YEAR 2006: ECONOMIC SUMMARY FOR UKRAINE

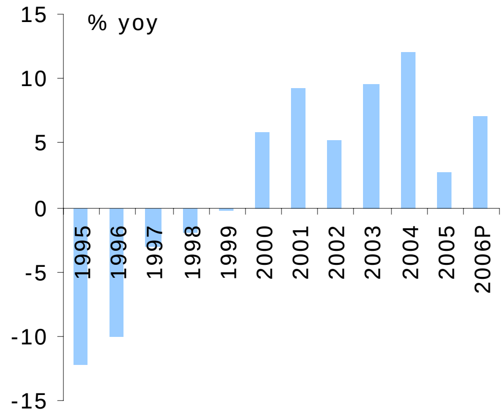
- In 2006 real GDP grew by 7.1% due to increased domestic demand.
- Investment activity revived in 2006 despite political turmoil.
- The industrial production increased by 6.2% as metal production and machine building growth accelerated.
- Government increasingly used the non-tariff barriers on both exports and imports of agricultural products.
- Tariffs for infrastructure services sharply increased during the year due to higher imported gas price.
- The current account balance was negative at USD 1.6 bn or 1.5% of GDP for the first time since 1998.
- Ukraine did not join the WTO in 2006, though it made a significant progress in negotiations.
- The access to the US market improved as the USA restored GSP benefits for Ukraine and cancelled Jackson-Vanick amendment.
- Strong growth of household incomes and consumption credits supported the consumption boom in the country.
- The central fiscal deficit was 0.9% of GDP in 2006 and is planned at 2.6% of GDP in 2007.
- Social standard indicators are to increase in 2007 but at a lower rate.
- The Pension Fund budget is planned to be balanced in 2007.
- Low privatisation receipts in 2006 raise concerns regarding success of the privatisation plan for 2007 set at ambitious UAH 10.6 bn.
- Ukraine turned to borrowing to cover the fiscal gap.
- Consumer prices increased by 11.6% eop.
- The growth of money aggregates somewhat decelerated.
- Profits of commercial banks sharply increased.

Population: 46.7 m
Industry/GDP: 26%
Agriculture/GDP: 8%
Investment/GDP: 24%
Exports to: Russia 23%, EU 28%
Imports from: Russia 31%, EU 35%

GDP: Real GDP increased by 7.1% in 2006 backed by domestic demand growth

According to the preliminary estimate of the Derzhkomstat, in 2006 real GDP increased by 7.1%, significantly accelerating during the year. In January the growth was estimated at mere 0.9% yoy. In nominal terms, the GDP is estimated at around UAH 536 bn, or USD 106 bn.

Real GDP Growth



Source: Derzhkomstat
P - preliminary estimate

The acceleration of economic growth could be explained by a recovery of investment activity (see *Investments*), continued growth in household consumption, and gradual improvement of external demand (see *Balance of payments*), in particular, due to favourable trends on the world metal market. Also, there was a growth of external demand for Ukraine's machinery, particularly in the CIS countries (see *Commodity trade*).

The important feature of 2006 was continued growth of household consumption that was estimated at 18.8% yoy during the nine months of the year, while the preliminary annual figure is 14.2% yoy. Overall real household consumption more than doubled since 2000. This explosion has been supported by high growth rates of incomes (see *Wages and incomes*) and rapid expansion of household credits (see *Banking*). The fastest growing components of consumption were clothing and shoes (33.2% yoy between January and September), and services, particularly "rest and culture" (35.0% yoy). The increased demand for services stimulated domestic production, reducing sensitivity of Ukraine's economic growth to volatility of the world market.

On supply side, the major driving forces for value added growth were industry (see *Industrial output*) and services, especially trade and

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transportation. In particular, value added in trade grew by 17.7% yoy in contrast with the reduction in 2005. Also, since February 2006 growth in construction value added turned positive thanks to business investments and upsurge in residential construction. At the same time, value added in agriculture stayed close to zero as low wheat harvest counterweighted decent harvest of other crops and growing animal breeding production.

The growth rates of real GDP in 2006 significantly exceed estimates done during the year. It is mainly explained by higher than expected resilience of the economy to imported gas price shock. The mismatch between estimated and actual figures could be attributed to increased world prices for metals and chemicals that partially compensated for the shock, and high initial capacity for energy saving. However, the further capacity of the Ukrainian economy to sustain the shock remains unknown.

Investments: Investment activity revived despite political turmoil

According to the Derzhkomstat, investments in fixed capital increased by 16.1% yoy in the nine months of 2006 compared to a 3.4% yoy growth a year ago. The acceleration of investment activity could be attributed to a pressing need for investments in new technologies as enterprises faced tougher international competition and growing energy prices. Also, booming domestic consumption created ample opportunities for development of the service sector. Thus, the acceleration occurred despite the political turmoil this year, indicating weakening relationship between economic and political activities in the country.

Services accounted for most investments and attracted 51.4% of all fixed capital investments, followed by industry (38.4%). Thus, services tend to outbid the industry in attracting investments.

The highest growth of investments was registered in fishery at 85.9% yoy (though, from the very low base) and in transport equipment trade and repair at 74.7% yoy. In the latter, investments were stimulated by exceptionally high demand for passenger cars registered in Ukraine in 2006 (see *Commodity trade*).

In addition to improved domestic investment activity, Ukraine managed to attract high FDI inflows in 2006 (see *Balance of payments*), particularly in the banking sector (see *Banking*). It is expected that the presence of foreign banks would stimulate the investments in other sectors of the economy as well, as foreign investors seem inclined to operate with familiar financial institutions.

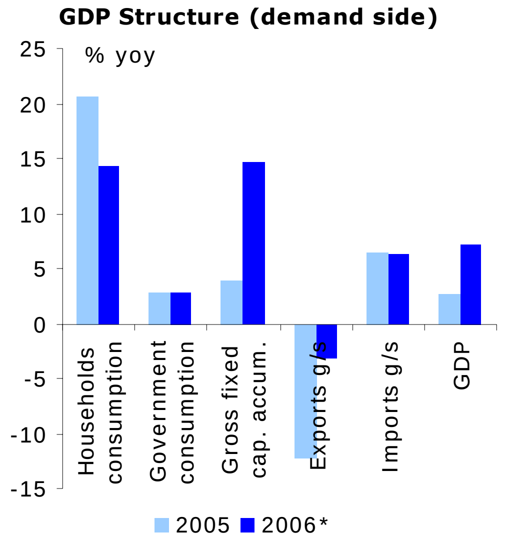
Thus, despite slow structural reforms and political confrontations, investment activity intensified, brightening the prospects of future economic growth.

Industrial output: Production increased despite a slow start

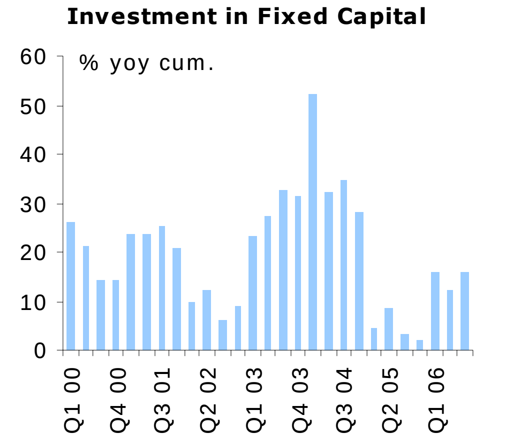
According to the Derzhkomstat, in 2006 industrial production increased by 6.2%, despite a drop in the first two months of the year.

The growth was registered in almost all branches of the industry, especially in metallurgy and machine building. The metallurgy grew by 8.9% against 1.5% reduction a year before, and the machine building growth accelerated to 11.8% in comparison with a 7.1% increase in 2005. High growth rates in these industries are explained by increased external and internal demand, including restored investment activity (see *Investments*), reflected in purchases of new equipment and machinery, as well as construction.

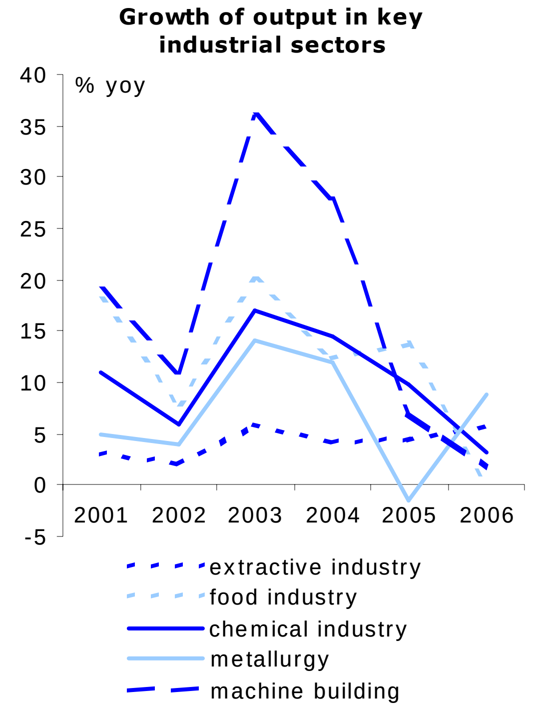
Only two branches showed an overall reduction: production of coke and petroleum-refining, and light industry. Coke production and petroleum-refining decreased by 12.1%, continuing the negative trend started in 2005 partially due to state interventions, e.g. introduction of non-tariff barriers on exports. Lower growth rates in light industry are related with lower output in textile manufacturing



Source: Derzhkomstat
* preliminary figures provide by the Derzhkomstat



Source: Derzhkomstat



Source: Derzhkomstat

that dropped by 4.8% likely due to reduced volumes of give-and-take row material transactions.

The extraction industry's output increased by 5.8% yoy. In particular, iron ore extraction boosted due to high demand by Ukrainian metallurgy.

Food industry grew by 10.0%. In particular, production of oils, sugar, meat, and tobacco increased, while output of cereals, flour and dairy products dropped. In general, sector benefited from growing domestic demand. However, the ban on exports of animal-related products to Russia (see *Agricultural policy*) had negative impact on sector's development.

Woodworking industry's output increased by 13.9% due to renewed activity and modernization of equipment in this business, especially in Western region of Ukraine where this branch is traditional.

Agricultural policy: Markets faced increased non-tariff barriers on both exports and imports

Grain. In October 2006 the Government introduced binding export quotas for wheat, barley, corn and rye until the end of the year[i], while in December grain export quotas were extended for the rest of the 2006/2007 marketing year, limiting total grain export to 1.2 m tons. The Government made this decision despite serious warnings of various domestic and international observers about significant negative consequences of such a step. In February, the Government finally lifted export quotas for barley and corn, but left wheat and rye export quotas untouched.

