INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING

Year 2008: Economic Summary for Ukraine

Farewell, good times?

Based on information
publicly available as of May 18, 2009

EXECUTIVE SUMMARY:

- A growth of real GDP during the first three quarters of the year turned into a rapid contraction in the fourth quarter. The real GDP grew by 2.1% in annual terms.
- Investments came to a standstill against the background of financial crisis and domestic political uncertainty.
- Ukraine gathered record grain harvest that triggered a sharp reduction of domestic farm gate prices.
- Issues of current and future price for imported natural gas attracted attention during the entire year.
- An increase of the state-regulated tariffs in infrastructure sectors was explained mainly by necessity to cover growing costs.
- In the fourth quarter of 2008 the negative current account balance was supplemented by financial account deficit creating background for sharp hryvnia depreciation.
- After 14 years of negotiations Ukraine has finally become the member of the World Trade Organisation. Liberalisation of access to domestic market was most evident for agriculture and food industry.
- Economic crisis stopped the growth of population welfare. Already in the end of the year unemployment increased, while wages contracted.
- The deterioration of economic conditions meant the increased pressure on fiscal expenditures, while sources of their funding sharply narrowed.
- Full-fledged Unified Tariff Scale in public sector was implemented in September, but terminated already in December 2008.
- Pension liabilities increase against the background of economic slowdown brought to formation of the Pension Fund deficit.
- The long-expected law on joint stock companies was adopted and will come in force at the end of April 2009.
- First half of 2008 was devoted to the fight with inflation. After peak in May, when CPI growth reached 31.1% yoy, inflation slowed to 22.3% yoy in December.
- Over the year hryvnya went from mild appreciation to sharp depreciation.
- Restricted access to external financing, deposit runs and accumulated non-payments on credits undermined banking stability in the country.

TABLE OF CONTENTS

GDP: Sharp deceleration of real GDP growth in the end of the year 1
INVESTMENTS: After thriving in 2007 investment activity once again cooled down 2
INDUSTRIAL OUTPUT: Rapid decline in the end of 2008 2
AGRICULTURAL OUTPUT AND TRADE: Troublesome crop recovery was hampered with financial turmoil 4
AGRICULTURAL POLICY: Ukraine's membership in the WTO eased access to domestic market of agricultural commodities 4
ENERGY POLICY: Crisis of natural gas supply scheme 5
TRANSPORT: Tariff increase did not result in better services or improved infrastructure 8
TELECOMMUNICATIONS: Legal inconsistencies left the sector without efficient regulator for most of 2008 9
UTILITIES: The approval of the Utilities Development Concept did not change current sector stance 10
BALANCE OF PAYMENTS: In the last quarter of 2008 both current and financial accounts were in trade deficit 10
COMMODITY TRADE: Drop in commodity trade in the end of 2008 did not cure the deficit 12
WTO: After 14 years of negotiations Ukraine has become the member of the WTO 13
MIGRATION: The likelihood of migrants' return increased on a back of economic deterioration in Europe and Russia 13
WAGES AND INCOMES: Nominal wages declined in the end of 2008 14
LABOUR MARKET: Demand for labour force decreased by the end of 2008 15
FISCAL POLICY: The attention was centred at ongoing issues 16
SOCIAL POLICY: Social standards declined in real terms in 2008 18
PENSION SYSTEM: The Pension Fund Budget had significant deficit in 2008 20
PRIVATISATION: In 2008 revenues from privatization made up 5% of the plan adopted at the beginning of the year 21
CORPORATE GOVERNANCE: Step forward – the law on the joint stock companies was adopted 22
STATE DEBT: Skyrocketing the domestic borrowings as a response to financial crisis 23
INFLATION: Consumer inflation accelerated to 22.3% in 2008 23
MONETARY POLICY: Financial crisis called for large changes in NBU monetary policy 24
FOREIGN EXCHANGE POLICY: Managed floating of hryvnia started in March 25
FINANCIAL MARKETS: Banking system stability was hit severely 26

GDP: Sharp deceleration of real GDP growth in the end of the year

Ukraine's economy entered in a recession in the fourth quarter of 2008 as the world financial crisis uncovered and aggravated weaknesses of the national economy. Real GDP growth decelerated from 6.3% yoy for the first nine months to 2.1% yoy for the year because of sharp decline in real exports and slowed households' consumption due to credit crunch. In nominal terms GDP constituted around UAH 949.9 bn (USD 180.3 bn) in 2008.

In the first two quarters real GDP was growing at 6.3% yoy, mainly driven by flourishing households' consumption on the demand side and uprising manufacturing on production side. In the third quarter agriculture took up real GDP growth to 6.4% yoy due to rich harvest of crops. However, since the end of August the economic conditions have already started getting worse as external demand and prices for metals gone down and credit crunch paralyzed domestic consumption and investment demand. Main sectors of economy – manufacturing and trade – responded with rapid decrease in value added.

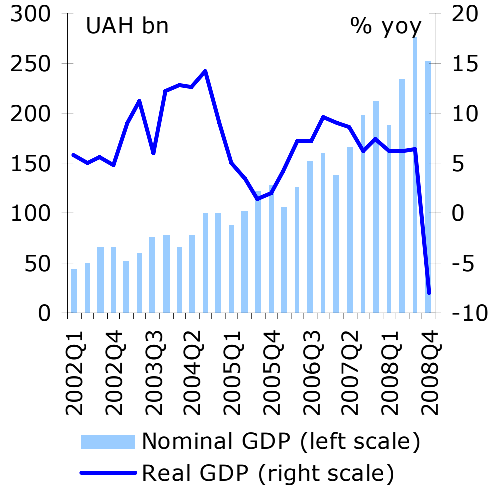
On demand side, households' consumption has been decelerating since the mid of the year due to growing costs of credits and slowing real disposable incomes (see *Wages and incomes*). Real final consumption of households slowed down from 22.5% yoy in the first quarter to 14.1% yoy in the third quarter. In the fourth quarter incomes were further hurt by economic crisis with lowering wages and rising unemployment (see *Labour market*), and consumption borrowings were restrained by credit crunch. Moreover, due to sharp devaluation of hryvnia households faced much more expansive imported goods and debt service on foreign currency credits. These factors exerted significant downward pressure on private consumption. On the other hand, hryvnia devaluation also stimulated short-term consumption boost as households tried to spend available hryvnia in fear of further devaluation. This factor and traditional high spending of holiday season somewhat supported households' consumption in the end of 2008 (real households' consumption grew by 1.6% yoy in the fourth quarter), delaying sharp drop in spending to early 2009. According to estimates of Derzhkomstat, the real households' consumption grew by 11.8% for the whole year.

Credit restrains and high political uncertainty against the background of high statistical base of the previous year actually undermined growth of investments in 2008. Namely, real gross fixed capital accumulation decelerated from 14.4% yoy in the first quarter to 0.1% yoy in the third quarter. In the fourth quarter, investments declined by 17.4% yoy as companies frozen their investment projects due to reduction in sales and severe credit crunch. Therefore, real gross fixed capital accumulation increased by 1.6% only.

In the mid of 2008 external economic conditions were extremely favourable for Ukrainian exporters, first of all for metal producers as world demand and prices for their production stroke historical highs. After meagre growth rates in the first two quarters, in the third quarter real exports of goods and services spurred by 19.2% yoy. However, in the last quarter of 2008 growth changed for contraction, by 10.4% yoy as worsening of external conditions was only partly compensated with high annual export volume of grains thanks to an elimination of quantitative restrictions and rich harvest (see *Agricultural output and trade*). In result, real exports of goods and services grew by 5.2% in 2008.

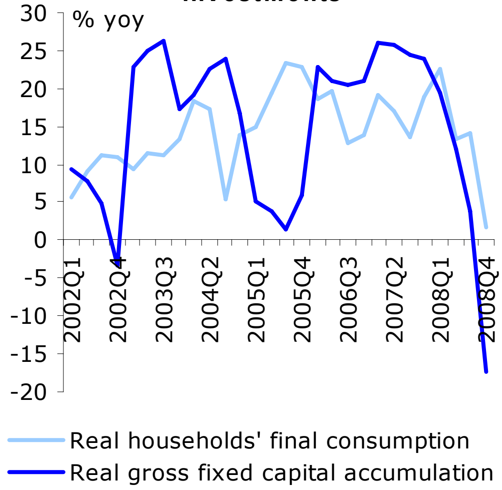
At the same time, strong domestic demand – in particular, by households – supported a spur in imports. Real imports growth was accelerating in the first three quarters from 23.8% yoy in the first quarter to 24.4% yoy in the second and further up to 29.6% yoy in the third. However, plummeted consumption and investment demand caused contraction of real imports 4.2% yoy in the last quarter of

Gross domestic product



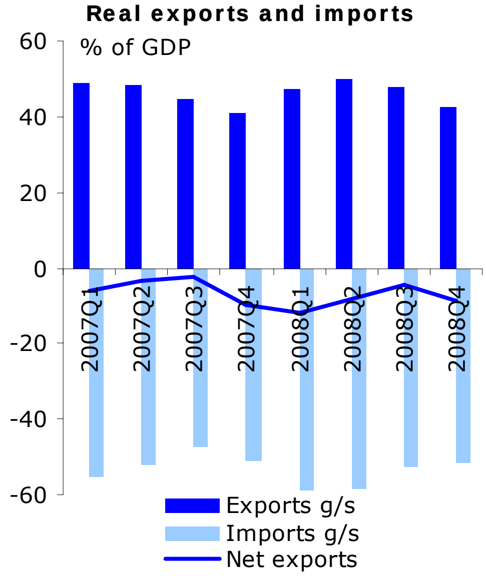
Source: Derzhkomstat

Private final consumption and investments



Source: Derzhkomstat

Real exports and imports



Source: Derzhkomstat

2008. According to the Derzhkomstat, real imports of goods and services grew by 17.1% for the whole year.

On production side, in 2008 the real GDP growth was ensured mostly by the still growing value added in agriculture (17.2% yoy) and transport (7.1% yoy), since the crisis did not hit those sectors considerably in 2008. High agricultural output and value added came as a result of previous successful sowing campaign and favourable weather conditions (see *Agricultural output and trade*); and transport rose thanks to stable growth of automobile transportation. The rest of sectors experienced decline in the last months of 2008. Construction sector suffered the most (-17.5% yoy in real terms) due to both credit crunch and high building materials' prices. Also, credit crunch and lower domestic production and demand resulted in significant slowing of real value added in trade from 15.7% yoy for the first quarter to 1.8% for the whole year. In the same time horizon value added in manufacturing turned from 9.0% yoy growth to 2.3% decline (see *Industrial output*).

Sector value added in 2008

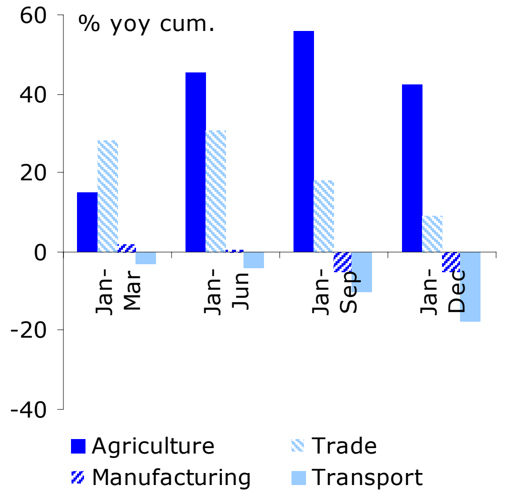
	Rates of change	Share of GDP	Contri-bution to growth
Agriculture	17.2	6.6	1.1
Extractive	-1.5	4.4	-0.1
Manufacturing	-2.3	19.9	-0.5
Gas, water, electricity	-4.8	3.2	-0.2
Construction	-17.5	4.2	-0.7
Wholesale & retail trade	1.8	13.2	0.2
Transport	7.1	9.7	0.7
Education	-0.6	4.6	0.0
Health	-0.6	3.1	0.0
Other services	1.9	22.2	0.4

Source: Derzhkomstat, IER calculations

Investments: After thriving in 2007 investment activity once again cooled down

High interest rates for credits in the beginning of the year and political turmoil had resulted in a deceleration of investment demand even before the eruption of a new phase of world financial crisis. The deceleration was especially evident against the background of high statistical base of the previous year. As a result, investments into fixed capital declined by 2.6% yoy in 2008 compared to 29,8% yoy in the previous year.

Investments in fixed capital in 2008



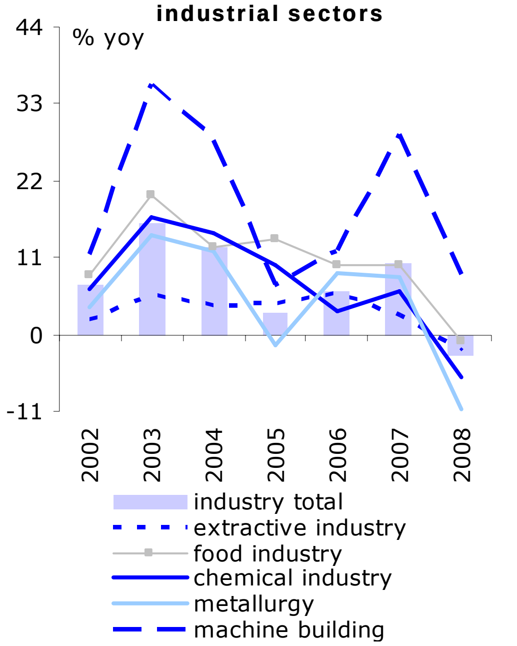
Source: Derzhkomstat

Highest growth of investments into fixed capital was noted in agriculture (42.3% yoy) and trade (9.0%), but their contribution in overall growth of investments was rather small. Fixed capital investments in manufacturing and transport, which together comprised 50.9% of the total spending, declined by 5.3% and 17.6%, respectively. The most significant decline in investments into fixed capital in manufacturing was noted in metallurgy (26.5%) though against the high statistical base of the previous year. The growth in investments in chemical industry and paper production (12.5% and 12.6% respectively) was not sufficient to offset reduction in other sectors of manufacturing.

Decline in investment spending was mirrored by recession in construction sector, which traditionally accounted for almost a half of total investment spending in Ukraine. Construction of many housing and commercial objects was frozen due to liquidity problems caused by building materials' prices growth and credit crunch. Problems in this sector imposed some risks of social instability as many people invested their many in housing construction. In order to solve this both economic and social problem, in the end of December the Parliament adopted the law that envisaged public financing of final construction works on unfinished objects[i]. Though the law provides good regulatory framework, actual absence of budget financing makes it realisation impossible in 2009.

