free trade agreement with the EU and the US should also be sought as a medium term goal.

Ukrainian laws allow for the free transfer of profits earned in the country once all the taxes and other required fees are paid. While foreign companies may repatriate their earnings, Ukrainian entities are required to sell 50% of their hard currency export proceeds on the inter-bank market. Currency conversion is freely available through commercial banks at market rates.

SigmaBleyzer Driver 5
Liberalization of Foreign Trade and Capital Movements



Although Ukraine has made substantial progress in the liberalization of its international trade and capital movements, the country's rank among other transition economies is low, due mainly to deficiencies in its customs administration, trade deficiencies caused by its status in the EU and the US as a non-market economy, and the fact that it's 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.

Public policy recommendations:

- Secure market economy status from the EU and the US.
- Ensure entry into the WTO as soon as possible; for this, sign protocols on mutual market access with the remaining countries in order to pave the way for WTO entry.
- Sign free trade agreements with the country's main trading partners (EU, USA, CIS countries).
- Eliminate all existing export restrictions, including export duties for some commodities and minimum export prices established by government.
- 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.
- Streamline customs procedures and formalities to ensure prompt consideration and to avoid opportunities for rent-seeking behavior.
- Eliminate the surrender requirement of 50% of export proceeds.

Driver 6: 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, a large number of private commercial banks, including foreign ones, functioning lending and deposit markets with liberalized interest rates, along with a developed stock market and an effective insurance system in place.

Ukraine can now boast a well-developed financial framework that includes basic regulations, institutions (including privately-owned) and infrastructure. It is a big advance from the Soviet-era state-owned banks and outdated payment systems that required days to process basic financial transactions. In 2000, Ukraine passed a new law on banks and banking activities that corrected many flaws in the regulatory framework that existed before. Amended by many bylaws and regulations, it paved the way for faster expansion of the banking sector in Ukraine.

Currently there are 158 active commercial banks; however, most of them are small regional banks with insignificant capital. The number of banks has decreased from the 1995 peak of 230 as a result of tighter supervision and regulations. The banking sector may be better off with a more significant degree of concentration, which is likely to take place over the coming years. To encourage this concentration, the central bank should rigorously enforce prudential regulations, including capital adequacy ratios and lending to related parties.

Financial supervision over commercial banks is executed through an independent central bank. The latter has done a lot to improve the effectiveness of the banking sector through modern prudential regulations. Also, the central bank significantly eased regulations on the foreign exchange market, which allowed the banks to better serve clients engaged in foreign trade.

The commercial banking sector has developed rapidly over recent years. Striving to stay ahead of the competition, many banks are offering more sophisticated instruments, including derivatives. Being largely under-capitalized, local banks engage in syndications with other local or foreign banks to accommodate the growing needs of businesses. Banks in Ukraine have now moved toward using international accounting standards and audit procedures, which enhance their transparency and accountability.

Some of the world's largest banks are very active in Ukraine, including Credit Lyonnais, Citibank, ING Bank, Credit Suisse First Boston, etc., with seven foreign-owned banks in total. Some 13 other banks have foreign-owned stakes. Entry of foreign banks used to be limited due to restrictions placed on their activities by the legislation, and through heavy lobbying from local banks. However, the 2002 law on banking activities eliminates any discrimination against foreign banks in Ukraine. Foreign banks, properly licensed by the central bank, may now carry out the same activities as domestic banks, and there is no ceiling on their participation in the banking system.

Some of the largest banks are former state-owned banks where the state still holds a large or even controlling stake. There are only two fully state-owned banks out of 158 functioning banks in Ukraine at the moment. There is some concern that the state-banks still enjoy a number of privileges that are not available to private banks, such as less stringent application of prudential supervision.

The loan and deposit markets have seen dramatic growth over recent years, primarily due to the broad recovery of the economy and its ensuing monetization. Stiffer competition among the banks resulted in higher quality services and a wider range of banking products offered to companies and individuals alike. Larger disposable incomes of the population spurred the development of consumer credit, as well as long-term loans, including mortgages. This was facilitated in part by more organized credit policies and streamlined procedures. With the passage of a very progressive mortgage law recently, the banking sector has been given another opportunity to pursue.