The economic costs of this policy for Ukraine are high. The ultimate impact was the reduction in farm gate prices and farm income, as traders rolled costs of increased uncertainty and revenue losses to farmers. Although grain processors, compound feed producers, and pig and poultry producers benefited from lower farm-gate prices and more grain in the short run, this benefit came at the expense of crop farmers and traders. Additionally, market transaction cost has been increasing. Thus, this measure is welfare-reducing and overall makes the country poorer.

The most important consequence is that in the long run these measures had sent a clear message to the rest of the world that in one year investors can lose more than they have earned in many years before. The result would be reduced investments, less efficient marketing systems than would otherwise be and, hence, lower grain prices for the farmers.

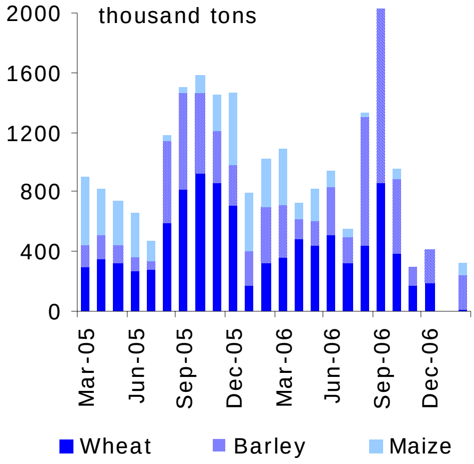
Moreover, the procedures for receiving quotas are not transparent increasing the risk of corruption. It also contradicts market competition principles, since 80% of the quota was to be allocated to traders with more than 3 years experience on Ukraine's grain market.

Dairy and Meat. In January Russia banned imports of Ukrainian livestock products. This decision significantly harmed Ukraine's dairy production, inflicting losses to both dairy industry and raw milk producers. The formal reason for banning livestock products' exports was violations of Russian veterinary legislation by Ukrainian meat exporters. However, it remained unclear why this ban has been extended to dairy products instead of tackling meat products directly, as no complaints on dairy products were filed.

Russia has traditionally been the largest export market for Ukraine's dairy industry, accounting for 64% of the entire Ukraine's dairy export in 2005. Moreover, Russia dominated in consumption of Ukrainian cheese, and Ukrainian companies had a market share of about 50% of the Russian cheese market.

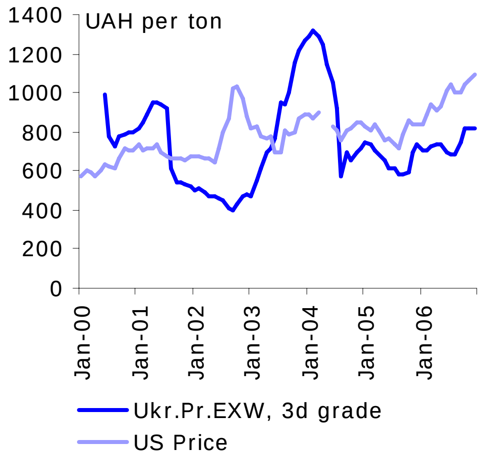
The loss of the Russian market was especially painful as low quality of raw milk supplied to dairy plants and incompliance of Ukrainian standards with international ones hampers dairy exports to Western countries. Despite clear negative consequences for the dairy industry, the conflict should provide momentum for improving

Ukraine's export of barley, maize and wheat



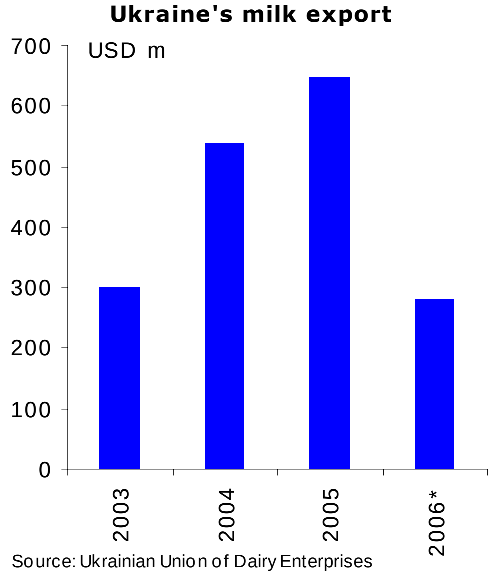
Source: Ukragroconsult

Wheat prices on the world and domestic markets



Source: APK-inform

Ukraine's milk export

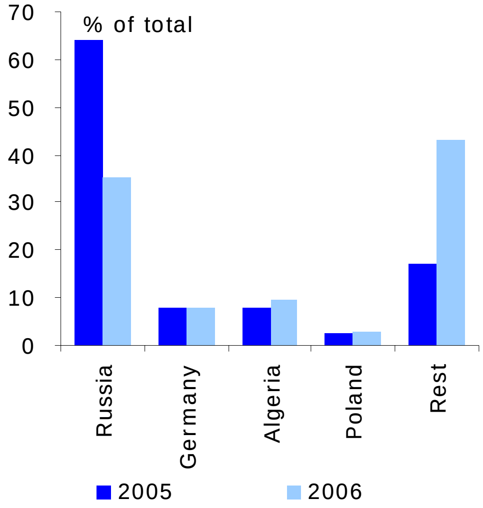


Source: Ukrainian Union of Dairy Enterprises
* preliminary data

industry's efficiency and competitiveness. Diversification of export markets could prevent significant losses in such situations.

In October 2006 two sides came to an agreement that seemed to solve the conflict. A list of Ukrainian companies was agreed to be inspected by Russian veterinary inspection services. However, due to non-transparency and a lack of information on the resolution process, it remained unclear whether and when all Ukrainian dairy and meat producers would receive the permissions from Russian side.

Structure of Dairy Export in 2005-2006



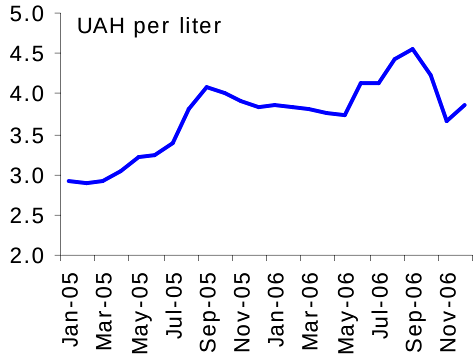
Source: the Ministry of Agrarian Policy

Farmland Markets. The Parliament once again extended moratorium on farmland sales until January 1, 2008 by overcoming the President's veto. The official justification was the lack of relevant legislation for the emerging farmland market. Although this statement is correct, it has to be noted that this justification for such a measure has been used for the fourth year in a row and little effort was made to work out and approve the necessary legislation for land markets, cadastre and land registration. There is no guarantee that a similar situation would not happen in 2007. The farmland sales moratorium has negative economic consequences, since it reduces investments, prevents movements of land from less to more efficient farmers and the development of rural financial markets. It is thus reducing overall efficiency and competitiveness of the sector. Also, the moratorium lowers incomes for rural households and local budgets, and shadow farmland markets leaving the land undervalued and violating the constitutional right of rural inhabitants to utilize their property freely.

Energy policy: Gas price significantly increased in 2006 and continued growing in 2007

Gas. In early 2006 "Gazprom", "Naftogaz Ukrainy" and "RosUkrEnergo" signed the agreement concerning Russian gas supply and conditions of its transit over the Ukrainian territory for the first half of 2006. The most notable points of the agreement included setting the transit fee over the Ukrainian territory at USD 1.6 per 100 km per thousand cubic meters (tcm) to be paid in cash (previously USD 1.09 paid in barter gas), fixing the price of gas for Ukraine at USD 95 per tcm at the Russian-Ukrainian border, and establishing joint-stock company "UkrGasEnergo" by RosUkrEnergo and Naftogaz Ukrainy. The new company was created to sell gas to the industrial consumers in Ukraine.

Retail petroleum price (A-95) in Kyiv

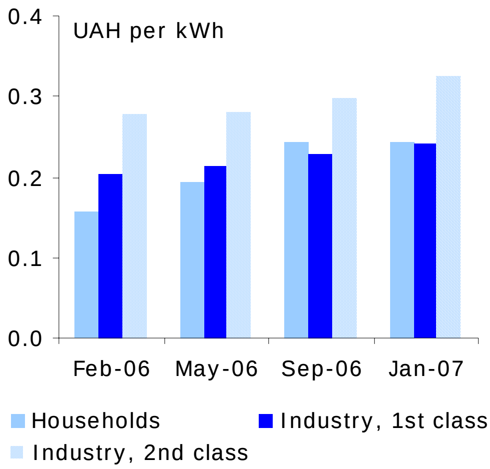


Source: Energobusiness, 'Psycheya'

Later the Antimonopoly Committee limited the share of UkrGasEnergo to 5 bn cubic meters (bcm) of gas, explaining that UkrGasEnergo exceeded critical market share of 35%. The Cabinet of Ministers adopted a price ceiling for gas sold on the Ukrainian market at USD 110 per tcm net of VAT and distribution costs to protect consumers from price hikes.

The January agreement set the price only for the first half of 2006, but afterwards RosUkrEnergo and UkrGasEnergo achieved two more agreements on gas supply to Ukraine at USD 95 per tcm at the border expanding the term till the end of 2006. The preservation of the imported gas price had positive short run impact, as provided more time for companies to adjust to the price shock and invest in energy-saving technologies.

Electricity tariffs for different groups of consumers



Source: NERC

In 2007 Ukraine will receive up to 62 bcm, but not less than 55 bcm of imported gas at a price not higher than USD 130 per tcm at the Russian-Ukrainian border. Such an agreement was signed between RosUkrEnergo and UkrGasEnergo in October 2006. That meant 37% growth in border price for gas for Ukraine. However, this price is still behind prices paid by Ukrainian neighbours, e.g. Poland, and very likely that it is below the cost incurred by RosUkrEnergo.

Petroleum. Reacting to growth of world oil prices, the government tried to control growth of domestic petroleum prices. However, no explicit regulations were introduced. Indeed, in August 2006 the Memorandum on partnership between the Cabinet of Ministers and the biggest players on the oil and oil products market was signed, which foresaw mutual obligations regarding pricing policy making, conditions of sustainable market development, modernization of oil-refineries and improvement of oil products quality. In December the Ministry of Fuel and Energy introduced the pricing formula for oil products that used average weighted world price (Platts) for diesel oil and knock-free petroleum for the previous 30 days as a benchmark. Although the consequences of the formula's introduction remain to be seen, its positive feature is that market operators took part in formula development reducing the level of potential dissatisfaction with the formula.