Investment spending on EURO 2012 preparation was less then expected. In particular, reconstruction and construction works on many objects (airports, stadiums, roads) did not started or with substantial delay in 2008. Both public and private investors faced problems with financing of those projects as both external and internal economic conditions turned to be difficult.

Growth of output in key industrial sectors



Source: Derzhkomstat

Industrial output: Rapid decline in the end of 2008

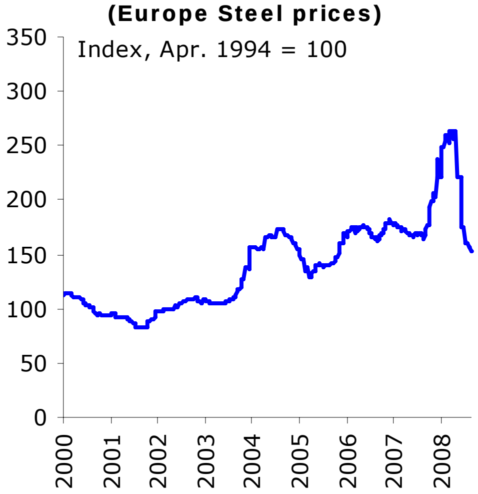
Ukraine's key industries were severely hit by world financial crisis and rapid deterioration of global economic conditions. Sharp demand decline on Ukrainian export commodities was coupled with low competitiveness of national companies resulting in abrupt downfall of industrial production in the end of the year wiping out positive growth rates registered in the first half of 2008.

According to the Derzhkomstat, industrial output contracted by 3.1% yoy in 2008 in comparison with a 10.2% rise in 2007. The last year with comparable reduction in industrial production was 1996. The major decline was in mining and smelting complex. Notably coke production and oil processing fell by 15.0% yoy, metal production by 10.6% yoy, and non-energy mining by 6.1% yoy.

As metal production, machine building and food industry are the largest manufacturing sectors; their dynamics are contributing the most to changes in total industrial output.

In particular, machine building that is one of largest three sectors preserved the growth by the end of 2008 thanks to extremely high growth rates in the first half of the year. In 2008 sector output increased by 8.6% yoy, while between January and June it grew by 29.3% yoy. The most rapid expansion was in production of vehicles in the first several months of the year urged by maintained then availability of bank loans to population (see *Financial sector*). As credit growth gradually diminished during the year, the vehicle production followed. In the last months of 2008 demand on passenger cars was slashed down as financial crisis flared up resulting in rapid reduction of vehicles output. While the construction sector responsible for the half of fixed asset investment spending was in recession since the beginning of 2008 (see *GDP*), investment demand for machines and various equipment remained high thus stimulating its production. However, sectors' output had been gradually decelerating during the year alongside with investment activity (see *Investments*), and finally sharply dropped in November responding to plummeted demand.

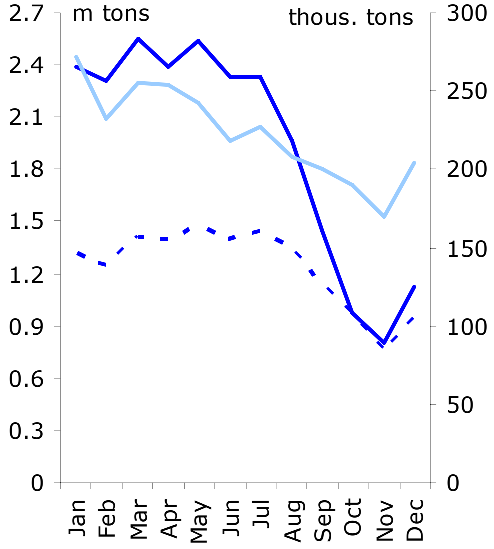
CRU Steel price index (Europe Steel prices)



Source: CRUonline.com

Ukraine's metal producers faced highly volatile world market conjuncture in 2008. The sector gained from high metal prices at mid-year allowing production growth by 3.3% yoy in the first six months of the year despite early-year problems. Unfolding the world financial crisis had led to the rapid reduction of the demand for and pushed down the prices on Ukrainian steel. When prices dropped below cost price the producers began to cut off the output. As a result, Ukrainian metal production decreased by 10.6% yoy in 2008 with the biggest output cut in November (48.8% yoy). The shock reduction of demand for steel on the domestic market – mainly from construction side – made impossible sales retargeting to domestic consumers.

Production of major export commodities in 2008



Steel semi-finished products (left scale)
Steel, excl. semi-finished products (left scale)
Nitrogen fertilizers (right scale)

Source: Derzhkomstat

The demand shortfall from the metal producers provoked the rapid output reduction in other sectors of domestic economy, namely non-energy materials extraction and coke production. The annual extraction volume of non-energy materials contracted by 6,1% yoy. The coke production and petroleum refinement plummeted by 15.0% yoy, the deepest reduction among large industrial sectors in 2008. Moreover, that was the only large manufacturing sector in recession during the entire year. The end-year demand shock from the metal producers' side added up to problems of the sector that already suffered from high oil price volatility and state price regulation of petroleum products.

The food industry output gradually decelerated during the year against the background of tougher domestic competition due to tariff liberalisation (see *WTO*), as well as demand shocks. In particular, in the first half of the year high inputs prices on domestic market, especially on grain and livestock products, forced food companies to raise prices thus dumping demand. In the last quarter of 2008 the prices for agricultural products went down (see *Agriculture policy*), but the industry was hit by another demand shock due to unemployment growth and wages shortfall. Moreover, the sector faced with increased arrears on receivables from large retail chains as the financial crisis made credits hardly available. As a result, sector output dropped by 0.9% yoy in 2008 comparing with 10.0% yoy growth in 2007.

Agricultural output and trade: Troublesome crop recovery was hampered with financial turmoil

Year 2008 brought spike-making figures of harvest for major crops thanks to benign weather conditions. Farmers harvested more than 53 m tones of grain, the highest estimate ever registered since 1991. According to the Derzhkomstat, agriculture, hunting and forestry exhibited 17.2% yoy value added growth in 2008, which is the largest number amid the sectors of the economy for that period. Increase in production is registered for majority of plantings apart from sugar beet that declined more than 19.9%.

Historical uphold in crops output was, however, not ensued with the same upturn in livestock production. Both enterprises and households produced less of meat and milk products, though this decline was slightly mitigated with increased output of eggs and wool. This is partially attributed to less profitability of certain commodities as competition got tougher fuelled with new environment established with WTO accession in May (See *Agricultural policy*). Thus, domestic animal husbandry continued to generate too little demand to consume buoyant supply of crops calling for export to clear the market.

Both trade enhancing opportunities and additional trade barriers emerged in 2008. The WTO facilitated the access to Ukrainian agricultural markets as general level of import tariff protection declined (See *Agricultural policy*). Import jumps were mainly observed for meats, vegetables, and sugar. According to the Derzhkomstat, imports of these product categories leaped five-, three-, and two-fold respectively over 2008 compared to the previous year.

Cancellation of quotas that hampered outflow of grain in 2007[ii] favoured exports that grew steadily from April until being depressed in the last quarter with significant drop of international prices and new trade barriers emerged in countries of destination. This included import duty uphold in the EU[iii] in October, and Egypt ban for import of milling grain from Ukraine in November due to quality concerns. Grain exports declined from October to the end of the year and did not suffice to consume excess supply of crops leaving the country with considerable ending stocks of grain.

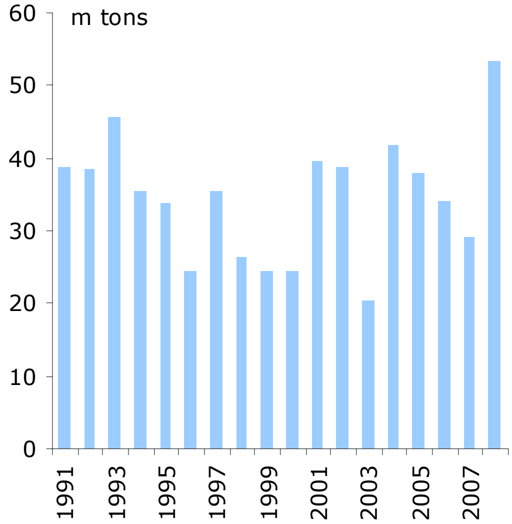
Sunflower-seed oil exports also faced increased administrative barriers. On the one hand, to suppress domestic price growth in March the Cabinet of Ministers applied quotas on exports of sunflower seeds and oil that were cancelled by Presidential Decree late in May (see *Agricultural policy*). On the other hand, the EU requested more certification of Ukraine's sunflower-seed oil exports after a quality of supplied product was questioned in May. As a result actual export volumes between April and August did not deviate considerably from quota volumes established for that period (355 thousand tons of sunflower oil and 0.505 tons of sunflower seeds compared to 300 thousand tons and 1 thousand tons for seeds within quotas).

Domestic prices for tradable agricultural commodities dropped drastically in the second half of the year due to excess supply, international prices downturn and deteriorated availability of financing. This often drove farm gate price below the cost of production. However, financial resources obtained from produce sales sufficed to finish autumn seeding campaign successfully with no visible reduction in total area seeded. Worse possibilities for external financing still hit severely small farms, traditionally less resilient to shocks due to lack of own funds.

Agricultural policy: Ukraine's membership in the WTO eased access to domestic market of agricultural commodities

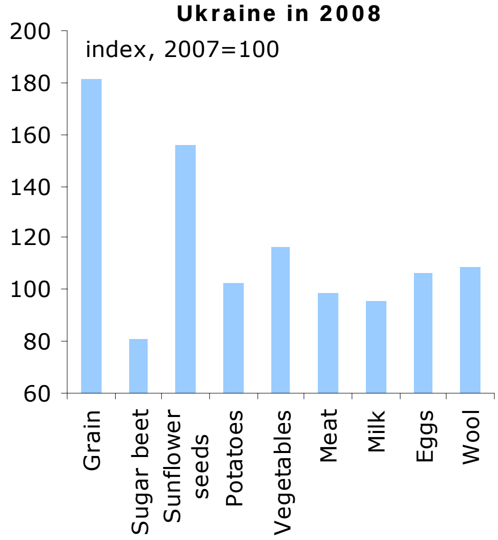
Export quotas. Grain export quotas designed to secure domestic consumption after droughty 2007 virtually led to no export for that year. However, expectations of high increase in crops production as

Grain production in Ukraine, 1991-2008



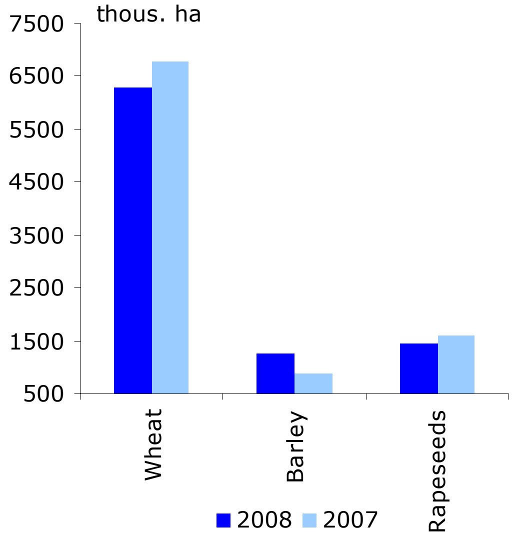
Source: Derzhkomstat

Agricultural production in Ukraine in 2008



Source: Derzhkomstat

Seeded area of major winter crops in Ukraine



Source: UkrAgroconsult

well as farmers' claims on lower farm-gate price appeared to be the main precondition for final abolishment of these restrictions for wheat, barley, and rye late in May 2008. Corn quota was repealed at the end of March[iv]. This resumed export flows and credibility of Ukrainian grain exporters.

Also in 2008, an attempt to introduce quotas for sunflower seeds and sunflower-seed oil was made to stop domestic price growth that repeated world price growth tendency under low harvest inside Ukraine. In March, the Cabinet of Ministers introduced quotas by adopting a corresponding Resolution[v]; the quotas were distributed during the month. But the President suspended this decision and sent it to the Constitutional Court.[vi] In late September – after the quota period established by the Government has already expired – the President cancelled his Decree on suspension of respective Resolutions[vii] of the Cabinet of Ministers leaving no need for further consideration of his request by Constitutional Court.

WTO accession. Ukraine formally joined the WTO in mid-May, considerably liberalizing the market access in agro-food sector. The membership resulted in lower import tariffs for major agricultural products, though they still remain much higher than those for industrial goods (simple average binding rates are 10.7% for agricultural products vs. 5.0% for industrial goods[viii]) with the highest MFN tariffs applied for sugar (50%) and sunflower-seed oil (30%)[ix]. Export duties for oilseeds are also to be reduced from 16% to 10% over six-year period. Still, the WTO requirements left certain space for government discretion leaving UAH 3.04 bn plus 5% of agricultural production for trade-distorting domestic support measures, and allowing unlimited supports of green-box measures. The WTO commitments did not bind the government as Budget 2008 allocated more than UAH 11 bn to agriculture, the highest nominal estimate for five-year sequence. Obviously almost double reduction in agricultural budget for 2009 was caused by economic crisis fears.

Taxation. Despite the pressure of WTO requirements, VAT privileges for milk and meat producers in the form of zero tax rate and rebates from manufacturing companies secured with Budget Law till January 1, 2009 survived through 2008. In October anti-crisis efforts of the authorities preserved existing special taxation regime for agricultural producers with minor modifications[x]. The VAT sums could still be used for production needs by agricultural enterprises. The government even extended the domain of possible uses of this financing previously restricted by purchases of raw materials.

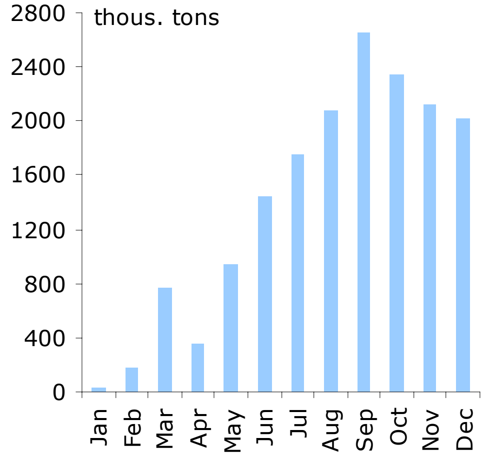
Land market. Agricultural land became more expensive to lease as payments were doubled from 1.5% to 3.0% of the value of plot owned[xi]. This hardly imply significant increase in actual incomes of rural land owners given little share of pecuniary payments for the land lease. Thus, little compensation realized in 2008 as the moratorium on sales of agricultural land sustained and owners did not obtained pledged opportunity to raise the funds from selling their plots, and agrarians still hope for the chance to use the land as a collateral.

