Year 2012: Economic Summary for Ukraine

Football and recession

EXECUTIVE SUMMARY

In the first half of 2012 Ukraine's economy was supported by government spending and tax preferences related to the Euro-2012 football championship. However, benefits from Euro-2012 were limited to improved infrastructure and modest improvement in Ukraine's visibility on international arena. In the second half of the year the stimulus was withdrawn and external demand slipped leading to recession. Ukraine did not achieve significant progress in domestic reforms and had limited success in external integration projects. Political instability remained one of the major risks for future development of Ukraine.

Politics. In 2012 Ukraine did not achieve progress at many external initiatives. Signing of Association agreement with the EU was put on hold, while negotiations with IMF failed. Russia also refused to make any concessions on imported gas price without Ukrainian commitment to deep economic integration. Parliamentary elections were recognized as step backward in Ukrainian commitment to democratic principles and led to increased political instability.

Real Sector. Real GDP grew by 0.2% in 2012 as strong domestic demand offset negative contribution of net exports and falling inventories. External demand weakened significantly leading to fall in real exports at 7.7%. Real gross fixed capital accumulation increased by 0.9%. Investments did not fall due to purchases of machine and equipment primarily attributed to the preparation for the EURO-2012.

Agriculture. In 2012, agricultural output declined by 4.5% due to lower crop production but share of agricultural exports in total merchandise exports reached 26%. Higher agricultural exports may be attributed to decline in exports restrictions and high stocks.

Energy policy. Ukraine continued efforts to decrease an energy dependency on Russia including reverse gas supplies from Europe, preparations for building LNG terminal. Ukraine also increased investment in renewables.

Infrastructure. In 2012 Ukraine completed investments in infrastructure related to the Euro-2012 including renovation of airports, introduction of high-speed train links, repaired and widened roads. However in the second half of 2012 investment reduced significantly.

Balance of Payments. The consolidated balance of payment was in deficit at USD 4.2 bn (2.4% of GDP). Increase in trade deficit resulted in widening of current account deficit to 8.4% of GDP.

Income: Continued increase in minimum wages and public sector spending on wages, pensions and social assistance resulted in increase in real disposable income by 9.7%. Real income from social assistance payments and pensions grew by 13.6% due to lower than expected inflation and populist social policies.

Fiscal policy. Government introduced a number of tax breaks for several 'priority' industries, while lower EPT rates went into effect. At the same time, the Government significantly increased social spending and continued to spend on Euro-2012. As a result, the Government faced significant gap between actual revenues and planned expenditures and was able to execute central fiscal expenditures at only 92.6% of plan.

Monetary policy. Average consumer inflation decelerated sharply to 0.6% as food prices fell and non-food inflation slowed significantly. The monetary policy was very tight in the second half of 2013 as the NBU attempted to control pressure on the currency exchange market.

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Politics: Challenged Ukraine's external policy under democratic down-sliding

Ukraine – EU. In 2012, Ukraine-EU dialogue was marked by the the prospects and conditions of moving forward with the Association Agreement (AA).The negotiations on the AA were officially completed by the end of 2011. Since then, the AA was put on hold for political reasons, as non-democratic practices and corruption accelerated in Ukraine.

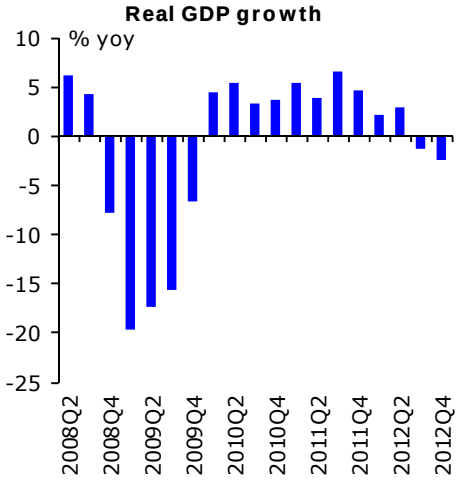
In March 2012, the parties have finally proceeded to the initialing of the political chapter of the Association Agreement. On July 19, 2012, this process was finalized with the initialing of more than thousand pages of the economic chapter on Deep and Comprehensive Free Trade Area between Ukraine and the EU.

The signing of the Agreement depends on Ukraine's respect for the EU's common values and its progress in addressing a number of issues that the EU sees as preconditions for moving on with the AA. They include elimination of the selective justice issue and implementation of broader judicial reform; the preparation and delivery of free and fair parliamentary elections in line with the OSCE commitments, and the acceleration of the reforms envisaged in the Association Agenda. Regrettably, in 2012 Ukraine failed to show any progress in fulfilling these conditions, and the country's leaders were facing continued criticism from the EU officials, as the worrying trends of further deterioration of democracy and rule of law persisted.

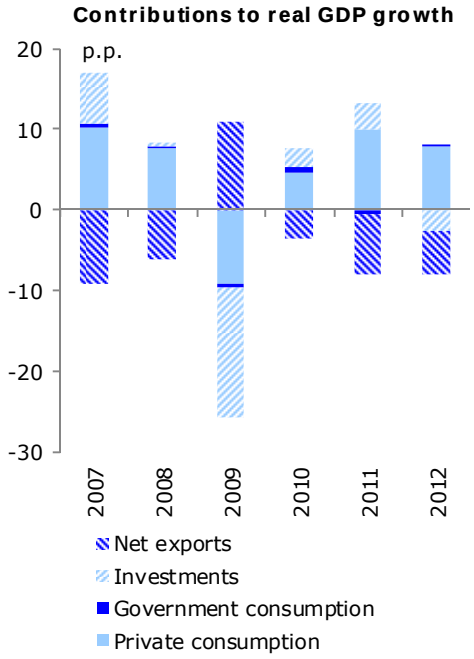
In protest to the politically motivated prosecution of opposition politicians the majority of European leaders opted to boycott the European football championship co-hosted by Ukraine and Poland in 2012. The EU Commission President Jose Manuel Barroso announced he would not go to Ukraine during Euro-2012 unless there is a swift improvement in the human rights situation. The same reason was behind European leaders' refusal to attend the East-Central European Summit that Ukraine was planning to host in Yalta in May, and which consequently was cancelled. Against this background, President Viktor Yanukovych has become an unwelcome guest in the majority of the Western countries, and was overtly cold-shouldered by their leaders during high level international meetings.

Besides, Ukrainian authorities failed to conduct free and fair parliamentary election in line with the OSCE commitments. Held in October 2012, these elections were critically assessed by international observers as the step backwards compared to parliamentary elections of 2006, 2007, and the Presidential election of 2010. International observers from the OSCE/ODIHR, PACE, the European Parliament and the NATO Parliamentary Assembly criticized Ukrainian authorities for "the lack of a level playing field, caused primarily by the abuse of administrative resources, lack of transparency of campaign and party financing, and lack of balanced media coverage". In addition, international observers have negatively assessed the tabulation process due to the lack of transparency and ungrounded delay in the announcement of results. The EU has also expressed its concern with the voting process and tabulation.

The conditions for signing the Association Agreement with Ukraine were debated at the EU Foreign Affairs Council meeting on December 10, 2012. In their conclusions, EU foreign ministers stated that there was a possibility of signing the AA at the next Eastern Partnership Summit in Vilnius in November 2013. With this view, the Ukrainian authorities are expected "to demonstrate determined action and tangible progress" in three areas: 1) compliance of the 2012 parliamentary elections' with international standards and follow-up actions; 2) progress in addressing the issue of selective justice and preventing its recurrence; 3) implementation of the reforms defined in the jointly agreed Association Agenda.



Source: Ukrstat



Source: Ukrstat, IER calculations

Besides, EU foreign ministers noted, "the signature could be accompanied by opening for provisional application of parts of the Agreement", while the scope of the AA provisional application will be subject to additional negotiations between the parties.

At the same time, the year was marked with some progress in EU-Ukraine visa liberalization talks, as the parties signed an amended Visa Facilitation Agreement, further facilitating people-to-people contacts and strengthening ties between the citizens of Ukraine and the European Union on July 23, 2012.

Ukraine - IMF. In 2012 the IMF did not disburse new instalment of the loan under the Stand-by Arrangements signed in 2010 as Ukraine failed to implement all required policy steps. In 2012 the SBA expired and has to be renegotiated. However, the chances of Ukraine's government succeed in negotiations on a new stand-by arrangement are rather low, given unwillingness of the authorities to increase gas tariffs for population and heating generating companies. Besides, the NBU's policies do not comply with the obligation to shift towards more flexible exchange rate regime.

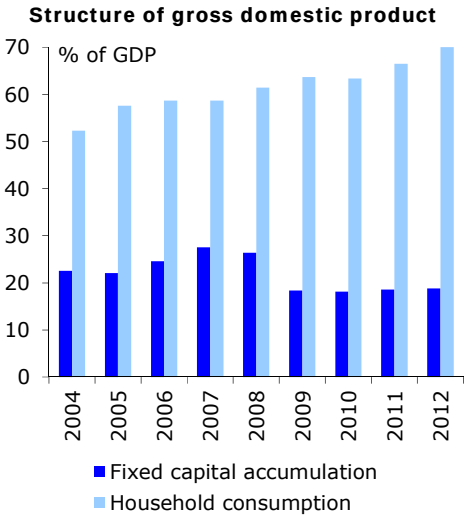
Ukraine – Russia. The year 2012 was marked by Moscow's increasing pressure as to Ukraine's joining the Customs Union of Russia, Belarus and Kazakhstan established within the frames of Eurasian Economic Community. The re-elected in March 2012 President Vladimir Putin dismissed Ukraine's "3+1" cooperation formula, which was suggested as an alternative to full membership in the Customs Union in order to disguise Kyiv attempts to combine its participation in European and Eurasian integration projects. Thus, Ukrainian leadership was once again reminded that Moscow favors an exclusive integration format. At the same time, this format does not comply with Ukraine's obligations on both DCFTA with the EU and within WTO.

By the end of the year, the intensity and tone of official statements as to compliance with the Customs Union provisions and harmonization of Ukrainian legislation with its norms raised serious concerns. For instance, on December 17-18, Viktor Yanukovych was supposed to visit Moscow and allegedly sign the agreements on Ukraine's accession to the Eurasian Economic Community, however, the visit was cancelled right on the eve. Ukraine's economic slowdown and permanently unsuccessful negations with Russian Gazprom on gas prices revision may be considered as a reflection of current fragility of Ukraine's European strategic choice.

Ukraine - WTO. In September 2012 Ukraine initiated talks with the WTO on customs duties revision in line with Article XXVIII of the GATT. Ukraine forwarded to WTO members the position document containing suggestions on the increase in binding tariffs for 371 tariff lines. These products account for 5% of Ukraine's total imports. Ukraine is expected to provide equivalent concessions to WTO partners. Ukraine's initiative raised serious concerns by the EU and the USA, which are Ukraine's important trade partners within the WTO. According to the EC officials, this initiative can harm Ukraine's progress in the formation of deep and comprehensive free trade area (DCFTA) with the EU. In the Council Conclusions of December 10, 2012 EU reiterated its request to Ukraine to withdraw the notification for renegotiations of its WTO commitments "as this initiative raises commercial concerns and poses a challenge to the integrity of the multilateral trading system".

GDP: Ukraine's economy in recession

After recovery in 2010 and 2011 Ukrainian economy entered recession in the second half of 2012. In particular, real GDP grew by 2.2% yoy and 3.0% yoy in the first two quarters of the year, respectively, but then declined by 1.3% yoy in the third quarter and fell by 2.5% yoy in the last quarter of 2012. Overall, real GDP edged up by 0.2% in 2012 as real private final consumption remained strong even in the second half of 2012.



Source: Ukrstat

Source: Ukrstat

On demand side, real private final consumption prevented GDP from sliding down with positive contribution at 7.8 p.p. It increased by 11.7% due to strong real disposable household income growth (see *Wages and income*) as well as decline in saving rate. Despite devaluation expectations in the second half of 2012 investments in foreign currency fell significantly over the whole of 2012.

Real gross fixed capital accumulation increased by only 0.9% in 2012 as its strong growth in the first half of year was offset by sharp decline in the second half of year. In particular, increase by 14.5% yoy in the first half of 2012 was explained by investments related primarily to preparation to the EURO-2012 (see *Investments*). In the second half of the year real gross fixed capital accumulation fell by 7.2% yoy due to end of Euro-2012 as well as difficult financial situation of companies and state.

Decrease in inventories after sharp increase in 2011, which was mostly explained by lower stock of grain by the end of 2012, made negative contribution to economic growth at 2.8 p.p.

Net exports made negative contribution to growth at 5.3 p.p. in 2012 as real exports of goods and services declined by 7.7% and real imports increased by 1.9%. Exports contracted due to weak demand for Ukrainian goods and services in major trading partners against the background of stagnant global economy. At the same time, imports grew primarily due to higher investment demand for machinery in the first half of 2012 and larger consumption demand for cars, food items, textiles and shoes.

On production side, real gross value added (GVA) declined in most sectors. In particular, real GVA in agriculture declined by 4.3% as the harvest was lower than record levels of 2011, even though it remained higher than average for last 5 years (see *Agricultural output*). Lower external demand for most Ukrainian products resulted in manufacturing GVA that declined by 3.5%, although domestically oriented sectors increased output (see *Industrial output*). Extractive sector increased GVA at 2.5% likely due to government policy to support coal industry and attempts to reduce imported natural gas consumption (see *Energy policy*). Difficult financial situation of most companies resulted in contraction of real GVA in construction by 8.8%.

Higher retail trade turnover growth compensated decline in wholesale and supported growth of real GVA in trade by 3.9%. At the same time, real GVA in transport and communication increased by only 0.9%. In particular, real GVA in the sector declined in the second half of the year due to lower industrial output and imports as well as smaller transit of natural gas and oil.

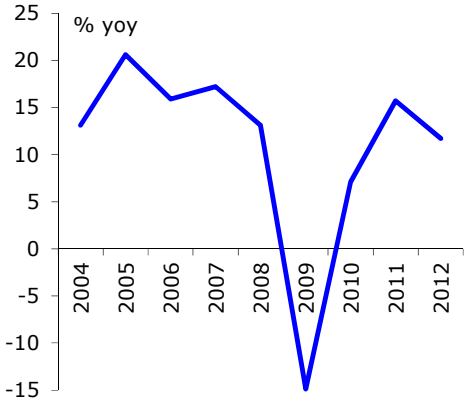
Investments: Stagnation in 2012

In 2012, real gross fixed capital accumulation increased just by 0.9%. Although annual total increased, in the last two quarters investments fell due to ending of the spending connected with EURO-2012.

The amount of capital investments (calculated using different methodology but providing more structural details) increased by 8.3% in 2012. The growth was primarily due to an increase in investment in construction by 18.0% (16.0% of all capital investments in 2012), investment in industry that was higher by 7.5% (36.1% of total) as well as increase in investments in ground transport increased by 52.3% (4.8% of total).

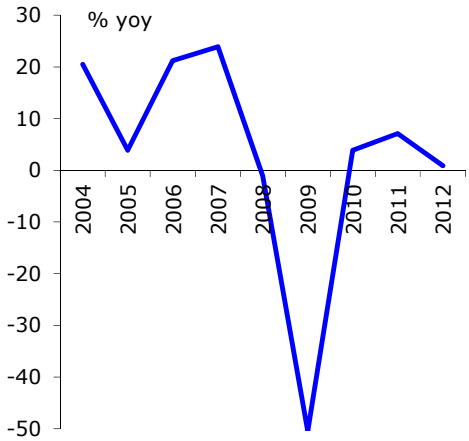
The main source of capital investments were own funds of the companies (59.2% in comparison to 58.6% year earlier). At the same time there was considerable decrease in funding from the consolidated fiscal financing (9.5% in comparison to 10.5% in 2011). The decrease in fiscal financing more likely was caused by decrease of spending related to preparation to the EURO-2012. The role bank credits was roughly the same as in year earlier (16.1% of all capital investments compared to 16.3% in 2011).

Real households' final consumption



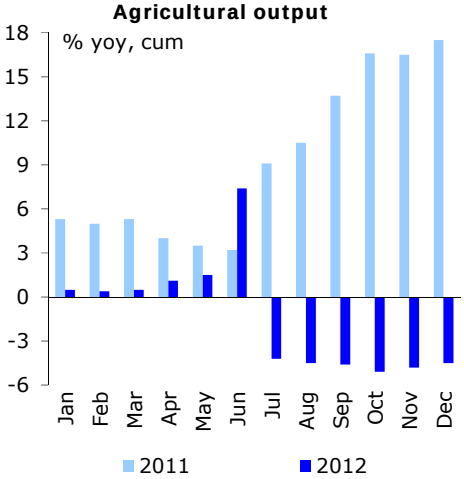
Source: Ukrstat

Real gross fixed capital accumulation



Source: Ukrstat

Agricultural output



Source: Ukrstat

Industrial output: Industrial production declined

In 2012 industrial output declined by 1.8%. In particular, external demand declined for most manufactured goods, while domestic investment demand also contracted.

Production in extractive industry increased by 1.9% due to higher extraction of coal (by 4.5%), which might be attributed to government policy. The Government continued subsidies for coal production and encouraged electricity and heating producers to switch over to coal.

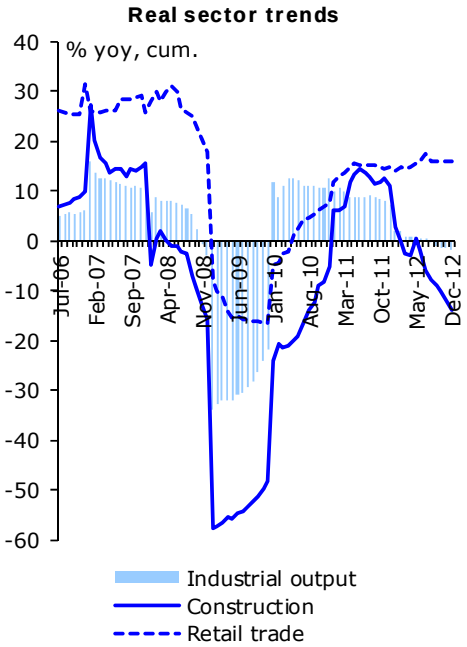
Manufacturing production declined by 3.7% primarily due to lower external demand. In particular, output in metallurgy contracted by 5.2%. Production in machine building declined by 6.0% due to lower external and domestic demand. Production of cars reduced by 28.5% as Ukrainians preffered purchasing imported cars. In particular, share of Ukrainian cars on the retail market declined by 2 p.p. to 12.6% (for comparison, its share was at 31.5% in 2008), which is explained by low competitiveness of Ukrainian cars on domestic market. Decline in construction resulted in drop of production of other non-metal products by 6.3%.

Production of oil products declined by 41.8% due to difficulty of competing with untaxed imports. Besides, Russia, Belarus and Kazahstan favoured exports of oil products rather than oil in setting export duties. Therefore, oil refineries in Ukraine lost their competitive advantage on domestic market.

At the same time, chemical production grew by 8.1% as domestic and external demand was high for most of the year. However, in the end of the year production in the sector declined due to downturn in demand.