Infrastructure: Tariffs for infrastructure services sharply increased during the year

The external shock – more than a 60% increase in price for imported gas in 2006 – made flat tariffs in infrastructure not feasible anymore and stimulated changes. In April 2006 electricity tariffs for population covered only 36% of its generation and distribution costs. Low household tariffs were compensated by higher prices for industrial consumers, creating an excessively high burden on industrial sectors.

The National Electricity Regulation Commission (NERC) decided to increase gas tariffs for all consumers except for industrial enterprises that faced growth of the same magnitude earlier. This became the first change in gas and electricity tariffs for households since 1999. Starting from May 1, gas prices for households were increased by 25%, and from July 1 additionally by 80%. Electricity tariffs for households were also increased by 25% from May 1 and again by 25% from September 1. Tariffs are to be further increased by 25% each half a year until the cost-covering level expected to be reached in April 2008. These changes in tariffs pushed utility prices up as well.

During the year the government made some attempts to mitigate negative impact of tariffs change on poor households, so the gas tariffs for households were reduced by 22% starting November 1, 2006. In December the NERC approved differentiated tariffs introduced January 1, 2007 that depend on quantities consumed according to a 4-level schedule.

Also, in December the government simplified the procedure of receiving utility subsidies. According to a new procedure households became eligible for subsidies if their utility bill exceeds 20% of the their total household income. The decision is a positive step as it simplifies the access of low-income individuals to subsidies, although a large amount of shadow payments makes the procedure subject to abuse.

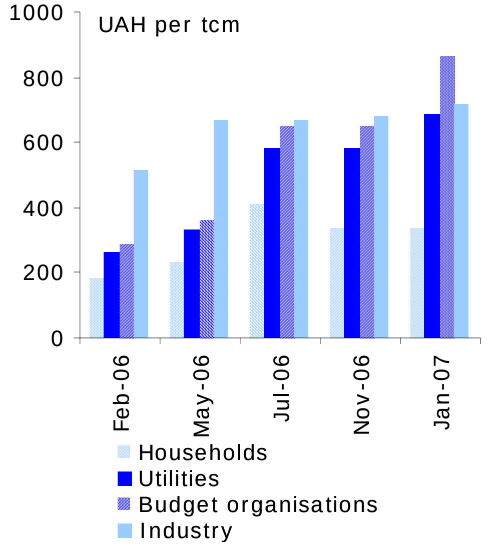
Tariffs for transportation and communication were revised as well. From June 2006 tariffs for domestic railway passenger travels were increased on average by 43%. In July 2006 the National Commission on the Telecommunications Regulation approved new tariff caps for telecommunication services. In particular, tariffs for domestic fixed line services were increased in two stages by 35% from July 15 and further by 15% since November 1. At the same time, international calls became cheaper thus creating an opportunity to increase the competitiveness of "Ukrtelecom" on this segment of the market.

Tariff revision contributed to reduction of cross-subsidization in infrastructural sectors, progressing structural reforms. However, the calculations of the cost covering tariffs and scope of the increases should be more transparent in order to convince the public in the justifiability of increases.

Balance of payments: Deficit of the current account was overwhelmingly covered by capital inflows

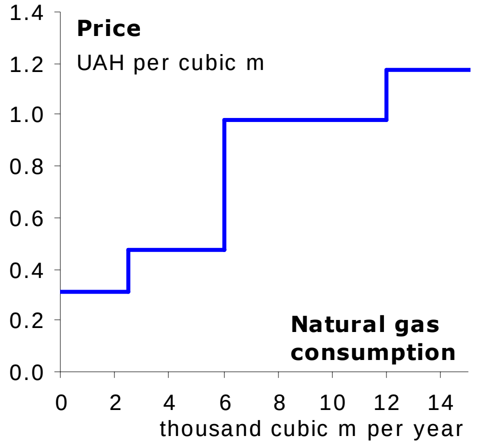
According to the National Bank of Ukraine (NBU), in 2006 the current account (CA) balance turned negative at USD 1.6 bn (1.5% of GDP) for the first time since 1998. In the third quarter the CA temporary improved and showed the surplus of USD 0.5 bn due to improved prices on the world market for metals and increased exports of travel

Gas prices for different groups of consumers



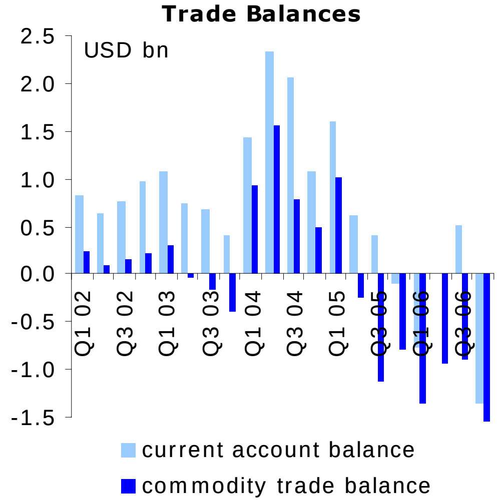
Source: NERC

Natural gas tariffs for households*



Source: NERC
Note: * for households that have installed gas meters

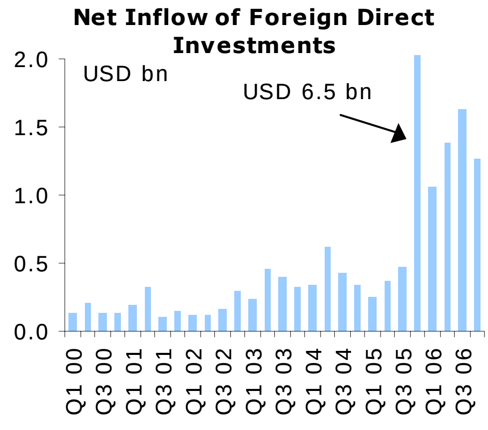
Current Account and Commodity Trade Balances



Source: NBU

services. The balance once again deteriorated in the last quarter of the year. The major reason for CA deficit was the negative commodity trade balance that reached USD 5.2 bn in 2006 compared to USD 1.1 bn deficit a year before (see *Commodity trade*).

In 2006 Ukraine experienced a sharp increase in the long-term financing inflows allowing adequate financing of the CA deficit. First, foreign direct investment (FDI) inflow reached USD 5.3 bn that is 2 times more than for the same period of 2005 if the privatisation of metal giant Kryvorizhstal is excluded. The capital was primarily directed into financial intermediation, real estate transactions, business services, and trade. FDI inward stock reached USD 22.7 bn as of the end of the year. As a result, the FDI per capita reached USD 487, although remained well below the average figure for economies in transition at around USD 1500. This gap emphasizes the potential for attracting more FDI in years to come if the investment climate is improved. Second, non-guaranteed medium- and long-term credits increased by USD 5.8 bn thanks to bank borrowings abroad. In addition, banks attracted short-term credits at USD 3.5 bn.



Source: NBU

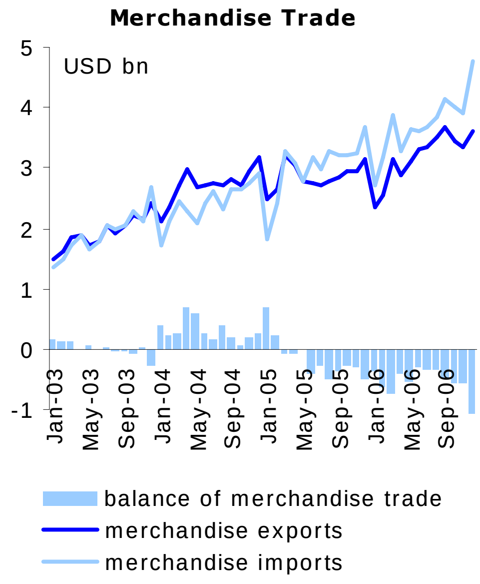
The inflow of primarily medium- and long-term capital was partially offset by outflow of short-term capital that stood at USD 10.9 bn in 2006. However, the balance of capital flows has not only allowed to cover the CA deficit, but also to increase the official reserves of the NBU by almost USD 2 bn.

Thus, the CA deficit in 2006 could be qualified as sustainable. First, it was to the large extent due to the increase in investment imports. Second, it was largely financed by the FDI, the most adequate form of deficit financing.

Commodity trade: Trade deficit sustained backed by fast growth of imports

According to the Derzhkomstat, in 2006 commodity exports increased by 12.1% yoy in dollar terms, while imports grew by 24.6% yoy. In nominal terms, exports constituted USD 38.4 bn, while imports were USD 45.0 bn. As a result, the deficit of commodity trade reached USD 6.67 bn compared with USD 1.9 bn a year before[ii]. The deficit could have been wider this year if no changes in trends had occurred. In particular, the growth rate of imports has decelerated during the year, while the growth rate of exports turned positive and accelerated.

Despite pessimistic expectations at the beginning of 2006, the sharp increase in gas price did not result in deterioration of exports, partially due to favourable prices at the world markets for metals and chemical products. After a drop in exports in the first quarter of 2006, they strongly revived later in the year. Apart from metals and chemical products, exports of machinery were growing quickly. In particular, exports of the overland transport equipment (excluding railways) increased by 62.4% yoy, to the large extent thanks to shipments for the CIS countries, particularly to Russia. Also, Ukraine expanded exports of electrical machinery and equipment by 39.5% yoy.



Source: Derzhkomstat

Among the factors that hampered the growth of exports was the ban on exports of meat and dairy products exerted by Russia (see *Agrarian policy*) and introduction of exports quota on grain by the Cabinet of Ministers in October 2006 (see *Agrarian policy*). Specifically, exports quotas led to 13.1% yoy drop in agricultural exports in the fourth quarter of 2006, according to the NBU.

Also, there were lower exports of mineral products, in particular ores and energy materials that declined by 12.7% yoy and 23.6% yoy respectively. This reduction is at least partially attributed to non-tariff regulations introduced to secure the supply of these products on domestic market (see *Trade policy*).

At the same time, increase in both investment and consumption components of domestic demand, as well as increased energy prices resulted in high growth of commodity imports that stably surpassed the growth of exports during the year. Two thirds of the total rise was due to growth in machinery and chemical product imports. In particular, surged demand for passenger cars led to 1.8 times increase in their imports.

Price increase in energy was partially counterweighted by a reduced amount of imports that dropped by 16.6% yoy for gas and 27% yoy for raw oil. As a result, energy imports increased by relatively moderate 19.2% yoy. A reduction in the amount of gas imports may indicate improved energy efficiency, though also a lower demand thanks to a mild winter. At the same time, low imports of raw oil are likely due to a decline in output of petroleum refineries. The revival of this industry in the fourth quarter of 2006 led to increased oil imports in the last months of the year.