Energy policy: Crisis of natural gas supply scheme

Gas sector. Major events in gas sector were traditionally associated with quarrels over pricing for imported natural gas supplied to industry and heat-power engineering. For years Ukraine has been paying for gas less than other European countries in return low transit fees. Although Ukraine has consumed recently mainly Central Asia gas, it has been supplied by Russian Gazprom making the latter *de-facto* monopolist gas supplier for Ukraine.

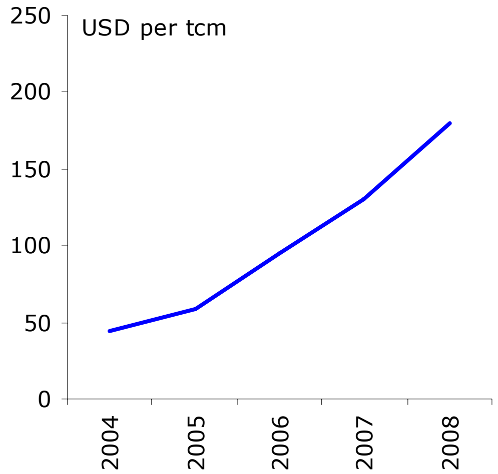
The beginning of 2008 was traditionally marked by already traditional row between NJSC Naftogaz Ukrainy and OJSC Gazprom over price of natural gas imported in the first months of the year. The contract agreed in December 2007 foresaw the purchase of gas from Central Asia. But in February Gazprom announced that Ukraine should pay for gas consumed in the first two months of 2008 USD 315 per thousand cubic meters (tcm) rather than USD 179.5 per tcm

Grain exports from Ukraine in 2008



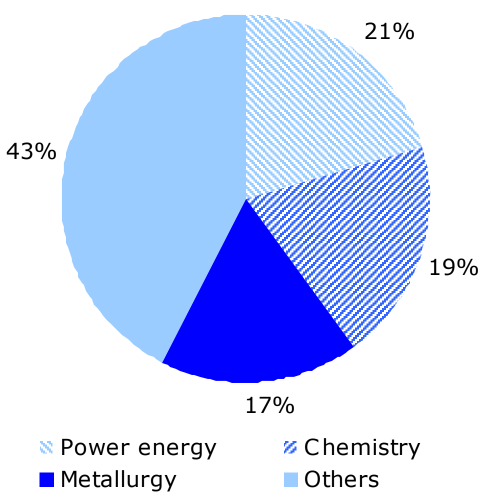
Source: UkrAgroConsult

Price for imported natural gas for Ukraine



Source: Gas contracts signed by NJSC Naftogas

Major industrial consumers of natural gas



Source: 'Energobusiness'

specified in contract. This problem resulted from temporarily crash of agreed supply scheme forcing Gazprom to substitute Central Asian gas by Russian one without prior notification. Finally, the sides reached an agreement in mid-March. The price for imported gas was preserved at USD 179.5 per tcm for the rest of 2008 with understanding that only Central Asian gas would be supplied. However, Naftogaz agreed to pay USD 315 per tcm for Russian gas consumed at the beginning of the year with the option to conduct in-kind payment through transfer of gas kept in storage facilities. Also, Gazprom received a right to sell a part of supplied gas directly to Ukraine's industrial consumers, while the rest of domestic distribution was reserved to Naftogaz. Before, imported gas was distributed through CJSC UkrGazEnergo, the joint venture of Naftogaz and RosUkrEnergo.

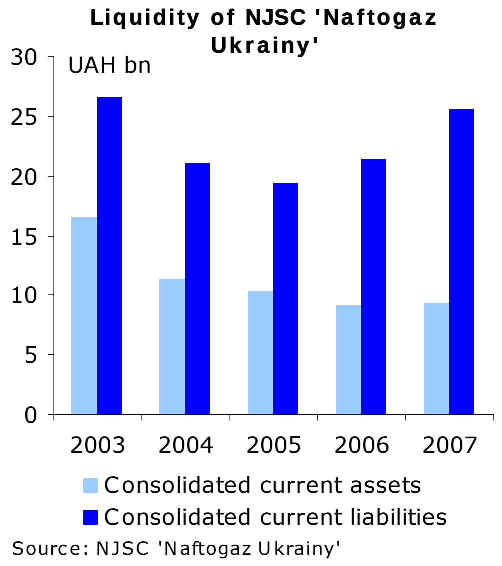
In accord with March agreement, the National Electricity Regulatory Commission (NERC) changed the structure of domestic gas market by issuing a five-year license on natural gas supply to OJSC Gazprom affiliate company – CJSC Gazprom Zbut Ukraine – allowing the company to sell 7.5 bn cubic meters of natural gas to consumers on unregulated tariff since April 2008. The license of UkrGazEnergo was simultaneously cancelled. But after UkrGazEnergo had contested this decision in court, the license was restored. Later the NERC limited gas volumes licensed for delivery to final consumers by UkrGazEnergo to 5 bn cubic meters per year, while before it was licensed to deliver 32 bn cubic meters per year. As a result, Naftogaz managed to partly retrieve the most profitable domestic market segment of import gas deliveries to industrial consumers.

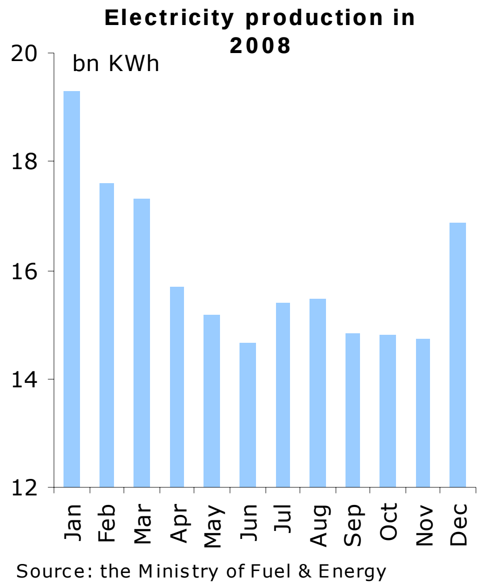
Important progress in gas negotiations was achieved in October when Naftogaz and Gazprom signed the memorandum outlining the principles of long-term cooperation in gas trading. According to the memorandum, Ukraine would receive gas directly from Gazprom in 2009 while RosUkrEnergo previously supplied gas to Ukraine as intermediary would be liquidated and the debt of Naftogaz to RosUkrEnergo for the supplied gas would be transferred to Gazprom. Moreover, the introduction of market-base pricing for natural gas supplied to Ukraine and for transit services was foreseen within three-year transition period.

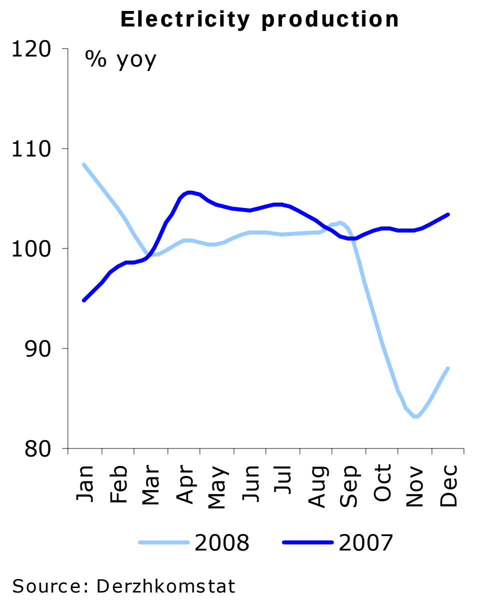
However, previous achievements were in fact vanished in the end of the year when Ukraine's gas debt issue was encountered. Naftogaz accumulated the total debt amounted at USD 2.6 bn between September and November, of which USD 1.95 bn of debt body without fees and penalties was paid on December 30 mainly at the expense of state credits. The failure to repay the entire debt became the official ground for collapse of gas talks between Gazprom and Naftogaz and for January gas shutdowns.

Naftogaz has faced serious financial difficulties that were partly caused by shortfall in company's revenues due to declined demand for natural gas by industrial consumers, especially chemical and metal producers (see *Industrial output*). Besides, Naftogaz was not able to attract anticipated USD 2 bn of external borrowings as world financial crisis deepened. Hryvnia depreciation further complicated the situation inflating foreign currency denominated obligations when measured in national currency.

However, the roots of Naftogaz financial problems have been in company's unfavourable operational conditions that significantly worsened over last five years. It was reflected in recently published consolidated financial statements of NJSC Naftogaz for 2007. According to it, consolidated revenues of Naftogaz amounted at UAH 30.4 bn, while consolidated losses reached UAH 66 m. As was stated by the auditor - Ernst & Young Ltd. – as at December 31, 2007 the Naftogaz's consolidated liabilities exceeded its current assets by UAH 16.2 bn. One of key problems has been the mismatch between growth rates and levels for imported gas price and for domestic tariffs, as changes in the latter has been limited by the Government.







Thus, tariff regulation reform should be in the heart of any policy actions aimed at securing financial stability of Naftogaz in the future.

Electricity sector. The first two quarters of 2008 were favourable for national power industry resulted in stable growth of electricity production, consumption and exports. The energy companies had been planning large-scale investments aimed on modernization of production and distributive facilities. But in the second half of the year the electricity sector encountered with consequences of economic crisis including credits freezing, payments defaults, and energy consumption slowdown.

The problems in the sector started in summer 2008 when the thermal power plants didn't get the required amounts of thermal coal from the state enterprise 'Coal of Ukraine' due to disagreement on price on primary market. The Ministry of Fuel and Energy planned to cover the gap by thermal coal imports, but finally started to import electricity from Russia and cancelled the power energy exports to Poland.

Industrial production drop resulted in decrease in electricity demand allowing stopping commercial imports of electricity from Russia since December. According to the Ministry of Fuel and Energy, the electricity production reached 191.7 bn kWh in 2008, which is by 1.8% less than a year ago. The major decline was registered in November when the total electricity production fell by 16.7% as compared to the same period of 2007. The largest shortfall was shown by thermal power plants (PP) that produced electricity by 29.6% less than a year ago.

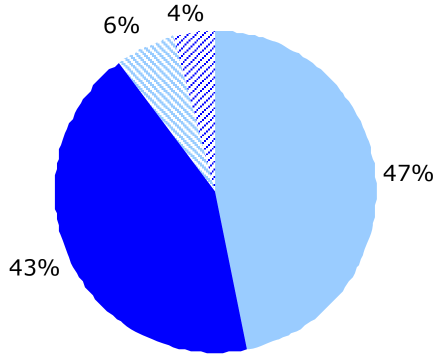
In 2008 the Government established new state concern 'Nuclear Fuel of Ukraine' that replaced its predecessor – concern 'Ukratomprom' – that was liquidated in March. The new enterprise includes a number of state companies involved in production of nuclear fuel. The final goal of the concern is to form closed nuclear cycle with establishment of own nuclear fuel fabrication plant. For this purpose UAH 0.88 bn was earmarked in State Budget 2009. Besides, the Government finally started implementation the project aimed at completion of two new power units on Khmelnitsky nuclear power plant. The Russian company 'Atomstroyeksport' won a tender.

Beyond this, some progress was achieved in completion of the Dnistrovska storage hydro power station, the most protracted construction in national hydropower engineering. On December 21, the first hydraulic unit was launched working at 30% of maximum capacity. This accomplishment is explained the sufficient funding from the state coffers at UAH 0.7 bn, although the expected placement of bond issue at UAH 0.2 bn failed due to turmoil on financial markets. Further UAH 0.65 bn are needed in 2009 to ensure the completion of first launching site (three hydraulic units) till the end of 2011.

Tariffs. The Parliament passed the amendments to Law 'On alternative energy sources' from September 25, 2008 introducing "green tariffs" for so-called alternative electricity and heat producers. According to the law, "green tariffs" will be set by the National Electricity Regulatory Commission (NERC)for the following 10 years, and will be at least twice the cost of electricity to the wholesale market for the year preceding the tariff decision. At same time, the average retail tariff for industrial consumers has been gradually raising over the year. As a result, the tariff has been increased by 43.4% up to UAH 0.51 per kWh. However, the Cabinet of Ministers froze the price of electricity for chemical, metal, and coke producers as a support measure during economic crisis[xii] thus leaving cross-subsidies mechanism that limits the possibilities for power engineering companies to accumulate funds needed for investments.

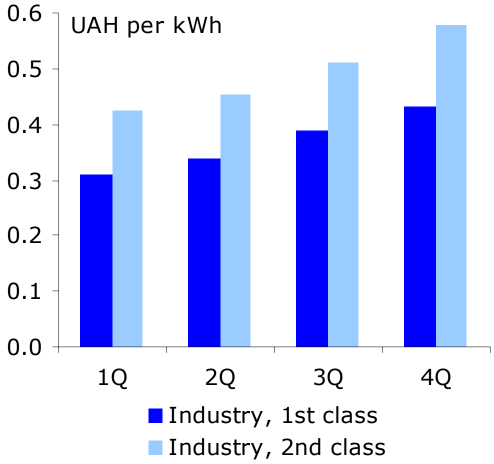
The NERC continued adjusting gas tariffs for households to cost-covering level. In August the Commission increased them by 13-14% effective from September[xiii]. The new tariff schedule preserved differentiated tariffs based on volume of annual gas consumption and on the availability of the gas meter. It was the first increase in gas

Electricity production structure in 2008



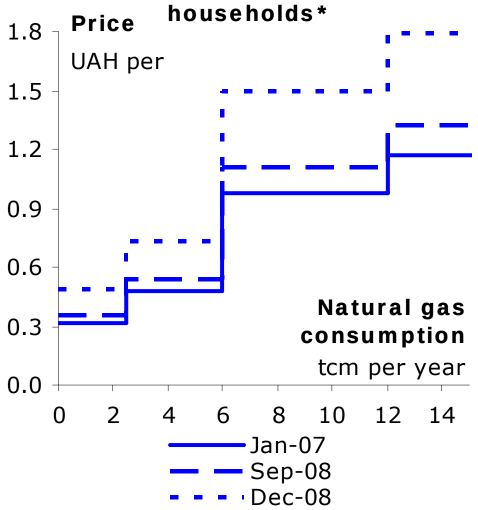
Source: Ministry of Fuel & Energy

Electricity tariffs for industrial consumers in 2008



Source: NERC

Natural gas tariffs for households*



Source: NERC

Note: * for households that have installed gas meters tariffs for households since January 2007. Changes were accelerated in the autumn. In line with the commitments to the IMF, the Government changed gas tariffs setting procedure[xiv]. In particular, it revoked maximum gas tariffs for households, and granted the Commission with the right to set gas tariffs without any co-ordinations with the Ministry of Economy and trade unions. As the result, in October the NERC increased gas tariffs by 35% effective from December[xv]. It is expected that rise of tariffs for households to economically justifiable levels would lead to decreased cross-subsidisation, and increased investments in gas transmission and distribution networks, and in domestic gas extraction. Also, high tariffs should further stimulate implementations of energy-saving technologies in the country.

