

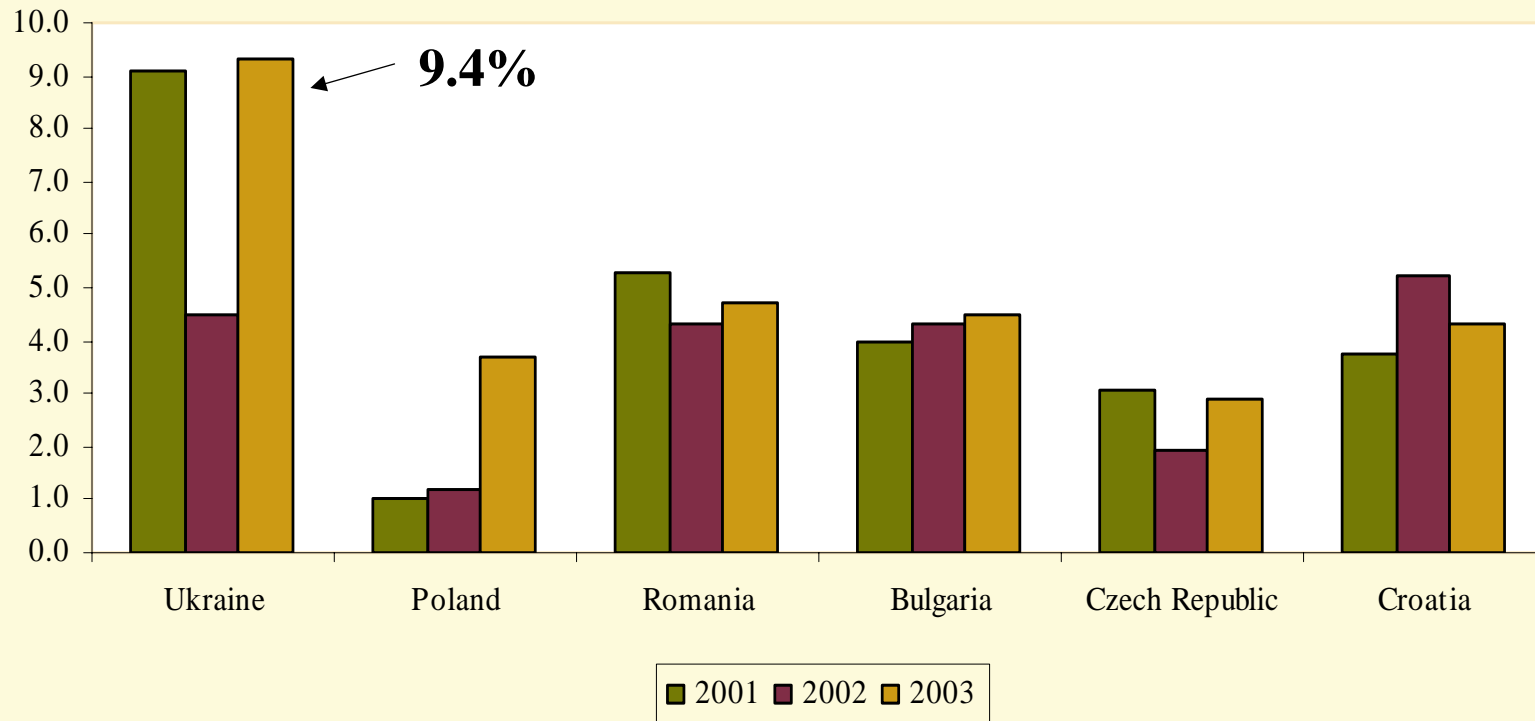
Ukrainian Odyssey : Economy 2004 and Investment Climate

December 2004

Macroeconomic Performance

For the 4th straight year, in 2003 Ukraine showed the best macroeconomic performance in Eastern and Central Europe

Real GDP growth in Ukraine and selected transition economies, %



.....Macroeconomic Performance

- **Through 2004**, the Ukrainian economy has continued to demonstrate good growth: In January-September 2004, real GDP growth in the country surged 14.4% year-over-year.
- In 2004, continued robust growth is taking place in agriculture, machine building, metallurgy, food processing and construction.
- Despite some pre-election loosening, fiscal policies have been reasonable so far, with fiscal deficits of less than 2% of GDP.
- Inflationary pressures worsened in 2004 as the consumer price index increased by 10.7% yoy in September 2004. In 2003, the country had experienced an inflation rate of 8.2% (principally due to increases in prices of agricultural products).