The improved trade regime with the USA (see *Foreign economic relations*) boosted exports to Americas by 38.9% yoy. Exports to the CIS and Europe grew by 18.0% yoy and 16.1% yoy respectively, with the steady acceleration of shipments to the latter thanks to increased metal prices. Fastest growth of imports was from Europe (32.6% yoy) and Asia (30.7% yoy), the former thanks to high domestic demand for its machinery and equipment.

Commodity trade structure in 2006

	Merchandise exports in 2006		Merchandise imports in 2006	
	USD m	% yoy	USD m	% yoy
Total	**38367.7**	**112.1**	**45034.5**	**124.6**
I - Live animals, animal products	396.5	54.2	649.0	129.9
II - Vegetable products	1951.1	115.1	671.7	127.8
III - Animal or vegetable fats and oils and their cleavage	971.4	165.4	191.1	93.6
IV - Prepared foodstuffs	1394.4	108.0	1654.7	113.7
V - Mineral products	3871.8	82.3	13506.2	116.8
VI - Products of the chemical or allied industries	3387.3	113.4	3888.6	125.6
VII - Plastics, rubber and articles thereof	803.4	139.7	2527.7	130.4
VIII - Leathers, skins and articles thereof	306.6	145.6	136.3	122.6
IX - Wood and articles thereof	603.1	113.0	265.0	132.6
X - Pulp, paper, paperboard and articles thereof	596.2	131.2	1173.3	116.9
XI - Textile and textile articles	915.3	100.2	1365.5	97.1
XII - Footwear, headgear, umbrellas	130.2	120.9	269.4	96.4
XIII - Articles of stone, plaster, cement, asbestos, glass	255.5	116.9	738.1	143.0
XIV - Precious and semi-precious stones and metals	124.0	124.7	173.5	77.3
XV - Base metals and articles of base metal	16420.1	117.2	3327.3	134.8
XVI - Machinery and mechanical appliances, electrical equipment	3330.5	117.3	7873.4	124.2
XVII - Vehicles, aircraft, vessels and associated transport equipment	2081.1	126.3	5147.1	159.9
XVIII - Instruments and apparatus	152.3	107.4	696.1	137.2
XX - Miscellaneous manufactured articles	275.8	126.4	443.2	137.2
XXI - Works of art, collectors' pieces and antiques	0.7	388.7	3.5	480.5
Goods purchased at ports	27.5	163.9	268.1	125.7
Other	373.1	152.4	65.7	179.8

Source: Derzhkomstat

Foreign trade policy: Ukraine continued using non-tariff instruments to regulate trade

In 2006 the government continued using non-tariff instruments for regulating commodity trade flows. In particular, import licensing was introduced for beef, pork, hogs, and cattle, thus increasing transaction costs of imports. This step favoured domestic meat producers at the expense of welfare loss for population.

Also, responding to the growing world prices on oil, gas, sugar and later on grain, export licensing of these products was established. The response was rather typical for the government that traditionally inclined to prevent the rise in domestic prices by curbing exports. However, this approach contradicts market principles as it distorts price regulation mechanisms and reduces the allocative efficiency in the economy. Moreover, licensing of grains was promptly replaced by quotas on wheat, barley, rye, and corn in the fourth quarter of the year further harming economic efficiency and damaging the image of Ukraine as a reliable trade partner (see *Agricultural policy*).

The adoption of WTO-related package of laws (see *WTO*) in the last months of the year introduced noticeable changes in Ukraine's trade regime. However, as some of these laws would come into force after the Ukraine's WTO accession, only in selected spheres immediate changes are expected. In particular, the elimination of discrimination in provision of legal services has come into force, as well as laws on intellectual right protection, and changes in legislation concerning licensing. Other laws that became effective include changes in state support of agriculture, changes in the VAT law, and in veterinary regulations. Also, the law eliminating the ban on imports of cars of more than 8 years old was enacted. This ban was substituted by economic measures, namely the introduction of a high tax on the first registration of cars that are older than 8 years in Ukraine.

A large set of laws would become effective only after the WTO accession, including opening the market for branches of foreign banks, changes in regulation of sugar and dairy markets, and various export tariffs. For the latter, several years of transition period are envisaged. Also, laws granting non-discriminatory access for insurance and publishing envisioned a 5-year transition period.

The WTO-related laws are expected to increase the openness of Ukraine's market to foreign competition benefiting consumers and stimulating the development of efficient sectors.

WTO: Ukraine is close to completion of trade talks

Although the goal of becoming the WTO member in 2006 was not accomplished (as it happened before with goals of gaining membership in 2005, 2004 and so on), Ukraine made very significant progress in completing negotiations launched in late 1993. According to the WTO director general Pascal Lami, Ukraine tops the list of 23 countries, nominated for accessing the WTO. Both bilateral and multilateral talks advanced. In 2006 Ukraine signed 7 protocols on accession on markets of goods and services, and 2 on accession of services' markets. In particular, very difficult talks with the USA and Australia were completed. Responding to the USA request, Ukraine committed to join zero binding tariffs sectoral initiatives concerning wood, machine building products, metals, etc. However, Ukraine will not join agricultural zero initiatives concerning oil seeds, fish and beer.

Altogether, in 2001-2006 Ukraine completed bilateral negations with 49 countries. To finalize bilateral talks, assuming that no other WTO member puts forward extra requests, Ukraine has to complete negotiations with Kyrgyzstan. Recently this country replaced its demand concerning debt repayment by zero binding tariffs request for approximately 300 tariff lines that far exceed current obligations taken by Ukraine. The vast majority of goods in question has a negligible share in Kyrgyz exports to Ukraine. Moreover, the current free trade agreement between countries ensures Kyrgyz goods enter Ukrainian market under zero tariffs in any case. Thus, Kyrgyz's demand seems to be only politically justified but not economically.

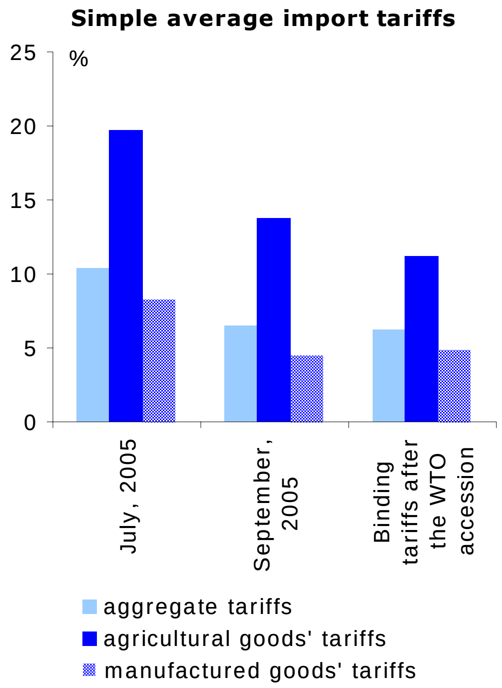
In November and December, Ukraine progressed in harmonizing legislation, a major issue of multilateral talks. The Parliament almost fully passed 20 laws required for the complete harmonization of Ukrainian legislation with the WTO rules. The exemption was one law. The amendments to the law on VAT were approved only partially, as the establishment of special regime of taxation for agricultural producers was once again postponed till 2008, while the WTO required to eliminate it. Now the members of the WTO conduct the verification of the passed changes expected to be completed in early 2007.

Except for the talks with Kyrgyzstan, the level of aggregate measure of support in agriculture, recently introduced quotas on grain exports and issues of meat imports are still among unresolved the problems. Although just few issues remained to be settled, they are very sensitive for Ukraine and may prolong talks further than till the mid-2007, the current target for the Ukraine's accession to the WTO.

Foreign trade relations: Access to the USA market significantly improved

In 2006 the major improvement of economic relations of Ukraine with the USA occurred. First, in January the USA excluded Ukraine from the Priority Foreign Country list and put it into Priority Watch List under trade legislation on enforcement and protection of intellectual property rights. As a result, the USA restores Generalized System of Preferences (GSP) benefits for Ukraine that were suspended in August 2001. The revision of Ukraine's status became possible after the Verkhovna Rada passed the law introducing criminal responsibility for production of pirated CDs in July 2005. The GSP provides preferential duty-free treatment for 3,400 products, including such export products as iron and steel, electrical and railway products, and casein that are important for Ukraine.

Next, the USA, following a similar decision by the EU in the end of 2005, has granted Ukraine the market economy status in February 2006. Ukraine's bid for market economy status began in 2002, in connection with an antidumping investigation on steel wire rod under the US Trade Law. As a result of the new Ukraine's status the US Commerce Department will now use the standard market economy methodology in considering antidumping cases meaning that investigation will be conducted on the basis of Ukrainian instead of the third country prices. Six criteria were considered in determining the market or non-market status of the Ukrainian economy. Those criteria included the extent of currency convertibility, free bargaining for wage rates, foreign investment, government ownership or control



Source: The Cabinet of Ministers

Regional Trade in 2006

		Merchandise exports in 2006		Merchandise imports in 2006	
		USD m	% yoy	USD m	% yoy
Total		**38367.7**	**12.1**	**45034.5**	**24.6**
including					
CIS		12665.5	18.0	20184.9	18.5
	including				
	Russia	8650.7	15.5	13787.2	7.4
EU-25		10869.6	18.0	15614.1	31.5
	including				
	Germany	1283.8	-0.1	4267.6	26.1
	Poland	1344.5	33.1	2109.1	50.0
	Hungary	946.1	37.4	802.2	23.9
Asia		8134.8	-2.9	6070.8	30.7
	including				
	China	544.7	-23.4	2310.2	27.6
	Turkey	2390.0	17.9	769.1	26.6
	Japan	98.6	20.2	848.6	54.8
Africa		2373.9	-0.8	413	-3.1
America		2543.8	38.9	1465.3	15.8
	including				
	USA	1201.7	25.6	879.1	23.8

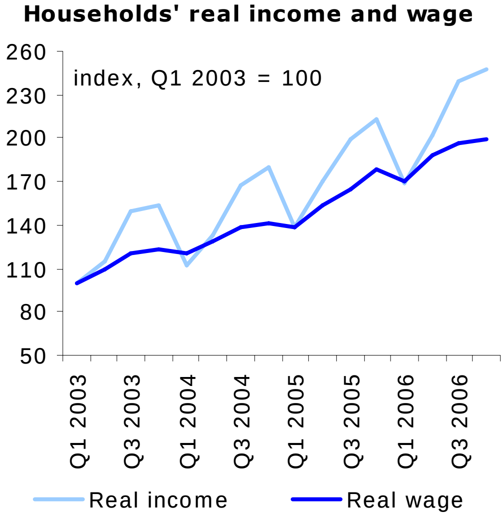
Source: Derzhkomstat

of production, government control over the allocation of resources, and other appropriate factors.