Transport: Tariff increase did not result in better services or improved infrastructure

Tariffs. The Ministry of Transport and Communications of Ukraine (MTCU) increased tariffs for several major types of transport services in 2008, steadily adjusting tariffs to ever growing costs.

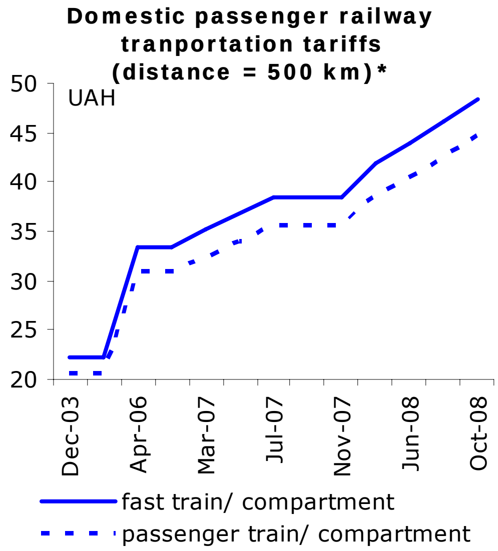
Stepwise adjustments of domestic passenger railway tariffs resulted in 15% cumulative increase of fares in 2008[xvi] as compared with 25% rise in 2007[xvii]. Fares to the CIS and Baltic countries were twice revised upwards with cumulative increase by 25%[xviii]. Starting from mid-December fares to non-FSU international destinations were pegged to euro. Moreover, tariffs for travels in second class were set by on average 15% higher than before[xix]. Freight railway tariffs were raised five times during the year with 48% cumulative growth[xx]. At the same time, discrimination among tariffs on freight transportation in different directions was eliminated in line with Ukraine's WTO commitments [xxi].

However, the increase in rail tariffs was reverted for several sectors as one of anti-crisis measures taken by the Government at the end of 2008. Namely, the Cabinet of Ministers granted metal and chemical producers with fixed lower freight rail tariffs till April 1, 2009[xxii]. As these two sectors are major Ukrainian exporters, introduction of reduced tariffs for them can be treated as trade-distorting subsidy and, consequently, might provoke the WTO member countries retaliation. Moreover, this decision adversely affected railway sector increasing revenues leakage, caused by reduced cargo flow in the last months of the year, by the amount of provided preferences[xxiii].

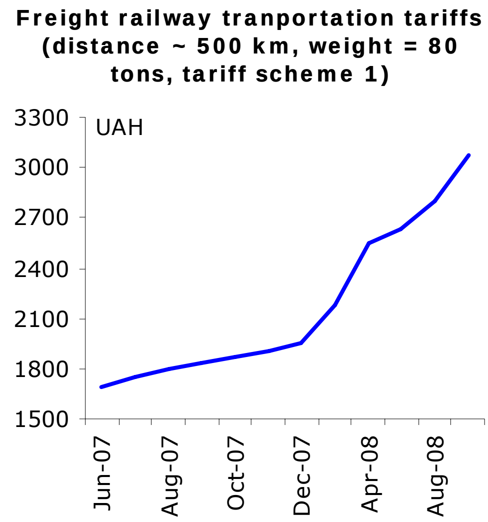
Port and airport services became more costly too. In particular, lump sum rates for ports services were increased twice, totally by 40%[xxiv]. In July, services for foreign ships provided by Ukrainian ports also became by approximately 60% more expensive[xxv]. Airport dues were increased in May in the range of 50-250%[xxvi]. Payments for aeronautical services grew in September by 14% for international flights, and by 190% for domestic flights[xxvii].

Thus, the MTCU persistently pushed tariffs up in 2008. It explained tariff revisions mostly by the necessity to cover growing costs of transportation and replace outdated equipment. However, service quality and the transparency of tariff setting has remained low. If tariffs increase is not followed by structural reforms in the sectors in the following years, transportation will remain ineffective sector and will likely become huge barrier for country's economic recovery.

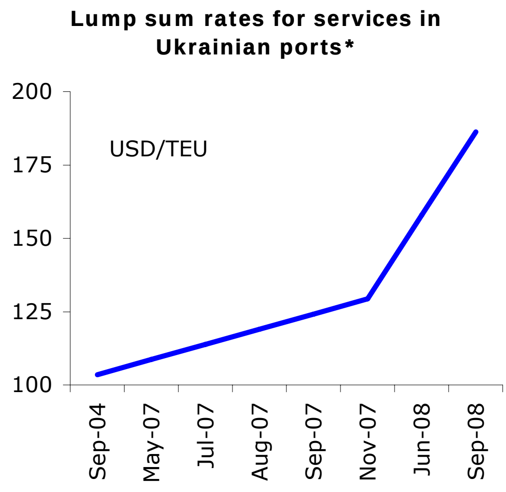
Regulatory environment. Constant deterioration of basic transport infrastructure and rolling stock made the Government to undertake some efforts in attraction of the investments into this sector. In particular, the Cabinet of Ministers elaborated and approved some documents on development of selected transport sectors. The Concept of the State Purpose Programme of Airports Development till 2020[xxviii] was approved in March, the Strategy of Development of Sea Ports Ukraine till 2015[xxix] in July, and the Concept of the State Programme of Reforms of Roads Sector Governance[xxx] in August. All of them are of mostly declarative character and foresee a



Note: * excluding VAT and insurance
Source: Ministry of Transport and Communications



Source: Ministry of Transport and Communications



Note: * loading/unloading services for exim cargo
Source: Ministry of Transport and Telecommunications

preservation of public ownership for basic transport infrastructure. Private participation could be introduced just for ancillary facilities, such as car parks, cargo handling buildings, passenger terminals, catering services, etc. But there are some improvements in sectors regulation that foresee separation of governance function and commercial activities, mainly in ports and roads. However, reforms in those sectors are highly dependant on the further government efforts to introduce them, including thought development of effective legislation, as well as from local authorities' capability to act transparently. So far neither of imminent reforms has been introduced.

Infrastructure maintenance and development. In March, Ukrzaliznytsya (UZ) presented the Complex Programme of Ukrainian Railway Rolling Stock Replacement for 2008-2020[xxxi]. According to the Programme, UZ plans to invest about UAH 130 bn in rolling stock, 75-80% of which is now outmoded. Lack of own funds has forced UZ to attract outside money. In November the state railways monopolist signed two credit agreements for the purchase of new freight cars. Namely, the European Investment Bank agreed to provide EUR 175 m, and the EBRD promised to lend USD 125 m. However, the efficiency of rolling stock replacement campaign will depend on how transparent the use of these funds will be.

Major credits of Ukrzaliznytsia

Year	*Credit amount*	*Creditor*
2004	USD 120 m	EBRD
2004	USD 700 m	Deutsche Bank
2007	UAH 500 m	Raiffeisen Bank Aval
2007	USD 550 m	Barclays Capital Bank
2008	USD 125 m	EBRD
2008	EUR 175 m	EIB

Sources: MTCU, EBRD, EIB

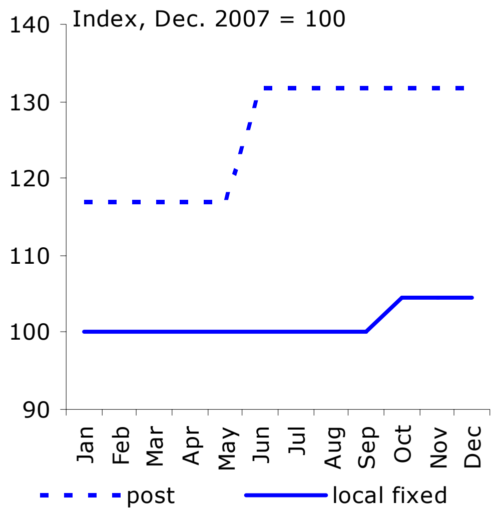
International airport Kharkiv was granted in concession to New Systems AM for 49 years starting from 2008. Private investor was obliged to pay for concession USD 360 thousand annually and to invest USD 120 m into airport infrastructure rehabilitation and extension, considerably improving passengers' hosting in the framework of Ukraine's preparations to the UEFA EURO-2012. It was first such concession in airport sector of Ukraine.

These efforts obviously can be considered as success stories in fundraising for transport infrastructure. But they are rather of discretional character than of general practice in Ukraine. The legislation on public-private partnership remains the urgent priority in country's reform agenda.

Telecommunications: Legal inconsistencies left the sector without efficient regulator for most of 2008

Regulatory environment. The issue of legal status of the National Commission for the Regulation of Communications (NCRC) was and remains the most important for telecommunications sector. The NCRC could not regulate market effectively until the dispute between the President and the Cabinet of Ministers over the authority of the government to make appointments to this regulatory body had been settled. The controversy seemed to cease at the beginning of the year renewed by the mid-2008. In May, Tymoshenko's Government appointed new head and staff of the NCRC[xxxii], and in June the President suspended the decision[xxxiii], repeating conflict of the previous year[xxxiv]. Only in September the members of the NCRC assigned by the Government took up their duties, after the President had cancelled his June Decree suspending the NCRC members appointment[xxxv]. However, legal inconsistencies remain and can cause further struggles for control over communications regulator.

Price indices for communications in 2008



Source: State Statistics Committee

Tariffs. Tariffs for communications services also grew in 2008 as transport tariffs did. In June, new maximum tariffs for universal post services became effective: they were raised by 40% on average. In October the NCRC increased monthly fee for home phones by 20%[xxxvi] and radio usage fees by 50%. In September the MTCU made a decision to increase tariffs for subscribed periodicals post circulation by 27% from January 1, 2009[xxxvii]. And in December state post monopolist Ukrposhta raised its prices for services that are beyond state regulation by 30-50%[xxxviii]. Such steps were officially explained by low cost-covering in fixed telecommunications and post.

In attempt to help state incumbents, tariff regulation was mitigated. Namely, the NCRC revoked state regulation of tariffs for fixed-line long-distance calls[xxxix]. This decision should have increased commercial independence of Ukrtelecom allowing it to compete with mobile operators in more successful manner. However, it did not help Ukrtelecom to regain lost market share in long-distance calls.

All abovementioned steps showed that the government preferred to cut losses in communications over attempts to limit inflation pressure through low regulated prices as well as over attempts to reform infrastructure sectors.

Utilities: The approval of the Utilities Development Concept did not change current sector stance

Regulatory environment. Negative developments in utilities such as frequent accidents with fatalities, poor service quality, and non-transparency of tariff-settings forced the Government to undertake some steps aimed at improving the situation. On July 9, the CMU adopted the Concept of Development of State Regulation in Utilities[xl]. It suggested gradual reform of state regulation of natural monopolies during next 3 years. On the first stage, it was planned to prepare necessary legislative grounds for reforms and create the State Housing and Public Utilities Inspection. On the second stage, it was foreseen to establish an independent regulator in utilities sector.

In June the CMU approved the establishment of State Housing and Public Utilities Inspection within the structure of the Ministry of Housing and Utility Services[xli]. This body was set to control natural monopolies activities in central water and heat supply, wastewater sectors, and their compliance with Ukrainian legislation. The drawbacks of this Inspection had already become evident: it had been closely associated with executive power and had insufficient financing in 2008. Despite drawbacks, in November one more government body was created – the Joint Council On Improvement of the State Regulation in Utilities Sector[xlii]. This step not only devastated government power to regulate utilities effectively, but also complicated regulatory procedures in the sector provoking further problems.

Tariffs. Tariffs for heating, water supply, wastewater and other utilities gradually moved up in various regions of the country in 2008[xliii]. But deterioration of economic situation in the last months of the year forced some of the local authorities to ban utilities tariffs increases, e.g. they did so in Sevastopol and in Kyiv.

Changes in tariff policy were not followed by major sector reforms. Service quality remained low, accidents occurred frequently, capital assets were not replaced, and almost no energy-efficient efforts were undertaken. Given poor regulation of the sector, it can be hardly expected that any improvements will take place in near future.

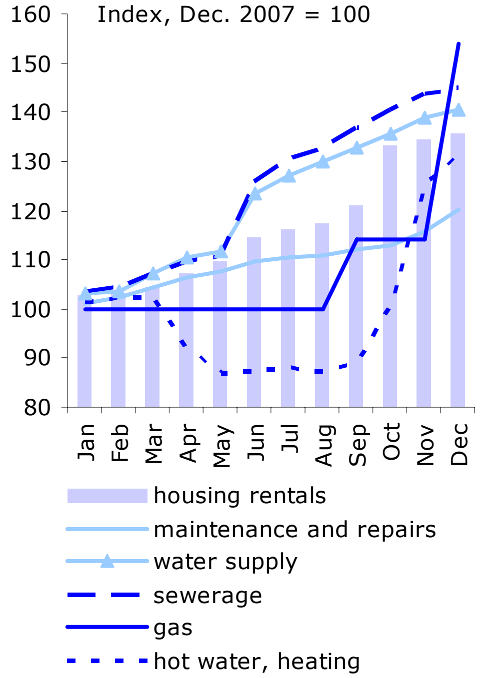
Infrastructure maintenance and development. In September Law on Loan Agreement between Ukraine and the International Bank for Reconstruction and Development (IBRD) was passed[xliv]. The IBRD lent USD 140 m to Ukraine to invest in water supply, wastewater, and wastes utilization in different towns. Odesa, Chernihiv and Ivano-Frankivsk had been already chosen to participate. Other towns and utility enterprises were welcome. The project will last for 5 years and first tranches are expected to be disbursed in 2009. Such initiative is insufficient to resolve all financing issues, but it can bring expertise in the sector, facilitate know-how and advanced technologies transfer, thus improving utilities' performance.