.....Macroeconomic Performance

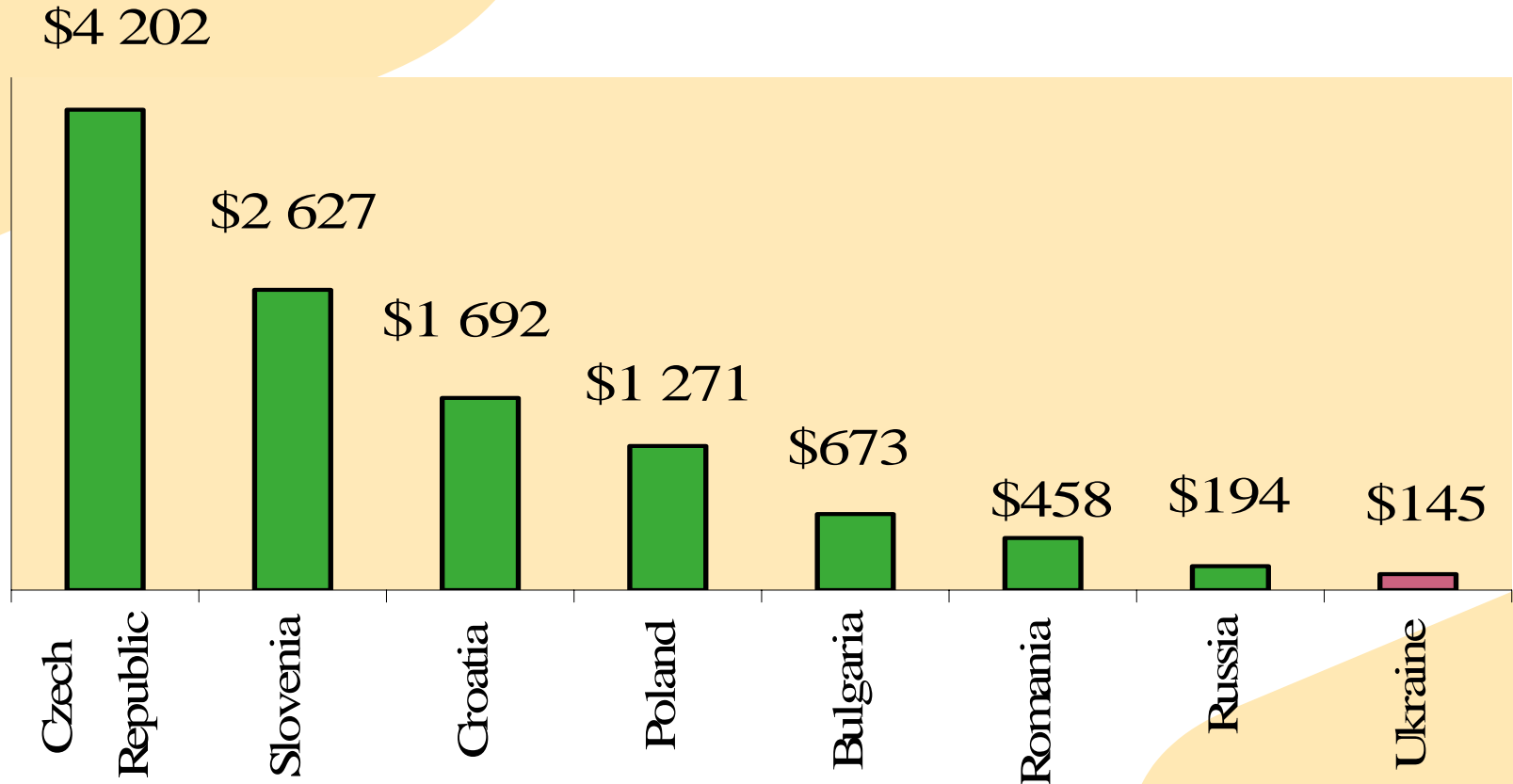
- Money supply (M3) continued to increase at a high rate of over 45% per year in 2003 as the NBU purchased large amounts of foreign exchange to stabilize the Hryvnia .
- The level of international reserves of the NBU has been expanding rapidly, reaching \$12.1 billion at the end of September 2004, equivalent to about 18 weeks of imports, consistent with IMF guidelines for international reserves.
- Current account balance reached \$2.9 billion in 2003 (5.9% of GDP).
- External debt amounts to \$10.7 billion, or about 22% of 2003 GDP. This is one of the lowest debt ratios in emerging markets.

Positive macroeconomic developments are having a positive impact on foreign direct investments (FDIs):

- In 2003, FDIs increased by almost 80% yoy, to \$1.4 billion, reflecting growing investor's confidence.
- In the first half of 2004, net FDI inflow reached \$884 million, and for the entire year is expected to reach \$1.5 billion.
- SigmaBleyzer's study indicates that Ukraine could between \$3.5 to \$6.4 billion per year of FDI if it were to improve its business environment (under middle and optimistic scenario, respectively).

Despite positive inflow dynamics, cumulative FDI in Ukraine is still extremely low compared to other economies in the region....

Cumulative FDI per capita in 2003



...reflecting, in part, still poor investment climate

Possible Risks to Economic Growth

- Inflationary pressures may emerge in 2005 as a result of:
Substantial fiscal loosening approved in 2004 (as a result of the increase in pensions approved in late 2004)
Spending of huge privatization receipts for current, non-investment purposes
- Lack of exchange rate flexibility
- Rapid credit expansion and low quality of credit portfolio
- External shock (Ukrainian growth is, to a great extent, export-led)
- If tight fiscal and monetary policies are not implemented by the new Government, inflation may reach two digit levels in 2005.

.....Risks to Economic Growth

To ensure sustainable economic growth over the medium term,

sound monetary and fiscal policies

Must be maintained and
must be complemented by

**policies facilitating sustainable investment activity
or “investment drivers”.**

Policy recommendations for Ukraine are arranged within the nine investment drivers framework:

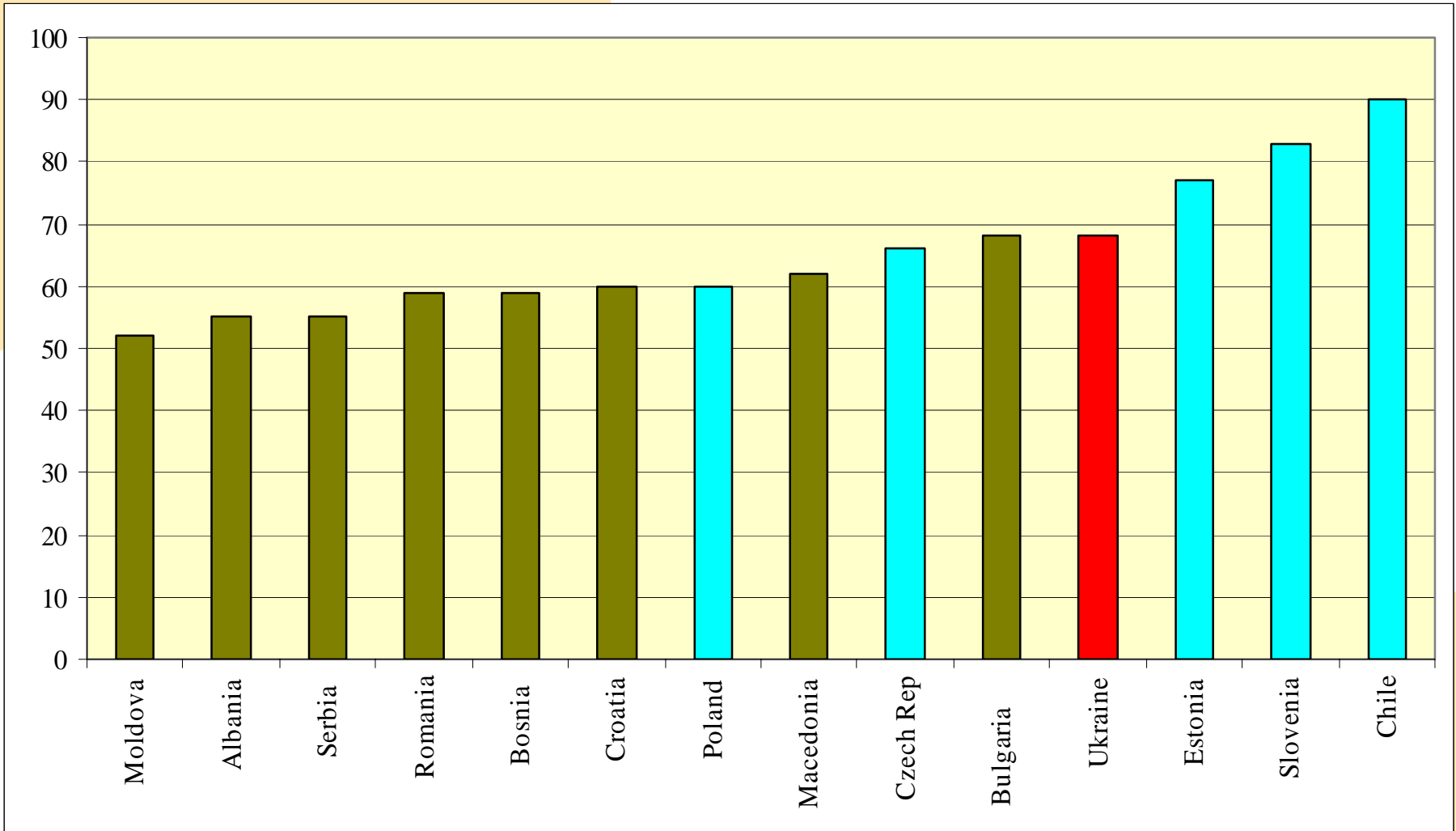
- (1) Macroeconomic stability
- (2) Business liberalization and de-regulation policies
- (3) Stable and predictable legal environment
- (4) Corporate and public governance
- (5) Foreign trade liberalization and international capital movements
- (6) Healthy financial sector
- (7) Corruption
- (8) Political uncertainties
- (9) Country promotion and image

Driver #1: Macroeconomic Stability

In order to sustain macroeconomic stability it is necessary to:

- (1) ensure that the fiscal deficit is sustainable by eliminating tax privileges and exemptions, and ensuring that state obligations, such as repayment of VAT arrears, are met.
- (2) gradually introduce more flexibility to foreign exchange rate policy by reducing the foreign exchange surrender requirements for exporters;

Driver #1: Macroeconomic Stability

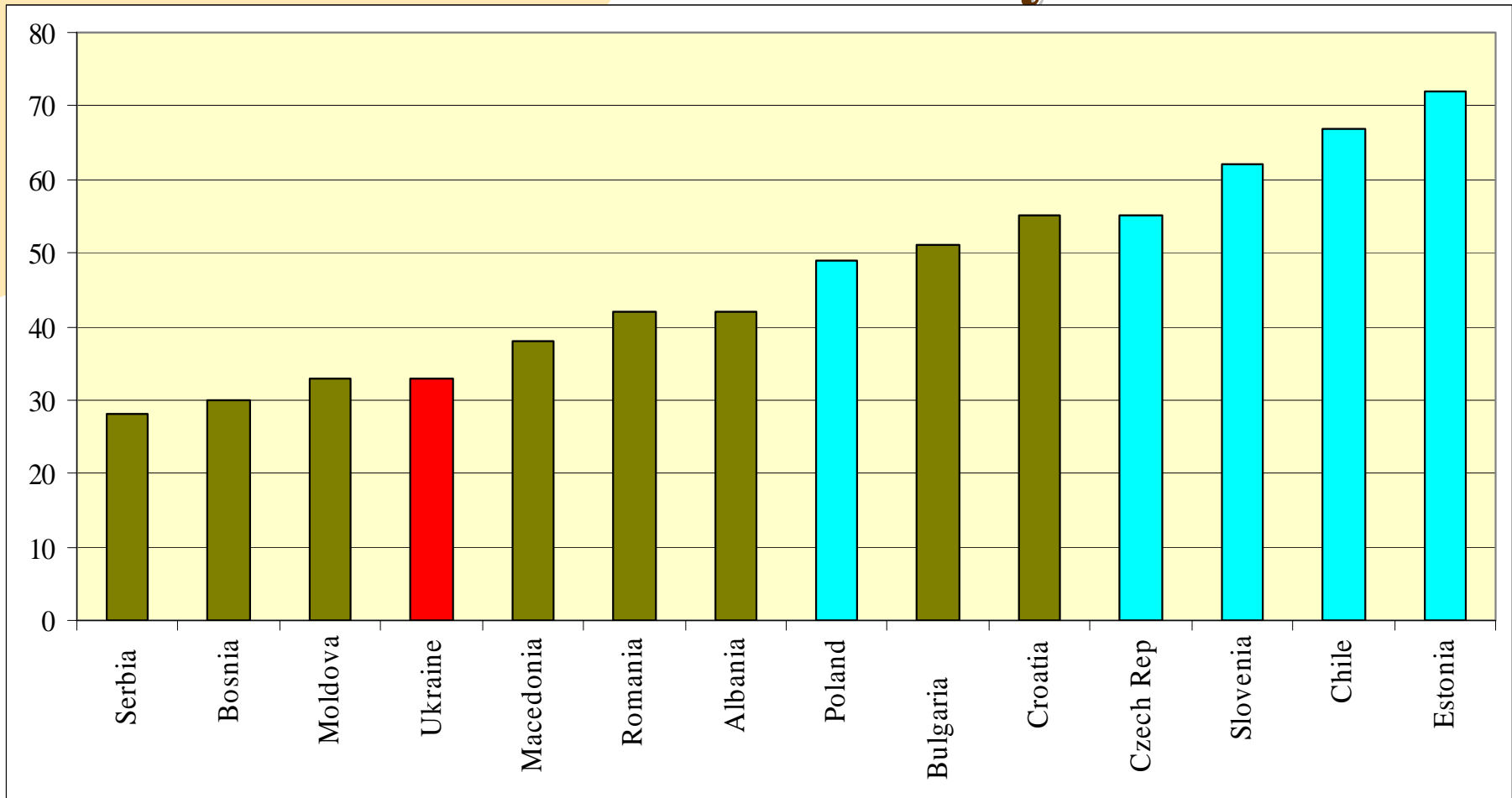


Driver #2: Liberalization and Deregulation of Business Activity

Priority actions to liberalize and deregulate business environment designed to:

- (1) to eliminate excessive government intervention in businesses by abolishing the incentives of state agencies to intervene in business activities;
- (2) to develop transparent procedures for the liquidation of companies, including disclosure of information.