Food production (excluding beverages and tobacco products) grew by 1.8% due to higher domestic demand for most foods products. Meat production increased by 6.7% against the background of good crop harvests in 2011 and 2012, which kept input prices down. At the same time, production of sugar declined by 18.0%, which is likely to be explained by lower harvest of sugar beets.

Overall, the situation in most industrial sectors deteriorated in the second half of the year against the background of weak external demand. Besides, some sectors lost their domestic market share to imports.



Source: Ukrstat

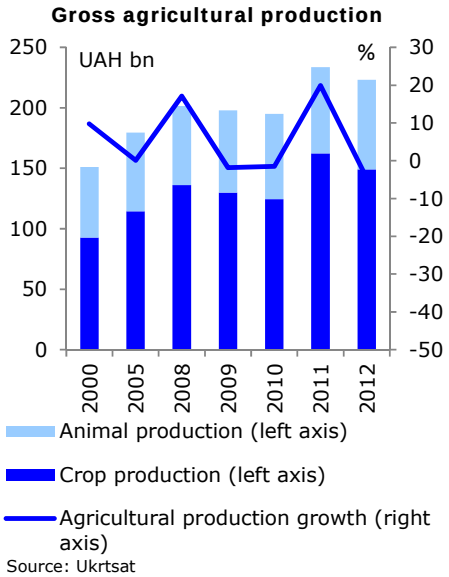
Agricultural output and trade: overall decline despite slight increase in livestock

In 2012, agricultural output declined by 4.5% due to downfall in crop production. The share of agricultural sector in GDP also declined from 8.3% in 2011 to 7.9% in 2012, while sector's share in merchandise country exports reached 26%.

Crop production. Severe weather conditions resulted in decline in gross crop production by 8%. Larger decline was observed in agricultural enterprises than in household farms, 10.9% and 4.6%, respectively, since the latter have different crop structure (almost no winter crops which suffered the most).

Grain harvests account for a large share of agricultural output. In 2012, harvest of grains and pulses amounted to 46.2 m t,37% of which constitutes food crops and 63% technical crops. The share of agricultural enterprises and households' farms in grain production remained the same as in the previous year, 77.9% and 22.1%, respectively.

Overall, grain production declined by 18.6%. Harvested area decreased by 3.5%, while yields declined by 15.7% mainly due to unfavorable weather conditions.The largest drop in production was observed for wheat (29.4%), barley (23.8%), millet (43.9%), buckwheat (15.3%) and corn (8.4%). Only oat and rye demonstrated higher production (by 24.5% and 16.7%,respectively).



Source: Ukrtsat

Oilseeds production slightly declined in 2012. Gross sunflower harvest decreased by 3.5% due to 10.3% loss in yields, which could not be compensated by 8% enlargement in harvested area. On the contrary, 27% improvement in rapeseed yields could not compensate for decline in harvested area by over a third resulting in 16% drop in production. Considerable decline of harvested area under rapeseed could be explained by unreadiness of producers to encounter additional costs for re-seeding of crops damaged in winter. Rapeseed area has been decreasing over the last 5 years because more and more farmers experienced low level of frost-resistance in rapeseeds and decided to switch to different crops. Only soybeans harvest increased by 6%, which resulted in increase of its share in total oilseed harvest to 20%.

Cropping area of sugar beet decreased by 13% due to overproduction in the previous year but higher yields (at 40.7 t/ha) resulted in just slight loss of harvest compared to previous year.

Gross harvest of potatoes decreased by 4% due to decline in productivity. Other vegetables and fruits demonstrated growth by roughly 2% and 6%, respectively.

Livestock production. Animal productionincreased by 3.8% with growth at 7.6% for agricultural enterprises and increase at 1.2% for households' subsistence farms. In particular, milk production at agricultural enterprises increased by 13%, while milk production at households remained at the same level because of stable state support.

The share of households in production of meat, milk and eggs is gradually decreasing, which is a positive trend since agricultural enterprises can achieve higher efficiency and ensure better food quality and safety, which, in turn, should stimulate exports. At the same time, about 66.6% of cattle (including 77.5% of cows), 52.8% of pigs and 84.8% of goats and sheep are still kept by households.

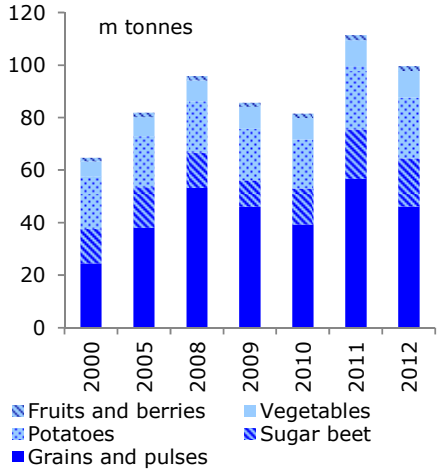
Agri-food exports. Despite overall decline in agricultural output, agri-food exports continue to grow (by almost 40%). Export of agricultural goods reached USD 17.9 bn, which constitutes about 26% of total merchandise exports. The largest growth in exports was observed in Crop products sector (66.6% compared to previous year), which was largely determined by uphold in Cereals and Oilseeds trade. Remarkably, grain exports almost doubled, among others due to improved policy framework. Effective dialog established between the Government and key players at the grain market helped to avoid export restrictions, which were used in previous years. Exports of Food industry products, Animal or plant fats and oils also significantly increased partially compensating for declines in exports of other non-agricultural commodities.

Agricultural policy: noble targets but inefficient policies

In 2012, some important achievements in agricultural policy were made, including implementation of more predictable regulation of grain exports and more consistent state support of the dairy sector; redirection of state support to "growth-enhancing" measures; introduction of important steps in land reform; introduction of "green" tariff for electricity generation from biogas projects. However, a lot more is still to be done to improve investment climate in the whole economy and the agricultural sector in particular to stimulate production. In pursuit of noble policy objectives, e.g. food security, development of domestic agri-machinery manufacturing, the Government is still relaying on economically inefficient policies, which require high costs, whereas sustainable results are questionable

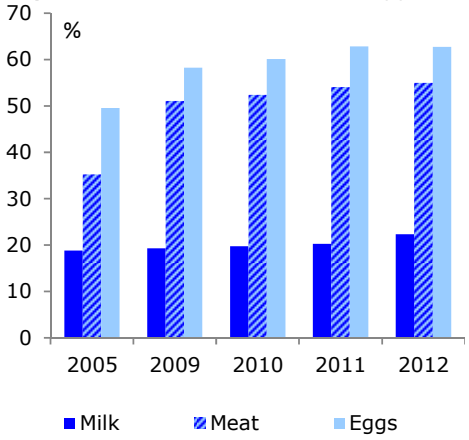
Budget outlays. In 2012, only 73.4% of planned agricultural outlays (UAH 9.8 bn) was actually allocated, which is the lowest percentage of annual target for the last 6 years. Notably, execution rate of direct financial support directed to livestock and crop production, and price support measures (0.8 bn UAH in 2012) is even lower at just 29%. Such inconsistent policy deteriorates trust in

Production of grains, vegetables and fruits



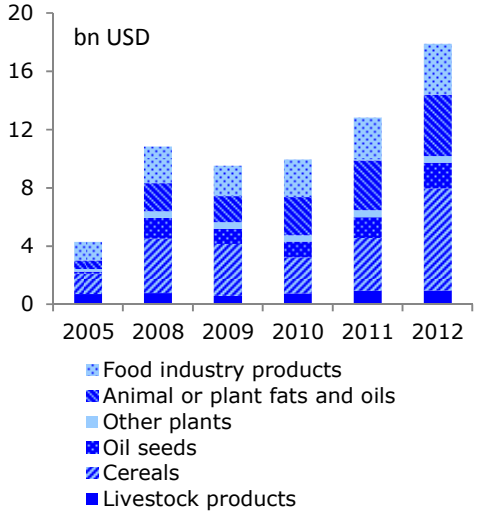
Source: Ukrstat

Share of agricultural enterprises in production of meat, milk and eggs



Source: Ukrstat

Export of agricultural and food commodities



Source: Ukrstat

the Government and hampers additionally investment climate. The share of growth-enhancing or "green box" measures is growing rapidly and reached 92%last year, which should support long-term development of the sector. However, relatively large and increasing share of administrative costs (34%) raises the question on effectiveness of such expenditures.

Grain exports. In 2012, Government regulation of grain exports was more predictable than in the previous year. The Ministry of Agricultural Policy and key players of the grain market signed a Memorandum of understanding in July, which facilitated effective dialogue between stakeholders taking into account the interests of grain traders and food security objectives of the government. It was initially agreed that grain traders would export not more than 5 m t of wheat, 12.4 m t of corn and 3 m t of barley in 2012/13 marketing year. Then, marginal amount of wheat allowed for exports was first revised to 5.5 m t in October and then increased again to 6.5 m t in November. Overall, about 20.2 m t of grains (6.3 m t of wheat, 11.5 m t of corn and 2 m t of barley) were exported since the beginning of the marketing year (July 2012 – June 2013). In the end of April 2013, the Government abolished limitations for grain export.

Land reform. Some progress was achieved with land reform in 2012. In particular, publicly accessible electronic cadaster was established and officially launched in January 2013. It still has deficiencies and mistakes but this is already an important step towards transparent management of land resources.

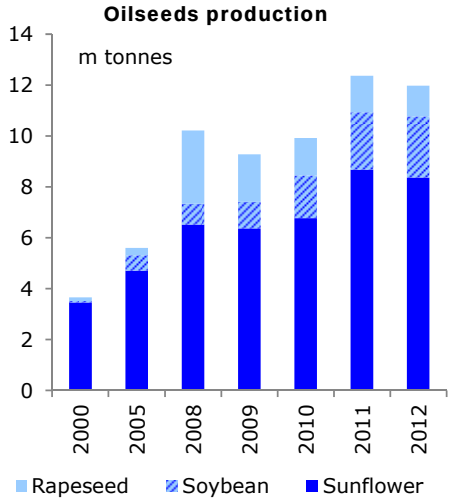
In addition, land plots registration procedures were simplified. The Government also established the State Land Bank, which is expected to facilitate land reform through creation of institutional basis for management of state-owned land plots and providing subsidized financing for small- and medium-sized enterprises. However, any combination of these objectives in one institution might result in the conflicts of interest and create problems with transparency and accountability. Thus, it is questionable whether such institutional arrangements could help to resolve the problem of limited finance in agriculture.

Adoption of the Law of Ukraine "On Land Market", which is one of the main preconditions for moratorium abolishment, was postponed again. The draft Law was approved in the first reading back in 2011 but received huge criticism from both large businesses and legal experts. It was expected that the Law would be revised and approved in 2012 but it was not even considered in the Parliament. For this reason, moratorium on the land sale was extended once again until January 2016.

State support of domestic agri-machinery production. To foster development of domestic agrimachinery production, the Government adopted amendments to the Law on supporting domestic agrimachinery production, which came into force in the end of November, 2012. According to the Law, only domestically produced agrimachinery could receive support from the budget (e.g., partial compensation of loans rates and leasing payments). Local content requirement for agrimachinery to be considered as domestically produced was increased from 50% to 60%. At the same time, import duties for some machinery components were cancelled, while import duites for completed machines were increased. Although policy-makers aim to stimulate development of domestic agrimachinery production, these policy incentives are economically inefficient. They are likely to result in dependency of the sector on state support rather than create conditions for the development of a competitive agrimachinery industry.

Energy policy: Concentration on energy independence

Gas market. In 2012 there were number of initiatives aimed at overcoming Ukraine's critical dependence on gas in total primary energy supply. This issue has become essential for Ukraine during recent years due to skyrocketing gas prices. In 2012 the average price for Russian natural gas surged by 38% and reached USD 426



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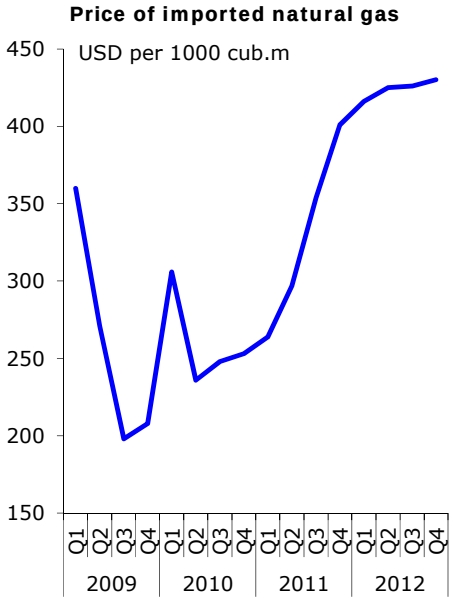
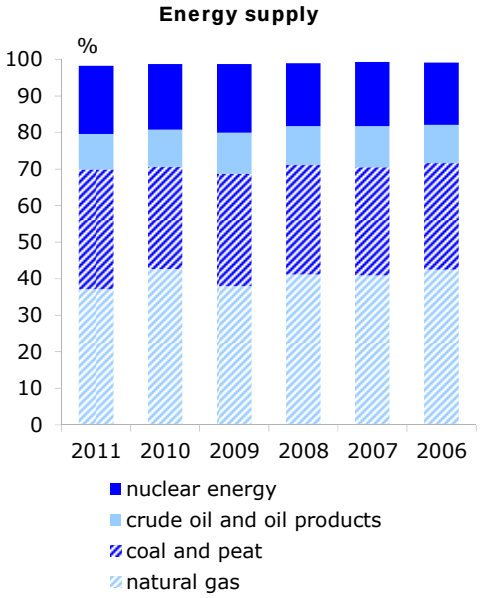


Source: Naftogaz



Source: Ukrstat

per thousand cubic meters (cm). This created significant price pressure on national industry, trade balance and public finance.

Ukraine continued efforts to boost domestic gas extraction and replace Russian pipeline gas by alternative supplies. In addition to the purchase of two floating drilling rigs for the Black Sea in Singapore, in May Ukraine led the tenders for conventional and non-conventional gas deposits exploration. ExxonMobil and Shell were chosen to explore off Ukraine's Black Sea coast conventional gas stocks, while later Ukraine signed the product-sharing agreements (PSA) on shale gas exploration with Shell and Chevron. Shell only plans to invest at least USD 10 bn in development of the new shale gas fields in Eastern Ukraine.

In February 2012 Ukraine signed the framework agreement with German RWE Supply & Trading on supply of 5 bcm of gas annually as was stated by the Ministry of Energy. This initiated a process of so-called reverse gas supplies to the domestic market, thus, diluting Gazprom's monopolistic power. According to the Ukrstat, Ukraine had imported 52.7 m cm of natural gas from Germany and paid the bill by USD 22 m. Therefore, the average price of reverse gas supply was USD 417 per thousand cm that is by USD 9 cheaper than the price of Russian gas. Despite the tiny amounts (0.2% of total imports) it can be considered as a pilot attempt to establish the alternative route of gas supply in the forthcoming years and reduce dependence from Russian imports.

In December NJS Naftogaz also attracted a credit line from Chinese Development Bank at USD 3.7 bn, guaranteed by the Ukrainian government, for implementation of four separate investment projects aimed on upgrading the national HPPs for using coal-water fuel and five coal gasification plants construction. As expected the projects will allow the replacement of about 4 bcm of natural gas with coal, create 2,020 jobs, help Ukraine to save an average of €1.13bn annually and stimulate the production of 10 m tons of domestic coal per year.

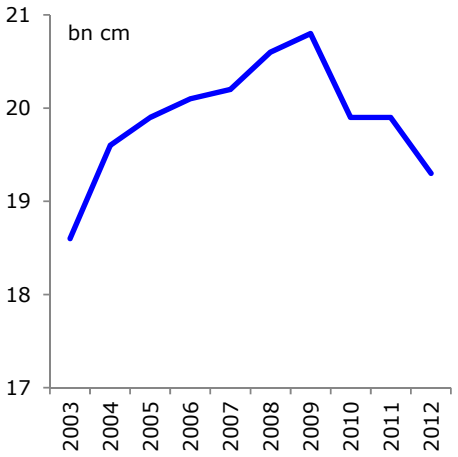
Another long-lasting gas supply diversification proposal to build an NG terminal, which is one of National Projects, still lacks investor. Moreover, it was involved in scandal when impostor signed Memorandum of intent on behalf of unsuspecting investor.

Domestic demand for natural gas dropped by 17.8% in 2012. As a result, gas imports from Russia contracted by 26.6% in 2012, which resulted in new turn of tensions with Gazprom. The Russian gas monopoly accused Ukraine in violation of the long-term supply contract "take-or-pay" obligation and issued USD 7 bn invoice to Naftogaz. Nevertheless, Naftogaz refused to pay stating that the company met all the obligations in regards to gas volumes consumed. Finally, the Gazprom did not enforce its decision via international arbitration leaving the dispute unsolved. Apart of this conflict Ukraine and Russia conducted number of unsuccessful bilateral talks in 2012 over the change of gas price formula envisaged in 2009 contract.

Gas transit. Commissioning of the second stream of Nord Stream in August 2012 and gas demand contraction in the EU resulted in further decrease in Ukraine's gas transit volumes. In 2012 the share of Russian gas transit via Ukrainian GTS declined to a record 58% after only 81 bcm were transited in 2012. Russian Gazprom also gave a start for another bypassing gas pipeline for Ukraine – South Stream – in October-November 2012 after the corresponding investments agreements with Eastern European countries on onshore section were signed. This would mean the worst scenario for long term use of Ukraine gas transit capacities, which potentially can drop to 30-40 bn cm annually up to 2030.[i]

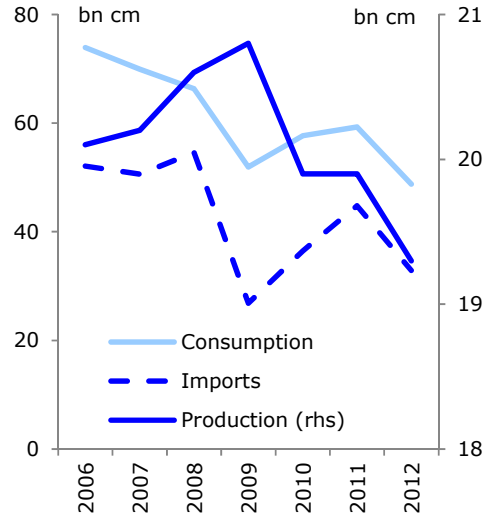
Naftogaz. The national gas monopoly NJS "Naftogaz" posted more than UAH 10 bn losses according to national accounting standards in 2012 as compared to UAH 7 bn profit in 2011. The deterioration of company's financial state is explained by increase in imported gas price, decrease in transit revenues, subsidized gas prices for

Domestic natural gas production



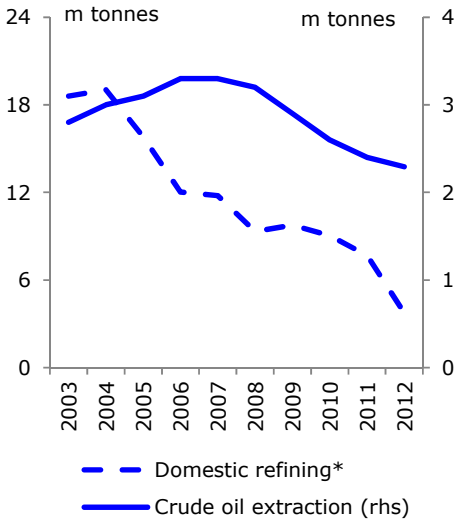
Source: Ukrstat

Natural gas flows



Source: Ukrstat, Naftogas, Ukrtransgas

Oil extraction and domestic refining



* Gasoline, diesels and heavy fuel

Source: Ukrstat

households and district heating companies, and high interest payments. In particular, the Government achieved a little progress in national gas market reform in 2012. Gas prices for population and heating generating companies were not increased regardless high urgency. As a result, the direct and indirect subsidy to the Naftogaz increased to UAH 18.3 bn in 2012.