Finally, in March the House of Representatives of the US Congress adopted a bill cancelling the discriminatory Jackson-Vanick amendment against Ukraine. This bill was signed by the US President George W. Bush. The approval of such bill grants Ukraine the status of a regular trade partner, facilitating trade between countries.

Economic relations with the EU in 2006 were a bit shadowed by the introduction of final antidumping duty upon several producers of seamless pipes until 2011 that claimed to be excessive. At the same time, Ukraine expanded the quota for metal exports to the EU-25 in 2006 thanks to unused quota in 2005.

Trade relations between Ukraine and Russia somewhat worsened in 2006. In particular, at the beginning of 2006 Russia banned import of Ukrainian livestock products, harming Ukraine's dairy production (see *Agricultural Policy*). Also, Ukrainian exports of alcohol products to Russia suffered losses due to technical problems with introduction of new excise labels in Russia.



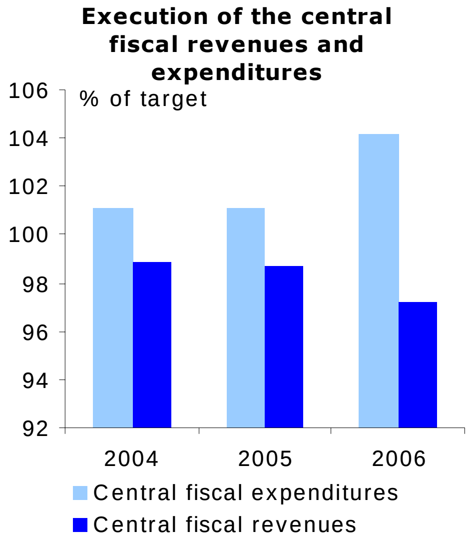
Source: Derzhkomstat

Wages and incomes: Wages returned as the major component of household income

In 2006 Ukraine sustained high growth of consumption (see *GDP*) supported by strong increase in household income and consumption credits. Between January and December real household income grew by 17.5% yoy. This growth was backed by equivalent growth in wage income as well as increase in agricultural and entrepreneurship incomes of households.

In 2006 real wages grew by 18.5%, thus following the previous year trend. The average wage equalled to UAH 1041.4 in 2006. While the state administration sector kept the highest growth rates of wages, growth rates in education and healthcare were lower than average for the economy. The growth of wages in industry also lagged behind and amounted 15.0% annual average. In particular, wages in such manufacturing industries as coke production and petroleum refinement, as well as metal production grew slower, for the latter likely due to gas price increase that required the redistributions of costs in the sector. In the fourth quarter of 2006 the wage growth in these sectors recovered. Even though the growth of wages in agriculture was higher than average for the economy, the wages in the sector remained the lowest and reached only UAH 552.9 for 2006.

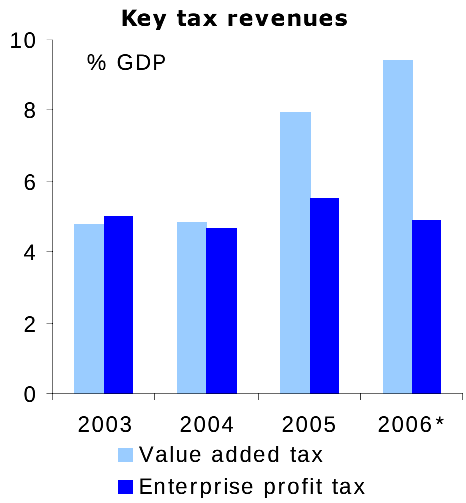
The growth rate of social transfers declined as compared to 2005 and amounted to 15.7% yoy for 2006. As a result, contrary to the previous year, wage incomes exceeded social transfers, becoming the primary source of households' income.



Source: State Treasury reports

Fiscal policy: High revenues did not stimulate fulfilment of expenditure targets

Budget process 2006. Good economic performance in 2006 allowed the government to finish the budget year 2006 successfully. The central fiscal revenues were executed at 104.2% of the targeted level, mainly due to high VAT revenues. These revenues reached 9.4% of GDP due to broadened tax base in 2005 and higher share of imports in GDP. For the most of the year the revenues from enterprise profit tax (EPT) were not entirely fulfilled. However, due to good collection rates of this tax in November and December, the EPT revenues constituted 100.2% of the target by the end of the year. This can be explained by a slow economic growth at the beginning of the year, which later improved, stimulating revenues collection. Another reason for good EPT revenues could be tax enforcement during the second half of the year. Besides, the largest share of EPT payments are collected at the end of the year by legal entities.



Source: State Treasury, Derzkomstat
* preliminary estimates

Traditionally, the execution rate of the central fiscal expenditures improved by the end of the year and reached 97.2%. Education, transfers to local budgets, and social protection had the highest execution rate. Central fiscal expenditures on utility sector and culture remained below 90% of the target.

The resulting central fiscal deficit reached UAH 4.9 bn or 0.9% of GDP. The deficit was mainly financed at the expense of borrowing. The amount of external borrowing was higher than previously planned (see *State debt*) due to low privatization receipts (see *Privatization*).

During the year the State Budget Law was amended several times. First, between January and March, the Parliament approved changes, which mainly resulted in higher social protection expenditures. Then, in November, the amendments envisaged increase in central fiscal revenues and expenditures by 1,38% and 1,40%, respectively. The additional revenues were planned to be received from higher than previously expected VAT revenues. They were used for financing increase in social payments, transfers to the local budgets, subsidies for utility services, and pension payments for military servants.

The budgeting process of 2006 was rather traditional. During the year the social protection expenditures and local budget transfers were increased. While these expenditures were made, the capital expenditures were financed at 87.3% of the target. The resulting deficit was lower than planned mainly due to lower than budgeted central fiscal expenditures, which is typical for Ukraine.

Approval of the 2007 Budget. The process of approving the budget for 2007 at end of 2006 was tense. For the first time in the history of independent Ukraine the President vetoed the State Budget Law. Even though the Parliament hardly incorporated any Presidential suggestions into a new version of the law, the President finally signed the Law. The major tensions were over the growth rates of social standards indicators including minimum wages and pensions as the President insisted on their increase (see *Social sector)*.

According to the State Budget Law for 2007 approved in December 2006, the central fiscal revenues and the central fiscal expenditures are budgeted at UAH 147.9 bn (24.9% of GDP) and UAH 161.8 bn (27.2% of GDP), respectively. These amounts are close to 2006 figures in terms of their share in GDP. The central fiscal deficit is planned at UAH 15.7 bn or 2.6% of GDP. The major source of its financing is to be privatization receipts foreseen at UAH 10.6 bn. Taking into account the failure of 2006 privatisation (see *Privatisation*) and an ambitious amount envisaged, the execution of privatization becomes one of the major fiscal risks of 2007.

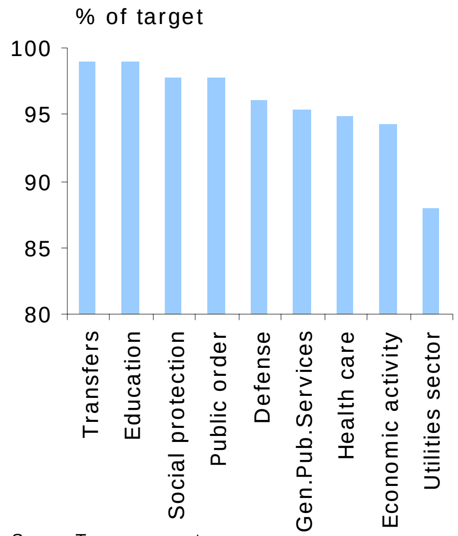
The positive feature of the budget process 2007 was that the amendments to tax legislation were written in the separate law. Besides, the provisions on the introduction of certain privileges for investment projects registered in special economic zones and territories of priority development were excluded from the Budget Law text. Instead, the government should develop a separate law on this issue. Also, abstaining from high growth of social standards, the government succeeded in keeping rather high capital expenditures as compared to previous years. At the same time, unclear specification of investment projects may result in inefficient use of fiscal funding.

In March 2007 the Cabinet of Ministers submitted to the Verkhovna Rada a draft law on amendments to the State Budget Law for 2007, which would result in higher central fiscal expenditures for wage payments and social protection.

Social sector: The provision of social payments becomes targeted in 2007

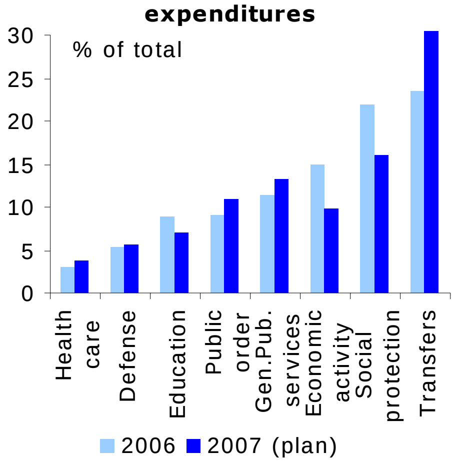
Children of war. The Law on social protection of the children of war was approved in the end of 2004 and became effective on January 1, 2006. According to the official estimates, the number of children of war is estimated at around 9 million individuals. Major privileges included reduction of utility payments by 25%, free transportation for certain types of transport, minimum pension increase by 30%. Even though this law was approved in 2004, the government has

Execution of central fiscal expenditures in 2006



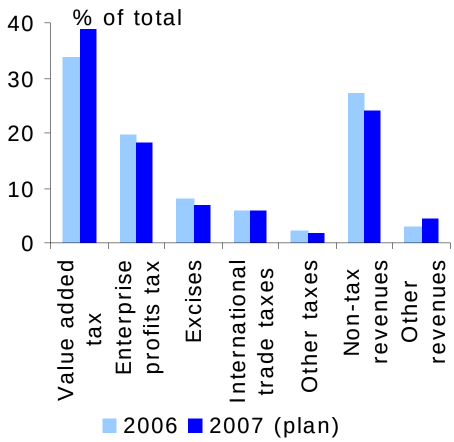
Source:Treasury report

Structure of central fiscal expenditures



Source: State Budget law for 2006, State Budget Law for 2007

Structure of central fiscal revenues



Source: State Budget law for 2006, State Budget Law for 2007 failed to provide enough funds to finance these privileges in 2006. As a result, amendments to the State Budget Law made in the beginning of the year accounted for increased expenditures of this program and only a partial provision of respective privileges in 2006. The amount of privileges was also restricted for 2006. Basically, this law joins a list of legal acts on numerous not funded subsidization programs to different groups of population.