Driver #2: Liberalization and Deregulation of Business Activity

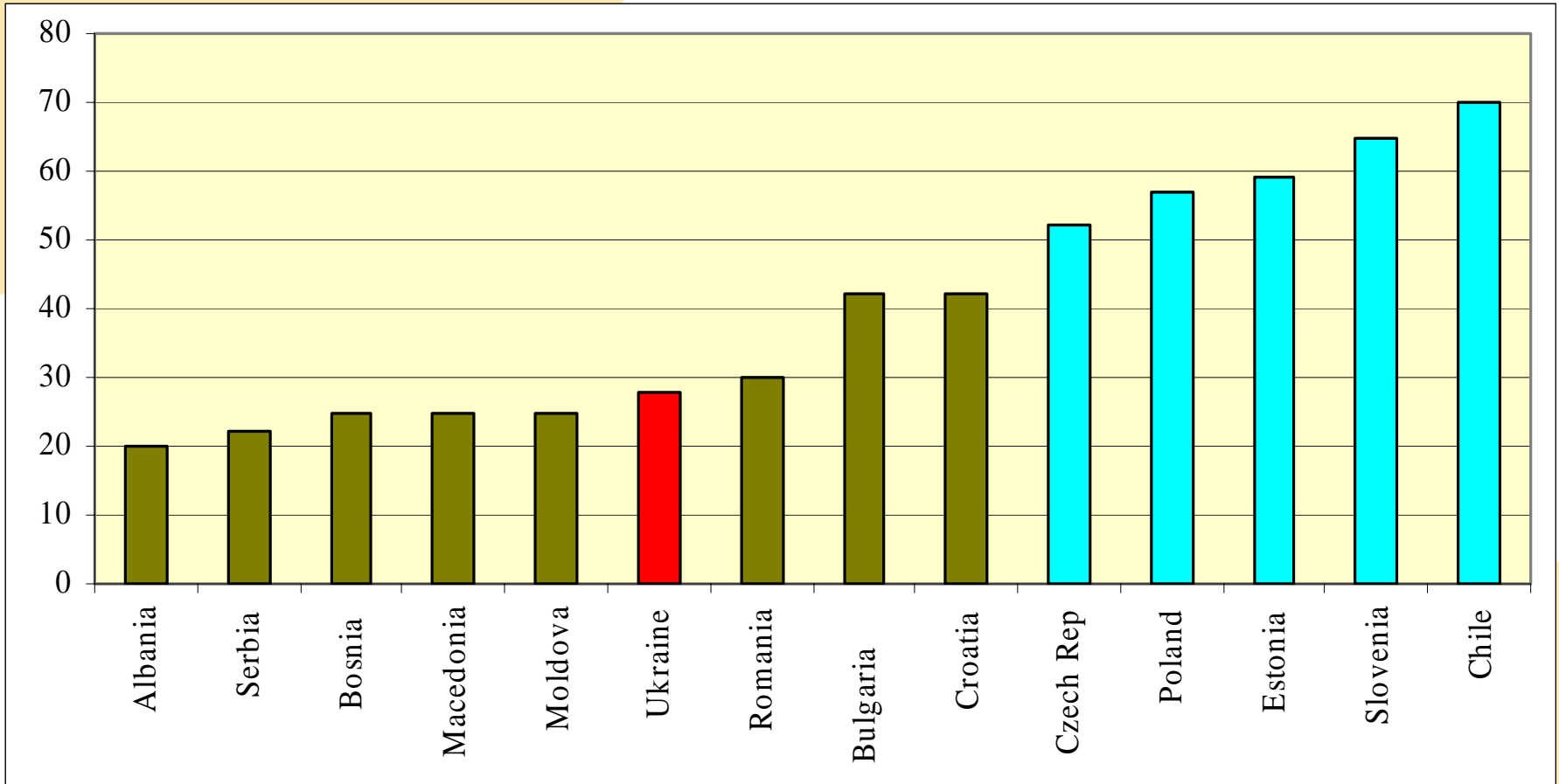


Driver #3: Stability and Predictability of Legal Environment

To create a stable and predictable legal environment with well-defined “rules of the game” for all businesses it is necessary to:

- (1) Further improve financing of courts and increase salaries of judges to ensure their independence;
- (2) Enhance commercial courts for settling disputes;
- (3) Set the practice of thorough consideration of any kind of regulations to adopted, including their correspondence with existing legislation