In November the Government initiated the corporatization of Naftogaz subsidiaries following the obligations on national gas market reform taken after Ukraine joined the Energy Community Treaty. But the market organization in 2012 remained unchanged: the subsidiaries of Naftogaz remained legally and operationally bundled and preserved its monopolistic market power due to lack of corresponding regulation required by the EU-type gas market legislation (like third part access to gas networks, capacity allocation rules etc.).

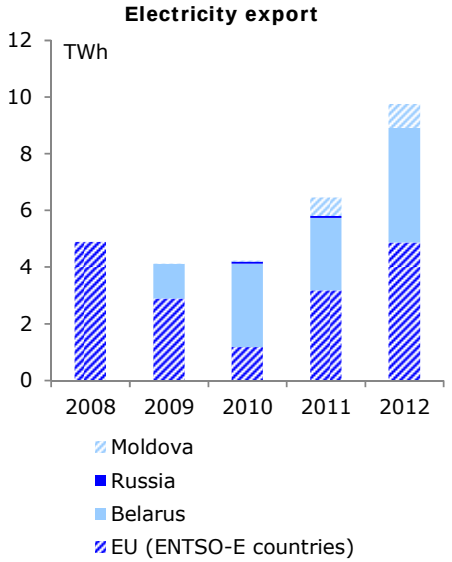
Oil market. National refinery was stagnant in 2012 against the background of strong competition of import petroleum products from Belarus and Russia. Only two out of six domestic refineries were in operation as other companies were not able to compete with imports due to low quality of Ukrainian petroleum products, limited oil supply, burdensome taxation and corporate conflicts. As a result, the domestic oil refining in 2012 halved to 4.5 m tonnes while the imports reached 7.6 m tonnes. The obligatory shift to EURO 4 and EURO 5 gasoline standards was again postponed until July 2013 abolishing the stimulus for modernization of domestic refineries.

Electricity. In 2012 electric power generation in Ukraine reached 198 TWh from which 150.7 TWh was consumed inside the country and 9.7 TWh was exported via state-controlled auctions.[ii] From the mid-2012 the electricity export capacities were allocated only to one trading company affiliated with the SCM Holding due to biased auction rules. As a result, the Energy Community Secretariat initiated an investigation stating that such provisions do not comply with EU Regulation EC 1228/2003 and set discriminative requirements for participation in auctions, and thus violates the Ukraine's obligations to Energy Community.

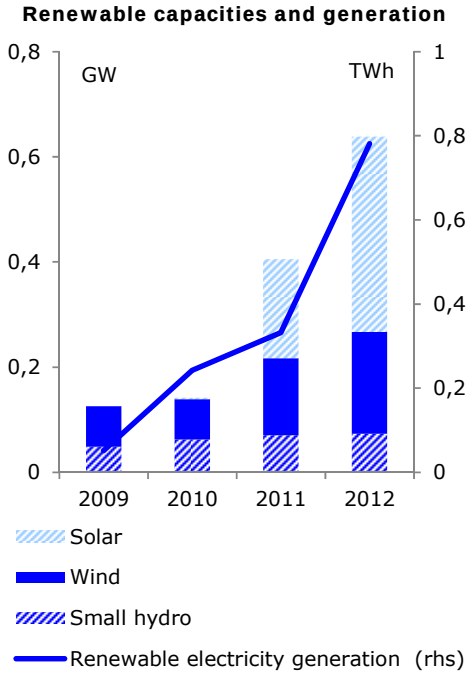
The National Commission for State Energy Regulation (NCER) continued differentiation of retail electricity tariffs by consumption volume. After May the tariffs were increased by 50% for consumption volumes over 800 KWh thresholds and 1800 KWh in case of use electric appliances for heating. Despite expected increase in suppliers' revenues these changes are generally insufficient to eliminate huge cross-subsidies[iii] inherent to current "pool" market model.

Renewables. 2012 became an outbreak year for renewable sector in Ukraine. Large projects in solar and wind energy made the significant additions either in total installed renewables capacities and generation volumes. The installed capacities increased by 1.6 times to 645 MW, while electricity generation tripled to 780 m KWh (though it still account only for tiny 0.4% in total electricity generation). According to the State Energy Efficiency and Energy Saving Agency after feed-in tariff adoption in 2009 the cumulative investments in the sector exceeded UAH 21 bn.

In November the Parliament approved changes in green tariff legislation.[iv] Namely, starting April 2013 the green tariffs for solar PV facilities is to be reduced by 22% at average to EUR 339.3 per MWh, the ones for small hydro – will be differentiated according to an installation size. Besides, the long awaited green tariff was established for electricity generated from biogas installations (though lower than was expected by the market) and small solar PV installations on the roofs and/or facades of private households with the capacity not exceeding 10 kW. Despite the fact these changes expanded the coverage of green tariffs they simultaneously made the "local content rule" (LCR)[v] tougher as the LCR should not lower than 30% after July 2013 and 50% starting from January 2014 (from January 2015 for biogas). Lack of detailed clarification of LCR content



Source: NCER



Source: NCER

for each type of project given weak development of national renewable equipment industry may hamper the next investments in the sector despite optimistic potential estimates.

Transport: Reforms ahead

Market trends. In 2012, the situation in transport sector of Ukraine worsened due to economic slowdown and lower gas transit. Freight turnover contracted by 7.6%. The rail freight decreased by 2.7%, air freight fell by 5.7%, and the volume of goods conveyed by water transport plummeted by 27.7%. Transport via pipelines decreased by 17.8%. The only growing sub-sector was the road transport with the volume of cargo carried increased by 1.8%.

The overall passenger traffic decreased by 1.2% yoy (measured in passenger-kilometers). Water transport traffic and railway traffic fell the most among all means of transport — by 7.2% and 2.3%, respectively. Only air transport did not experience a decline.

The number of passengers served by Ukrainian airports increased by 13.2%. The growth was driven by the 2012 UEFA European Football Championship (Euro-2012) and heavy investment in airports of the championship host cities in recent years. Most of additional passengers travelled, however, by foreign airlines. The share of people using domestic airlines (51% in 2012) may decrease further in 2013 because of the bankruptcy of the Aerosvit, the largest Ukrainian air carrier, which has ceased almost all flights since December 2012.

Tariffs. In 2012, the Ministry of Infrastructure did not raise rail freight rates in order to stimulate demand for transport services. The average freight rates increased, however, by 9.8% due to their gradual growth in 2011.[vi] According to the Ministry's decision now more transit goods can be handled at discount at seaports. In 2012, the volume of transit cargo handled in Ukrainian seaports contracted by 18.5% (while the total cargo handling volume decreased only by 0.7%).

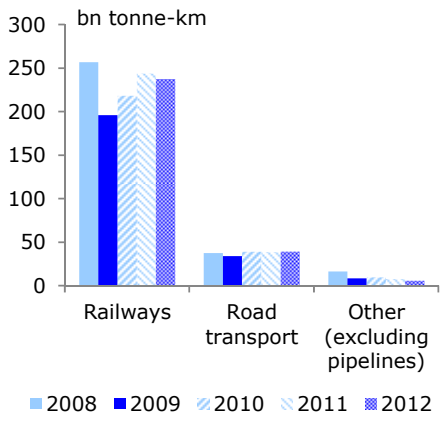
The Ministry of Infrastructure increased base rail fares for travelling in standard compartment carriages by 14.3% (gradually during the year), and modified the rail fare system. According to the modified system, train fares are indexed seasonally to ensure more even distribution of passenger traffic during the year, and to alleviate cross-subsidization of passenger transportation.[vii] In 2012, the losses of the railway monopolist Ukrzaliznytsia (UZ) from low passenger rail fares were estimated at UAH 6.9 bn (UAH 6.6 bn in 2011).[viii] The losses were fully covered by profit from freight services.

Transportation policy. In 2012, the Parliament of Ukraine created a legal framework for reforms in two transport sub-sectors — railways and seaports. Two laws aimed at reforming the railroad system management were approved in February 2012. The main idea of the reform is to split public administration and commercial functions, which have been combined by the UZ, in order to enhance efficiency of national railways. The administration will be transferred to the Ministry of Infrastructure, while commercial functions will remain the responsibility of the UZ, which will be reorganized into a public joint stock company. This is expected to increase access of the UZ to domestic and international capital markets. The reorganization is expected to start in the second half of 2013.

The law that creates a framework for seaport regulation reform was approved in May 2012 and will be effective since June 2013. The main changes include separation of regulatory and commercial functions in seaports, possibility of privatization and concessions, and price liberalization. The goal of the reform is to attract investment to increase cargo traffic, especially transit traffic. The reform is expected to encourage investment in seaports because it will expand opportunities for investors and strengthen their rights.

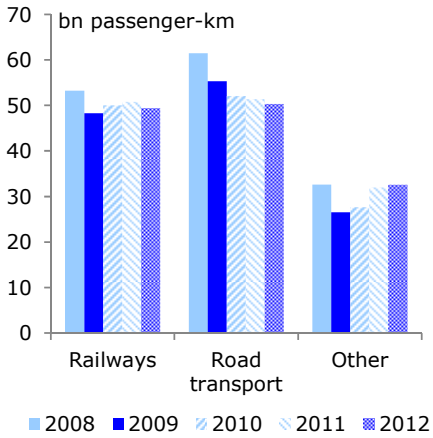
Infrastructure projects. Improvements of infrastructure in 2012 were primarily associated with projects conducted in the framework

Freight transportation



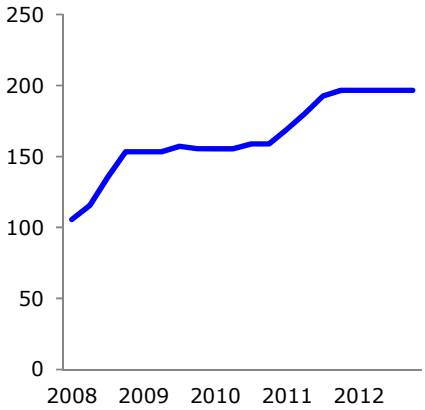
Source: Ukrstat

Passenger transportation



Source:Ukrstat

Freight rates index



Source: Ukrstat Note: Q4 2007 = 100

of preparation to the Euro-2012. These projects included renovation of roads and airports, improvements of passenger trains etc.

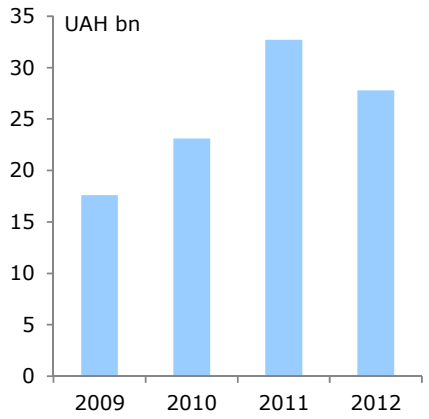
In May 2012, the UZ started to use high-speed trains. The trains, which were produced by Hyundai and Skoda and were able to travel at the speed of 160 km per hour, transported passengers between the Euro-2012 hosting cities. In December, the European Bank for Reconstruction and Development (EBRD) pledged to provide a loan of up to USD 62.5 m to the UZ to finance the purchase of freight wagons.

In 2012, the Ukravtodor, the state road agency of Ukraine, built 25.3 km of roads and repaired 230.8 km of roads (in 2011 the figures were 122.8 km and 355.4 km, respectively). Most of road reconstruction was financed at the expense of funds provided by international financial institutions. This reconstruction was aimed at improving the condition of roads between the Euro-2012 hosting cities. In October, the World Bank signed a loan agreement with the Ukravtodor to finance the second project of improvement of condition and quality of sections of the M-03 road (Kyiv-Kharkiv-Dovzhanskyi) and road safety enhancement in Ukraine. The amount of the loan was USD 450 m.

In 2012, the Government and private investors finished the renovation of the airports in four cities hosting the Euro-2012 — Kyiv, Donetsk, Kharkiv, Lviv. The EBRD signed an agreement to provide loans of up to EUR 41 m to the Ukrainian State Air Traffic Service Enterprise (UkSATSE) to renovate air navigation equipment.

The state-owned Yuzhny Commercial Sea Port, one of the largest seaports in Ukraine by capacity and by cargo handling volume, started the project on deepening its approach channel from 15 meters to 19 meters. Möbius Construction Ukraine, a subsidiary of Josef Möbius Bau-GmbH of Germany, was selected to conduct this work. The value of contracts is UAH 1.922 bn (USD 240 m). The project is expected to be finished in 2015. The project will be financed from the port's own funds and by loans.

Investment in transport sector



Note: Investment in tangible and intangible assets

Source:

Telecommunications: The regulator unified access to cable ducts

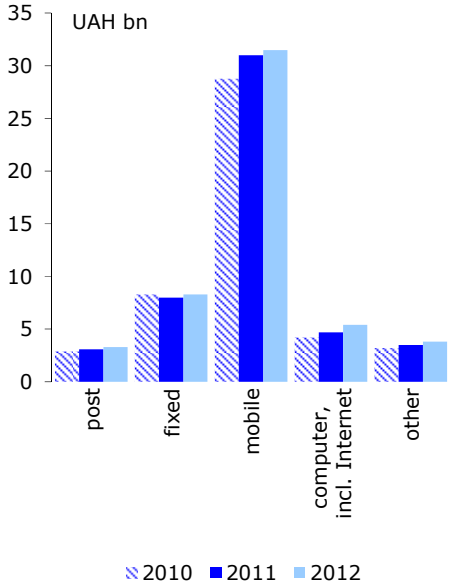
Legislation. In July, the National Commission for the State Regulation of Communications and Informatization (NCCIR) approved the Procedure for traffic routing in public switched telephone network[ix] that established unified requirements for routing voice telephony traffic irrespective of applied technologies. Adoption of this document creates conditions for further development of the voice telephony market in Ukraine.

In August, the NCCIR approved the Rules of leasing the electronic communication cable duct[x] which established access conditions and regulated the relations between operators and owners of the duct. The Rules together with the Tariff formation procedure[xi] adopted in October envisage transparent price setting on the electronic communications duct (TCD) market. The NCCIR established tariff limits for such services as provision of technical specifications, approval of the draft, technical supervision by TCD supplier, booking, providing space, and usage of TCD channel. Telecom operators that offer their TCD for access are entitled to a 40% tariff discount.

In November, the Administration of State Special Communications adopted Technical requirements to telecommunications networks for transfer of subscriber phone numbers.[xii] The new legislation streamlines the process of number transfer regardless of the technology used.

In November, the NCCIR approved the Basic requirements to the agreement on provision of telecommunication services[xiii] that ensure clear and transparent conditions for services provision, accuracy of tariffs application and consumer right for high quality communications.

Revenues from communication services



Source: Ukrstat

In December, the NCCIR approved the State supervision procedure over the telecommunications market[xiv] that defined the market inspection mechanism, rights and obligations of the telecom operators.

Market trends. According to the Ukrstat, the number of mobile numbers per 100 inhabitants in 2012 increased by 7% to 130.3 [xv]. The mobile phone penetration rate is not uniform across regions and is less than 1 to 1 n three regions: Khmelnytska (89.9%), Ternopilska (90.0%) and Kirovogradska (96.4%). At the same time, the number of fixed phone subscribers decreased in 2012 by 3.7% to 25.7 subscribers per 100 inhabitants due to loss of competition to other types of communcations. The monopolistic provider of fixed phone services was Ukrtelecom with 71% share of the market.

There are three main operators at the mobile telephone market - Kyivstar, MTS Ukraine and Astelit (trading as *life:)*).

By the end of2012, there were and 6.7 m subscribers of fixed broadband Internet access (corporate and individual) out of which 5.97 m subscribers were households[xvi]. Accordingly about 35% of households had broadband internet access in 2012. The biggest provider of fixed broadband Internet was Ukrtelecom with 1.54 m subscribers, second was Kyivstar (629,300 subscribers) and the third was Volya (534,300)[xvii]. Kyivstar continued to increase its number of broadband Internet subscribers (by 52% in 2012) which allowed it to outrun Volya. Other Top-10 fixed broadband Internet providers were Triolan, Datagroup, Vega, Tenet, Fregat, Freenet, and Airbites. Overall, there were 670 operators that offered Internet access services in Ukraine.

Marginal tariffs. In July, the NCCIR raised maximum tariffs[xviii]: for use of phones in cities without hourly fee for non-budget entities (by 5%), for population and budget entities (by 10%); for use of phones in cities with hourly fee (by 10%), for use of phones in rural areas for population (by 10% from July 1 till October 31 and by additional 10% from November 1). This move was necessary to protect5 revenues of Ukrtelecom taking into account its shrinking fixed-phone subscriber base.

Utilities: The regulator works on introducing incentive tariffs

Legislation. In June the Verkhovna Rada approved amendments to the law on natural monopolies that introduced incentive tariff regulation.[xix] As a result, in November the National Regulatory Commission for Public Utility Markets of Ukraine (NCPU) adopted methodologies for calculating incentive tariffs for water and heat supply. The methodology envisages introduction of efficiency and quality indicators to stimulate the companies to reduce inefficient spending and prevent deterioration of services quality.

In August, the NCPU developed new licensing conditions for activities on public utility markets[xx]. Due to the modified criteria for providing heating, water supply and sewerage services large companies serving several regions that previously were licensed by regional authorities now are only subject to NCPU regulation. Also according to new licensing conditions, large enterprises that previously produced heating energy for internal usage are no longer subject to NCPU regulation. Such a move allowed the NCPU to better control public utility companies that provide services to the population.

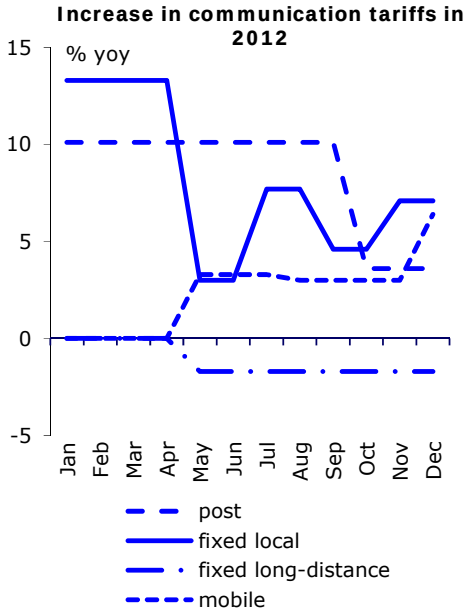
In October, the Commission set the rules for connecting to heating networks[xxi] that defined a uniform connection procedure, determined the contract procedure and set the typical form of the contract on connection to heat networks. The new rules will enhance mutual responsibility of the owner of the heating networks and heat energy producers.