Rapid expansion of consumer lending has recently put a big strain on the banking system, which found itself with a lack of capital and a growing mismatch between the primarily short-term deposits and the medium to long-term loans it provided. However, the central bank is acting promptly to avoid possible crisis by introducing adequate measures. The central bank is aware that this matter should be under continuous review.

In recent years, Ukraine has seen a boost in its corporate bond market. With the legislation in place, many companies began borrowing extensively, both internally and externally. There is a concern, however, that some of the bond issuers may not be fully creditworthy and that the next few years may see major bond defaults. Even though the situation is unlikely to be serious now, the central bank is aware that this issue should be closely monitored to ensure the stability of the financial system.

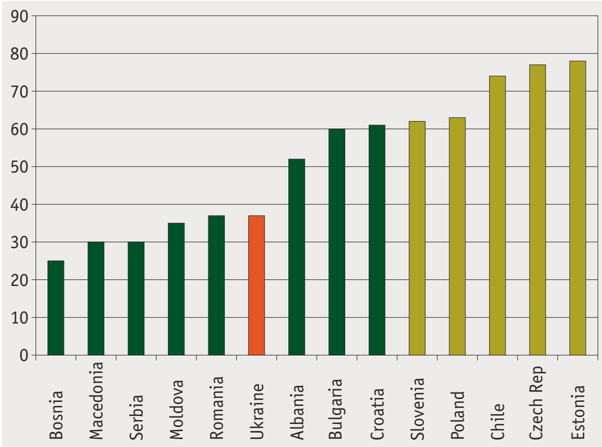
Ukraine has an effective deposit insurance system in place. Even though it offers just up to $560 per deposit contract, this amount will cover nearly 85% of all deposits due to their small sizes. The central bank is considering increasing the deposit insurance maximum amount to about $1,000 within a few years. Bank insolvency cases are scarce, with the most significant being the collapse of the state-controlled bank "Ukraina" a few years ago.

The insurance sector has been rapidly developing in recent years. New products and services have been introduced (such as life insurance, agricultural risk insurance, etc). However, most are not very popular due to the limited purchasing power of local clients. A big impediment to further development of the insurance market is the fact that foreign insurance companies can do business in Ukraine only through establishing a local branch or investing in a local company. Also, minimum capital requirements for foreign companies are higher than for local companies. The government is currently considering abandoning these discriminating regulations to encourage well-known foreign insurance companies to enter the market. Also, stricter statutory capital requirements led to a wave of consolidations in the insurance industry, making the companies and the sector as a whole more solvent and reliable.

While leasing activities could be a financially sound option for many companies, those were not very popular until recently due to inappropriate legislation. After continuous pressure from different IFIs, the law on leasing was amended at the end of 2003 and it now allows financial leasing operations. The new version of the law also eliminated inconsistencies with the Civil Code and the Commercial Code that existed in its earlier version. It also reduced the number of specific provisions that are required to be included in a financial lease contract from 14 to 3, which provides for less regulation and allows the financial lease contracts to be more transparent and easily enforced. Nevertheless, for financial leasing to be developed in Ukraine, there is a need to revise other related legislation such as tax and accounting treatments for leasing operations.

The stock market has seen some improvement over recent years in terms of higher capitalization and higher trading volume. However, most equity transactions are taking place beyond the organized stock market for tax reasons. Ukraine's Securities and Exchange Commission is working to strengthen its regulation of the stock market.

SigmaBleyzer Driver 6
Financial Sector Development



Despite some existing irregularities, Ukraine's financial sector has grown into a developed and rather stable system. Further improvement is ensured by sound regulation by the central bank, increased confidence in the national currency and the financial system as a whole, and constant use of and movement towards world's best practices. Although Ukraine performs much better than many other countries in the region, its financial sector development is still behind many other transition countries, in particular those who have already joined the EU.