Driver #3: Stability and Predictability of Legal Environment

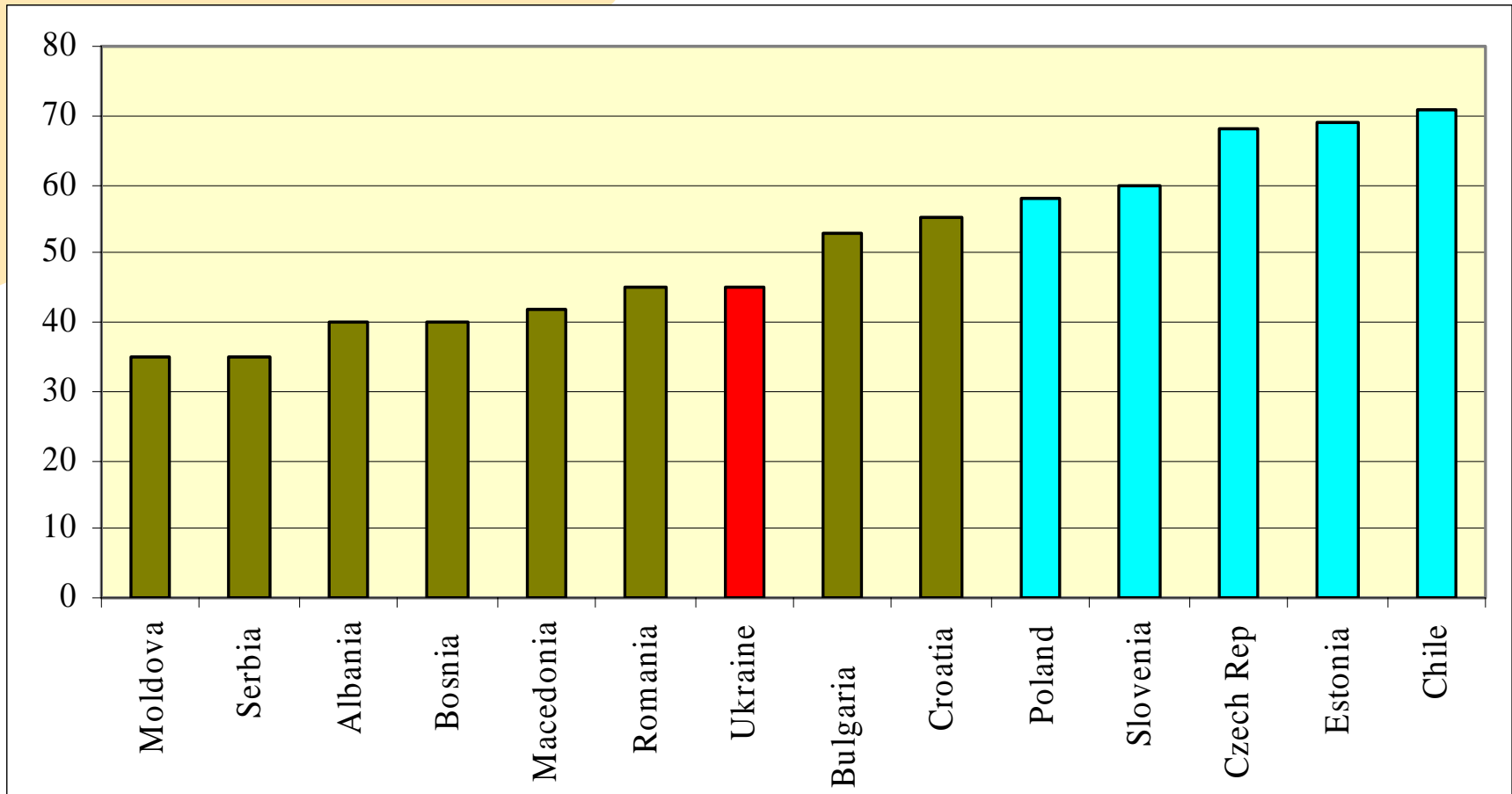


Driver #4: Corporate and Public Governance

Development of **sound corporate and public governance** will benefit greatly from:

- (1) The adoption of the Joint Stock Company Law, according to international standards;
- (2) Functional and operational reviews of government agencies to streamline decision-making process;
- (3) Establishment of adequate procedures to ensure that privatization process is transparent and competitive