In December, the NCPU together with the Ministry of Regional Development, Construction and Housing and Communal Services developed the Procedures for development, coordination and approval of investment programs in the areas of heating, water

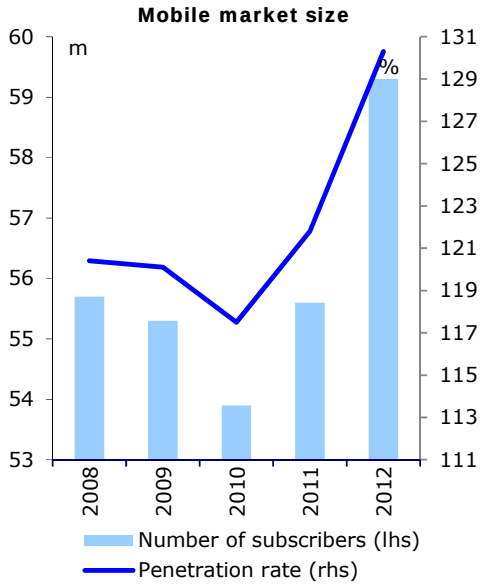
Market shares for mobile telephones, % of revenue

Operator	Market share in 2011	Market share in 2012
Kyivstar	50.1	48.9
MTS Ukraine	37.7	38.2
Life:)	12.2	12.9

Source: iKSConsulting



Source: Ukrstat

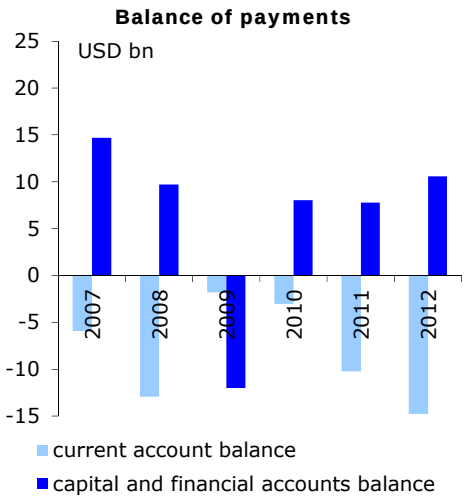


Source: NCCR

supply and sewerage[xxii] which ensure that the investment component of tariffs is economically grounded. This will allow to control the use of funds for investment program implementation and prevent violations. Also the structure of investment programs and the allocation of funds will become more transparent.

Tariff regulation. Before the administrative reform of 2011 public utility tariffs were set by the National Electricity Regulatory Commission (NERC) and currently NCPU uses NERC methodology for setting utility tariffs. NCPU licenses and controls only big utility companies, smaller enterprises (which comprise around 10% of the total number) are regulated by local authorities. And despite the fact that all tariffs have to be set according to common methodologies local authorities can influence the tariffs for small companies.

Between January and April of 2012, the NCPU raised heating tariffs for industry and budget entities by 50% to UAH 751 per GCal. According to the NCPU, in 2012 the tariffs for households covered 72.8% of the thermal energy costs (UAH 227 out of UAH 312 per GCal). However, heating tariffs for the population remained unchanged. The Commission also raised tariffs for water supply and sewerage services for households by 7.8% on average due to increased costs of electricity and purchased water.



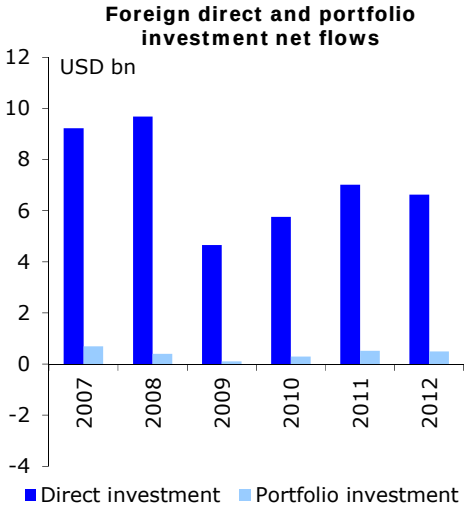
Source: NBU

Balance of Payments: Consolidated balance of payment was in deficit

In 2012, the NBU had to use international reserves to close balance of payments as current account deficit at USD 14.8 bn (8.4% of GDP) exceeded the surplus of financial and capital account at USD 10.6 bn (6.0% of GDP).

Current account. Current account deficit widened to 8.4% of GDP from 6.3% of GDP mostly due to higher merchandise trade deficit (see *Merchandise trade*) at USD 20.5 bn. A surplus in trade in services dropped slightly to USD 5.7 bn from USD 6.0 bn as gas transit volumes continued to fall (See *Energy*), while imports of construction services grew due to the Euro-2012. At the same time, the Euro-2012 had limited impact on exports of travel services and increase in revenue from foreign residents on Ukrainian soil (by 13%) was offset by similar increase in foreign spending of Ukrainian residents.

Net income outflows narrowed to USD 3.0 bn in 2012 from USD 3.8 bn in 2011. Ukrainian emigrant and freelance workers fared better in 2012 as their earnings increased by 15% to USD 5.5 bn.[xxiii] The NBU also managed to observe significant revenue from FDI abroad for the first time since observations started in 1998 (at USD 1.0 bn). Ukrainian private sector managed to refinance debt on more or less favorable terms as interest payments (at USD 4.0 bn) increased slower than debt outstanding. Payouts to foreign direct investors continued to grow and more than doubled as compared to 2010.



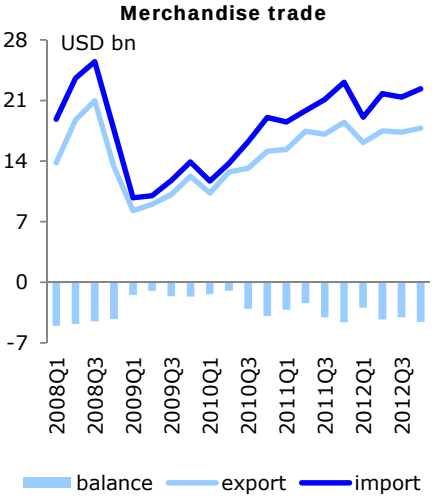
Source: NBU

Net current transfers from abroad dropped to USD 3.0 bn as inbound transfers fell in response to economic problems in the EU and outbound transfers grew due to use of foreign workers during the EURO-2012.

Financial account. Financial account surplus increased to USD 10.6 bn or 6.0% of GDP thanks to higher external borrowing by real sector as well as government. Outflows of cash foreign currency from banks were also significantly lower but still high in 2012 at USD 7.7 bn.

In 2012, banks continued to repay external debt. Outflows of debt capital from banks reached USD 3.0 bn. This reflected limited ability to raise foreign funding in the open market, desire of foreign parents of Ukrainian banks to reduce exposure to Ukrainian market and limitations on foreign currency lending in Ukraine.

At the same time, the Government regained access to global financial markets and raised net USD 2.4 bn even after repaying USD 2 bn loan due to Russian VTB (see *State debt*). The Government also



Source: Ukrstat

facilitated external borrowing by real sector through provision of government guarantees including USD 3 bn raised in the end of 2012 from China.

Real sector borrowed USD 6.6 bn more than it repaid due to government support, continued access of larger companies to foreign borrowing, movement of funds from foreign affiliates of Ukrainian companies. Real sector also increased other foreign liabilities such as trade loans by 4.0 bn.

FDI. According to the NBU, net FDI inflows in 2012 declined by UAH 0.4 bn to USD 6.6 bn. Nevertheless, inward FDI continued to grow and reached USD 7.8 bn and investment in real sector was close to pre-crisis highs in nominal terms. FDI stock that is attributed to sectors of economy increased by smaller amount[xxiv]. FDI flows were mostly concentrated in business services (including investment related to the EURO-2012) and food industry. Financial sector retains highest stock of FDI despite low inflows after 2009.

Cyprus remained the main source of FDI to Ukraine and was the only country with significant increase in FDI stock over the last few years. As Cyprus is often used by CIS investors (including Ukrainian) as intermediary it is hard to guess how much of Cyprus FDI is genuine.

Merchandise Trade: Increased share of agricultural exports in 2012

According to the Ukrstat, merchandise trade deficit widened USD 15.9 bn in 2012 from USD 14.2 bn in 2011 due to faster growth in imports than exports.

In 2012, merchandise exports grew only by 0.6% in dollar terms due to weak external demand for most products. Exports of products of the group XV "Base metals and articles of base metal" and VI "Products of the chemical or allied industries" declined by 14.5% and 6.1%, respectively, due to decline in external demand.

The decline in exports of mineral products (group V) at 25.4% is attributed to problems with providing refineries with imported resources. These problems relate primarily to policies favouring imports of oil-products, particularly, gasoline to Ukraine (see *Industrial output*).

The highest rate of growth of exports was in group II "Vegetable products" (66.6%) due to increase in both grain demand and prices. Grain exports almost doubled. It was restricted by government policy (see *Agrarian policy*). In general, the share of agricultural products (groups I – IV) increased by 7.2 p.p. to 26 % of the total merchandise exports in 2012.

In 2012, the share of vegetable products, animal or vegetable fats and oils increased in the total exports to 13.4% and 6.1%, respectively. In turn, decline in exports of base metals and articles of the base metal resulted in reduction of their share in total merchandise exports to 27.5% as compared to 41.2% in 2008.

In 2012, merchandise imports increased by 2.5% to USD 84.7 bn. The most important contributor to imports growth was increase in imports of group XVII "Vehicles, aircraft, vessels and associated transport equipment" at 30.0%. As a result, its share reached 9.5% of total merchandise imports. Imports of group XVI "Machinery and mechanical appliances, electrical equipment" grew by 3.0%, which brought share of this product to 15.5%. Higher imports of machines and equipment was likely to be attributed to conduction of the EURO-2012 in Ukraine.

Imports of group VI "Products of the chemical or allied industries" grew by 7.1% due to higher imports of pharmaceuticals and fertilisers.

The share of imports of group V "Mineral products" declined by 3.9 p.p. to 32.5% of total merchandise imports due to lower purchases of natural gas from Russia (see *Energy sector*) and decrease in imports of crude oil (at 61.1%).

Commodity trade structure between January and December, 2012

	Exports		Imports	
	USD m	% yoy	USD m	% yoy
Total	**68810**	**0.6**	**84658**	**2.5**
I - Live animals, animal products	961	2.6	1718	66.0
II - Vegetable products	9214	66.6	2430	33.8
III - Animal or vegetable fats and oils and their cleavage	4212	24.0	406	-13.3
IV - Prepared foodstuffs	3494	18.9	2965	-2.0
V - Mineral products	7650	-25.4	27542	-8.3
VI - Products of the chemical or allied industries	5059	-6.1	8586	7.1
VII - Plastics, rubber and articles thereof	1000	6.6	4467	-0.7
VIII - Leathers, skins and articles thereof	136	-19.5	247	23.7
IX - Wood and articles thereof	1061	-1.6	370	-6.0
X - Pulp, paper, paperboard and articles thereof	1132	2.4	1813	-1.3
XI - Textile and textile articles	784	-9.3	2564	28.8
XII - Footwear, headgear, umbrellas	176	-15.8	794	119.5
XIII - Articles of stone, plaster, cement, asbestos, glass	583	6.1	1107	-4.3
XIV - Precious and semi-precious stones and metals	140	38.7	493	-33.6
XV - Base metals and articles of base metal	18890	-14.5	5239	-8.0
XVI - Machinery and mechanical appliances, electrical equipment	7027	4.0	13179	3.0
XVII - Vehicles, aircraft, vessels and associated transport equipment	5964	22.8	8067	30.0
XVIII - Instruments and apparatus	297	5.3	1219	16.4
XX - Miscellaneous manufactured articles	609	9.5	1015	19.8
XXI - Works of art, collectors' pieces and antiques	0	-69.7	8	-66.5
Goods purchased at ports	30	-5.0	374	0.2
Other	394	15.0	54	25.2

Source: Ukstat

The CIS and the EU remained major Ukraine's trading partners, even though their shares in trade (exports plus imports) declined. At the same time, the shares of Asia, Africa and America increased. In particular, Ukraine almost doubled exports to African countries and increased imports from Asia and America.

Overall, the CIS countries accounted for 37% of total exports (decreased by 1%), while their share of imports was 41% (decreased by 4%). The share of exports to the EU reached 24.8 %, while the share of imports from the EU was at 30.9 %.

In terms of individual countries, Russia is the largest trading partner of Ukraine (25.6 % of exports and 32.4 % of imports in 2012). Merchandise trade deficit with Russia is attributed to energy imports.

Germany, Poland and Italy are among European largest trade partners of Ukraine. Poland and Italy are the biggest importers of Ukrainian goods (3.7 and 3.6% of the exports, respectively), while Germany and Poland are the biggest exporters to Ukraine (8.0 and 4.2% of the imports, respectively).

Ferrous metals, cereals, ores, slag and ash were the most exported products to the EU (22.7%, 11.6 % and 9.5 % of total exports to the EU, respectively). Mechanical machines (13.9%), transport means (11.4%) and pharmaceutical products (8.3%) were major imports from the EU to Ukraine.

Migration: There was no expected progress towards visa liberalization

Regulation. The regulation on migration did not improve in 2012. The Government prepered the draft law on labour migration, which, though, was not approved.

Implementation of the first phase of the EU-Ukraine Visa Action Plan was not completed in 2012 due to major two reasons. First, the Government did not create effective Anticorruption Agency. Second, the Government did not push through the law on the prevention and combating discrimination.

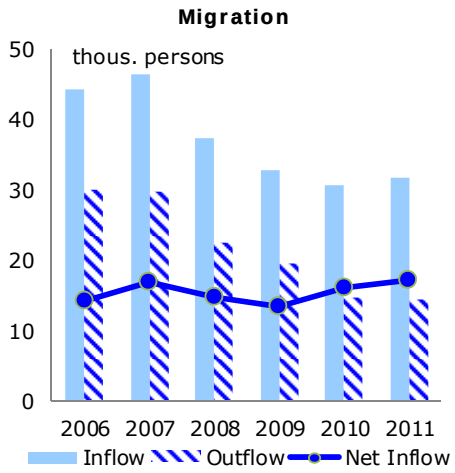
Migration flows. In 2012, according to the Ukstat, net inflow of migrants increased to 61800 from 17100 in 2011. This was caused by a surge in the number of immigrants, while the outflow of emigrants remained roughly the same (14.52 thousands in comparison to 14.59 thousands in 2011). The net flow of immigrants was positive almost for all regions except for Zakarpattia oblast. The highest growth in the number of immigrants was observed in regions with a high level of business activity and where a lot of universities are located (Kyiv, Odesa, Kharkiv).

New wave of migration survey was completed in 2012 by the Ukrstat and the ILO. According to survey, 1.2 m individuals (3.4% of population in age between 15-70 years old) either worked or looked for a job abroad between January 2010 and June 2012. 98.2% of these individuals worked abroad, while the rest looked for a job. The share of labour migrants in working labour force reduced from 5.1% in 2005-2008 to 4.1% in 2010-2012 likely due to worse economic situation in recipient countries. In particular, the EU, which faces economic problems, was a recipient country for 50% of labour migrants work. 43.2% of Ukrainian migrants go to work to Russia.

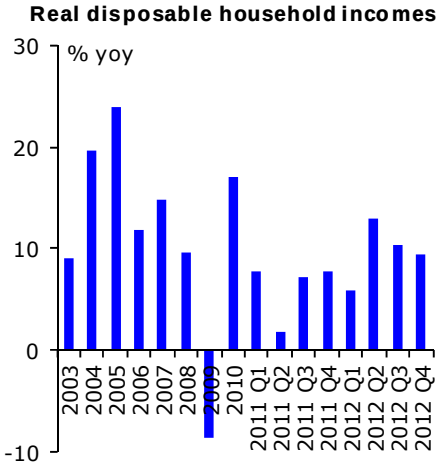
Wages and income: Disposable income continued growing rapidly

Despite economic slowdown growth of disposable household income remained strong. It grew by 10.3% in nominal terms and 9.7% in real terms.

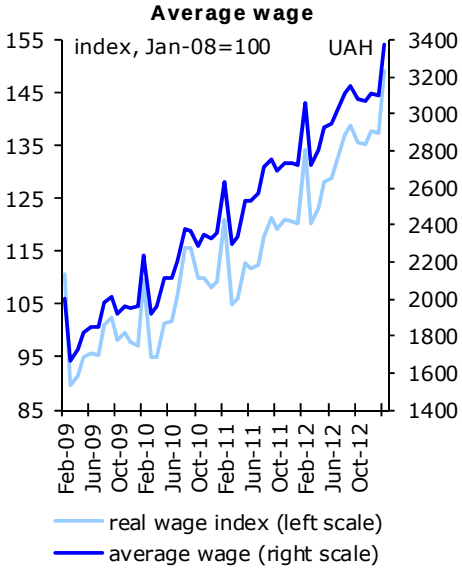
Wage income increased by 11.5% in real terms due to growth of average wage by 14.4%. Increase in minimum wage (by 14.2% in nominal terms) was likely to be major contributor to wage growth. The highest wage growth was in education and health care (by 20.9% and 23.3%, respectively) due to increase in salary of first tariff rate in the Single tariff scale for public employees and higher



Source: Ukrstat



Source: Ukrstat



Source: Ukrstat

wage differentiation. In particular, first tariff rate was increased to 74.0% of minimum wage as of December 2012 as compared to 65.1% in December of 2011. Increase of wages in health care was also influenced by the introduction of health care reform in several regions, which resulted in increase of wages in primary health care. At the same time, wages in education and health care remained much lower than average in economy (by 16.5% and 17.3%, respectively). Increase in wages in trade and business services (at 16.6%) is likely to be explained superior economic performance of these sectors as compared to others.

Income from social assistance increased by 13.6% due to increase in social allowances as well as higher pensions (see *Pension Fund*). Larger banking deposits and higher interest rate contributed to increase in income from property at 9.1%. Good harvest and strong consumption resulted in growth of income from entrepreneurs activity and subsidiary farming by 5.5%.

Labour market: ILO unemployment rate remained above pre-crisis level

Unemployment rate. Labour market in 2012 remained weak against the background of economic slowdown. Unemployment rate (ILO methodology) declined to 7.5% of economically active population of age between 15-70 years from 7.9% in 2011.

Unemployment rate declined to 6.6% of economically active population of age between 15-70 years old in the third quarter of 2012 and then increased to 8.0% in the fourth quarter. It was by 0.2 p.p. lower than in the last quarter of 2011, but by 1.1 p.p. higher than in the fourth quarter of 2007.

Unemployment rate of men remained higher than for women (8.5% and 6.4%, respectively). At the same time, unemployment rate in urban areas was only by 0.2 p.p. higher than in rural areas (the difference was at 0.5 p.p. in 2011) due to more rapid decline in unemployment in urban areas.

Economic slowdown did not impact unemployment in the end of 2012 as preferred initial response of companies was either reduced working hours or temporary lay-offs. If the economic situation does not improve soon enough, some of these employees might become unemployed.