Public policy recommendations:

- Ensure a fair playing field for all banks, including state-owned.
- Provide adequate regulation of corporate bond issues.
- Implement effective mechanisms for dealing with bad debts.
- Increase the maximum level of deposit insurance.
- Allow foreign banking and non-banking institutions to fully operate in Ukraine.
- Encourage stock market transactions to be made on the organized market through tax incentives and improved legislation.
- Introduce a modern three-pillar pension system and ensure development of private pension funds.
- Enact the Mortgage Law regarding farm land mortgages

Driver 7: 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 is one of the gravest impediments to the successful development of a competitive market economy in Ukraine. It is a problem that spreads through nearly all aspects of the country's economic, political and social life. According to Transparency International's most recent Corruption Perception Index, Ukraine is placed at 106th position out of 133 countries surveyed, sharing this position with Bolivia, Honduras, Serbia and Montenegro, Sudan and Zimbabwe, while neighboring Russia ranked 86th. A recent study by a local NGO showed that the number of officially registered instances of corruption in public administration decreased only marginally, from 4,500 in 1998 to 4,030 in 2002. This is in part due to an insufficient number of specialized anti-corruption teams in government institutions, and a lack of measures to prevent corruption in the groups of officials most prone to such illegal activities.

The Ukrainian authorities have gone a long way from initially ignoring the problem to acknowledging that it exists, to working to tackle it seriously. The country has had a wide range of anti-corruption laws and regulations for years. However, Ukraine still lacks systematic efforts to actually fight corruption and to prevent it.

The Ukrainian President has established a coordination committee for combating corruption and organized crime composed of officials from the State Security Service, Justice Ministry, Ministry of Internal Affairs, and State Customs Service. The parliament held a number of hearings on the topic. The Minister of Justice decided to set up a special internal monitoring facility to track corruption in the legal system. Recently, the President launched a wide-ranging anti-corruption campaign by passing a special decree that sets out specific measures to eliminate the causes and conditions that encourage 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. This Convention is the first truly international initiative to have a coordinated policy and practice for preventing and fighting corruption. Ukraine is also a signor to a similar Convention of the Council of Europe.

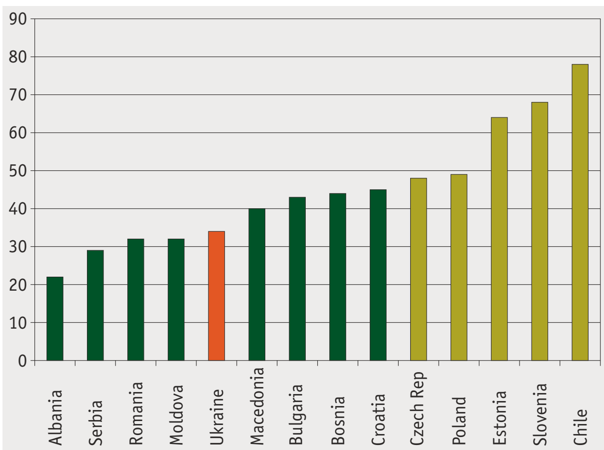
Recently, Ukraine approved an action plan against "VIP corruption" in the former Soviet countries, developed by OECD's Anti-Corruption Network for Transition Economies. By approving this document, Ukraine committed to take active measures to develop effective and transparent civil service, to fight bribery and to support public participation in policy-making. Successful implementation of the anti-corruption measures would serve as a basis for the on-going financial support of the anti-corruption campaign.

In an attempt to raise public awareness of the problem, Ukraine is launching an educational campaign on corruption as part of the joint Ukrainian-Canadian project on improving conscientiousness in civil service. There will be two educational courses: one to be taught at colleges and universities, and the other for training of civil servants.

While corruption in Ukraine stems from a lack of institutional traditions of transparent decision-making, it is largely fueled by the low standards of living of public officials. Policy measures that the government is taking to encourage sustained economic growth and increased standards of living are the first step to alleviate the problem.

The level of corruption in Ukraine is still high compare to other countries. Ukraine is far behind the new EU-member states.