Driver #4: Corporate and Public Governance

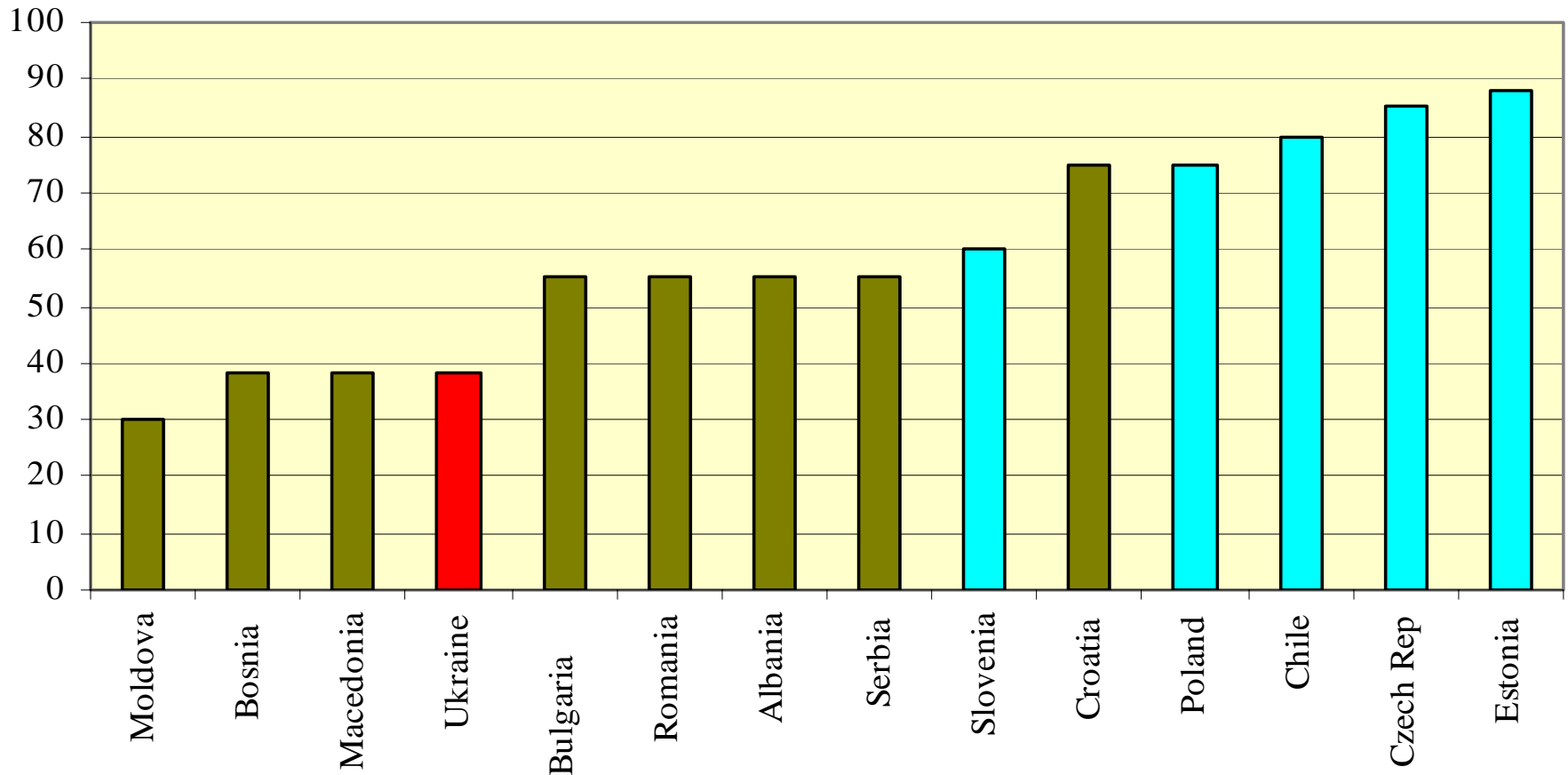


Driver #5: Liberalization of Foreign Trade and Capital Movements

Key to further **liberalization of foreign trade** is to:

- (1) Secure market economy status from the EU and the US and entry into the WTO
- (2) Sign Free Trade Agreements with the country's main trading partners (EU, USA, CIS countries)
- (3) Streamline customs procedures and formalities to ensure prompt consideration and to reduce rent-seeking

Driver #5: Liberalization of Foreign Trade and Capital Movements

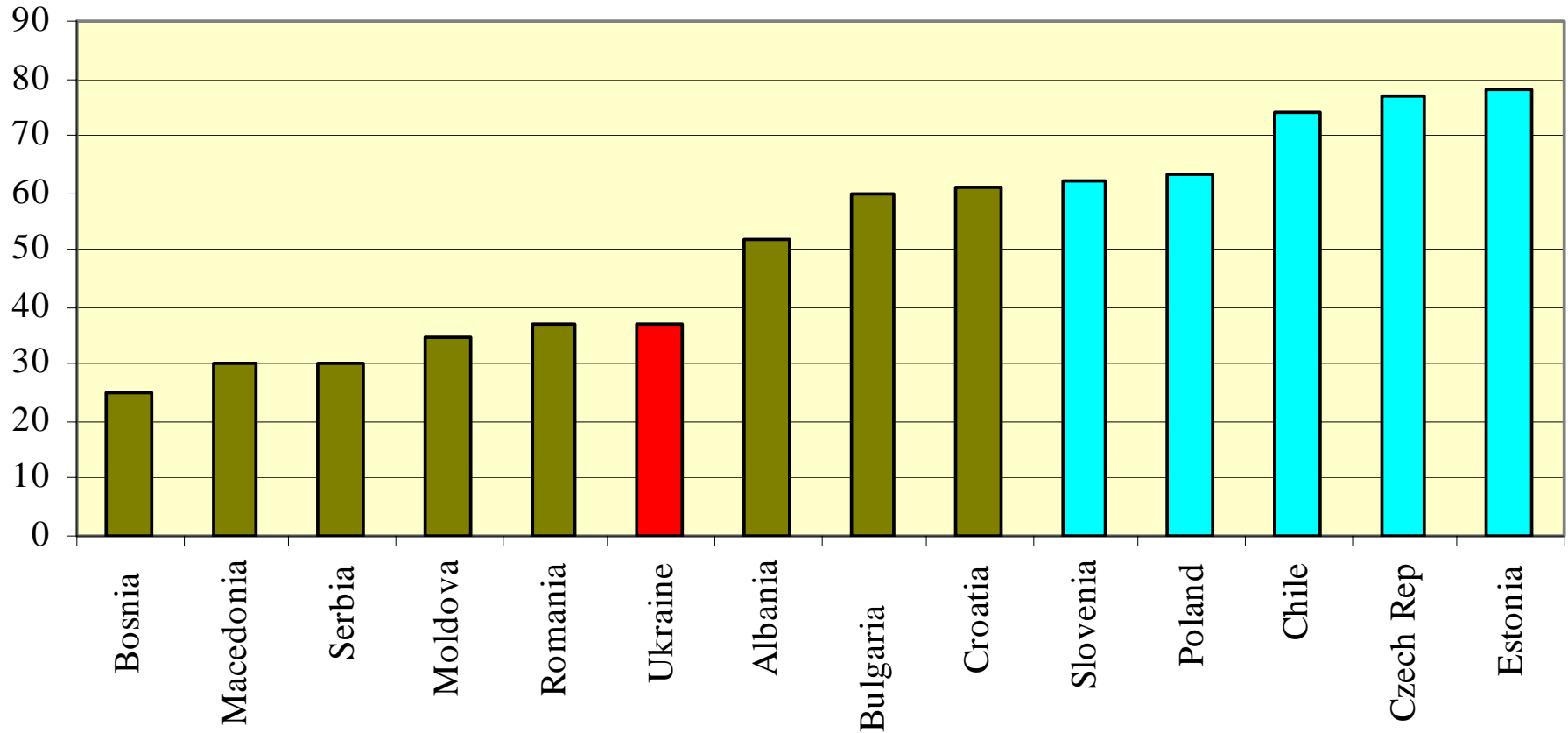


Driver #6: Financial Sector Development

In order to develop a **healthy financial sector** capable of meeting financial needs of growing businesses it is necessary:

- (1) To further improve banking supervision, including stronger prudential regulations (capital adequacy, lending to related companies, etc.);
- (2) Encourage stock market transactions to be made on the organized market;
- (3) To facilitate the development of private pension funds.