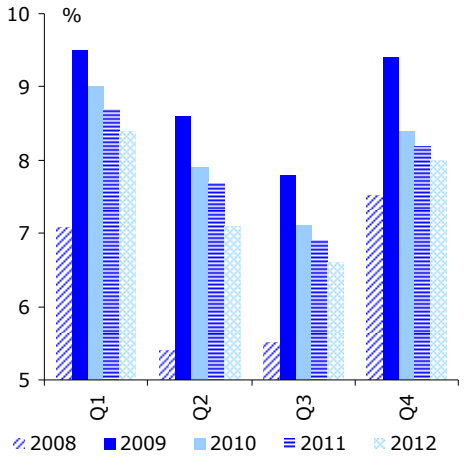
New Employment program.[xxv] The Government approved the Program on Employment and Job Creation until 2017, which envisages measures aimed at higher employment, incentives for employers to create jobs and labour capital development. The major target of the Program is increase in number of employed individuals by 0.9 m to 21.2-21.4 m persons. The unemployment rate (ILO methodology) is to decline from 7.7-7.9% to 6.3-6.6% by 2017 of economically active population between 15 and 70 years old. Such parameters indicate that the Government plans to increase employment by engaging economically inactive people in the workforce. Program is also aimed at reduction of informal employment, eradication of working poor, improvement of workplace conditions and increase in wages.

Most measures are very general and the results are too broad. Besides, terms of introduction of such measures are defined very broadly. This raises concerns on the effectiveness of the Program. Therefore, the Government is still a long way to go to increase employment.

Fiscal Policy: Fiscal stance remained vulnerable

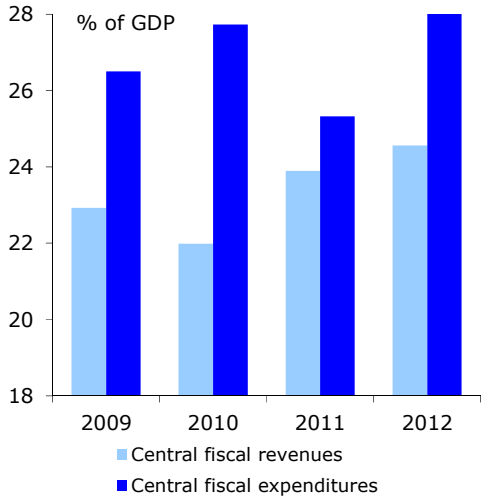
Budget process 2012. The 2012 the State Budget Law was based on optimistic macroeconomic assumptions and approved in December 2011 with a delay as the Government attempted to negotiate reduction in natural gas prices with Russia[xxvixxvii]. Central fiscal revenues and expenditures were set at UAH 333 bn (22.2% of GDP) and UAH 358 bn (23.9% of GDP) respectively. Central fiscal deficit was narrowed compared to 2011 and projected at 2.5% of

Unemployment rate (ILO)



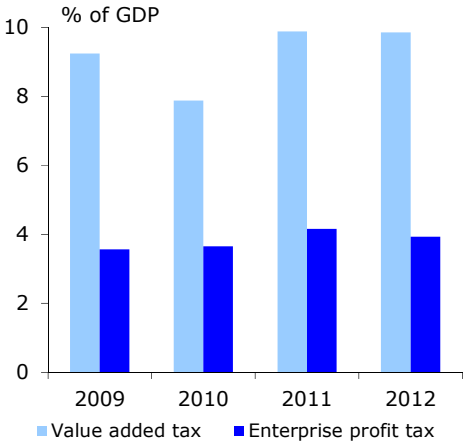
Source: Ukrstat

Central fiscal revenues and expenditures



Source: State Treasury

Key tax revenues



Source: State Treasury, Derzkomstat

GDP (including recapitalization of the Naftogaz), which generally complies with the fiscal target envisaged in the Stand-by Agreement with IMF[xxviii]. The deficit was expected to be financed primarily at the expense of borrowings and privatization receipts.

In April, the State Budget Law for 2012 was significantly amended due to President's social initiatives based on unrealistically upgraded macroeconomic forecast. As a result, the target of central fiscal revenues increased by 10.2% to UAH 367 bn. At the same time, central fiscal expenditures were raised by 9.4% to UAH 392 bn, which were spent on increased pensions and social payments (See 'Social policy') as well as state aid and Parliamentary elections needs. Central fiscal deficit remained unchanged. However, in October-December, the planned deficit were substantially raised (by 71.2% from the approved level), which was covered by increase in domestic borrowings. Additional funds were allocated to LGEs for compensating the difference between housing and utility tariffs and cost-covering level. Thus, the Government fell back from initially declared fiscal consolidation, increasing fiscal sustainability concerns.

Execution of the Budget 2012. Central fiscal revenues and expenditures were both under-executed in 2012 due to unrealistic fiscal planning combined with economic slowdown. In particular, the fiscal parameters for 2012 were based on optimistic macroeconomic assumptions of GDP increase by 3.9% and consumer inflation at 7.9%. However, actual real GDP growth was 0.2% and CPI decline was at 0.2%. Besides, President's social initiatives introduced in April led to overblown revenues and expenditures, which were already too optimistic.

As a result, central fiscal revenues reached only 90.3% of the annual target. In particular, VAT collections amounted to 84.6% of target due to lower than projected import and domestic production. The share of VAT refund made automatically increased insignificantly compared to 2011 and constituted only 50.3% (as of January 1, 2013), which is by 19.7 p.p. lower than the IMF target. It is primarily explained by rather discriminatory criteria established for VAT refund regime, as middle – and small-size companies have restricted opportunities to receive the refund.

Receipts from EPT were under-executed by 5% despite persistent advance tax payments. However, the plan of non-tax revenues were fully executed as NBU profits transferred to the budget doubled. Overall central fiscal revenues grew by 10.0% (to UAH 346 bn).

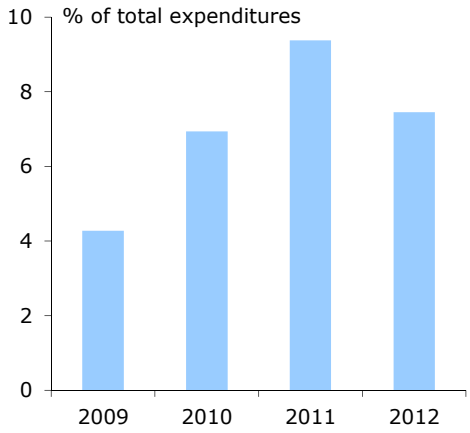
At the same time, overall central fiscal expenditures grew by 18.7% (to UAH 396 bn) at the background of higher social standards and increase in direct and indirect transfers to the Naftogaz. Increased social spending due to President's social initiatives were financed almost in full, while capital expenditures were substantially under-executed. They reached only 65.1% of the target undermining future economic growth in the country. As a result, central fiscal expenditures were by 7.4% lower than target.

Their financing was supported by rapid increase in central fiscal deficit. The deficit (without Naftogaz and banks recapitalisation) exceeded the 2012 target and expanded to 3.8% of GDP compared to 1.8% of GDP in 2011. However, the deficit, which accounted for banks recapitalisation and unreported loans to the Pension Fund is estimated at 4.5% of GDP, which is higher than the target foreseen for 2012 in the SBA with IMF. The deficit was primarily financed at the expense of domestic borrowings (see '*State debt*') and privatisation receipts.

Overall, the fiscal consolidation was postponed under rather expansionary fiscal policy and unrealistic budget planning. Therefore the Government should continue to implement medium-term budget planning and approve the State budget law based on more pessimistic scenario.

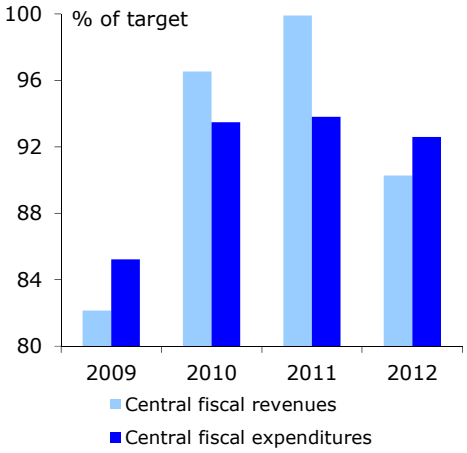
Tax policy in 2012. The Tax Code of Ukraine was numerously amended during the year. The SME taxation rules were changed with

Capital expenditures



Source: State Treasury reports

Execution of central fiscal revenues and expenditures



Source: State Treasury reports

the aim of simplification. In particular, restrictions on the voluntary registration as a VAT payer was abolished and faster VAT registration for unified tax payers was introduced. Paper copy of VAT invoice is no more required if it is completed in electronic format. Besides, two new groups (V and VI) of unified tax payers with the annual turnover up to UAH 20 m were introduced [xxix]. Therefore, system became more generous, which might create more room for fraudulent behavior.

The fiscal revenues in 2012 were undermined by tax rates reduction and introduction of new tax exemptions. Besides, the introduction of property tax was again postponed to January 1, 2013.

In particular, EPT rate was reduced from 23% to 21%, which was aimed to create incentives for profits de-shadowing. Besides, PIT rate on dividend income received by individuals from foreign sources was reduced from 15% or 17% to 5%.

Tax losses accumulated prior to December 31, 2011 were allowed to be deducted from the tax base of EPT during 2012-2015. It was the long-awaited decision, greatly welcomed by business.

Besides, the Government continuously granted significant tax privileges in selected sectors for chosen enterprises. Lowered tax rates, tax exemptions and permission for expedited depreciation were provided for eligible projects of the companies in the priority industries for the period of 2013-2022[xxx]. However, their efficiency is expected to remain low as eligible for privileges projects are often arbitrary defined by the Cabinet of Ministers.

Moreover, more favorable taxation was introduced for IT sector, which will likely contribute to de-shadowing of this industry. In particular, from January 1, 2013 till January 1, 2023 supply of software will be exempt from VAT. Besides, eligible IT companies will be allowed to apply 5% EPT rate instead of general rate at 21%.

At the same time, several tax changes resulted in further tightening of tax administration. It concerns introduction of obligatory monthly advance EPT payments for enterprises with an annual turnover exceeding UAH 10 m since 2013[xxxi]. Moreover, taxpayers reporting losses are not any more entitled to an automatic VAT refund.

In addition, the Government introduced a special excise tax on sale or other disposal of securities at rates ranging from 0% to 1.5% from January 1, 2013. In particular, 0.1% rate is applied to disposal of listed securities on the over-the-counter market, 1.5% - to disposal of non-listed securities and UAH 85 - for each derivative on the over-the-counter market[xxxii].

Finally, the end of 2012 was marked by Government decision to introduce administrative changes. In particular, the State Tax Service (including Tax Police) and the State Customs Service were planned to be reorganized into the Ministry of Revenues and Duties. Such centralization of tax revenue bodies complies with international practice and aimed at simplification of tax administration procedures and increase in fiscal revenue collections. However, it may strengthen the administrative pressure on businesses.

Amendments to the Budget Code. In October, the Verkhovna Rada approved amendments to the Budget code[xxxiii]. The changes were primarily aimed at improvement of financial viability of local budgets, co-financing of infrastructure projects, and clarification of budget classification. In particular, local bodies received more power in reallocation of budget funds between local budgets of different levels to use resources more effectively. Moreover, funds for the construction and maintenance of municipal roads are currently transferring from the State budget to local budgets each ten days (instead of each month), which is likely to speed up the financing of infrastructure projects at local level. Besides, the main sources of formation and use of the special fund of the State budget will now be defined directly in the Budget Code. It is expected to slightly weaken

Table. New classification (groups) of entrepreneurs due to revised simplified taxation

Group	Incorpo-ration	Max annual turnover, thd UAH	Max number of empls	Tax rate
1	Indivi-duals	150	0	1-10% of min wage
2	Indivi-duals	1 000	10	2-20 of min wage
3	Indivi-duals	3 000	20	3% of turnover incl. VAT(or 5% without VAT)
4	Legal per-sons	5 000	50	3% of turnover incl. VAT (or 5% without VAT)
5	Indivi-duals	20 000	20	5% of turnover incl. VAT (or 7% without VAT)
6	Legal per-sons	20 000	50	5% of turnover incl. VAT (or 7% without VAT)

Source: Tax Code amendments as of November 20, 2012

ad-hoc decision-making of the Government and make budget process more transparent.

Approval of the Budget 2013. The State Budget Law for 2013 was approved with a delay in December 2012[xxxiv]. The Government continued negative practice of bundling changes to other laws with the State Budget Law as a way to ensure sufficient revenues. The provisions of the Law differ much from the approved earlier Main Guidelines for Fiscal Policy in 2013.

Fiscal parameters of the Budget 2013 are based on optimistic macroeconomic forecast with real GDP growth at 3.4% and December-to-December consumer inflation at 4.8%. Central fiscal revenues and expenditures are projected at UAH 363 bn and UAH 412 bn, which is by 4.9% and 4.2% higher than 2012 actual figures respectively. Central fiscal deficit excluding deficits of the Naftogaz is planned at 3.2% of GDP (UAH 50.5 bn).

The main risks of the Budget 2013 relate to revenues execution, capacity of the Government to finance fiscal gap as well as further debt growth. Besides, further growth of Naftogaz and Pension Fund deficits is likely which increase the overall fiscal gap.

Social policy: Social standards surged

Social standards and minimum wage. Social standards were again raised sharply and far ahead CPI growth. General level of subsistence minimum was increased by 14.2% on average in 2012. At the same time, minimum pensions were raised by 10.0%. Low-income family allowances tied to subsistence minimum also increased. Such increase is a positive step as this is a means-tested social program, which proved to be efficient in targeting poor families.

Minimum wage was also increased by 14.2%. This created additional pressure on companies, that faced financial constraints in the second half of the year.

General subsistence minimum and minimum wage are to be increased by 6.7% and 4.9%, respectively, on average in 2013.

Housing for young families.[xxxv] In October the Cabinet of Ministers approved the Program on Housing for families under 35 for 2013 – 2017, which succeeded similar Program approved for 2001-2011. The execution of previous Program was much lower than planned. In particular, central fiscal funding accounted for only 42.4% of target, while local fiscal financing reached only 30.2% of planned amount. Lack of medium term expenditures framework contributed to this, as it is required for effective implementation of multi-year programs.

New Program envisages total fiscal funding at UAH 5.5 bn including 60% of central fiscal spending. Budget funds will probably be used mostly for subsidizing interest rate on commercial mortgages. In this case it will be affordable only for families with high and middle income. Given limited funds for housing subsidies the Government should concentrate on affordable housing programs for poor families.

Pension system: The Pension Fund's deficit remains high

The sustainability of the Pension Fund remained in doubt in 2012. The Fund's deficit remained high at UAH 28.6 bn (or 12.2% of Fund's spending) as compared to UAH 30.0 bn in 2011. Deficit was funded by central fiscal transfer (UAH 15.3 bn), remaining funds from previous year as well as, opaque off-budget loans from the State Treasury at UAH 11.9 bn. These loans were supposed to cover short-term liquidity gaps of the Fund but were in fact used to fund deficit for a few years in succession. As Pension Fund is unlikely to have surplus any time soon, the Government will have to write off these loans.

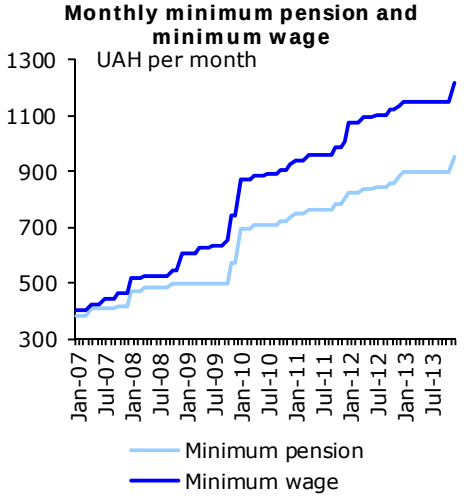
The Pension Fund's revenues (excluding loans) reached UAH 223 bn, from which 71% were collections of the pension insurance

Subsistence minimum, UAH

	2012		*2013*	
	Jan.	Dec.	Jan.	Dec.
General level	1017	1095	1108	1176
In particular:				
For children less than 6 years old	893	961	972	1032
For children of 6-18 years old	1112	1197	1210	1286
For working able individuals *	1073	1134	1147	1218
For individuals that lost ability to work**	822	884	894	949

Note: * minimum wage
** minimum pension
Source: the State Budget Law for 2011, the State Budget Law for 2012

Monthly minimum pension and minimum wage

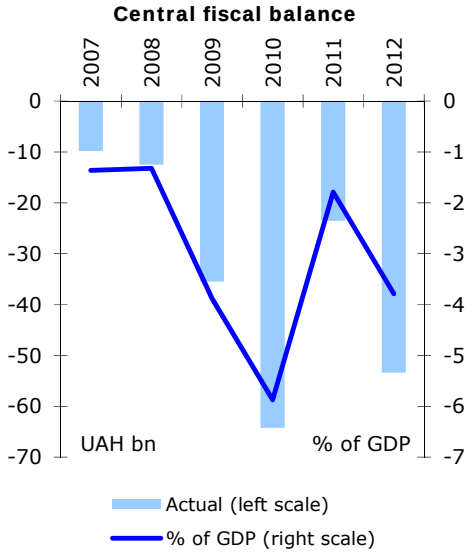


Source: State Budget Laws for 2007 - 2013

contributions. Another part of revenues is central fiscal transfer to finance special pension programs, including financing of gap between minimum pension and pensions calculated on the basis of formula envisaged in the Pension Law.

The actual deficit of the Pension Fund was almost twice higher than envisaged in the State Budget Law primarily due to so-called social initiatives of the President. In particular, pensions to individuals retired before 2008 are to be revised as they have disproportionally lower pensions than pensioners who retired later due to deficiencies of formula used for pensions calculations. Pensions of war veterans and several other groups had higher increases.

If the Government continues increase pensions beyond Pension Fund's means (as determined by wage growth) the sustainability of the Pension Fund will remain the issue. The debates on the introduction of second pillar of the pension system – accumulative pillar -, thus, remain not relevant.

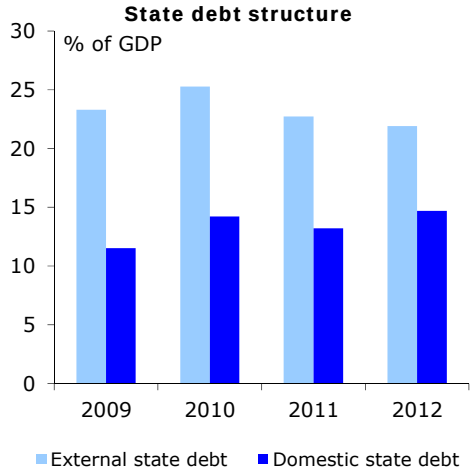


Source: State Treasury Reports

State debt: Debt continued growing

The 2012 annual borrowing plan was reached already in September as the Government was actively borrowing on both local and external markets. However, the amended annual target was under-fulfilled by 3.1% by the end of the year after it was increased in November. Total state debt (direct and guaranteed) grew by 9.0% to UAH 516 bn) under higher needs for fiscal expenditure financing against the background of lower than planned fiscal revenues (see *Fiscal policy*). However, its growth was suppressed by significant debt repayments, scheduled for 2012. In particular, the debt increased in relation to GDP only by 0.6 p.p. to 36.6%. The structure of the state debt slightly changed in a favour of domestic debt, which share in total debt increased to 40.0% from 36.7% in 2011. The state debt level remained moderate by international standards, however it already exceeded the average level for developing countries (35.7% in 2012)[xxxvi]. The debt sustainability risks remained high. They include significant share of short-term borrowings and borrowing denominated in foreign currency, unsolved problems with unaccounted conditional liabilities.