Balance of payments: In the last quarter of 2008 both current and financial accounts were in deficit

BOP. September world financial crisis became the turning point for Ukraine's external balance triggering a net outflow of foreign capital and halting trade.

According to the latest NBU data, in 2008 the current account (CA) deficit reached USD 12.9 bn or 7.1% of GDP that is more than twice above the previous year figure. Moreover, the CA deficit widening in October and November at USD 3.5 bn was almost equal to entire CA deficit of first quarter of 2008. However, already in November the

Price indices for utilites in 2008



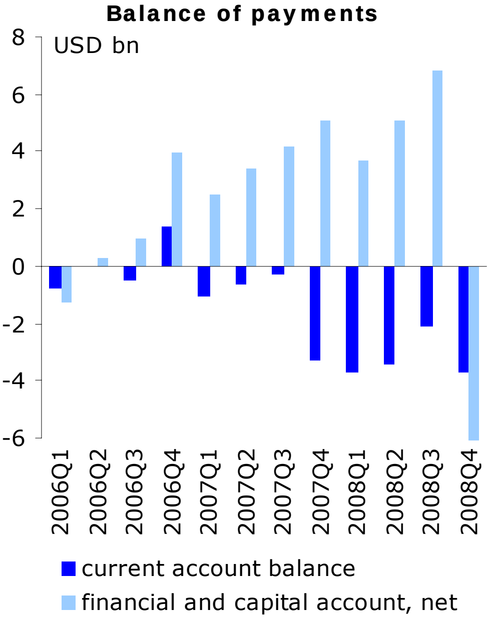
Source: State Statistics Committee

Major loans to utilities sector

Year	*Creditor*	*Borrower*	*Credit amount*
2008	EBRD	Cherkasy District Heating Company	EUR 11.2 m
2008	EBRD	Odesa District Heating Company	EUR 21.9 m
2008	IBRR	Government of Ukraine	USD 140 m

Sources: EBRD, World Bank

Balance of payments



Source: NBU

current account deficit improved slightly to USD 1.6 bn compared to USD 1.9 bn in October and became almost balanced in December (USD 0.2 bn) due to continuous decrease in imports.

Sharp depreciation of hryvnia and credit crunch resulted in monthly drop in commodity imports by 10.7% yoy in dollar terms in November, the first monthly reduction in imports for four year of observations. Import fall accelerated in December and reached 29.0%. November-December reduction of exports equated to around 15.4% yoy due to plummeted exports of metals, automotive and chemical products caused by significant shrinkage of external demand and consequent reduction in prices. In December both exports and imports continued to fall in annualized terms, pushing down cumulative commodity trade growth rates. Thus, in 2008 exports and imports grew by 35.9% yoy and 40.1% yoy, respectively, compared to 50.0% yoy and 59.5% yoy increase for nine months of the year. However, monthly exports were higher in December than in November (by 9.2%), while imports continued dropping even in month-on-month terms. That allowed reducing the gap between annual growth rates of exports and imports. The annual commodity trade deficit in Ukraine reached USD 16.9 bn compared to USD 10.6 bn a year ago.

The positive balance of trade in services at around USD 2.4 bn and current transfers' net inflow at above USD 3.1 bn balanced out the outflow of incomes at USD 1.5 bn paid as dividends for the foreign direct investments (FDI) in 2008.

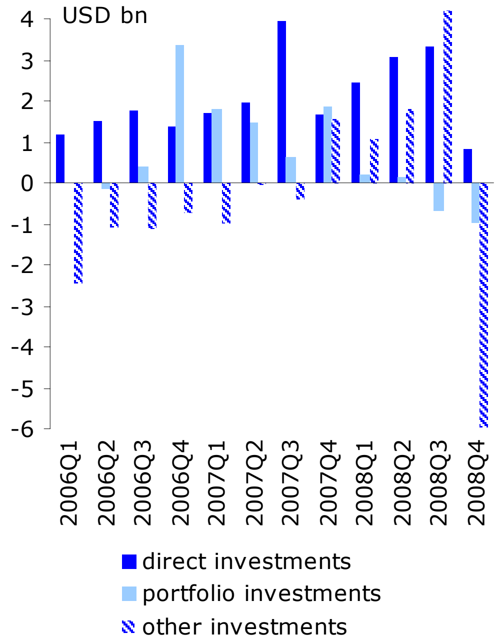
During first nine months of 2008 current account deficit was financed by inflow of long- and medium-term capital. In particular, between January and September the net foreign direct investment inflow reached USD 8.8 bn. Nine-month positive balance of the financial account reached USD 15.6 bn compared to USD 10.0 bn a year ago. However, the situation dramatically changed in the fourth quarter. First, the inflow of long-term capital was almost halted. In last quarter of 2008 the net inflow FDI constituted only USD 0.8 bn, while the net inflow of long- and medium-term borrowings by private sectors, including banks, was at USD 2.5 bn, more than twofold drop compared to previous quarter. Banks were especially hurt by the financial crisis being unable to attract amount of external financing comparable with previous records. Moreover, the financial system witnessed a sharp outflow of other investments including an outflow of foreign cash from banking system. These factors led to net outflow on financial side at USD 6.1 bn in the fourth quarter resulting in contraction of positive financial account balance to USD 9.5 bn in 2008.

To meet the demand for foreign currency, the NBU was forced to sell international reserves, but also to allow significant depreciation of hryvnia (see *Foreign exchange policy*). The receipt of USD 4.5 bn instalment of the IMF credit helped the NBU to replenish reserves considerably exhausted during last months of the year.

FDI. According to the Derzhkomstat, as of January 1, 2009 Cyprus remained the major investor to Ukrainian economy accounting for 21.5% of all inward FDI stock in Ukraine. It was followed by Germany and the Netherlands that contributed 17.9% and 8.9% of the stock, respectively. Cyprus leadership was insured by record capital injections in the second quarter of 2008. However, already in fourth quarter of 2008 the FDI inflows started decreasing with fastest deceleration of investments from Cyprus.

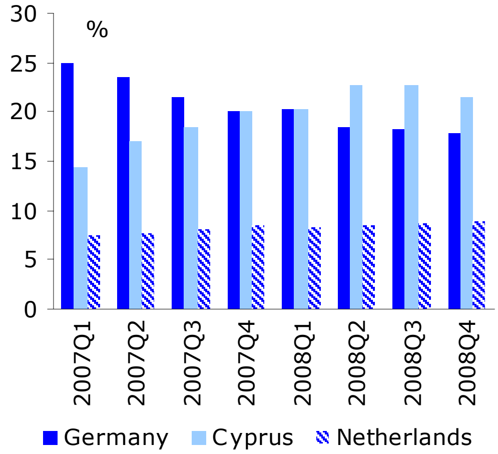
As in the previous year, one of the most attractive sectors for the FDI remained financial intermediation with 37.0% of FDI inflow in 2008 and 20.0% of FDI inward stock. Investments in manufacturing, specifically in metal production and food industry, and retail trade followed. However, due to aggravation of problems at global financial markets the net FDI inflow has significantly shrunk already in the third quarter of 2008 compared to second quarter, starting the path to FDI outflow.

Investments net inflow



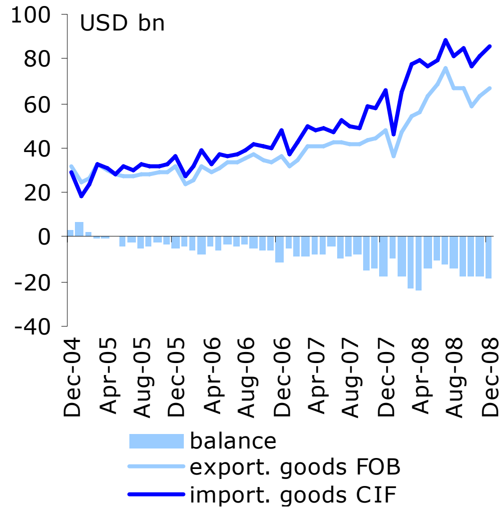
Source: NBU

Structure of foreign direct investment



Source: Derzhkomstat

Merchandise Trade



Source: Derzhkomstat

As of January 1, 2009, the FDI inward stock per capita reached USD 775.3, still being significantly lower than in other transition countries.

Commodity trade: Drop in commodity trade in the end of 2008 did not cure the trade deficit

Major changes in domestic and external demand provoked by global crisis reversed Ukraine's commodity trade trends in the last quarter of 2008. However, these changes were insufficient to considerably reduce the deficit accumulated in the first three quarters. According to the Derzhkomstat, in 2008 commodity trade deficit reached USD 18.5 bn compared to USD 11.3 bn a year ago.

Between January and September commodity export and import growth reached 50.1% yoy and 60.2% yoy in dollar terms, respectively, showing highest ever results. But already in October situation started worsening. Leading exporting industries suffered from consequences of world financial turmoil resulting in lower external demand and falling prices. Imports also started to slowdown because of hryvnya depreciation and decreased demand for raw materials by national producers. As a result, annual growth of exports and imports considerably decelerated to 35.9% yoy and 41.1% yoy in dollar terms, respectively, with harsh drop in trade value in November-December.

All major Ukrainian export commodities suffered from the downturn of external demand and prices in the end of 2008. In particular, exports of ferrous metals – the largest export category in Ukraine's commodity trade – decelerated to 37.4% yoy in the first eleven months of the year as compared to 62.6% yoy growth in the first nine months after exhibiting 39.4% yoy drop in November and falling even further by 43.5% yoy in December. Considerable slowdown was registered in exports of mineral products, machinery and chemical products. Among export categories that continued its growth in annual terms even after aggravation of financial crisis were exports of plants (223.0% yoy) mainly thanks to grain exports (see *Agricultural output and trade* and *Agricultural policy*).

Strong domestic demand (see *GDP*), hryvnia revaluation (see *Foreign exchange policy*), and higher energy prices that had pushed up commodity imports during the first three quarter of 2008 ceased to exist in the last quarter. Already in November sharp devaluation of hryvnia and depressed domestic incomes significantly lowered imports. November-December imports dropped for all commodity categories except for gas, animal husbandry products, and plants. In particular, imports of transport equipment plummeted most considerably (by 37.2% yoy in November and 41.3% yoy in December), dragging down cumulative annual growth of this category to 47.2% yoy compared to 79.3% yoy rise in the first nine months of the year.

No major changes occurred in geography of commodity trade, although Ukraine continued to gradually diversify trade flows intensifying trade with non-neighbouring countries. Still, the EU-27 as a single customs territory was the largest commodity trade partner for Ukraine accounting for 27.1% of overall exports and 33.7% of imports. Ukraine remained the net importer in trade with the EU as export growth rates lagged behind import ones. However, in 2008 exports to the EU increased by 34.4% yoy in dollar terms, while imports grew by 37.4% yoy, though trade flows considerably decelerated compared to nine-month figures as economic situation both in Ukraine and the EU worsened.

The role of the Russian market in Ukraine's foreign trade decreased compared to the previous year. Export share to Russia declined by 2.2 percentage points to 23.5% of total exports, while import share by 5.1 percentage points to 22.7% of total imports. This tendency was somewhat accelerated by the global financial crisis and the reduction in commodity prices. The Ukrainian exports to Russia and imports from it dropped by over 40% each in November. In December imports dropped more than exports (by 57.7% yoy and

Commodity trade structure between January and December, 2008

	Exports		Imports	
	USD m	% yoy	USD m	% yoy
Total	67002.5	35.9	85534.4	41.1
I - Live animals, animal products	783.4	4.8	1702.0	120.7
II - Vegetable products	5577.1	223	1462.5	69.9
III - Animal or vegetable fats and oils and their cleavage	1945.8	13.3	612.9	57.9
IV - Prepared foodstuffs	2524.3	20.5	2679.2	28.1
V - Mineral products	7046.1	64.8	25441.5	47.8
VI - Products of the chemical or allied industries	5045.4	24.3	6959.1	30.9
VII - Plastics, rubber and articles thereof	997.7	1.1	4476.8	31.1
VIII - Leathers, skins and articles thereof	359.5	-8.9	232.5	45.8
IX - Wood and articles thereof	801.2	-3.2	545.7	45.7
X - Pulp, paper, paperboard and articles thereof	874.4	13.9	1835.2	20.5
XI - Textile and textile articles	984.6	-0.6	2099.2	41.2
XII - Footwear, headgear, umbrellas	178.1	19.9	531.1	143.8
XIII - Articles of stone, plaster, cement, asbestos, glass	454.8	26.8	1276.5	28.7
XIV - Precious and semi-precious stones and metals	146.9	-1.3	1032.0	283.4
XV - Base metals and articles of base metal	27633.1	33	6390.0	34.7
XVI - Machinery and mechanical appliances, electrical equipment	6341.2	27.4	13378.6	26.5
XVII - Vehicles, aircraft, vessels and associated transport equipment	4324.1	30.8	12091.4	47.2
XVIII - Instruments and apparatus	242.9	19.3	1222.6	21.2
XX - Miscellaneous manufactured articles	438.9	21.7	1011.0	69.9
XXI - Works of art, collectors' pieces and antiques	0.7	-66.3	4.1	15.4
Goods purchased at ports	59.4	43.2	515.0	59.2
Other	242.9	-36.4	35.4	-45.9

Source: Derzhkomstat

22.9% yoy respectively), partially due to hryvnia depreciation. In total during the year, commodity exports to Russia grew by 24.2% in dollar terms, while imports by 15.3% yoy.

In sum, high annual export and import growth rates were assured by sharp development of commodity trade in the beginning of the year, while last quarter provided considerable corrections of annual performance.

WTO: After 14 years of negotiations Ukraine has become the member of the WTO

Among events of 2008 the membership in the WTO was a milestone bringing changes that would have long-term implications for the country's development. Ukraine joined the WTO on May 16, 2008, after both the General Council of the WTO approved the accession package of Ukraine in February, and the Verkhovna Rada ratified it in April. Hereby Ukraine successfully completed almost fourteen years of negotiation process.

The WTO membership caused several important immediate changes in Ukraine's trade regime. In particular, import tariffs were reduced and bound at around 10.66% on average for agricultural products and at around 4.95% on average for industrial goods[xlv]. Moreover, specific and mixed tariffs rates were almost completely replaced by ad-valorem rates, ensuring higher predictability and transparency of tariff policy. Number of international tariff spikes, i.e. tariff rates over 15% more than halved: from 44.3% to 21.4% of tariff lines comprising agricultural products, and from 1.43% to 0.58% of tariff lines comprising industrial goods.