Social standards in 2007. The State Budget Law for 2007 foresaw gradual increases in social payments, including minimum wages, subsistence minimum, minimum pensions, and other social payments. However, the growth rates of social payments would be lower than in 2004-2006. Some of them would even decline in real terms. Such change in the trend became a confrontation point of the budgeting process 2007 as the President demanded greater increases of social standards. In response, the Parliament approved a Resolution in which obliged the Cabinet of Ministers to increase the subsistence minimum for individuals that lost their ability to work and minimum wages above the levels planned in the Budget Law 2007.[iii] The law submitted to the parliament by the government in March 2007 envisages higher growth rates of social standards indicators, than what is indicated in the current version of the Law.

In 2007 the provision of social privileges, social assistance and other social payments becomes targeted. First, eligible individuals are those, whose income does not exceed 1.4 subsistence minimum set for working able individuals. Second, maximum amount of assistance is limited by the guaranteed subsistence minimum level. This innovation is one of the positive features of the new Budget Law as it increases the efficiency of social funding.

Minimum wage. The Parliament approved a law, according to which starting January 1, 2009 minimum wage is to be set at the level of the subsistence minimum for able to work individuals. By the end of 2007 minimum wage is expected to reach 83.9% of the respective subsistence minimum. Therefore, the law will cause a sharp increase of the minimum wage in 2008-2009, pumping up local governments' expenditures for wage payments.

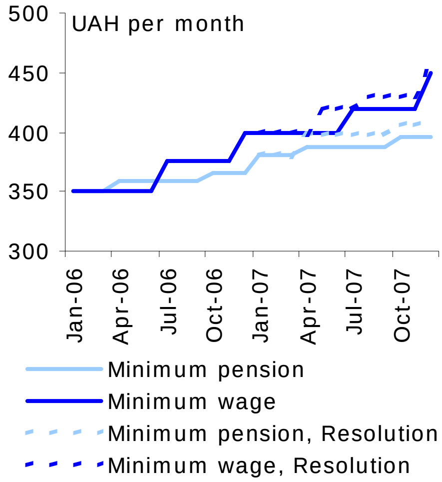
Pension system: Pension Fund Budget is planned to be balanced in 2007

Pension Fund Execution in 2006. In 2006 the nominal average pension increased by 12.5% and reached UAH 457.48, partially due to the scheduled increases of minimum pension set in State Budget Law for 2006. The growth of pensions boosted the Pension Fund expenditures to UAH 72 bn (13.5% of GDP). Although growing 7.4% faster than planned, own revenues of the Fund at UAH 54 bn were not sufficient to cover these expenses. The gap was filled by the total central fiscal transfer at UAH 17.6 bn, from which UAH 7.3 bn were directed towards deficit financing.

Pension provision in 2007. For 2007 the government plans to approve balanced budget of the Pension Fund. To ensure sufficient revenues, the government took several ad-hoc steps that include increase in the contribution paid by employers to 33.2% of the wage bill (from 31.8% in 2006); cap on the pensions paid according to some state pension programs; and restrictions on pension payments. At the same time, harmful for investments pension duty paid on non-cash currency exchange purchase-sale operations was reduced by 0.3 percentage points to 1.0%.

Some of these measures are rather questionable and inefficient in the long run. For instance, the increase of the insurance contribution to the Pension Fund, which accounts for more than 80% of total payroll tax, sends wrong signals to the business, even though the cumulative payroll tax remains the same. Such policy does not coincide with government's announcements to reduce tax pressure. The cap on pensions paid according to different state pension programs is still high as compared to average pension in Ukraine. The reduction of the pension duty paid on currency exchange

Monthly minimum pension and minimum wage



Source: State Budget law for 2006, State Budget Law for 2007, the Parliament Resolution

Payroll tax and deductions from wages, 2007

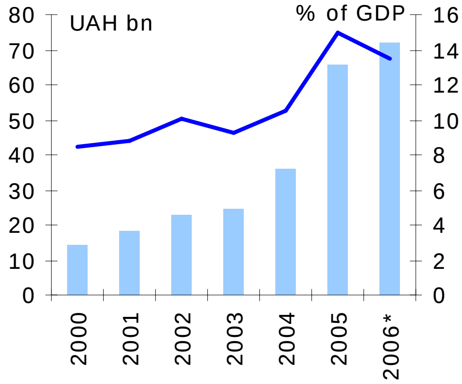
	Contrib-n made by employer (%)	Contrib-n made by employee (%)	Total contrib-n (%)
Cumulative social insurance contributions	36.66-49.6	1.5-3.5	38.16-53.1
Including:			
Pension Insurance	33.2	0.5 – 2.0*	33.7-35.2
Social insurance in case of temporary working disability	1.5	0.5-1.0*	2.0-2.5
Social unemployment insurance	1.3	0.5	1.8
Social insurance in case of working accidents	0.66-13.6**	0.0	0.66-13.6**

* the lower rate is paid by employees with wages below the subsistence minimum set for working able individuals, and higher rate is paid by those with wages above this level.
** the rate depends on the class of risk
Source: The Law On the size of contribution to compulsory types of insurance, the State Budget Law for 2007.

operations is a positive step, though it is not sufficient for significant reduction of investment barriers.

Central fiscal transfer to the Pension Fund is planned at UAH 22.3 bn. From this amount, UAH 10.3 bn is to be spent for financing additional task to the Pension Fund, namely payment of pensions to the retired military and retired judges. UAH 10.6 bn goes for financing pensions paid according to different state pension programs. Besides, as previously, the Pension Fund is to be compensated for the losses caused by lower contributions envisaged by fixed agricultural tax scheme (UAH 1.4 bn). Thus, the high central fiscal transfer is not related with the Fund's deficit.

Expenditures of the Pension Fund



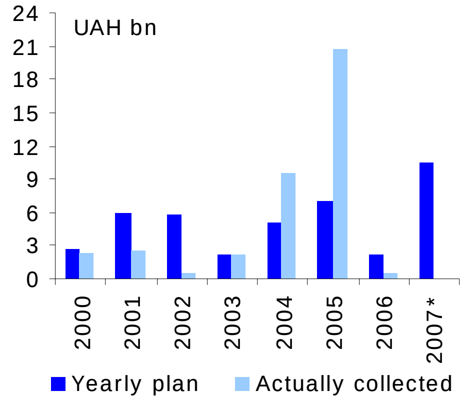
Source: The Pension Fund, the Ministry of Labor and Social Policy
* preliminary estimate

Privatisation: Slow privatization is one of the major fiscal risks in 2007

Year 2006. In 2006 privatization was significantly under-performed. Total receipts were only UAH 0.6 bn or 26.3% of the annual target. The major reason for under-performance was the lack of political will partially related with the political instability in the country. Important impediment for privatization process has been the absence of the new State Privatization Program. The privatization process is still regulated by the Privatization Program 2000-2002. That undermines consistency and efficiency of property transformation. In autumn the government submitted the draft Program 2007-2009 to the parliament, but it has not been approved yet.

The privatization receipts could be higher, if the government accomplished at least announced privatization tenders. For instance, the sale of 76% of the machinery plant "Luhansk Locomotive" that could have brought more than UAH 0.3 bn was suspended by the court decision. Also, the sale of JSC "Komsomolske Rudoupravlinna", producing limestone flux for metal production, was cancelled by the court.

Privatisation Receipts



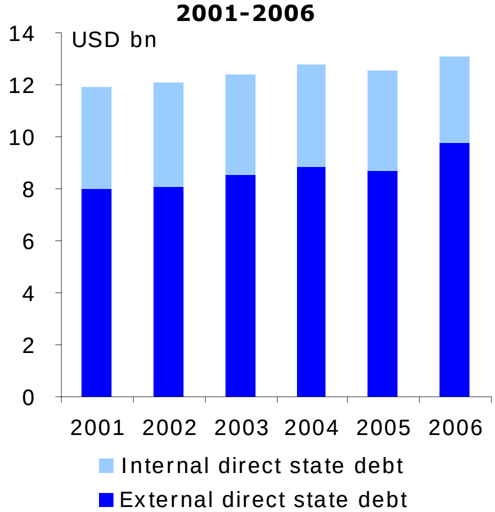
* plan
Source: State Property Fund

During the year the government tried to change the rules of privatization in order to increase the number of potential investors. In particular, in September the Cabinet of Ministers approved the procedure of the sale of state owned enterprises together with land lots[iv]. The new procedure should be applied to industrial enterprises of industry, transport, and communication evoking interest among investors eager to buy some land lots in big cities. The realization of the new sale procedure could be risky for private shareholders that own part of assets situated on the same plot. Such rule can lead to the situation when the land and property located on it belong to different owners.

Plans for 2007. The privatization receipts for 2007 are planned at UAH 10.6 bn. The plan seems risky taking into account the failure of 2006 privatisation. To fulfil the plan, it is suggested to sell shares of such large companies as the telecommunication company "Ukrtelecom" and chemical enterprise "Odessa by-port plant" as well as around 500 smaller companies, including shares in "oblenergoes".

To facilitate privatisation, in December the Verkhovna Rada approved the List of state owned enterprises to be privatized in 2007. The list contained 596 enterprises, mostly small and medium share holdings with total book value at UAH 5.65 bn. This law was vetoed by the President. The approved final version did not contain the list of enterprises for privatisation, but relaxed prohibition on privatisation of several large enterprises like JSC "Ukrtelecom", Hotels "Sport" and "Dnepr", machine building plant "Electotyazhmash", and "Odessa by-port plant"[v].

Structure of the direct state debt in 2001-2006



Source: the Ministry of Finance

State debt: The government turned to the debt market

As privatization revenues have been too small to finance budget deficit, Ukraine turned to domestic and international borrowing to finance this gap (see *Privatization*). On November 16 Ukraine finished placement of USD 1 bn issue of 10-year eurobonds with 6.58% coupon priced at quite modest 197 basic point spread over the US treasuries.[vi] Since August Ukraine also resumed domestic state bonds (OVDP) auctions and issued modest UAH 1.6 bn worth of domestic bonds as the Ministry of Finance was reluctant to offer attractive yields to domestic buyers. Such emphasis on lowering nominal coupon yield and willingness to accept currency risks will further delay development of government bond market in Ukraine, which can provide benchmark prices crucial for financial markets development.