Driver #6: Financial Sector Development

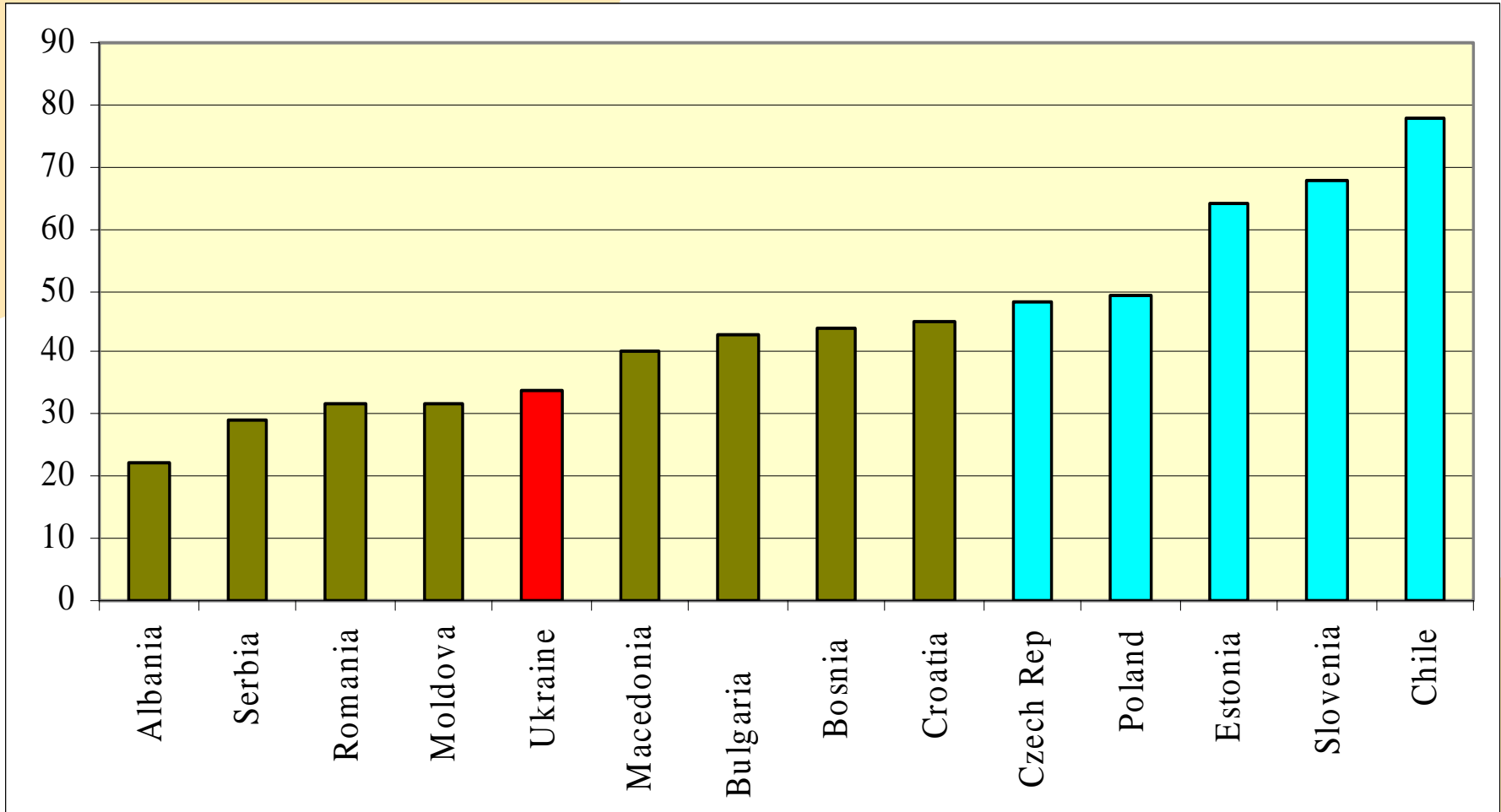


Driver #7: Corruption

Important measures to prevent **corruption** are:

- (1) to continue with the public administration reform to improve transparency of decision-making process;
- (2) to reduce the ambiguity of government regulations and raise accountability of the public servants for their decisions;
- (3) strengthen the internal audit office.

Driver #7: Corruption (100 – no corruption)