Maximum binding import tariff rate was set for sugar (50%). However, Ukraine also opened a tariff quota on raw cane sugar at 260 thousand tons at 2% tariff, and removed quantitative restrictions on production and exports (so called quotas B and C).

Also, the country committed to gradually reduce export tariffs applied to oil-bearing crop seeds, cattle, skins, and metal scrap. However, quite long transition periods were agreed allowing domestic producers that use these products as input to prepare for changed environment.

The important achievement for trade facilitation was Ukraine's commitment to reform the system of technical barriers to trade, and of sanitary and phyto-sanitary controls.

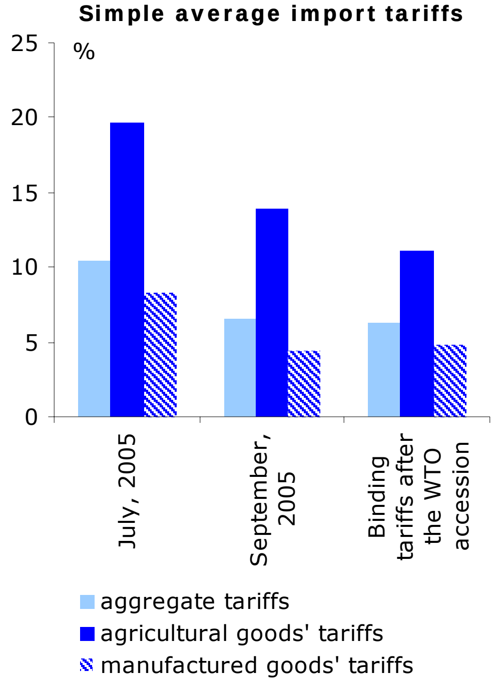
Ukraine took wide commitments in service trade regarding the provision of free market access and national treatment regime. The specific obligations were taken in all eleven "core" service sectors. The exemptions from most favoured nations treatment include audiovisual services, internal waterway transport, and rail transport.

Alongside with better access to Ukraine's market the membership in the WTO improved the access to external markets for the Ukrainian exports. Immediately after accession EU quotas set on steel products exports from Ukraine were lifted. Yet other benefit of the WTO membership has been the access to trade dispute facilities.

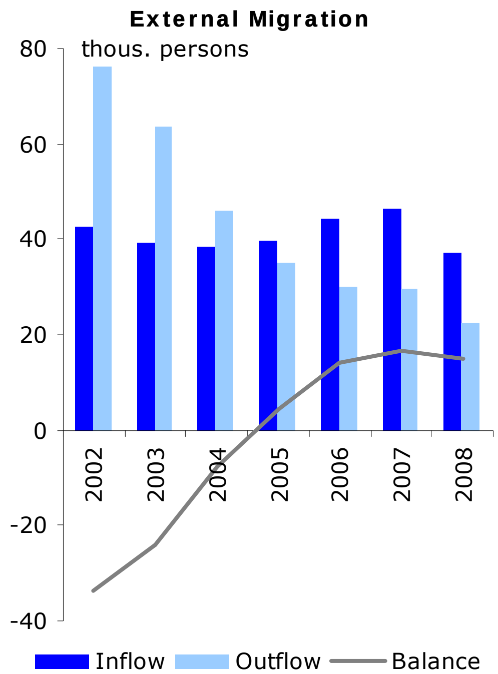
High growth rates in trade in 2008 (see *Commodity trade*) should be attributed not only to the WTO accession. Only after several years true benefits and costs of the accession can be evaluated. But already the WTO membership had paved the way to further opportunities, in particular allowing to start official talks on the deep free trade area with the EU, the largest Ukraine's trade partner.

Migration: Expected return of labour migrants back to Ukraine did not happened in the end of 2008

Regulatory environment. In January the agreements between Ukraine and the EU about simplification of visa regime and readmission came into effect. According to visa agreement, certain categories of Ukrainians could receive free visas, while for the rest fees were decreased. Also, convenient visa issuance and border passing procedures were agreed for all categories of Ukrainian



Source: Cabinet of Ministers



Source: Derzhkomstat

citizens. Though some advances were achieved, the monitoring revealed that many consulates did not provide information for Ukrainians about new procedures complicating visa issuance processes. Moreover, the inclusion of the Central and Eastern European into the Schengen zone resulted in increase in visa requirements in these countries, *de-facto* exerting additional barriers for Ukrainians. Thus, the situation remained practically unchanged despite *de-jure* simplification.

Migration flows. In 2008 the number of migrants that moved into Ukraine decreased to 37.3 thousands compared to 46.5 thousand in 2007. At the same time, outflow of Ukrainian citizens declined by somewhat smaller amount to 22.4 thousand reducing the balance of external migration to 14.9 thousand. Contraction of legal migration has been noted for the first time since 2005, apparently due to consequences of global economic crisis. Volumes of illegal and unregistered moves are still missing in the official statistics, making the full picture of migration in Ukraine unclear.

Recent full-scale survey of Ukraine's labour migrants conducted by the Derzhkomstat in the mid of 2008 shed some light on migration flows in pre-crisis period. The estimated number of labour migrants abroad during one year (May 2007-May 2008) was around 1.3 m. The revealed number appeared to be much lower than supposed and discussed by public using the estimate at around 3 m. On the threshold of economic crisis the biggest share of migrants worked in Russia (46.5%), Italy (14.5%), and Czech Republic (11.6%). Most of them worked in construction sector (50.7%), household service (16.1%), and trade (9.6%).

Destination countries of Ukrainian labour migrants

	thous. persons	% of total
Russia	599.0	46.54
Italy	186.7	14.50
Czech Republic	150.5	11.69
Poland	98.0	7.61
Hungary	49.6	3.85
Spain	40.0	3.11
Portugal	36.2	2.81
USA	19.4	1.51
Germany	16.5	1.28
Belarus	13.4	1.04
Israel	10.7	0.83
Total	**1287.2**	**100.00**

Sources: Labour Migration Survey conducted by the Ukrainian Centre for Social Reforms and the Derzhkomstat in 2008

The economic crisis led to decrease in economic activity in the EU and Russia that causes layoffs of employees. In order to provide workplaces for own citizens many countries (including Russia and Spain) announced plans to limit quotas for legal migrants and took measures to return labour migrants back home. However, the expected arrival did not happen – in situation of uncertainty and work absence in Ukraine migrants tried to stay at their places abroad by all means. It seems that lower labour costs compared to domestic workers was a forcible argument for employers to retain qualified Ukrainian labour migrants.

Wages and incomes: Nominal wages declined in the end of 2008

Continued growth of household's incomes supported high consumption growth in the first half of 2008 (see *GDP*). However, in the second half of the year the growth of all income components decelerated. In particular, in 2008 the growth of real households' incomes slowed down to 8.5% yoy compared to 19.0% yoy growth in the first quarter of the year.

Against the background of economic slowdown real wage growth decelerated in all sectors of the economy with average rise at 6.8% yoy in 2008 as compared to 13.8% yoy in the first quarter. The real wage growth in industry slowed to below-average 3.7% yoy. Reverting the previous trend of high wage growth the construction demonstrated decline in real wages as sector output sharply declined. The growth of real wages in public sectors was higher than average for economy.

Real wage, % yoy

	2007	Jan-March 2008	2008
Average wage in economy	**14.9**	**13.8**	**6.8**
Agriculture	17.5	19.6	17.3
Industry	13.6	9.3	3.7
Construction	15.6	9.3	-1.5
Trade and repairs	12.9	10.3	5.7
Hotels and restaurants	13.8	9.7	3.4
Transport and communication	11.4	10.6	5.6
Financial intermediaries	19.8	17.3	8.1
Real estate	18.4	11.8	4.5
State administration	3.9	9.7	11.3
Education	16.4	23.4	9.2
Health care	17.2	21.6	8.0
Culture and sports	16.7	18.2	10.7

Source: Derzhkomstat, own calculations

November became a turning point for average wage development. The growth turned into contraction with average November wage at UAH 1823 being by 4.9% lower than in October. The largest decline in wages was in industrial sectors (8.6%). In December, a month of traditionally high wages due to payments of premiums and bonuses, the average wage was at UAH 2001 with all sectors paying higher wages than in November. However, the wages in industry, construction and agriculture remained lower than in October, 2008. The highest wage growth was in state administration (at 23.2% as compared to October), which was unexpected taking into account the officially announced strategy of cost-saving policies, including restricted wage growth (see *Fiscal Policy*).

Due to the deteriorated financial state of some enterprises, wage arrears increased in November to UAH 1.7 bn, which is by 66.4% higher than in October. Already in December they declined to UAH 1.1 bn, being still by 7.7% higher than in October. Such reduction could be attributed to partial recovery in industry (see *Industrial output*), which accumulated more than half of wage arrears. Reduced nominal wages and increased wage arrears were accompanied by higher unemployment (see *Labour market*) negatively influencing households' incomes and revenues of social insurance funds, primarily the Pension Fund (see *Pension system*).

At the same time, the wage incomes remained the largest source of households' incomes accounting for 42.4% in 2008. The growth of other income components also slowed down in the second half of the year. In particular, the growth rates of incomes received from agricultural and entrepreneurship activities significantly decelerated from 36.1% yoy in the first quarter of 2008 to mere 3.6% yoy during the year.

Thus, welfare growth experienced during last several years had been over by the end of 2008, turning into much gloomier perspectives of the year 2009.

Real households' income by components, % yoy

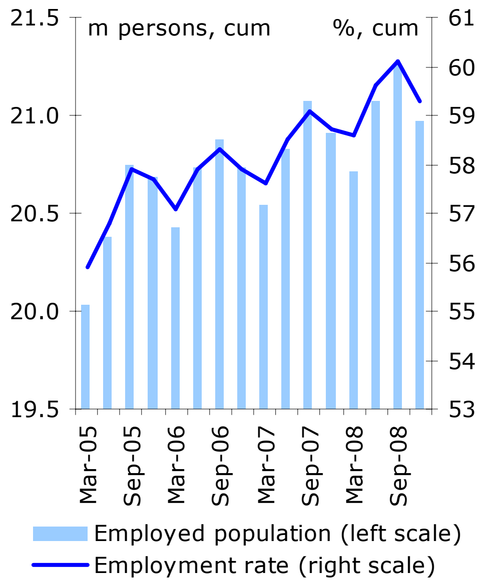
	2007	Jan-March 2008	2008
Households' incomes	16.7	19.0	8.5
In particular:			
Wage incomes	15.5	14.8	7.6
Social payments and current transfers	13.1	19.3	11.3
Incomes from agricultural and entrepreneurship activity	22.8	36.1	3.6
Incomes from property	55.9	26.9	11.9

Source: Derzhkomstat, own calculations

Labour market: Demand for labour force decreased by the end of 2008

Though the first signals of approaching crisis had already been visible in some sectors by the end of September, employment continued growing in the first three quarters of 2008. In particular, the employment among the population of age 15-70 increased to 60.1% in the first nine month of the year. That was by 0.5 p.p. higher than for the first six month of 2008 and by 1.0 p.p. higher than for the same period a year before. At the same time, period unemployment decreased to 6.0% that was by 0.2 p.p. lower than three months and year ago.

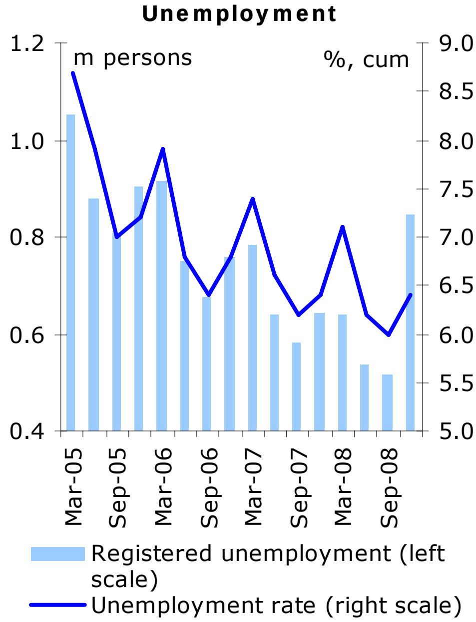
Employment



Source: Derzhkomstat

However, the situation on the labour market changed dramatically in the fourth quarter as Ukrainian enterprises declined its production due to both domestic and external shocks. According to the last IER Quarterly Business Tendency Survey, in October 15% of industrial enterprises' managers was going to fire personnel and 26.3% considered layoffs as a possible anti-crisis measure. Moreover, 47.4% of enterprises had already decided or could decide on shortening of working hours for their employees. Significant dismisses took place in financial sector and industry. As a result, unemployment increased significantly to 7.5% in the fourth quarter and to 6.4% for the entire 2008.

Unemployment



Source: Derzhkomstat

The registered unemployment increased in the end of 2008 as employers started firing workers against the background of economic recession. In particular, the registered unemployment rate reached 3.0% of working able population in December, while in September it was at 1.8%. During the same period labour demand more than halved from 198.6 thousands persons to 91.1 thousands. As a result, labour supply per one vacancy increased from 2.7 in September to 9.6 persons in December 2008, reaching the highest value from March 2002. In such circumstances probability to obtain work place declines, while duration of unemployment rises significantly.

The Government tried to deal with new challenges on the labour market. As an immediate measure each memorandum with industrial producers included point about preservation of current number workplaces on enterprises in exchange to the Government support for those enterprises[xlvi]. However, as the economic conditions were continuing to worsen and the Government did not undertake meaningful steps to support industrial producers, the massive dismiss of employees became reality.

On December, 25 2008 the Parliament passed the Law dealing with consequences of world financial crisis on labour market which is supposed to overcome rigidities of the governmental employment policies and institutions[xlvii]. In particular, the State Employment Office received higher flexibility in offering vacancies and retraining services for unemployed. The new law restricted employment of foreigners and widened usage of paid public works to increase labour demand. However, affect of the law on labour market in 2009 will be limited, since financing of public works is doubtful due to lack of money in the budget, while higher flexibility of employment services is not effective measure during recessions, when unemployment hits all industries.

Fiscal policy: The attention was centred at ongoing issues

State Budget Law 2008. In the Budget Law 2008[xlviii] approved in the end of 2007 the central fiscal revenues and expenditures were set at UAH 215.4 bn (24.2% of GDP) and UAH 232.4 bn (26.1% of GDP), respectively. The central fiscal deficit was initially planned at UAH 18.8 bn or 2.1% of GDP. Privatisation receipts (UAH 8.9 bn), domestic (UAH 4.1 bn) and external (UAH 5.8 bn) borrowings were supposed to contribute almost equally to deficit financing. Besides, expected additional receipts from privatisation at UAH 12 bn were earmarked for repaying devalued savings in the Soviet Sberbank (see *Social policy*). In the latter case the central fiscal deficit could increase up to 3.3% of GDP.