Domestic borrowings. Domestic state bonds outstanding increased by 17.9% yoy as of the end of December 2012 to UAH 186 bn[xxxvii]. The maturity structure of bonds changed substantially in favor of mid-term and long term bonds. Their share for the first time reached near 50% of total value. At the same time, the share of bonds with maturity up to one year dropped from 33.7% in 2011 to 24.5% in 2012. However, the structure of bondholders remained almost unchanged compared to previous year with shares of NBU and banks at 56.8% and 35.6% respectively.



Source: Ministry of Finance reports

The bonds were issued primarily for financing fiscal expenditures and redeeming previous issues of bonds. Besides, the Government continued the long-lasting practice of increasing statutory capital of state enterprises. In particular, the Government issued special state domestic bonds for recapitalization of the NJSC Naftogaz at UAH 6.0 bn in March and the Ukrgidroenergo at UAH 1.0 bn in September.

The Ministry of Finance continued to introduce new financial tools to increase the demand for domestic state bonds against the background of low banking sector liquidity and stll high expectations toward hryvnia depreciation in 2012. In particular, the Government introduced EUR-denominated bonds in March and USD-denominated treasury bills (T-bills) for population in October. Though these instruments were aimed to reduce currency risks of investors, they increased the government's exposure to exchange rate risks and didn't help the Government to attract significant funds (only EUR 317 m and near USD 100 m, respectively). At the same time, USD-denominated bonds, introduced in 2011, were more successful. The Ministry of Finance obtained near USD 2.5 bn of such bonds in 2012.

The weighted-average yields increased from 9.2% p.a. in 2011 to 12.9% p.a. in 2012 as the Government was more willing to increase

rates on the primary market to ensure sufficient funding and debt redemption.

External borrowings. The external borrowings increased by 54.8% and were almost at the target level (98.4% of the plan) due to temporary improvement on international financial markets in the second half of 2012. First, the Government placed USD 2 bn of five-year Eurobonds at 9.25% p.a. in July. In September, it placed USD 0.6 bn of Eurobonds at more favourable yield (7.5% p.a.). It was additional tranche to the first issue. The third placement was conducted in November, when the Government successfully placed USD 1.25 bn of ten-year Eurobonds at 7.8% p.a. Significant external borrowings were primarily used for repayments of debt to the IMF, the Russian VTB and previous Eurobond issues. However, they were acquired at extremely high yields compared to ones in the counties, most affected by financial crisis.

Besides, the Ministry of Finance managed to reach an agreement with the Russian VTB Bank on redemption of USD 2 bn loan, received in 2010. As a result, the Government repaid 50% of the loan (USD 1 bn) along with all accrued interest in June. The rest was repackaged into USD 1.0 bn Eurobonds issue with yield at 7.95%.

In addition, in mid-February the World Bank approved a new Country Partnership Strategy for Ukraine for 2012-2016. It envisaged the lending program of USD 500 m per annum from World Bank (as IBRD) and USD 400 m per annum from the International Finance Corporation (IFC). The Strategy was focused on two priorities: increase in efficiency of government services and public finance system as well improvement of business climate.

Summing up, significant domestic and foreign borrowings somewhat eased fiscal pressure and helped the Government to pay off the debt due in 2012. However, loose fiscal policy, which results in further accumulation of debt burden might put public finances on an unsustainable path in mid-term perspective. In 2013 the debt payments will grow substantially. The Government will have to redeem UAH 81.1 bn of state debt and pay UAH 35.0 bn of interest, accounting cumulatively to 7.3% of GDP.

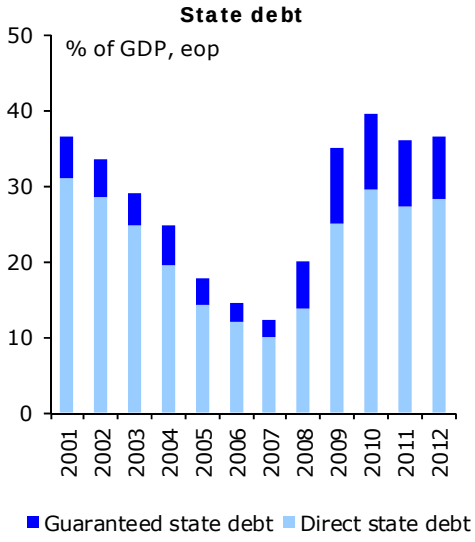
The Debt Management Strategy. In May the Cabinet of Ministers approved the Medium-Term Government Debt Management Strategy for 2012-2014, replacing the previous document for 2011-2013. Most provisions of the Strategy remained unchanged. However, targets for main debt indicators were substantially revised based on state debt risks assessment, which was first introduced in the Document. In particular, direct state debt relative to GDP was planned to be reduced to 25% of GDP in 2013-2014 (previously, to 28% in 2013). It will be rather hard to achieve under projected fiscal policy.

At the same time, the target for other debt indicators became loosened. Thus, the expected weighted average maturity of state debt for 2013-2014 was downgraded to 4.2 and 4.3 years respectively (compared to 5 years in 2013 due to previous version). The share of refinanced state debt for this period is not to exceed 20% (before -16%). Softer targets made the Strategy more realistic and applicable, however, the ways of achieving goals defined by the Strategy remained insufficient.

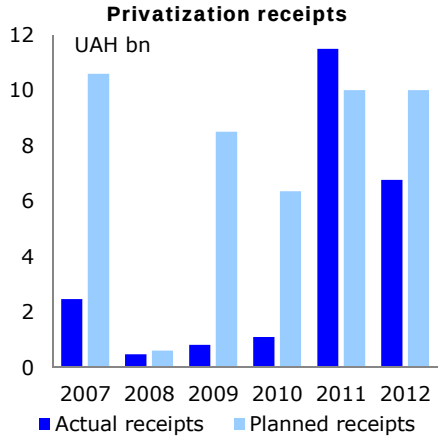
Privatization: Increased concentration in the energy sector

Privatisation process. The Plan for privatization receipts in 2012 was executed only by 67.6% (UAH 6.8 bn).[xxxviii] The privatisation process was often characterised by unfair competition and low transparency, which resulted in little difference between bid and sell price contributing to lower privatisation receipts.

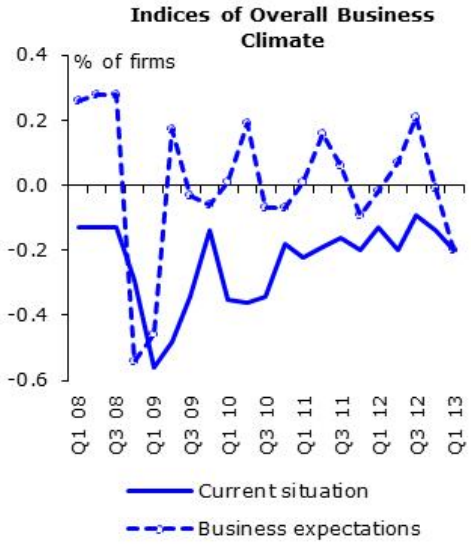
Privatisation revenues in 2012 were ensured by sells of energy sectors. In particular, the State Property Fund (SPFU) sold the blocking stakes in three largest power generating companies that own and operate heat power plants (Dniproenergo, Zahidenergo and Kyivenergo) and one power distributing company



Source: Ministry of Finance



Source: SPFU



Source: IER Surveys

(Donetskoblenergo). The auctions, which was described by the expert community as a non-transparent and biased, was won by DTEK, the energy subsidiary of SCM holding. With the new acquisitions the holding concentrated 33% of total power generating capacity in the country including 54% of heat power generation that undermines the competitive environment in the sector.

In 2012 the SPFU sold 17 stakes of gas distribution companies. All of them were sold in excess of starting price. 13 of these stakes were bought by the Gaztek, which in 2012 became the largest company in the sector.

Regulation. At the beginning of 2012 the State Privatization Program for 2012-2014 was approved. The Program is expected to reduce the share of public sector in the economy to 25-30% and provide revenues to the state budget of Ukraine in the amount of UAH 40-60 bn during three years.

In Ukraine there are 1492 companies included into the list of firms that cannot be privatized. In 2012, the draft low that envisaged reduction in this number to 299 was submitted to the Parliament, but not approved. This reduction is necessary for ensuring privatisation receipts in 2013-2014.

Business climate - enterprises: Pessimistic business expectations in 2012

Overall business climate. According to the results of the IER quarterly enterprise survey managers' assessment of the overall economic conditions in Ukraine during 2012 fluctuated but predominantly was pessimistic. The corresponding indexes were below zero throughout entire year. This means that the number of enterprises' managers that reported an improvement of business environment remained lower than the number of those, who pointed to the worsening of business climate in the country.

In February 2012 the managers' assessment of overall economic conditions/business climate worsened compared to October 2011: the value of the respective index decreased from -0.08 to -0.18. In April and July the value of the index increased to -0.02 and to -0.07, respectively. However, this was not a trend towards the improvement in business climate assessment as in October the value of the corresponding index dropped again to -0.19. In terms of shares of respondents in October almost every third respondent (30.4%) reported worsening of the business climate, and only 8.8% of managers assessed the climate as favourable for their enterprises' activity.

The index of business expectations, which reflects the respondents' assessments of changes in overall economic conditions in the next six months, increased from -0.02 in October 2011 to 0.07 in February 2012. In April the value of the index rose by 14 points (up to 0.21). However, already in July its decline to -0.01 was recorded. In October the situation has not changed: the value of the index equalled -0.02.

Impediments to business development. According to the results of the survey, conducted in October 2012, low demand, lack of finance (liquidity problems), excessive taxation, unfavourable regulatory climate, large competitive pressure and high interest rates were named as major impediments of business development.

Low demand was ranked as the first in the list of impediments in October *(see GDP)*. The importance of this barrier was increasing throughout the year, and, finally, in October it was reported by 65.8% of respondents.

Problems with liquidity, which led the list in the beginning of the year, in October were ranked the second largest barrier for business development *(see Financial markets)*. Its absolute value slightly increased from 55.1% to 59.9% in October.

Excessive taxation took the third place in the list *(see Fiscal Policy)*. Although the importance of this barrier increased in April compared

Source: IER Surveys

Impediments to production growth

	Q1 12	Q2 12	Q3 12	Q4 12
Low demand	55.0	56.7	66.0	65.8
Liquidity problems	63.7	53.6	55.1	59.9
Excessive taxation	59.2	61.5	37.9	48.0
Unfavorable regulatory climate	33.6	45.3	43.5	43.9
High regulatory burden	**23.5**	**30.9**	**33.7**	**37.0**
Changes in economic legislation	**11.4**	**14.4**	**12.3**	**12.2**
Corruption	**5.5**	**6.5**	**6.3**	**6.3**
High interest rates	29.1	45.7	46.0	35.4
High competitive pressure	32.9	34.0	26.7	32.9
Shortage of raw materials	19.7	10.7	22.5	24.1
Access of credits	31.1	23.4	14.0	13.8
Outdated technologies	15.6	14.8	10.5	12.2
Problems with energy supply	4.5	7.9	10.5	9.4
Unstable political situation	9.7	7.6	14.4	9.1
Shortage of skilled workforce	11.4	7.9	9.5	7.2
Shortage of capacities	8.3	7.9	4.9	5.6

Source: IER Survey

to February from 59.2% to 61.5%, but in July its urgency dropped: the percentage of respondents who reported this obstacle equalled to 37.9%. However, in October the respondents reported again about the significant growth of the barrier (48%).

Unfriendly regulatory climate was at the forth place by importance. Fluctuation of this indicator shows that pick of the issues has been recorded in the second quarter of 2012. The share of managers stating regulatory climate as a major obstacle to their business activity decreased in February 2012 as compared to October 2011 from 45.2% to 33.6%.However already in April it grew and reached the value of the fourth quarter of 2011. In the third and fourth quarter of 2012 the corresponding values did not change (43.5% and 43.9% respectively).

The absolute value of the barrier "high interest rates" was constantly declining throughout the year and in October equalled 35.4%. During 2012 the barrier "high competitive pressure" remained relevant for enterprises, and its importance made up 32.9%.

The absolute values of other impediments were not higher than 25%. Against this background the significance of the barriers "lack of raw materials", "lack of capacities" and "outdated technology" grew, and the significance of the barriers "access to credits" and "problems with energy supply" declined.

Investment activity. The results of the study, focused on the investment activity of enterprises, which is conducted in January and February every year, showed that among all surveyed managers only 36.6% planned to make investments during 2012. In return the share of firms which made investments in 2012 equalled 41.1%. In general, the level of investment activity decreased for the firms of all sizes in 2012 compared to 2011. In 2013 business expectations concerning investment are somewhat higher than in 2012: 40.1% of managers plan to invest compared to 36.6% in 2012.

The vast majority of the polled enterprises' managers (57.1%) estimated 2012as unfavourable for the purchase of equipment. However, this share reduced by 17.5 p.p. as compared to 2011.

According to the results of the survey, among the main obstacles, that impeded managers in planning investments in 2012, top three positions were occupied by insufficient income (55.5%), high cost of capital (28.2%) and fear of defaults (20.1%).

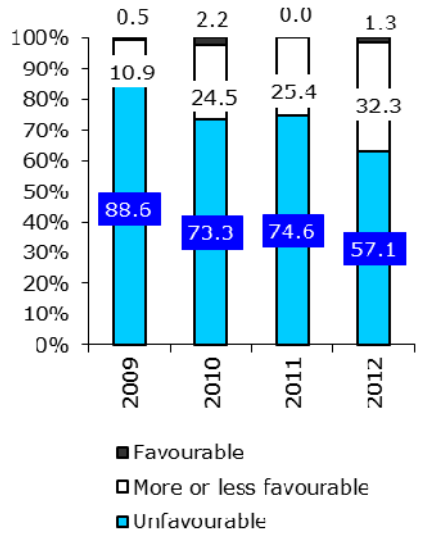
Business climate - banks: Banks remained pessimistic in 2012

Business climate. The results of the IER Banks' survey revealed absence of any significant changes of economic situation in Ukraine. In every survey taken in 2012, majority of the banks (from 50% up to 85%) assessed business climate as satisfactory. At the same time, share of managers who assessed the situation as negative was higher than of those who reported positive changes.

Therefore, the value of the respective index was below zero. In February 2012, the index of current business climate assessment by banks was -0.05. Neutral assessments of business climate dominated, and the share of banks with negative opinion about economic situation was somewhat larger than of those with positive assessment. The trend continued in the following months. In summer the index declined to -0.18 as almost one third of the banks estimated current business climate negatively. In October, index of business climate assessment reached zero, which was its highest mark in the whole year. It occurred due to balanced responses on positive and negative assessments. Banks' expectations about future changes of business climate fluctuated in 2012. A period with the highest index of expectations (in summer) was followed by the most pessimistic one (in autumn). Still, most of the banks were neutral about future changes of business climate.

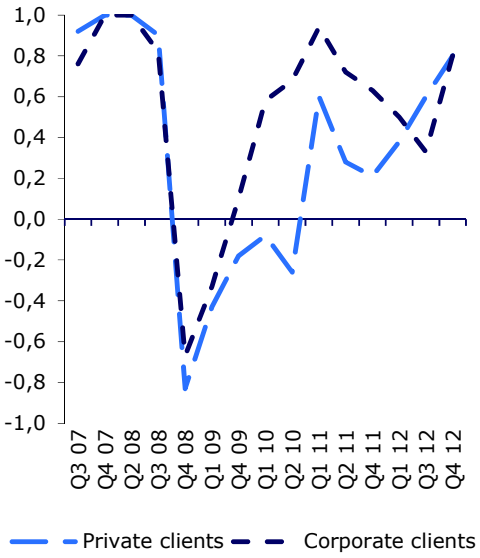
The index of expectations that shows the banks' assessments of overall economic conditions changes in the next six months equaled

Is it favourable time for investment?, % of firms



Source: IER Surveys

Expected volume of loans issued



Source: IER

to -0.10 in February 2012. In June 2012, it rose to 0.12 as number of "optimists" (35.3% of banks) was higher than number of "pessimists" (23.5%). However, in October 2012, the index dropped to -0.18. The abrupt fall of the index occurred because the share of pessimistic expectations (27.3% of banks) was three times bigger than the share of optimistic ones (9.1%), which might be explained by deterioration of economic situation in the country *(see GDP)*. Still, two thirds of the respondents (63.6%) did not expect any changes of the overall economic conditions during the following six months.

Loans to private and corporate clients. Banks expected to increase lending to private and corporate clients throughout the year. In spring 2012, 56.3% of banks intended to increase lending to private clients and 68.8%, to corporate clients. In summer 2012, banks that planned to increase lending to corporate clients comprised 55.6%, and those who intended to increase loans for private clients accounted for 60% of the banks. Banks' forecasts became more optimistic at the end of 2012, when 80% of banks hoped to increase lending to private clients in the following quarter and 90% of banks expected the growth of loans to corporate clients. Throughout the year, the share of banks planning to decrease lending either to private or to corporate clients did not exceed 25%.

Enterprises assessment of the banks' willingness to give loans almost matches the intentions of banks regarding lending to corporate clients. According to the quarterly enterprise survey by the IER, about half of the industrial enterprises considered that banks were willing to give loans to similar enterprises. In particular, 44% of enterprises in April and 55.5% in October thought that banks were planning to give long-term loans. The percentage of industrial firms that considered banks ready to give medium-term loans ranged from 48.1% in April to 61.4% in October. The share of the enterprises that believed that banks would give a short-term loan to a similar enterprise was the smallest in April (57.4% of enterprises) and peaked in July to 70.2% of industrial firms.

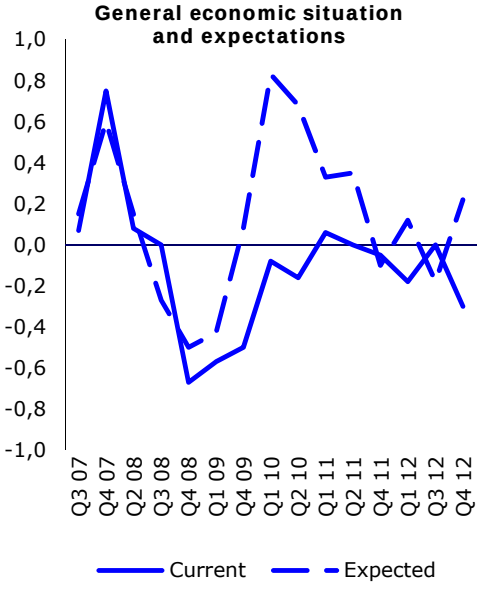
Impediments to business development. The number of banks that reported unfavourable regulatory climate and unfavourable political situation as major obstacles for their development gradually increased over the year. At the beginning of the year, 41.2% of banks listed unfavourable regulatory climate as a barrier for banking. In late 2012, already 50% of the banks reported this impediment. In addition, unfavourable political situation did not appear to be a very significant problem for banking in the first half of 2012. However, the survey taken in October demonstrated that half of the polled banks considered this as an essential barrier.