SigmaBleyzer Driver 7
Corruption level (100 — no corruption)



Public policy recommendations:

- Continue with public administration reform to improve transparency of decision-making.
- Reduce the ambiguity of government regulations and reorganize responsibilities of public servants to reduce the room for arbitrary decisions.
- Increase official compensation of public servants as a result of the reduction in their number, achieved through restructuring of government agencies.
- Raise accountability of public servants for their decisions; strengthen the internal audit office.
- Educate the population on the damage corruption brings to society and the economy; encourage individuals to avoid involvement in corrupt activities and introduce public watch measures.

Driver 8: Political Risks

This driver includes policies and actions to minimize the effects of political uncertainties on business activities. This is achieved through 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.

For twelve years since gaining its independence from the Soviet Union, Ukraine has been moving along a thorny path of building its civil society and setting basic socio-economic regulations. The government conducted reforms to bring to life a functioning market economy, overseen by authorities at all levels.

A great achievement of the Ukrainian authorities is that over the years, there were no significant incidences of violence and no military clashes in the country. This was despite a considerable economic downturn in the mid-1990s, which resulted in falling standards of living and some acute political tensions erupting periodically.

However, Ukraine is known for the large impact that political events have on the economy and the people. Election years are the most notorious example. Recent political initiatives to change the balance of power between the different branches, combined with the scheduled presidential elections at the end of 2004, have created some additional tensions in the country.

Due to Ukraine's location between Russia and the enlarged EU, the country finds itself in the middle of increasing pressures both sides. The government always declares its strategic objective of closer ties with the EU, including full membership in the organization. Ukraine is a member country of the United Nations, World Bank, IMF, other universal international institutions and organizations, and is a signatory to most important international treaties. Since the country is moving towards closer integration with the EU, accession to the WTO and even NATO, it is under continuous scrutiny from these and other organizations, who constantly monitor Ukraine's progress in building a democracy and a functioning market economy.

Ukraine's participation in the initiatives of former Soviet countries has for the most part been formal. Even though the country recently signed an agreement with Russia, Belarus and Kazakhstan on forming a Common Economic Area, full implementation of this agreement beyond free trade agreements is deemed unlikely.

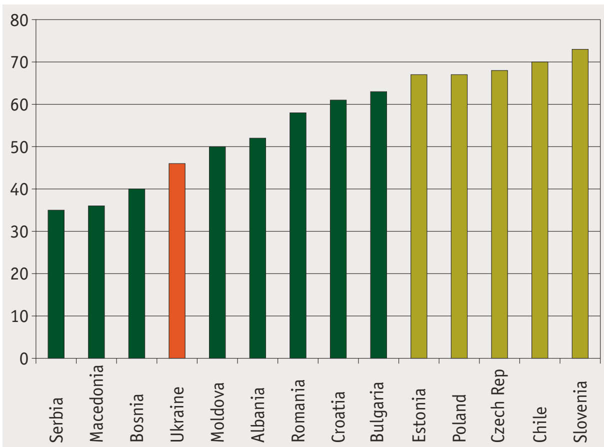
A certain degree of uncertainty remains over what course the country will take in the wake of this year's presidential elections. Namely, those that will come to power may either pursue a policy of closer integration with the EU and the West, or may allow for deeper influence of the Russian Federation. There is broad recognition, however, that the two main presidential candidates are likely to continue Ukraine's move towards a market economy and closer relationships with Europe and the US.

The last few years have been marked with the rise of local oligarchs, which started to play critical roles in policy-making at all levels of the government through extensive lobbying. The activities of these vested interest groups often explain the sluggishness of reforms, the reluctance to adopt progressive legislation, etc. It remains a challenge for the authorities to set aside such demands and continue building a strong economy and civil society. This effort may be supported by the fact that several of these vested interest groups are now in the process of seeking "legitimization".

In general, Ukraine remains a rather stable country without serious risks of civil conflicts, violence, or extensive political tensions. Even though some uncertainty exists regarding the political future, it is highly unlikely to change Ukraine's determination to build a strong market economy.

The comparison of Ukraine with other transition countries shows that it suffers from a high level of political risks. This is mostly explained by political uncertainty, which exists in the country due to the great fragmentation of political parties in Parliament and due to the upcoming presidential election. However, the level of political risks in the country should be substantially reduced after the elections, and Ukraine should increase its rating.