Property aspects: Ukraine attempted to improve the property legislation in 2006

State Property. In November the Parliament approved the draft Law "On the State Property Fund of Ukraine" in the first reading. This law defines the relations of the State Property Fund with other authorities and its duties, such as the administration of the state property and investment policy implementation. Approval of this document should play an important role in the regulation of state property issues in Ukraine.

In September 2006 the President signed the Law "On state property management"[vii]. The main managerial bodies are the State Property Fund, the Cabinet of Ministers of Ukraine and authorized managerial bodies. The established institute of the "state controllers" should contribute to the effective asset management of state holdings. Another positive step in the state property management is the creation of the Unified Register of State Property Objects and approval of the Law "On holding companies in Ukraine"[viii]. The above-mentioned act defines methods of foundation, functioning and liquidation of holding companies in Ukraine, including creation of state holding companies by corporatisation or privatisation.

Private Property. In 2006 Parliament passed the law that lowered the quorum level of general meeting from more than 60% votes to more than 50%. However, the President vetoed this Law, claming that it contradicts the Constitutional principle of inviolability of private property and would lead to the violation of rights of minority shareholders, e.g., repartition of property.

Another problem aggravated during 2006 was so-called 'raiding' process, which is a misuse of rights by minority shareholders in order to get illegal control over the enterprise. Raiding is possible due to flawed legislation and illegal actions. In Ukraine this process is caused by briberies, threatening and attacks (based on court decisions). Ukrainian judicial, legislative and law-enforcement systems are unable to prevent the development of raiding in the country. Occurrences of raiding harms investment climate of Ukraine and threaten foreign investors operating in the country. To reduce raiding it is necessary to set up a clear corporate legislation.

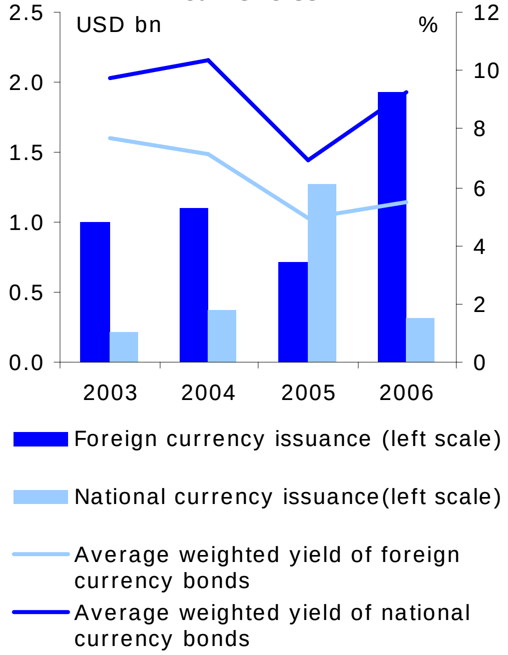
Regulatory reform: No significant steps were taken in 2006 to improve regulatory climate in Ukraine

In 2006 regulatory policy did not change significantly compared to 2005. The State Committee for Regulatory Policy and Entrepreneurship traditionally opposed the adoption of economically ineffective regulatory acts and conducted expert examination of regulatory-legal acts of central and local executive bodies to identify limitations hindering business activity[ix]. The change of the Government team did not impact these activities. In particular, both Governments did nothing to adjust and resume the procedure of quick deregulation, which was suspended in early 2006. There were no serious initiatives to amend regulatory environment expected by the business.

Inflation: In 2006 consumer prices increased by 11.6% yoy

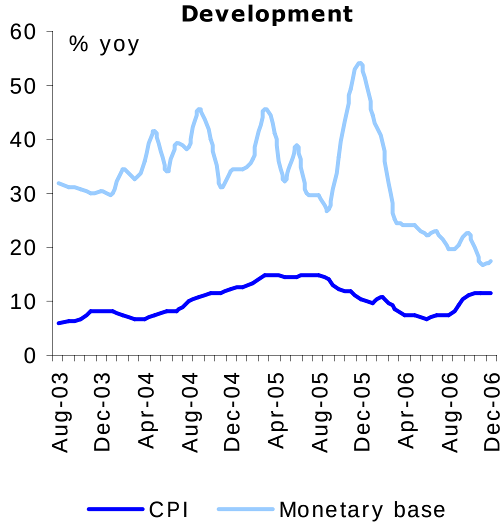
In 2006 consumer prices increased by 11.6% yoy. Thus, inflation remained in the double digits the third year in a row despite slowing to 6.8% yoy in the middle of 2006. While prices for food and non-food goods that constitute most of the consumer basket, grew by 3.5% yoy each, service prices grew by whopping 49.4%, rate of growth unseen since 1996. The sharp growth of service prices is related to a significant increase in price of imported gas and a wave

Isuance and average yield of state bonds in national and foreign currencies



Source: NBU, the Ministry of Finance, IER estimations

CPI and Monetary Base Development

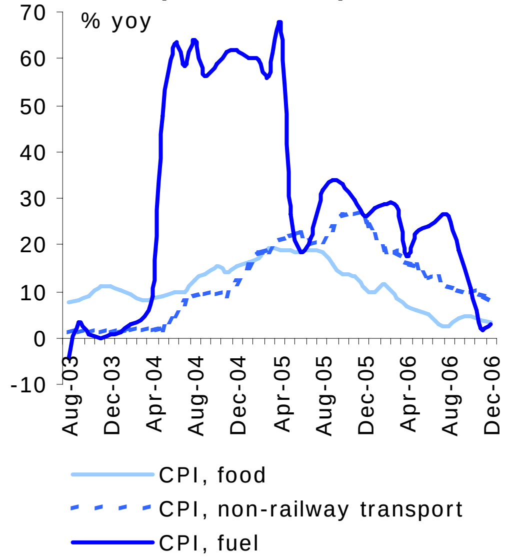


Source: Derzhcomstat, NBU

of abrupt increases in utility and other regulated prices in the second half of the year after these prices were hold unchanged for several years (see *Infrustructure*). At the same time, favourable food market conditions and export restrictions on dairy and meat products to Russia helped to keep the growth for food prices low (see *Agricultural policy*). Also, a stable exchange rate and low global inflation allowed keeping prices for non-food products low, especially imported ones.

In 2006 the Coalition Government sometimes tried to use a subtle approach to regulating prices. In November Antimonopoly Committee of Ukraine (AMC) in compliance with the request of the Prime Minister investigated reasons for no price reduction for transportation services and food products that should have occurred after a decrease in fuel costs. After the investigation, the AMC issued a set of recommendations to individual producers, traders, transport carriers, and local governments to revise prices according to the fuel cost decrease. The government also signed memoranda with agricultural producers and talked to transport carriers. The reaction was mostly negligible decreases or postponed increases in prices for some of the products under investigation, though price dynamics did slow down. Although the impact so far was limited, active state interventions in the price formation mechanism could be harmful for business development in the country.

Development of food, transport and fuel prices



Source: Derzhkomstat

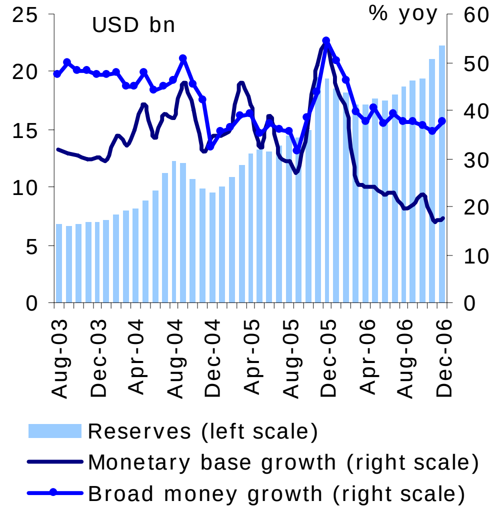
Monetary policy: Monetary expansion slowed but still remained significant

Growth rates of monetary aggregates significantly decelerated in 2006 compared to previous years, confirming that the inflation had non-monetary character. In 2006 monetary base increased by 17.5% yoy, while money supply was up by 37.5% yoy. Velocity of money decreased to 2.25 from 2.66. Moderate dynamics of monetary aggregates is explained by reversal of current account into deficit that limited amount of the foreign currency bought into reserves. Net interventions of the NBU totalled to quite modest USD 906 m. Money supply grew faster due to significant decreases in reserve requirements for national currency deposits.

To improve efficiency of interest rate-related monetary policy instruments, the NBU approved new regulation on managing banks' liquidity effective from November 17. New rules include wider access of banks to NBU refinancing facilities, introduction of currency swap as separate instrument of regulating liquidity, and more straightforward framework of standing credit and deposit facilities. Improved regulatory base provides good grounds for more efficient monetary policy, but the question whether available instruments would be actually used remains open.

Political uncertainty and improved access of Ukrainian banks to world financial markets caused a significant increase of dollarization. By the end of 2006 49.5% of bank credits and 38.0% of bank deposits were in foreign currency as compared to 43.3% and 34.3% respectively a year before. The NBU responded by decreasing national currency reserve requirements from 4-6% to 0.5-1% over the year. Further policy options may range from higher reserve requirements on foreign currency operations to outright ban of foreign currency credits to households.

NBU foreign reserves and growth of monetary aggregates



Source: NBU

Foreign exchange policy: Sufficient international reserves allowed for stable exchange rate in 2006

The NBU continued pegging hryvnia to US dollar in 2006 and kept official rate unchanged. Political uncertainty on the eve of parliamentary elections forced the NBU to spend USD 2.1 bn to support hryvnia between January and April. However, later in the year the NBU resumed purchases of foreign currency and bought USD 3 bn to prevent appreciation of hryvnia against the dollar. Despite rare spikes up to 5.20 UAH per US dollar over the course of the year, the NBU mostly kept the inter-bank exchange rate in the narrow range of UAH/USD 5.00-5.06. In 2006 average daily closure was UAH/USD 5.032. Rather comfortable level of international reserves that increased by 14.7% to USD 22.3 bn by the end of the year and relatively balanced foreign exchange supply and demand allowed the NBU to maintain exchange rate stability in 2006.