At the same time, the importance of competition in the banking sector decreased. 70.6% of banks included it in the group of barriers at the beginning of the year; and in summer, 81.8% of the banks considered competition as an impediment for business. But at the end of 2012, the share of the banks reporting this problem shrunk down to 40% likely due to aggravation of importance of other barriers. Also, in the latest survey none of the banks mentioned any problems with finding skilled employees. To compare, at the beginning of 2012, shortage of skilled personnel was reported as a barrier by 11.8% of banks.

Financial state of enterprises: Fall in profits

A rapid increase in profits, which was registered in 2010-2011, ended in 2012 due to slowdown in economy. The consolidated financial result of domestic enterprises declined by 16.6% to UAH 102 bn due to increase in losses. The ratio of profitable and loss making enterprises (at 64.5% and 35.5%, respectively) was close to shares in 2011 indicating that mostly large and medium companies increased losses.

In 2012, net profit was positive in most sectors, though its changes differ by sectors. Weak demand and low prices on external markets contributed to a decline in pretax net profit of industrial companies by 64.3% to UAH 20.9 bn. The largest decrease in net profits was



Source: IER

Impediments to banking, % of respondents

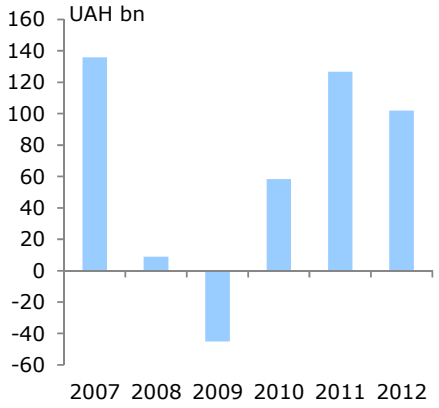
	Q1'12	Q3'12	Q4'12
Competition in the sector	70.6	81.8	40.0
Low demand	52.9	45.5	60.0
Unfavorable regulatory climate	41.2	45.5	50.0
Unfavorable political situation	29.4	27.3	50.0
Other	29.4	36.4	40.0
Tax pressure	5.9	9.1	10.0
Shortage of skilled employees	11.8	9.1	0.0
No impediments	0.0	0.0	0.0

Source: IER

observed in steel industry, chemical industry, and mining sector. A sharp drop in profit (at 43.9%) was also registered in trade, which might be attributed to increase in competition in the sector. Food industry was the only industry with significantly increased pretax profits in 2012 (see *Industrial output*).

Profits expanded substantially in professional services sector and in administrative services sector. Pretax profits in financial sector also increased due to improvement in the quality of bank loan portfolio (see *Financial results*). Profit growth in agriculture can be explained by higher prices for the main crops on the world market and absence of export restrictions (see *Agricultural output*). The amount of losses in construction sector fell significantly (from UAH 3.9 bn in 2011 to UAH 0.5 bn in 2012) despite a decrease in the amount of construction works.

Consolidated financial result of Ukrainian companies



Source: Ukrstat

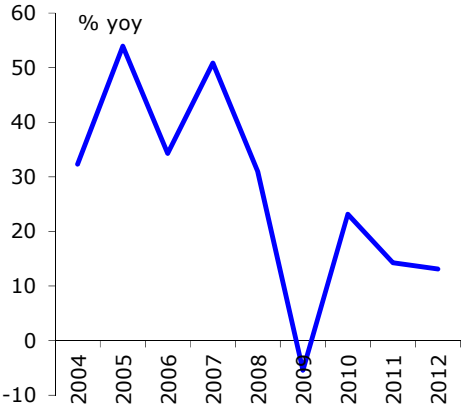
Monetary policy: Tight monetary conditions in the second half of 2012

In April 2012 the NBU council gathered for the first time in few years and approved NBU monetary policy in 2009, 2010 and 2011 as well as guidelines for monetary policy in 2012. Monetary policy guidelines for 2012 were quite vague. While they do mention the need for inflation below 7.9% in 2012 and growth of monetary base by 12-16% they are not very clear on the issue of exchange rate liberalization and operational issues of monetary policy.

De facto NBU continued to focus on maintaining exchange rate stability while monetary policy was subordinated to interventions on foreign exchange market and quasifiscal operations with government bonds. At the same time traditional refinancing operations remained severely limited. Where NBU supplied liquidity to banks it was through opaque repo operations, stabilization loans and extensions to loans issued in 2008 and 2009.

In 2012 NBU withdraw about UAH 60 bn through interventions on foreign exchange market and injected UAH 27 bn by buying government bonds. Government also injected liquidity by converting foreign currency borrowing in national currency and by spending almost all funds on government account at NBU by the end of the year. NBU also supplied refinancing mostly to government-owned banks. This allowed monetary base to increase by 6.4% in 2012 to UAH 255 bn.

Money supply (M2)



Source: NBU

Still monetary base was lower than in December 2011 for the most part of the year and NBU tightened reserve requirements to banks in 2012. Reserve requirements for deposits in national currency remained zero while reserve requirements on long term foreign currency deposits and external borrowing increased to 3% from 2%. Reserve requirements on short term deposits in foreign currency went up to 9% from 7.5%. As a result required reserves increased from UAH 15 bn to UAH 20 bn.

Overall monetary conditions were extremely tight in the second half of 2012 as interbank lending rates in national currency averaged at over 17% p.a. with peak rates in October and November exceeding 40% p.a. Nominal lending and deposit rates also went up with deposit rates for households topping 20% p.a. even as observed inflation was almost non-existent throughout year and expected inflation returned to single digits in the second half of 2012.

Money supply growth slowed to 12.8% in 2012 but money supply grew faster than monetary base as monetary multiplier increased. Share of cash outstanding in money supply steadily decreased over the year fell to 26.3% in December 2012 from 28.1% in December 2011. This probably reflected increased opportunity costs of holding cash.

In sum, the monetary conditions were tight in 2012 in particular in the second half of the year inhibiting lending and economic growth.

Inflation: Consumer inflation close to zero in 2012

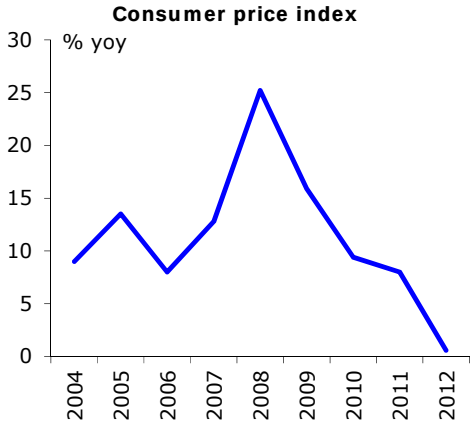
In 2012 average consumer inflation slowed to 0.6% as compared to 8.0% in 2011. Food prices fell by 3.1% subtracting 1.5% from inflation. Prices for alcohol and tobacco increased by 7.5% reflecting reliance of government on excise taxes as revenue source. Price of gas and transport services jumped by 10% despite almost no change in average oil prices. Prices for other items increased on average by 3.4%.

Decrease in food prices by 3.1% reflects comparatively good harvest (that was lower than record previous year but still high by historical standards) and improved storage infrastructure and restrictions on food exports in 2011. This led to dramatic fall in prices of vegetables and sugar (by 46% and 29% respectively) and limited increase in prices for other food items (by 3.0% on average).

On the demand side household consumption growth in nominal terms slowed down to 13.9% in 2012 from 26.2% in 2011 as a result of slowdown in income growth and high deposit rates. Banks increased lending to households significantly in 2012 as national currency consumption loans outstanding grew by 20% yoy and gross loans issued to consumers jumped by 31% (excluding credit card loans and loans over five years in maturity). However households also repaid more foreign currency loans issued before crisis. Inflation expectations also went down significantly and reached single digits.

Demand pressure on domestic inflation was ameliorated by increased share of imported goods in consumption. Retail sales of imported goods in 2012 jumped 25% while sales of domestically produced goods increased only by 10%. As a result average core inflation in 2012 slowed to crawl at 3.3%.

Supply side factors constrained price growth. Increased domestic fuel costs were more than offset by lower food costs. Government policy also contributed to low increase in CPI as government limited increases in utility prices and expanded efforts to control consumer prices through direct regulation. informal pressure and goods interventions. Efforts at price regulation contribute to price distortions and help cement low competition on many Ukrainian markets. Besides inefficient utility price subsidies increase fiscal pressure on central and local budgets.

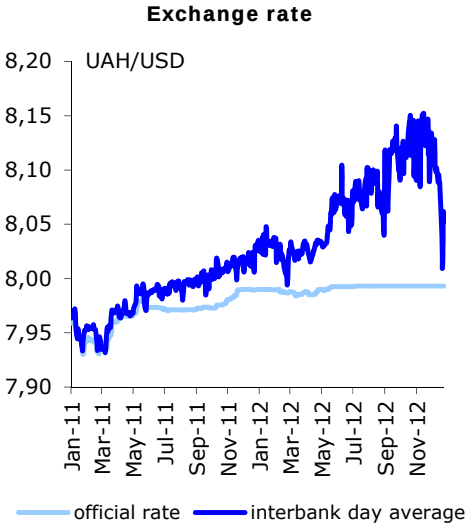


Source: Ukrstat

Exchange rate policy: Exchange rate was stable despite pressure

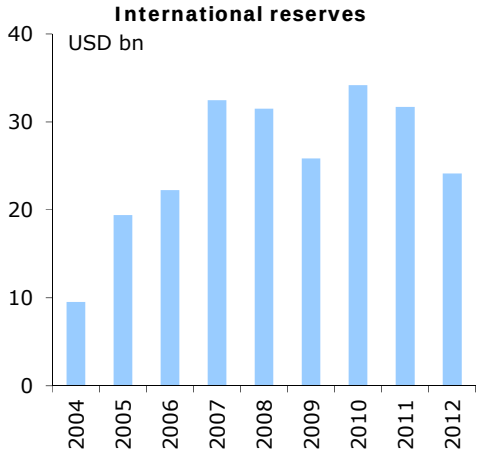
UAH/USD interbank exchange rate remained generally stable in 2012. It depreciated a little with average rate of UAH/USD 8.09 in December as compared to UAH/USD 8.03 in January. Over the year average rate was UAH/USD 8.07. Average daily exchange rate remained in narrow range of UAH/USD 7.99-8.15 or only 2% throughout the year with little day-to-day changes. The NBU continued interventions on the foreign exchange market as needed to preserve exchange rate stability and when pressure on the exchange rate increased in the second half of 2012 it also used administrative measures.

In the first half of 2012, foreign currency supply was almost balanced with demand. While export revenues were stagnant and access to foreign borrowing limited, inflow of FDI and loans related to Euro-2012 continued. Besides there were almost universal expectations that exchange rate is unlikely to change until elections in November. As a result USD 1.6 bn excess of supply over demand in cashless segment of the market was observed. Although net demand for foreign cash was moderate at USD 2.9 bn NBU still had to sell more foreign currency than to purchase. Net interventions were USD 1.3 bn although NBU didn't sell foreign currency in March and April. Exchange rate was in UAH/USD 8.00-8.04 range between January and April and weakened slightly to UAH 8.06-8.08 per USD in the next two months.



Source: NBU

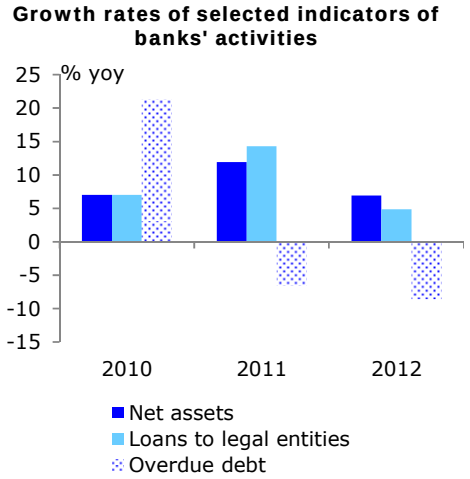
In the second half of the year, depreciation expectations increased due to coming Parliament elections (scheduled for November). This increased demand for cash foreign currency and supported imports even as import demand related to Euro-2012 subsided. Demand and supply on cashless segment of the market was still close to balance with total surplus of USD 1.0 bn over six months. However demand for cash foreign currency spiked at USD 7.2 bn. Contrary to expectations NBU decided to keep exchange rate more or less fixed even after elections. To keep exchange rate fixed NBU at first increased interventions and allowed exchange rate to weaken slightly. Overall net interventions in the second half of the year totalled USD 6.2 bn causing international reserves to drop below 3 months of imports.



Source: NBU

However, in November interbank market started to fragment as some participants hoarded foreign currency and different banks could pay widely different prices for exchange. In response NBU introduced administrative measures to control the market. First NBU rushed the draft law expanding its powers through parliament. Draft law was approved using express procedure on November 6 and president signed it on November 15. Than on November 16 new law was officially published and became effective. During the same day NBU approved resolution forcing exporters to obtain payment and repatriate export revenues within 90 days of exports and immediately sell 50% of export revenues repatriated to Ukraine. The resolution was registered in the Ministry of Justice on the same day (as opposed to usual lag of 7-30 days) and was published and became effective the next day. Also on November 16 draft law on taxing sales of cash foreign currency at 15% was introduced in Rada. Draft law foresaw grace period of 60 days after approval before tax kicked in and citizens could avoid the tax by keeping foreign currency on bank deposit for 30 days. Although draft law never came to vote and it was controversial even within ruling party it was widely publicized and discouraged demand for cash foreign currency. Administrative measures were very effective in restoring order in the market and NBU was able to decrease interventions in foreign exchange market significantly in December and exchange rate returned below UAH 8.1 per USD. At the same time in November average daily interbank exchange rate reached 8.15 with some banks paying UAH 8.20-8.30 for foreign currency.

Overall, NBU was able to maintain exchange rate peg in 2012 despite significant pressure. Success of administrative measures in supporting exchange rate probably points to significant speculative element in foreign exchange demand in the end of 2012.



Source: NBU

Financial markets: Healthier but still fragile banks

Banking. In 2012, the banking sector of Ukraine continued recovering from the 2008-2009 financial crises. Profits of Ukrainian banks went up since the overall quality of loan portfolio improved. The banks continued to increase deposits from households and legal entities, and reduced external debts. But the banks remain vulnerable to exchange rate fluctuations and to possible deterioration of loan quality. Moreover, bank lending slowed down substantially.

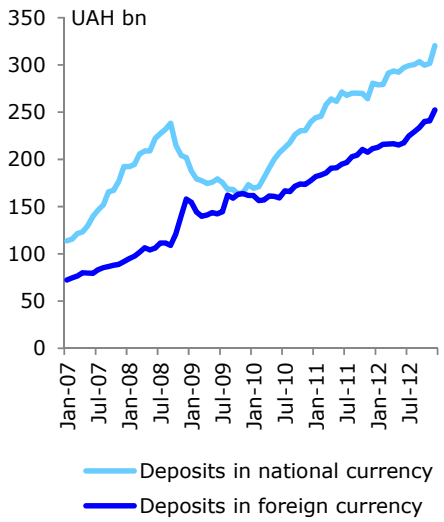
In more details, the positive trends were the following. First, banks' financial results improved as more banks reported profits. In 2012, 149 out of 175 Ukrainian banks posted pre-tax profits, including 12 out of 15 largest banks, while there were 133 profitable banks in the preceding year. Moreover, less banks reported huge losses: only 2 banks made losses exceeding UAH 500 m (in 2011, there were 7 such banks). As a result, in 2012, Ukrainian banks posted a total pre-tax profit for the first time since 2008 (in the amount of UAH 5.3 bn).

Second, the overall quality of loan portfolio somewhat improved. 63 banks that increased the amount of outstanding loans decreased loan loss provisions at the same time. In other 36 banks the provisions expanded at a slower pace than the amount of loans. In total, loan loss provisions contracted by 10.2% yoy. Their reduction was the

main reason for the increase in profitability of the banks. The quality of loans remained, however, poor. In 2012, the portion of overdue loans decreased by 0.7 p.p. to 8.9%. The share of non-performing loans was 13.8% in the third quarter of 2012 (compared with 15.3% in the same period of 2011)[xxxix].

Third, most banks increased deposits from households and legal entities, including 13 out of 15 largest banks. The overall bank deposits grew by 13.9% (compared with 19.4% growth a year earlier). The amount of household deposits increased by 19.1% due to higher interest rates and bigger people's confidence in banks. Growth of deposits from legal entities at 6.2%[xl] was primarily attributed to provision of a loan to state-owned companies by Chinese government under state guarantees (at the total amount of USD 1.5 bn). At the same time, the growth of deposits from legal entities was restricted by slowdown in economic activities. New deposits were, however, distributed not evenly among banks. Ten banks accounted for 76.9% of the net increase in deposits. Bank deposits increased their role in bank liabilities as total liabilities grew only by 6.5%.

Bank deposits

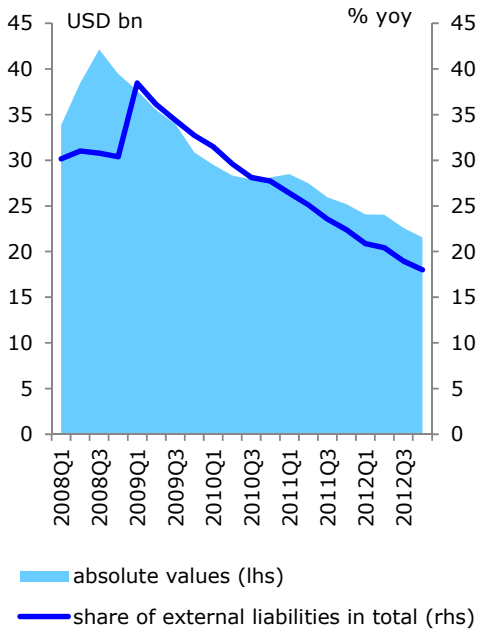


Source: NBU

However, there were several negative trends. First, bank lending slowed down. In 2012, net loans to legal entities and households grew only by 4.2% (compared with 9% a year earlier). 114 out of 175 banks expanded the amount of net outstanding loans. But the increase was distributed very unevenly: four banks accounted for 43% of the total amount of additional loans (among the banks that increased net outstanding loans). Five large banks with European capital decreased the amount of net loans substantially. Banks lent money mostly to trade companies, business services companies, and manufacturing firms. Mining, transport and communication companies expanded their share in the total credit portfolio too, while the sum of loans to construction companies contracted. The weighted average loan maturity decreased. The amount of short-term loans (less than 1 year) grew by 18.0%, the portfolio of mid-term loans (1 to 5 years) contracted by 3.8%, and the sum of long-term loans shrank by 7.7%.