SigmaBleyzer Driver 8
Political risks (100 — no risk)



Public policy recommendations:

- Take measures to eliminate power abuses at different levels.
- Ensure that laws and regulations are passed with the nation's interests in mind rather than to serve vested interests.
- Assure the private sector that the government will not allow any form of expropriation.
- Ensure stability of the legal environment; avoid government decisions affecting businesses that have retroactive action.
- Strive for governmental stability, including longevity of key officials
- Continue the policy of reconciliation and avoidance of civil disorders that may affect the private sector.

Driver 9: Country Promotion and Image

This driver includes policies and actions to promote the country and improve its image as perceived by foreign and domestic investors. Key measures include the government's consistent and detailed action plan on country promotion, support to current investors in resolving problem issues, and the country's active position internationally.

Ukrainian authorities have realized that improving the country's image is one of the most important challenges they currently face. Having made considerable advances in economic and social policies, the country often suffers from a lack of international recognition of its achievements.

Recently, the Ukrainian government issued a State Program on creating the country's positive international image for the period of 2003-2006. The program outlines specific measures that need to be taken in a number of areas, namely, measures in political and cultural areas, measures to improve Ukraine's attractiveness for tourism, and to harmonize the country's legislation with that of the EU. Also, the program specifies measures for creating a positive image in the areas of business, banking, finance, and energy, as well as improving the country's cooperation with regional and international organizations.

Ukraine's active position on some of the world's problem issues has helped the country to overcome a notable chill in its relations with the U.S., which came as a result of political scandals involving the country's top officials. Currently, relations are back to normal, allowing the two countries to resolve some long-time economic issues (including resumption of US poultry imports and Ukraine's crackdown on copyright violations in the country.)

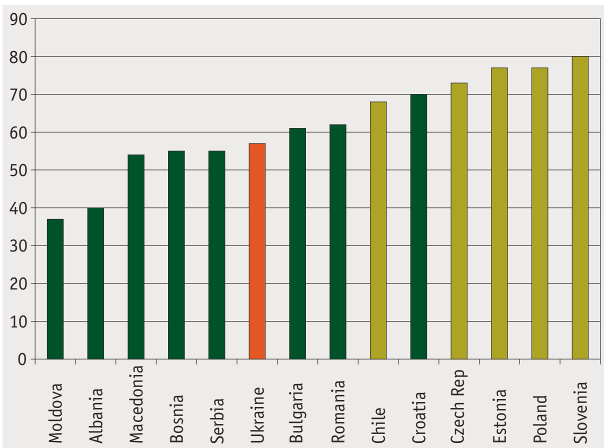
Top-ranking Ukrainian officials have pledged to resolve all current investment disputes soon. The U.S. Overseas Private Investment Corporation (OPIC) has recently decided to resume its support for U.S. private sector investment projects in Ukraine by 2005, after a long-time investment dispute that forced OPIC to stop its operations in the country was finally resolved.

In 2003, Ukraine was very successful in its international financial operations. In fact, in a special issue for the annual World Bank and IMF meeting in October 2003, Emerging Markets magazine ranked Ukraine's 10-year eurobonds issue earlier that year as the best state financial transaction of the year. International rating agencies, including Standard & Poor's and Fitch, have upgraded Ukraine's country rating and outlook a few times over the past few years; the current ratings stand at B+ with a positive outlook. JP Morgan recently praised improvement in Ukraine's investment climate and expressed its full commitment for further investments in Ukraine.

Ukraine continues to actively cooperate with its global donors and international financial institutions. The country is known for full, timely payments of its foreign debt. At the end of 2003, the World Bank approved a $250 million Second Programmatic Adjustment Loan (PAL-II) for Ukraine, praising the country's macroeconomic performance, which was followed by resumption of active cooperation with the IMF. Ukraine has been recently removed from the Financial Action Task Force on money laundering (FATF) blacklist of countries fostering money-laundering, after the country's legislation and activities had been brought in line with the organization's requirements in record time.

Overall, despite some political and economic policy setbacks that negatively affected Ukraine's relations with the West over the last few years, the country managed to prove through its economic, social and political achievements that it is a country of great potential and it belongs among the world's most attractive emerging markets. Ukraine has performed very well compared to other countries of the region, including those which already joined the EU.