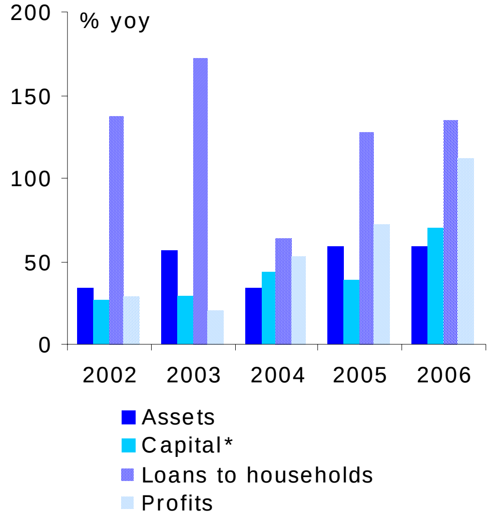
Financial markets: Profits of commercial banks sharply increased in 2006

Banking. According to the NBU, commercial banks in 2006 earned profits of UAH 4.6 bn, which is 2.1 times higher than in 2005. Main reasons behind a rapid increase in profits were the expansion of high-margin though risky consumer lending, higher share of foreign-owned banks and overall growth of assets (see *Investments*). The share of credits granted to households in the credit portfolio grew to 32.0% from 23.4% at the end of 2005. This upward trend signals that the role of commercial banks in stimulating the household demand on durables is becoming more important. For banks, it requires further improvement of risk management and supervision.

In November the Parliament approved a law[x], according to which foreign banks from countries that co-operate with FATF, adopted Basel principles of good governance, and signed agreement on bank supervision with the NBU will be allowed to open branches in Ukraine since Ukraine's WTO accession (see *WTO*). The NBU will have significant leeway in allowing foreign bank branches to open in Ukraine as it can deny permission to open a branch due to financial or legal problems of the parent bank or non-compliance with regulatory documents of the NBU. Therefore, degree of additional inflow of foreign capital in the banking sector will heavily depend on the regulatory decisions of the NBU. Still, the law will simplify access of foreign banks to the Ukrainian financial market and liberalize trade in financial services. This step should contribute to improving pricing, quality and availability of financial services, but can also bring some drawbacks as increasingly influential foreign banks can potentially "cherry-pick" less risky assets forcing weaker domestic banks to take on riskier assets and be less inclined to lending to smaller enterprises.

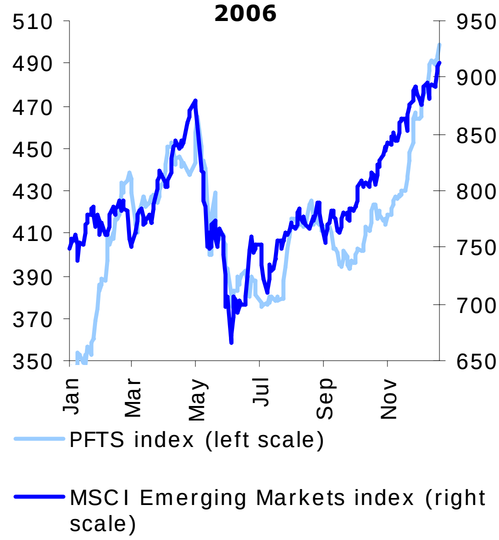
Stock market. Stock market in Ukraine fluctuated in line with the stock markets of other emerging economies. After a peak in the first half of May PFTS index lost 19.6% by mid June as investors began "flight to quality" due to concerns of rising interest rates and inflation worries in developed economies but later recouped all of the losses as previous concerns were unfounded. Other factors influencing index were political uncertainty and negative corporate news. Prospects of political stabilization and improved investment climate lead to higher stock prices by the end of the year.

Growth rates of selected indicators of bank's activities



Source: the NBU
*Book value

PFTS index and MSCI Emerging Markets index in 2006



Sources: PFTS, MSCI
Note: PFTS - First Stock Trading System
MSCI - Morgan Stanley Capital Investments

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[i] The Cabinet of Ministers Resolution No.1418 from October 11,2006.

[ii] The commodity trade figures provided by the NBU and the Derzhkomstat are dissimilar due to differences in methodology. The major source of discrepancy is that the NBU provides commodity imports in FOB prices, while the Derzhkomstat in CIF prices.

[iii] The Resolution of the Verkhovna Rada No. 518-V "On the revision of the subsistence minimum and minimum wage in 2007" from December 22, 2006.

[iv] The Cabinet of Ministers Resolution No. 1360 "On approving for 2006 the order on sale of state-owned land plots, on which the objects for privatization are situated" from September 26, 2006.

[v] The Law of Ukraine No. 580-V "On amendments to some laws of Ukraine" from January 11, 2007.

[vi] The Ministry of Finance placed 12-year CHF 768 m debt with 3.5% coupon and embedded three-year put option at 2.6% discount and 4-year samurai bonds with 3.2% coupon at 1.2% discount from JPY 35.1 bn par value.

[vii] The Law of Ukraine No. 185-V „On management of state-owned enterprises" from September 21, 2006

[viii] The Law of Ukraine No. 3528-IV „On holding companies in Ukraine" from March 15, 2006.

[ix] See: Information of Operation of the Department of Regulatory Policy of the State Committee for Regulatory Policy and Enterprise in the III quarter of 2006. http://www.dkrpgov.ua

[x] The Law of Ukraine No. 358-V "On amendments to the law of Ukraine "On banks and banking activities" from November 16, 2006.

Economic Trends		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
GDP growth (real)	% yoy	0.9	2.2	4.0	3.5	8.5	9.3	7.7	7.1	8.9	9.0	8.2	...
GDP growth (real)*	% yoy cum.	0.9	1.5	2.4	2.7	4.0	5.0	5.5	5.7	6.2	6.5	6.7	7.0
Industrial production (real)	% yoy cum.	-2.9	-0.6	0.2	0.4	2.4	3.6	4.8	5.4	5.5	5.3	5.6	6.2
Agricultural production (real)	% yoy cum.	3.3	3.6	4.0	4.1	4.7	3.2	-1.9	-2.8	-2.8	-1.1	-0.9	0.4
CPI	% yoy eop	9.8	10.7	8.6	7.4	7.3	6.8	7.4	7.4	9.1	11.0	11.6	11.6
PPI	% yoy eop	10.7	8.1	6.5	5.4	4.8	6.3	9.4	10.9	10.7	13.1	14.0	14.1
Exports (USD)***	% yoy cum.	-6.3	-5.4	-4.4	-3.9	-0.9	2.1	4.8	7.9	10.4	11.2	11.4	12.1
Imports (USD)***	% yoy cum.	50.0	39.6	30.2	23.2	24.4	22.1	21.3	21.2	22.2	22.6	22.4	24.6
Merchandise trade balance	USD bn cum.	-0.4	-1.0	-1.8	-2.1	-2.6	-2.9	-3.3	-3.6	-4.1	-4.6	-5.2	-6.7
Gross international reserves	USD bn eop	18.6	18.3	17.3	17.2	17.7	17.7	18.0	18.6	19.1	19.5	21.2	22.3
Monetary Base	% yoy eop	44.3	39.4	25.2	24.0	23.9	22.4	23.8	19.5	20.3	22.5	17.2	17.5
Lending rate on UAH credits **	% pa, aop	16.0	15.9	15.8	15.7	15.3	15.5	15.0	14.6	14.6	14.3	14.4	15.1
Exchange rate (official)	USD aop	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05
Exchange rate (official)	EUR aop	6.10	6.04	6.07	6.17	6.45	6.40	6.40	6.47	6.43	6.37	6.49	6.67

SOURCES: Derzhkomstat, Ministry of Finance, NBU, IFS, own calculations

* Monthly figures do not include the regular quarterly revision of the GDP series

** Weighted average for different maturities (source: NBU)

*** Growth rate in dollar terms

Key Economic Indicators		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Nominal GDP	UAH bn	93.4	102.6	130.4	170.1	204.2	225.8	267.3	345.1	441.5	535.9
Nominal GDP	USD bn	50.2	41.9	31.6	31.3	38.0	42.4	50.1	65.0	86.2	106.1
GDP growth (real)	% yoy	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	2.7	7.1
Industrial production	% yoy	-0.3	-1.0	4.0	13.2	14.2	7.0	15.8	12.5	3.1	6.2
Agricultural production	% yoy	-1.9	-9.6	-6.9	9.8	10.2	1.2	-11.0	19.7	-0.1	0.4
CPI	% yoy aop	15.9	10.6	22.7	28.2	12.0	0.8	5.2	9.0	13.5	9.1
CPI	% yoy eop	10.1	20.0	19.2	25.8	6.1	-0.6	8.2	12.3	10.3	11.6
PPI	% yoy aop	7.7	13.2	31.5	20.9	8.6	3.1	7.6	20.5	16.7	9.6
PPI	% yoy eop	5.0	35.4	15.7	20.8	0.9	5.7	11.1	24.1	9.5	14.1
Exports (gs, USD)	% yoy	0.0	-13.4	-7.9	17.9	9.5	10.7	24.0	42.6	7.5	13.2
Imports (gs, USD)	% yoy	2.0	-14.0	-19.1	18.9	14.1	4.9	28.7	31.3	20.4	22.0
Current account	USD bn	-1.3	-1.3	0.9 °	1.2 °°	1.4	3.1	2.9	6.9	2.5	-1.6
Current account	% GDP	-2.7	-3.1	2.9 °	3.8 °°	3.7	7.6	5.9	10.6	2.9	-1.5
FDI (net)	USD bn	0.6	0.7	0.5	0.6	0.8	0.7	1.4	1.7	6.5	5.3
International reserves	USD bn	2.36	0.79	1.09	1.48	3.09	4.42	6.94	9.52	19.39	22.26
Fiscal balance'''	% GDP	-6.8	-2.7	-2.1	-0.7	-1.9	0.8	-0.2	-3.0	-1.9	-0.9
Total state debt	% GDP eop	30.3	49.4	61.0	45.3	36.5	33.5	29.0	24.7	17.7	15.0
External state debt (total)	% GDP eop	19.4	38.4	49.9	33.0	26.3	24.1	21.4	18.6	13.4	11.9
Monetary base	% yoy eop	44.6	21.9	39.3	39.9	37.4	33.6	30.1	34.1	53.9	17.5
Exchange rate	USD aop	1.86	2.45	4.13	5.44	5.37	5.33	5.33	5.31	5.12	5.05
Exchange rate	USD eop	1.90	3.43	5.07	5.44	5.30	5.33	5.33	5.31	5.05	5.05
Exchange rate	EUR aop	2.11	2.77	4.39	5.03	4.81	5.03	6.02	6.62	6.40	6.32
Exchange rate	EUR eop	2.11	4.02	5.20	5.10	4.67	5.53	6.66	7.22	5.97	6.65

SOURCES: Derzhkomstat, NBU, IFS, Ministry of Finance, own calculations

''' "Minus" denotes a consolidated fiscal deficit

° The value of goods transferred to Russia according to the inter-governmental agreement reached in May 1997 on the Black Sea Fleet division totaling USD 726 m is not included

°° The value of the aircraft complexes transferred to Russia as repayment of a gas debts according to the inter-governmental agreement reached in October 1999 totaling USD 274 m is not included.

Notes:

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