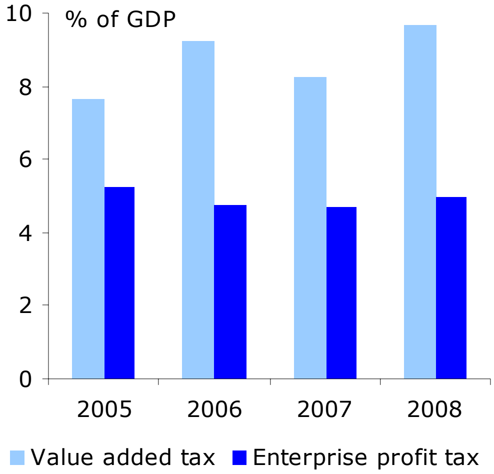
According to December Budget Law, it had to be amended in the spring 2008. However, parliamentary crisis postponed the first amendments till summer. In June the Parliament adopted changes to land tax regulations concerning in particular rules of land auctions and taxation of non-evaluated land plots[xlix]. Also, excises on some goods and payments for the extraction of natural resources were increased (see *Tax amendments*). Besides, social sector legislation was amended (see *Social policy*). However, in terms of revenues, the effect of these amendments was insignificant as their target level was raised by 0.2% (UAH 0.3 bn).

Next amendments of the State Budget took place in the end of July, mainly aiming to finance the expenditures related to a liquidation of flood consequences (see *Social policy*). The central fiscal expenditure plan was increased by UAH 5.8 bn, including UAH 4.4 bn on the liquidation purpose. The rest was directed on agricultural sector support (UAH 1.4 bn). The increase was planned to be financed from the VAT and excises without deficit revision.

Subsequent minor amendments to the State Budget were approved in September. The additional funds were planned to receive mainly from higher receipts of VAT on imports and used to support agriculture (UAH 1.8 bn) and state coalmines (UAH 0.6 bn in funding and UAH 3.1 bn as state guarantees), to pay increased wages to public sector employees (UAH 1.1 bn), and to increase sports spending (UAH 0.4 bn). Consequently, the central fiscal revenues plan was increased by UAH 3.9 bn to UAH 224.7 bn.

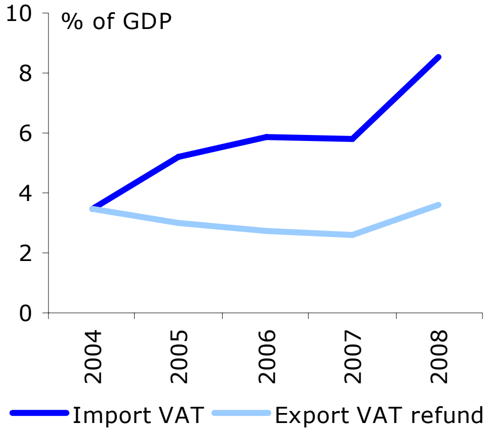
Last amendments took place in December. The central fiscal expenditures were raised by 13.6 bn (or 5.7%) to UAH 253.2 bn. These amendments were partly related to financing of additional expenditures, approved by the first Anti-Crisis Law that came to force on November 5[l]. Funds were earmarked for newly established Stabilization Fund (UAH 3 bn) and for additional financing of the Deposit Insurance Fund (UAH 1 bn). Besides, additional funds were foreseen for transfers to Pension Fund and NJSC "Naftogas Ukrainy". The increase in expenditures was covered by higher central fiscal revenues (UAH 7.3 bn) and central fiscal deficit growth (by UAH 6.2 bn to UAH 25.0 bn). The sources of deficit financing were changed either. Plans for privatisation receipts was sharply downgraded to UAH 0.6 bn (see *Privatisation*), while plan for domestic borrowings revised upwards to UAH 10.8 bn. Besides, the funds accumulated at the Unified Treasury Account were increased to UAH 6.6 bn.

Key tax revenues



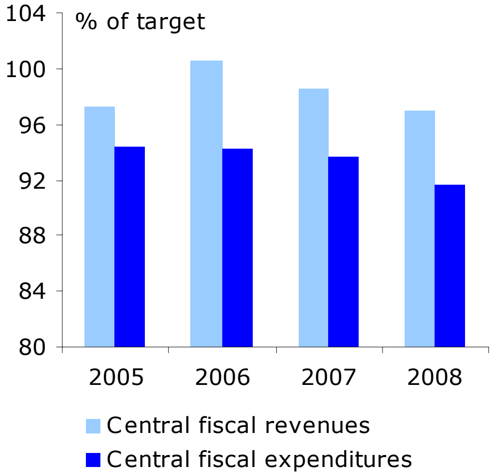
Source: State Treasury, Derzkomstat

Import VAT and export VAT refund



Source: State Treasury Reports, Derzhkomstat

Execution of central fiscal revenues and expenditures



Source: State Treasury reports

Summing up, majority of amendments to the State Budget-2008 during the year were traditionally related to social aspects and sector support of state enterprises. Only last revision could be treated as exemption as it was provoked by the economic crisis aggravation requesting urgent actions.

Budget 2008 execution. In 2008 the central fiscal revenues were executed at 97.0% of projected level. The receipts from enterprise profit tax (EPT) exceeded the plan by 12.3% despite a sharp decline in economic activity in the last quarter of the year. It could be explained by good financial results of enterprises during previous quarters. Also, non-tax proceeds were above the target (by 1.4%). Particularly, the revenues from property and entrepreneurship including portion in profits and accrued dividends transferred by state enterprises were over-executed by 14.1% of the target.

At the same time, revenues from VAT, excises, taxes on international trade and official transfers (transfers from local budgets to the State Budget) were below the target. Specifically, the VAT collections were under-executed by 7.3% primarily due to low domestic VAT revenues (91.6% of the target). Besides, receipts from import duties were slightly under-executed by 1.4%.

The central fiscal expenditures in 2008 were executed at 91.6% of revised annual plan[li]. As in previous years, the utility sector financing had the lowest execution rate (39.7% of the target), while financing of social protection, public order and defence was executed at over 95% of the plan.

The central fiscal deficit reached UAH 12.5 bn or 1.3% of GDP in 2008[lii]. It was primarily financed at the expense of funds accumulated at the Unified Treasury Account and domestic borrowings (see *State Debt*) as privatisation receipts were extremely low (see *Privatization*).

Tax regime in 2008. Key tax amendments supplementing State Budget for 2008[liii] included higher excise rates, fivefold increase in taxes on non-evaluated land plots in populated localities, and threefold growth of annual rental for non-agricultural land. In parallel, some tax privileges were granted. Particularly, the provision cancelling VAT on transactions related to delivery of waste and ferrous metal scrap (including imports) was extended for 2008. Besides, special taxation regime was preserved for agricultural producers (see *Agricultural policy*). Rent rates for extraction and transportation of natural resources was also preserved at the level of 2007 to support extracting industry development.

One of positive changes in tax legislation approved by the State Budget Law for 2008 was the return to practice that allows an inclusion of previous year losses into gross costs in enterprise profit tax base calculation. Although it reduced the enterprise profit tax base, such change was in line with European taxing practice and enabled the enterprises to optimize their tax payments.

Besides, the circulation of VAT bills was suspended in 2008, what, on the one hand, allowed the State Customs Service to substantially exceed target receipts in the first half of 2008, but, on the other, drained operating assets of budget-making exporters. This measure was accompanied by the resumption of State Programme 'STOP Smuggling!' and continuation of the large-scale "Tsunami" campaign launched in November 2007 aimed at combating smuggling[liv], thus further improving import taxes collection.

During 2008 some further changes in tax regime were introduced aimed at facilitating tax collections. For instance, excises on cigarettes were increase thrice during 2008. At the same time, *de-facto* tariff protection was reduced in line with WTO membership commitments after Ukraine joined the organisation in mid-May (see *WTO*).

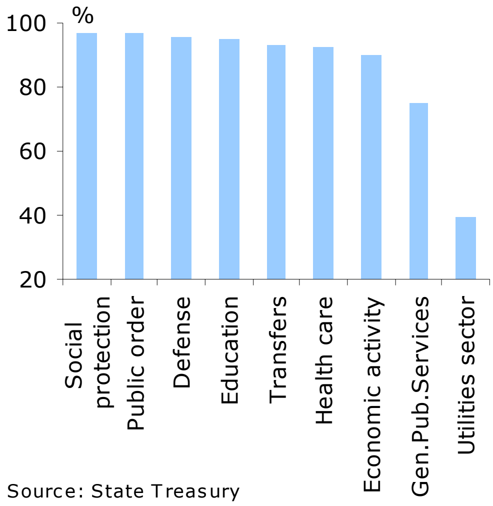
Besides, the Government proceeded with introduction of electronic reporting of VAT payments (besides the electronic VAT declarations

Central fiscal expenditures

% GDP	2007	2008
General public service	2.3	2.3
Defence	1.3	1.2
Public order	2.5	2.6
Economic activity	4.1	4.1
Health care	0.9	0.8
Culture and Education	2.4	2.6
Social welfare	4.1	5.3
Transfers to local budgets	6.2	6.2
Total expenditures	**24.2**	**25.4**

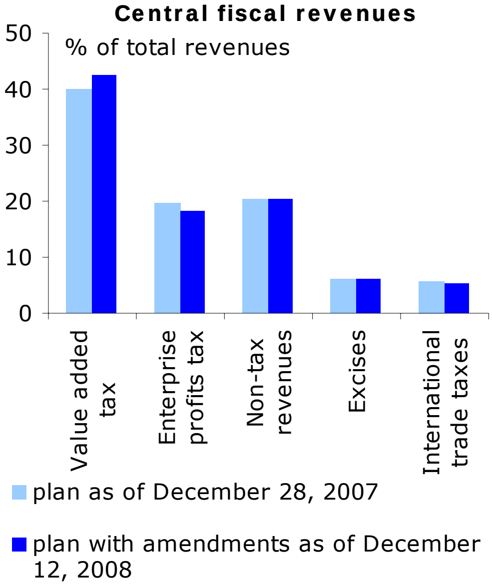
Source: Treasury reports

Execution of central fiscal expenditures in 2008



Source: State Treasury

Central fiscal revenues



Source: the State Budget Law for 2008 as of December 28, 2007, and with amendments as of December 12, 2008 enterprises were to provide a number of detailed annexes[lv]) and somewhat improved internal control and monitoring of VAT refunds[lvi].

Fiscal reforms. Important fiscal reforms were once again failed to implement in 2008 as in previous years. Draft Tax Code submitted to the Parliament by deputies representing 'Our Ukraine – People's Self-defence' faction was not even considered in the first reading. Important changes in the Budget Code aimed at strengthening local fiscal autonomy and medium-term budget planning was passed only in the first reading[lvii].

'Anti-crisis' fiscal measures approved in 2008. Sharp deterioration of domestic macroeconomic conditions under the global financial crisis called for fiscal policy response, namely for supportive and stimulating fiscal measures. At the time, a deceleration of fiscal revenue collections registered already in the last quarter of 2008 required streamlining of fiscal expenditures to ensure that priority spending goals would have been met. Several 'anti-crisis' acts were passed by the Parliament and the Government in 2008, although no comprehensive rescue strategy was generated.

The first 'anti-crisis' law was passed by the Parliament in end-October[lviii] as one of precondition for the approval of the IMF stand-by loan (see *Monetary policy*). The main provisions of the law concerned the establishment of the Stabilization Fund, procedures of public recapitalisation of commercial banks, increase in deposit insurance coverage, and prolongation of special taxation regime in agriculture (see *Agricultural policy*). Measures aimed at shielding households and domestic producers from the crisis consequences were passed later. In particular, laws targeting low-income families (see *Social policy*) and unemployed (see *Labour market*) were passed[lix]. Also, some sector received state support. The tax privileges were granted to manufacturing enterprises from the beginning of 2009[lx]. Also, the public financing of unfinished housing construction was envisaged[lxi]. The abovementioned measures infer increased fiscal obligations, putting additional pressure on already overstretched budget and thus requiring counterbalances.

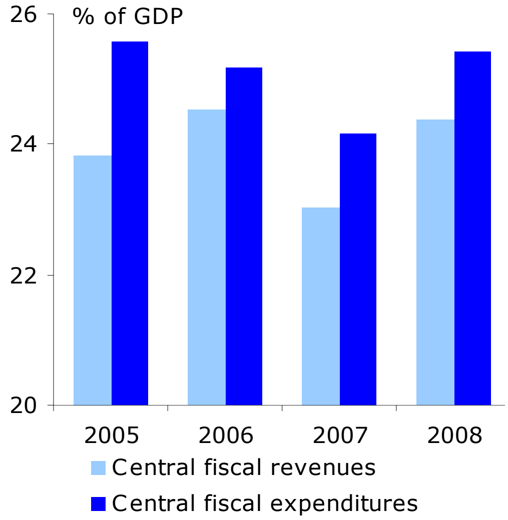
The fiscal liabilities expansion was partly counterweighted by both increased taxation and restricted other expenditures. Namely, excises on specific goods and selected rent rates were increased considerably[lxii]. Moreover, the Cabinet of Ministers passed resolution foreseeing rigid economy of administrative expenditures and avoidance of new expenditure items in 2008[lxiii]. Beyond this, the expansion of social payments was fairly stopped for 2009 (see *Social policy*).

State Budget Law for 2009: The State Budget Law for 2009 was approved with significant delay on December 26, 2008, against the background of political tensions and declining economic activity that marked the end of the year. According to the Law, the central fiscal revenues and expenditures will increase in nominal terms to UAH 238.9 bn and UAH 267.3 bn, respectively, but decline in relation to GDP to 22.8% and 25.5%. The deficit is foreseen at UAH 31.3 bn or 3.0% of GDP. This violates terms of the Memorandum signed between Ukraine and the IMF, according to which a zero ceiling on the cash deficit on general government is set for 2009. High deficit is primarily explained by the establishment of the Stabilisation Fund, which is to be used for financing programs aimed at stimulating economic development. At the same time, the increase in social fiscal spending is restricted in 2009 (see *Social Policy*).