SigmaBleyzer Driver 9
Country Promotion and Image



Public policy recommendations:

- Ensure effective functioning of the investment promotion agency.
- 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.
- Continuously interact with representatives of the private sector in Ukraine to learn the problems they are facing and provide feedback on dealing with those problems.
- Engage the country's embassies and other missions to disseminate up-to-date information on Ukraine and its business opportunities.
- Resolve outstanding investment disputes with foreign investors; ensure fair treatment of foreign investors in courts.
- Ensure timely repayment of foreign debt and other international obligations; participate in international programs and initiatives.

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Appendix

Key Economic Statistical Information*

	1997	1998	1999	2000	2001	2002	2003	2004 (p)	2005 (p)
GDP									
Real GDP (% YoY)	−3.1	−1.9	−0.4	6	9.2	5.2	9.4	9.7	7.7
GDP nominal (UAH bn)	93	104	127	175	205	221	263	317	363
GDP per Capita (US$)	856	828	612	555	720	859	1012	1061	1449
Gross Investment (% of GDP)	21.4	20.8	17.4	19.7	21.8	18.9	20.8	21	21.5
Gross National Savings (% of GDP)	19	18	22	20	20	22	25.6	26.3	30
Industrial Growth Rate, %	−0.3	−1	4	13.2	14.2	7	15.8	16	—
Public Finances									
Fiscal Balance (% of GDP)	−6.6	−2.2	−1.5	0.6	−0.3	0.7	−0.2	−0.8	−0.5
Revenues (% of GDP)	30.1	28.2	25.2	28.9	26.9	27.6	28.5	26.8	26.7
Expenditures (% of GDP)	36.8	30.4	26.7	28.3	27.2	27.3	28.6	27.6	27.2
Monetary Statistics									
Consumer Prices (%YoY)	10.1	20	19.2	25.8	6.1	−0.6	8.2	7.2	6.5
Monetary Base (%YoY)	44.6	22.2	39	40	37.4	33.6	30.1	27	24
Money Supply-M3 (%YoY)	33.9	25.2	40.5	45.4	42	41.7	46.5	37	31
Exchange Rate (UAH/$)	1.9	2.5	4.1	5.4	5.4	5.3	5.3	5.3	5.3
Exchange Rate (UAH/Euro)	—	—	4.4	5	4.8	5	6.6	5.5	—
Balance of Payments									
Goods Exports (US$bn)	15.4	13.7	12.5	15.5	17.1	18.7	20.1	—	—
Goods & NFSE (US$bn)	20.4	17.6	16.3	19.3	21.1	23.4	25.3	35.1	38.9
Goods Imports (US$bn)	19.6	16.3	13	14.9	16.9	18	23	—	—
Goods & NFSI (US$bn)	21.9	18.8	15.2	18.1	20.5	21.5	25.1	33.5	37.7
Trade Balance (US$bn)	−4.2	−2.6	−0.5	0.5	0.2	0.7	0.1	−0.4	−0.4
Current Acc. Balance (US$bn)	−1.3	−1.3	0.9	1.2	1.4	3.2	2.9	3.3	2.9
Direct Investments (US$bn)	0.6	0.7	0.4	0.6	0.8	0.7	1.4	1.4	1.5
Gross Reserves (US$bn)	2.3	0.8	1.1	1.6	3.1	4.4	6.9	8.7	10.6
Gross Reserves (weeks of imports)	6	2	2.8	3.6	6.8	7.6	11.2	12	12
Public Debt									
External Debt (US$bn)	9.6	11.5	12.4	10.4	10.1	10.2	10.7	10.7	—
External Debt Service (US$bn)	1.2	1.8	2	1.7	1.8	1.4	1.5	1.5	—
Domestic Debt (US$bn)	4.6	3.7	2.9	3.8	3.8	4	4.2	4.3	—

** Projections for 2004 and 2005 are presented based on a consensus forecast developed by major forecasting agencies in Ukraine and the forecasting department of the Ministry of Economy of Ukraine.*

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