Lower credit activity was due to several reasons, including tight monetary policy, high lending rates, and crowding out. In particular, banks increased investment in government bonds by 14.4% yoy. Besides, unfavorable external economic environment contributed to deterioration of financial results of Ukrainian companies, which resulted in lower demand for credits. In 2012 banks also repaid external debt, which decreased by 14.5%. As of January 1, 2013, the external debt was USD 21.5 bn — a half of the amount as of October 1, 2008.

Foreign liabilities of banking sector



Source: NBU

Second, banks remain vulnerable to fluctuations of the national currency exchange rate. Decline in external debt was more than compensated by increase in FX deposits and holdings of FX state domestic bonds. As of January 1, 2013, the share of liabilities in foreign currency was 52.3% — just 1 p.p. less than a year earlier. The foreign currency assets increased from 39.6% to 40.0% of total assets in the same period.

Third, the outlook for the performance of loans became more negative. The share of substandard loans increased from 23.5% (as of December 31, 2011) to 26.7% (as of December 1, 2012) due to worsening financial results of Ukrainian companies.

Fourth, an increase in rates on deposits had a negative impact on profits because banks could not raise lending rates correspondingly. Interest expenditures grew by 14.7%, while interest income increased only by 5.2%.

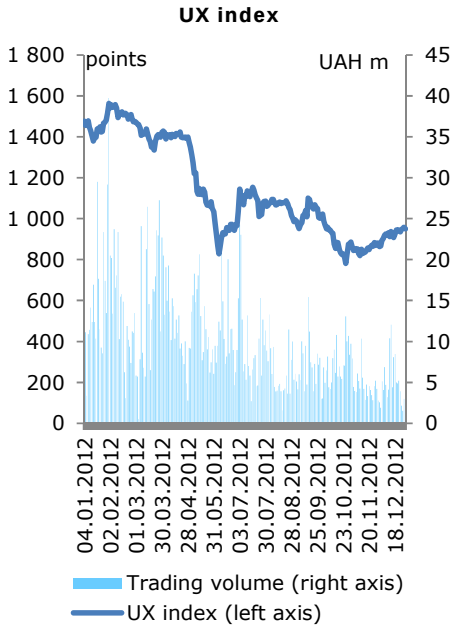
Stock market. In 2012, share prices on Ukrainian stock exchanges continued to fall. The Ukrainian exchange (UX) index plunged by 35.6% (to 950.6 points) throughout the year, and the PFTS Index went down by 39.9% (to 328.7 points). The downward trend was caused primarily by outflow of foreign investors, which were leaving Ukraine due to economic slowdown, worse financial results of

companies, and unsuccessful negotiations between the Government and the IMF. Negative expectations before the parliamentary election in October also contributed to the decline. In 2012, the average daily trade volume on the UX was UAH 9.8 m, which is six times less than in the preceding year (UAH 66.9 m).

The downward movement of share prices was not steady: there were also periods of correction, of which the lengthiest were between June and July and between October and December. The maximum of the UX index (1563.3 points) was on February 1, while the minimum (781.8) on October 25. In 2012, the total trade volume on the UX exchange was UAH 2.5 bn (UAH 16.7 bn in 2011).

In July 2012, the Parliament adopted the Law "On the depository system" (to be effective since October 2013)[xli]. The law makes provision for establishment of the single central depository and the single settlement organization for trade in shares in Ukraine. Both will be controlled by the NBU. Now there are two depositories that hold shares in Ukraine (a public one and a private one).

The law will have a negative impact on the Ukrainian stock market. First, the single settlement organization will in fact monopolize clearing services on the market. As a result, development of new stock exchanges' products will be limited and competition between stock exchanges will be hindered (because stock exchanges will be able to offer to their customers only the products that can be serviced by the single settlement organization). Second, the consolidation of settlement and clearing operations in one organization significantly increases the transaction non-fulfillment risk and makes risk management more difficult for investors. Third, the monopolization is likely to increase transaction costs for investors.



Source: ux.ua

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i According to the draft Energy Strategy of Ukraine up to 2030.

ii The difference in 37.6 TWh is explained by grid electricity losses that reached 19% in 2012.

iii According to NCER estimates such cross-subsidies reached almost UAH 35 bn in 2012.

iv The Law #5485 "On Introducing Changes to the Law of Ukraine "On the Electricity Sector" (regarding promotion of electricity production from renewable energy sources) as of November 29, 2012.

v The "local content" means a share of components of electricity facility (elements of the local content) of the Ukrainian origin used for construction of electricity facility and applies to electricity facilities, the construction of which has started after 01 January 2012.

vi Ukrstat

vii http://www.uz.gov.ua/contacts_feedback/faq/

viii http://www.uz.gov.ua/press_center/up_to_date_topic/327743/

ix http://zakon4.rada.gov.ua/laws/show/z1252-12

x http://zakon4.rada.gov.ua/laws/show/z1571-12

xi http://zakon2.rada.gov.ua/laws/show/z1901-12

xii http://zakon4.rada.gov.ua/laws/show/z1947-12

xiii http://zakon4.rada.gov.ua/laws/show/z2150-12

xiv http://zakon2.rada.gov.ua/laws/show/z0092-13

xv http://proit.com.ua/article/telecom/2013/03/21/133549.html

xvi According to iKS-Consulting data

xvii http://proit.com.ua/news/telecom/2013/02/26/143404.html

xviii http://zakon1.rada.gov.ua/laws/show/z1031-12

xix http://zakon4.rada.gov.ua/laws/show/4998-17

xx http://zakon2.rada.gov.ua/laws/show/z1466-12

xxi http://zakon4.rada.gov.ua/laws/show/z1856-12

xxii http://zakon4.rada.gov.ua/laws/show/za097-13

xxiii Note that remittances from migrants that remain resident in Ukraine as well as payments to freelance workers from foreign companies are accounted as income while remittances from migrants that established themselves abroad are counted as current transfers

xxiv Significant part of FDI stock is not attributed to any industry

xxv Monthly Economic Monitor Ukraine, No.11 (145), November 2012

[xxvi] Law of Ukraine, No. № 4282-VI, from December 22, 2011.

[xxvii] As negotiations failed, the 2012 Budget Law was based on the current gas price of USD 416 per thousand cubic meters.

[xxviii] However, central fiscal deficit was planned at UAH 25.1 bn or 1.7% of GDP.

[xxix] Individual entrepreneurs and companies with the gross annual income below UAH 20 m and the number of employees not exceeding 10 (for individual entrepreneurs) and 50 (for companies) may apply single tax in amount of 10% of gross income (if not paying VAT) or 7% of gross income (if paying VAT).

[xxx] In particular, profits derived from an eligible investment project in priority sectors will be taxed at 0% from 1 January 2013 through 31 December 2017; 8% from 1 January 2018 through 31 December 2022. Real estate and improvements of land used in the eligible investment project will be depreciated with the expedited depreciation method, which is currently available only for machinery and equipment. Equipment of such companies will be exempted from customs duties.

[xxxi] From the 1st of 2013, taxpayers with annual income exceeding UAH 10 m will be obliged to pay EPT in advance on a monthly basis in the amount not less than 1/12 of the last year tax.

[xxxii] At the same time, deposit certificates, shares in private joint-stock companies, shares in limited liability companies, securities issued by non-residents, State securities are tax exempt. 0% rate applies to transactions carried through a stock exchange.

[xxxiii] Law of Ukraine 'On Amending the Budget Code of Ukraine' No.5428-VI, from October 16, 2012.

[xxxiv] Law of Ukraine, No.5515-VI, from December 6, 2012.

[xxxv] Monthly Economic Monitor Ukraine, No.11 (145), November 2012

[xxxvi] According to the IMF estimate.

[xxxvii] According to the NBU.

[xxxviii] Report on work of the State Property Fund of Ukraine in 2012

[xxxix] http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/15369/Prospectus%20-%20Standalone%20302601.PDF

[xl] Financial Statistics of Ukrainian Banks, http://www.bank.gov.ua/control/uk/publish/category?cat_id=64097

[xli] The law # 5178-VI was approved by the Parliament on July 6, 2012.

National accounts		Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
GDP	UAH bn	214.1	250.3	259.9	217.3	256.8	301.3	307.3	257.7	311.0	369.8	363.6	293.5	349.2	387.6	378.6
GDP (real)	% yoy	-17.3	-15.7	-6.7	4.5	5.4	3.3	3.7	5.1	3.9	6.5	5.0	2.2	3.0	–1.3	–2.5
Household consumption (real)	% yoy	-14.5	-14.3	-16.2	0.2	6.8	7.8	12.8	13.2	14.2	16.1	18.5	8.6	15.7	14.0	6.9
State consumption (real)	% yoy	-1.6	-4.3	-3.7	3.8	-4.0	5.8	10.0	2.0	2.9	-9.4	-6.6	0.9	2.7	7.9	–1.3
Gross fixed capital formation (real)	% yoy	-55.9	-53.2	-33.7	-5.7	-3.2	9.5	10.5	-1.8	3.7	9.7	12.0	12.3	16.2	–6.9	–7.5
Exports of goods and services (real)	% yoy	-34.1	-30.9	6.9	0.4	13.2	2.0	0.9	19.4	4.9	0.3	-4.1	–8.2	–9	–4.9	–8.7
Imports of goods and services (real)	% yoy	-52.3	-47.6	-11.1	-6.2	17.2	20.2	13.2	38.1	23.3	12.5	5.2	–2.3	9.9	4.2	4.0
Agriculture, hunting, forestry (real)*	% yoy	3.4	2.2	-11.6	5.4	0.5	-3.2	0.9	4.9	1.3	16.7	38.1	0.4	11.3	-8.4	–3.9
Manufacturing industry (real)*	% yoy	-26.1	-25.6	6.5	10.9	10.1	7.6	7.6	7.8	3.4	4.6	-2.9	–0.1	–0.1	-6.1	–7.2
Construction (real)*	% yoy	-42.7	-43.6	-32.8	-7.7	-5.8	9.6	3.9	1.7	10.9	0.1	2.0	–3.4	–0.2	-15.1	–12.2
Trade, repair services (real)*	% yoy	-15.7	-22.0	-16.4	6.1	9.6	10.1	4.7	9.8	2.8	6.1	3.0	5.1	6.8	3.5	0.3
Transport (real)*	% yoy	-9.2	-5.7	-0.4	1.3	1.8	3.0	0.1	10.2	7.9	5.7	11.1	3.7	3.8	–1.8	–1.5
Balance of payments																
Current account balance	USD bn	-0.2	-0.1	-0.9	0.0	0.5	-1.0	-2.5	-1.6	-1.7	-2.6	-4.4	-2.0	-3.8	-4.1	-4.9
Current account balance	% of GDP	-0.6	-0.2	-2.7	-0.1	1.6	-2.6	-6.5	-4.9	-4.4	-5.6	-9.5	-5.6	-8.7	-8.5	-10.3
Trade balance in goods	USD m	-622	-1396	-1407	-1236	-697	-2870	-3585	-3084	-2267	-3928	-4526	-3895	-5622	-5252	-5833
Trade balance in services	USD m	432	1256	550	930	1115	1536	823	1007	1227	1686	967	1366	1413	1946	1084
Current transfers	USD m	667	640	722	608	728	797	842	1039	878	988	803	672	785	765	711
Direct investment (FDI)	USD m	1279	1210	1282	923	1196	1470	2170	882	2284	2100	1275	1663	1102	2152	1871
Portfolio investments	USD m	-351	-2286	1428	-307	804	2532	1288	1163	1838	-938	-506	222	-369	2890	339
Gross international reserves	USD bn	27.3	28.2	26.5	25.1	29.5	34.7	34.6	36.4	37.6	35.0	31.8	31.1	29.3	29.3	26.8
Exchange rate (interbank), UAH/USD	aop	7.76	7.99	8.06	8.00	7.91	7.90	7.96	7.95	7.98	7.99	8.01	8.03	8.04	8.09	8.11
Exchange rate (official), UAH/USD	aop	7.66	7.82	7.99	7.99	7.91	7.90	7.93	7.94	7.97	7.97	7.98	7.99	7.99	7.99	7.99
Fiscal indicators																
Consolidated fiscal revenues	% of GDP	30.6	25.5	36.0	30.9	30.4	23.3	32.3	32.8	30.0	29.5	30.7	33.6	31.6	28.2	33.7
Personal income tax	% of GDP	5.3	4.4	4.7	4.9	4.8	4.4	4.8	5.0	4.8	4.2	4.7	5.1	4.9	4.4	5.0
Enterprise profits tax	% of GDP	3.3	3.7	3.6	4.3	3.0	3.4	4.2	4.5	4.5	3.6	4.4	4.9	4.1	2.9	4.2
Value-added tax	% of GDP	8.3	6.4	11.0	9.8	9.8	8.5	9.9	7.6	12.9	9.6	9.6	10.8	10.3	8.6	10.0
Excise tax	% of GDP	2.3	2.5	2.6	2.4	3.0	2.5	2.6	2.1	3.0	2.7	2.4	2.8	2.9	2.8	2.4
Consolidated fiscal expenditures	% of GDP	36.6	29.6	34.5	33.0	38.7	30.3	37.6	32.8	33.1	26.9	35.6	33.7	33.8	30.7	41.4
Current expenditures	% of GDP	34.9	27.0	31.4	32.4	37.4	26.6	32.8	31.5	30.8	23.9	30.1	31.8	31.3	27.7	37.4
Capital expenditures	% of GDP	1.7	2.6	3.1	0.6	1.4	3.7	4.8	1.3	2.4	3.0	5.5	1.9	2.4	2.9	4.0
Consolidated fiscal balance	% of GDP	-6.2	-4.5	1.1	-2.0	-8.0	-7.5	-5.6	-0.3	-3.4	-3.9	-5.5	-0.2	-2.6	-3.0	-7.8
Privatisation receipts	% of GDP	0.2	0.1	0.0	0.1	0.0	0.1	0.2	0.4	3.2	0.0	0.1	1.4	0.3	0.1	0.4

Sources: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, Reuters, IER estimates
* change in value added
[e] preliminary NBU estimates for balance of payments

Key Economic Indicators		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Nominal GDP	UAH bn	170.1	204.2	225.8	267.3	345.1	441.5	544.2	720.7	948.1	913.3	1082.6	1302.1	1408.9
Nominal GDP	USD bn	31.3	38.0	42.4	50.1	64.9	86.2	107.8	142.7	179.9	117.2	136.4	163.4	176.3
GDP growth (real)	% yoy	5.9	9.2	5.2	9.6	12.1	2.7	7.3	7.9	2.3	-14.8	4.1	5.2	0.2
Industrial production	% yoy	13.2	14.2	7.0	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	11.2	7.3	-1.8
Agricultural production	% yoy	9.8	10.2	1.2	-11.0	19.7	-0.1	0.4	-5.2	17.5	0.1	-1.0	17.5	-4.5
CPI	% yoy aop	28.2	12.0	0.8	5.2	9.0	13.5	9.1	12.8	25.2	15.9	9.4	8.0	0.6
CPI	% yoy eop	25.8	6.1	-0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2
PPI	% yoy aop	20.9	8.6	3.1	7.6	20.5	16.7	9.6	19.5	35.5	6.5	20.9	19.0	3.7
PPI	% yoy eop	20.8	0.9	5.7	11.1	24.1	9.5	14.1	23.3	23.0	14.3	18.7	14.2	0.3
Exports (gs, USD)	% yoy	17.9	9.5	10.7	24.0	42.6	7.5	13.2	27.5	33.8	-36.7	27.1	28.2	1.0
Imports (gs, USD)	% yoy	18.9	14.1	4.9	28.7	31.3	20.4	22.0	35.5	38.6	-43.1	29.3	33.8	5.6
Current account	USD bn	1.5	1.4	3.1	2.9	6.9	2.5	-1.6	-5.3	-12.9	-1.9	-2.9	-9.3	-14.8
Current account	% GDP	4.7	3.7	7.6	5.9	10.6	2.9	-1.5	-3.7	-7.2	-1.7	-1.7	-5.6	-9.0
FDI (net)	USD bn	0.6	0.8	0.7	1.4	1.7	6.5	5.3	9.2	9.9	4.5	5.7	6.6	6.6
International reserves	USD bn	1.5	3.1	4.4	6.9	9.7	19.4	22.4	32.5	31.5	26.5	36.7	31.8	31.4
Fiscal balance'''	% GDP	-0.7	-1.9	0.8	-0.2	-3.0	-1.9	-0.7	-1.1	-1.5	-2.4	-6.0	-1.8	-3.6
Total state debt	% GDP eop	45.3	36.5	33.5	29.0	24.7	17.7	14.8	12.5	19.9	33.0	39.9	36.0	37.4
External state debt (total)	% GDP eop	33.0	26.3	24.1	21.4	18.6	13.4	11.7	9.8	15.0	21.5	25.6	22.8	22.0
Monetary base	% yoy eop	39.9	37.4	33.6	30.1	34.1	53.9	17.5	46.0	31.5	4.4	15.8	6.3	6.4
Exchange rate	USD aop	5.44	5.37	5.33	5.33	5.32	5.12	5.05	5.05	5.27	7.79	7.94	7.97	7.99
Exchange rate	USD eop	5.44	5.30	5.33	5.33	5.31	5.05	5.05	5.05	7.70	7.98	7.96	7.99	7.99
Exchange rate	EUR aop	5.03	4.81	5.03	6.02	6.61	6.39	6.34	6.92	7.71	10.87	10.53	11.09	10.27
Exchange rate	EUR eop	5.10	4.67	5.53	6.66	7.22	5.97	6.65	7.42	10.86	11.68	10.57	10.54	10.30

Sources: Ukrstat, NBU, Ministry of Finance, own calculations
''' "Minus" denotes a consolidated fiscal deficit; without recapitalisation

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INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING PRODUCTS

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The MEMU contains a monthly review and brief analysis of the key economic policy measures and data that come public during the previous month. The MEMU supplement presents extended analysis of one key event in the Ukrainian economy. There are 12 issues per year disturbed among subscribers.

Macroeconomic Forecast of Ukraine (MEFU)

The MEFU includes forecast of the GDP and its components, fiscal indicators, balance of payments, inflation, exchange rate for current and next years. There are 12 issues per year – 4 quarterly issues and 8 updates with short comments – disturbed among subscribers.

Infrastructure Monitoring of Ukraine (IMU)

The IMU is an annual report that presents information on the restructuring of six key infrastructure sectors of the Ukrainian economy in a standardized manner, which allows for cross-industry comparisons. Monitored indicators are qualitative and fall into three broad categories: (1) commercialisation, (2) tariff reform, and (3) regulatory and institutional development. Twenty-one indicators allow for economic and policy-making analysis at different aggregation levels. It is distributed free of change.

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Policy Papers

The policy papers are the joint product of the German Advisory Group for Economic Reforms in Ukraine and the IER aimed at providing economic policy recommendations to Ukraine's policy makers. The recommendations are based on the careful analysis of Ukraine's situation, state-of-the-art economic theory, and best international practices. The papers are available for policy makers and – with some time lag – for general public.

Notes:

avg average
cum. cumulative
mom month on month change
qoq quarter on quarter change
yoy year on year change
ytd year-to-date
p.a. per annum
eop end of the period
aop average of the period
gs goods and services