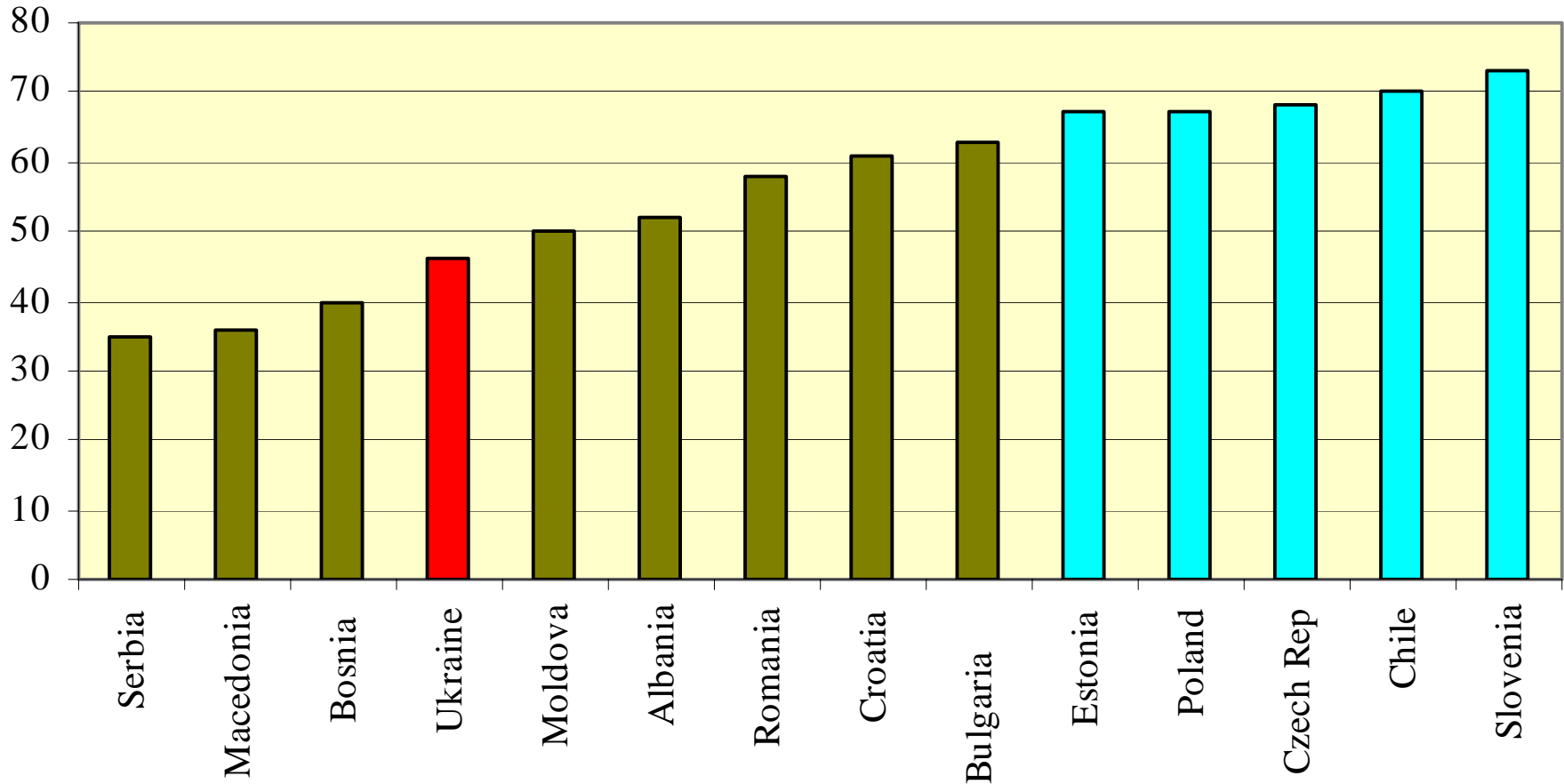


Driver 8: Political Risks

In order to minimize the **political risks** for business activities it is important:

- (1) to strive for governmental stability, including longevity of key officials;
- (2) to take measures to eliminate power abuses at different levels of the authorities.

Driver #8: Political Risks (100 – no risk)

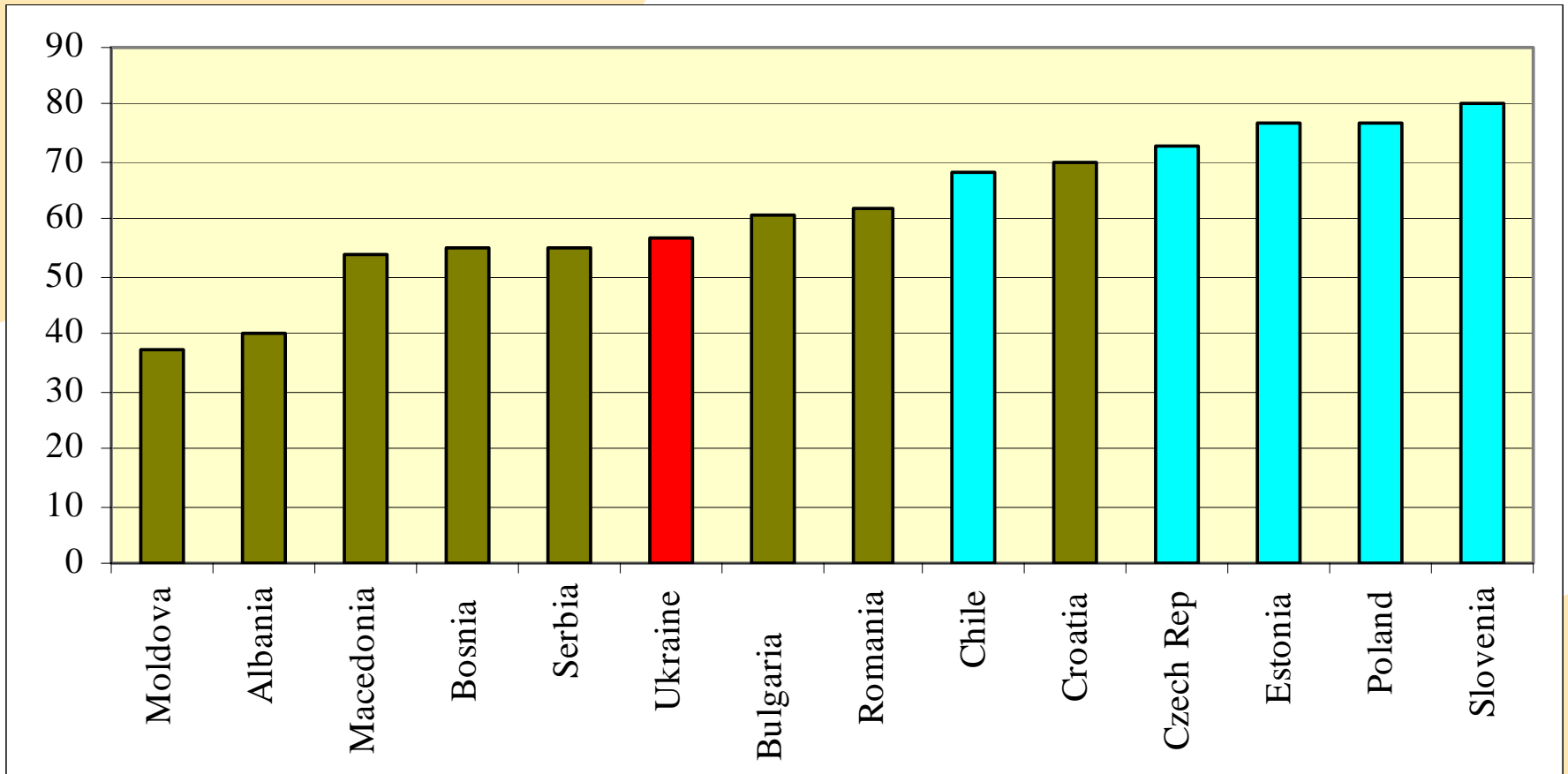


Driver 9: Country Promotion and Image

Among priority actions to **promote and inform investors about business opportunities in the country** are:

- (1) To ensure effective functioning of the investment promotion agency;
- (2) 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.

Driver 9: Country Promotion and Image



- Experience across many transition economies show that sustainable growth requires a favorable economic environment in which small, medium and large business are free to pursue profitable activities without undue interference of Government agencies.
- This policy could be accompanied by more concrete efforts to attract large foreign investors to the country.
- But without a liberalized business environment, stable legal system and good public and corporate government, these efforts will not yield results.
- The success of the new Government will be measured by the extent to which these policy measures are implemented.