Social policy: Social standards declined in real terms in 2008

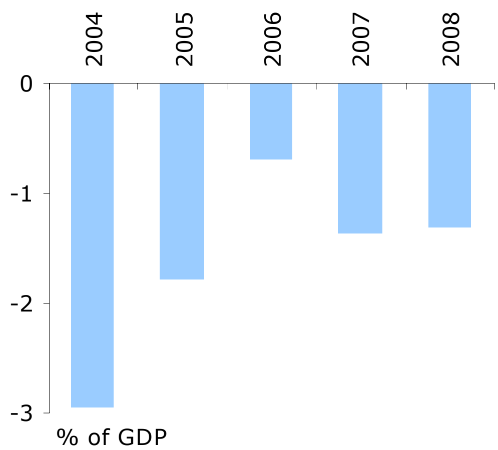
Social standards and minimum wage. Social standards for 2008 were defined in the State Budget Law[lxiv] and not increased above the foreseen levels, except for the minimum pension, though the inflation level was higher than officially projected. In particular, according to the Law general level of subsistence minimum was gradually increased from UAH 592 as of beginning of the year to UAH

Central fiscal revenues and expenditures



Source: State Treasury reports

Central fiscal deficit



Source: State Treasury Reports, the State Budget Law for 2008 with amendments on December 12, 2008, IER calculations

Subsistence minimum, UAH

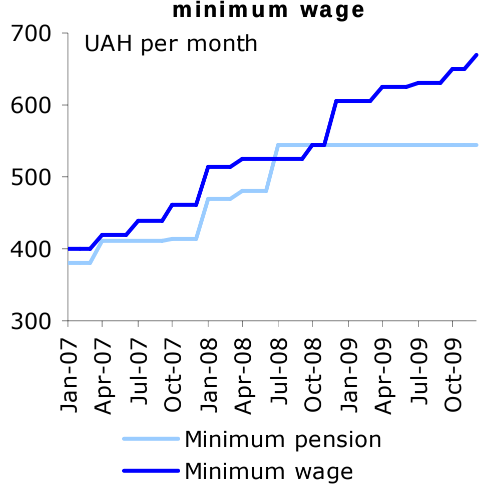
	from Jan. 2008	from Apr. 2008	from Jul. 2008	Oct. 2008 - 2009
General level	592	605	607	626
In particular:				
For children less than 6 years old	526	538	540	557
For children of 6-18 years old	663	678	680	701
For working able individuals	633	647	649	669
For individuals that lost ability to work	470	481	482	498

Source: the State Budget Law for 2008

626 as of October. Minimum wage and subsistence minimum as well as the amount of social assistance to low-income households declined in real terms in 2008. At the same time, real minimum pension slightly increased (by 0.8% yoy) as it was raised by the Government above the level of the subsistence minimum for individuals that lost ability to work from July 1, 2008 (see *Pension system*).

The State Budget Law for 2009 keeps subsistence minimum unchanged, while minimum wage will be gradually increased starting second quarter 2009 and will reach UAH 669 on December 1. Thus, the equalisation of minimum wage with subsistence minimum for working able individuals planned since January 1, 2009 is postponed till the end of the year.

Monthly minimum pension and minimum wage



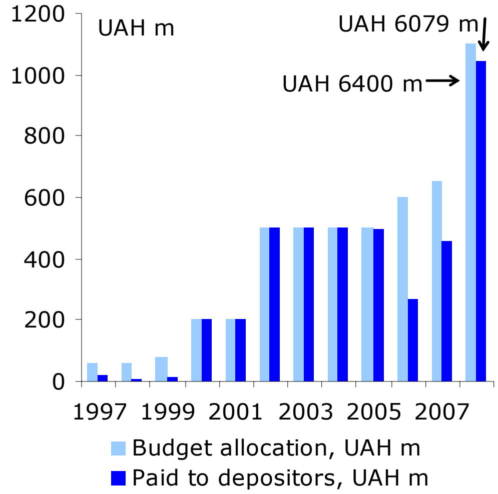
Source: State Budget Laws for 2007, 2008 and 2009

Unified Tariff Scale. According to the State Budget Law for 2008 the third (the last) stage of the Unified Tariff Scale (UTF) used for paying wages to public sector employees was to be implemented in November 2008. However, in May, the Government rescheduled this step for September[lxv]. Due to political tensions, additional funds for financing the rescheduling were allocated in the State Budget only in mid-September[lxvi] (see *Fiscal policy*). However, the full-fledged use of the UTF was once again suspended since December 2008 as the wage of the first tariff grade has been fixed at UAH 545,[lxvii] instead of setting it at current minimum wage level.

Compensations of devalued Sberbank savings. In 2008 the state bank "Oschadbank" received UAH 6.1 bn or 95.0% of annual plan from state coffers for compensation to the owners of the devalued savings in the Soviet Sberbank. The compensation procedure defined in the Resolution of the Cabinet of Ministers[lxviii] has been comprised of several steps. First, the depositors or their heir were supposed to register all Soviet Sberbank accounts at the Oschadbank and choose the currency of compensation.[lxix] Second, the reimbursement not exceeding UAH 1000 was to be available for withdrawal in three days after registration. Besides, there was a possibility for depositors to put this money on the special two-years deposit in the Oschadbank. The Government did no fulfil its promise to elaborate the scheme that allows paying utilities with the rest of the deposit.

As the privatisation plan was not fulfilled (see *Privatisation*), the Government failed to allocate for compensation additional UAH 12.0 bn planned in the State Budget Law. As a result, by the end of year only around 50% of people registered for compensation were able to execute their right.[lxx] Only 1.2% of them have put their money at the special deposit at the Oschadbank.

Compensations of devalued savings allocated between 1997 and 2008



Source: State Treasury of Ukraine, Oschadbank

Social privileges. The State Budget Law for 2008 foresaw steps towards improvement of targeted provision of the social privileges. In particular, it was planned that starting May 1 only individuals with incomes lower than 1.4 times the subsistence minimum were to receive social privileges. However, the Government *de facto* eliminated this change in April deciding on the provision of the privileges to certain groups of individuals, including labour veterans, retired judges and prosecutors, disabled persons etc. regardless of income.[lxxi] Therefore, the introduction of the targeted social assistance was once again delayed increasing under-funded social mandates.

Besides, in May the Constitutional Court of Ukraine approved a decision on the unconstitutionality of several provisions of the State Budget Law for 2008. It revoked the provisions that terminated privileges to judges and court officials, public sector employees and military men, as well as war veterans and pensioners. Such decisions have been approved by the Court almost every year, repeatedly drawing attention to the necessity of social welfare system reform as the system has been over-burdened by various privileges.

Assistance to the flood victims. In the end of July 2008 the Verkhovna Rada allocated fiscal financing required for household assistance payments and infrastructure renovations in the Western regions of Ukraine suffered from the massive flood (see *Fiscal policy*). The state assistance to flood victims was paid in three instalments according to the lists compiled by district state administrations. Overall 136.2 thousands individuals are eligible to receive state assistance. As of November 28, the assistance financing was executed at UAH 0.9 bn or 79.4% of target.

Compulsory state social insurance in 2009. Due to increase in registered unemployment (see *Labour market*) the spending of the Unemployment Insurance Fund for paying unemployment benefits increased in the end of 2008 and is expected to further grow in 2009. In order to increase the potential Fund's revenues the Parliament changed the social insurance contribution rates for 2009.[lxxii] In particular, the cumulative contribution for unemployment insurance was increased by 0.4 p.p., while the contribution rates for temporary disability insurance and working accidents insurance were slightly lowered. The Unemployment Insurance Fund is likely to have funds only for paying unemployment benefits with very restricted possibilities to finance active labour market policies.

Pension system: The Pension Fund Budget had significant deficit in 2008

Pension Fund budget in 2008. In January 2008, the Government approved the balanced budget of the Pension Fund for 2008.[lxxiii] The Fund's expenditures were planned at UAH 141.2 bn, while own revenues at 101.8 bn. The central fiscal transfer remained high at UAH 34.8 bn. It was to be spent for financing pensions defined according to different pension programs, pensions to retired militaries and judges as well as for compensating the losses of the Pension Fund from special contribution rate paid by participants of the fixed agricultural tax scheme.

In order to restrict the expenditure increase in 2008, the maximum pension was set at 12 sizes of minimum pension (UAH 5640 in the first half of the year and UAH 6528 in the second half).[lxxiv] Pensions for retired members of the Cabinet of Ministers, people deputies, and prosecutors were capped by UAH 10000. Although pension ceilings seem justified, they are still high as compared to average pension that reached UAH 895 by the end of 2008.

Due to pensions increases during the year as well as an introduction of new state pension program for miners[lxxv], the Pension Fund faced a deficit in the end of 2008. For its financing the Fund received additional central fiscal transfer at UAH 5.2. bn as well as a loan from the State Treasury at UAH 4.6 bn. The loan was later written off in the text of the State Budget Law for 2009.[lxxvi] In total the Pension Fund received from the budge UAH 47.5 bn, which accounted for 30.8% of cumulative Fund's revenues.

Pension benefits in 2008. The Cabinet of Ministers increased minimum pensions to different groups of pensioners during the year.[lxxvii] In particular, in March additional social payments was introduced for selected groups of pensioners. The Government also changed the minimum survivor's benefits to take into account the number of dependents. Overall around 1.4 m pensioners received higher pensions since April. However, the Government did not envisage additional financing for increased pensions, thus *de-facto* forming the deficit.

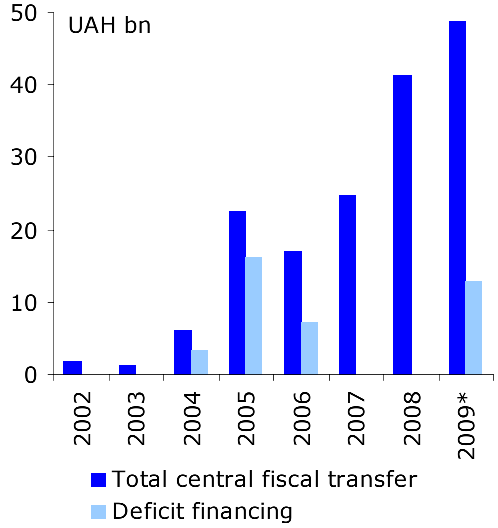
The pensions were again raised since July 1, 2008 by the decision of the Cabinet of Ministers made in mid-July after the Verkhovna Rada failed to pass the respective amendments to the State Budget Law.[lxxviii] In particular, the minimum old-age pension was increased by 13% to UAH 544. As a result, the minimum pension became higher than minimum wage in the third quarter of 2008. Pensions of Chernpobyl accidents victims and retired military servants were also increased. This increase was implemented as special subsidy instead of permanent pension increase. However, the special central fiscal transfer to the Pension Fund, required for financing such subsidies

Cumulative contribution rates for compulsory state social insurance, % of wage*

	2008	2009
Social insurance contributions	38.16-53.1	39.86-53.3
In particular:		
Pension insurance	35.2	35.2
Social insurance against temporary working disability	2.0-2.5	1.9-2.4
Social insurance against unemployment	1.8	2.2
Social insurance against working accident and occupational disease	0.66-13.6	0.56-13.5

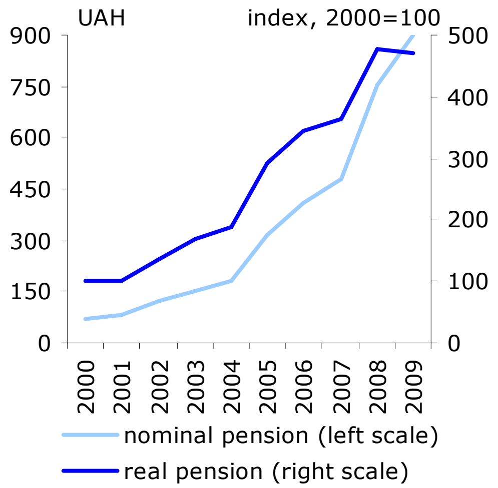
Note: * starting January 13, 2009
Source: the Law 'On Size of Contribution Rates for Selective Types of Compulsory State Social Insurance', the Law 'On Duty for the Compulsory State Pension Insurance', the Law 'On Insurance Fees for Compulsory State social insurance against working accident and occupational disease

Central fiscal transfer to the Pension Fund



Note: * plan
Source: State Budget Laws for 2003-2009

Average pension in January



Source: the Pension Fund, Derzhkomstat, IER calculations was once again not foreseen at the moment of its introduction, thus elevating a burden for the Pension Fund budget.

Another pension increase was introduced for retired miners in the approved Law on the Promotion of Miners' Work in September.[lxxix] In particular, minimum pension of miners that worked underground for at least 15 (7.5) years for men (women) was defined at 80% of average wage of miners, but not less than three sizes of subsistence minimum for individuals that lost ability to work. The implementation of new state pension program has required additional annual central fiscal transfer to the Pension Fund (see *Fiscal Policy*).

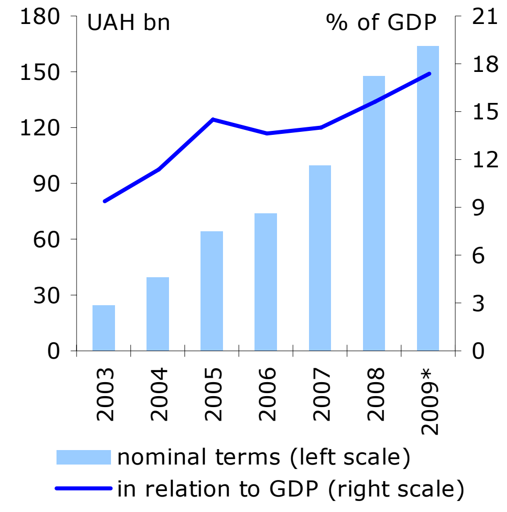
Therefore, in 2008 the Government continued increasing pension benefits in addition to approved in the State Budget Law levels, thus adding to already high inflationary pressure, thus clearly indicating priority of social policy over anti-inflationary measures.

Pension Fund budget in 2009. The Pension Fund budget will be again in deficit in 2009. In particular, the Pension Fund budget for 2009, approved by the Government in March 2009, envisages the Fund's deficit at UAH 15.2 bn, from which UAH 13.1 bn will be financed by central fiscal transfer. The rest of deficit is to be covered by funds, received by the Fund from the Government in the end of 2008. Besides, it is foreseen that the Pension Fund is to receive UAH 35.8 bn from Central budget for paying pensions according to different state programs, pensions to retired militaries, judges and miners as well as for covering the losses created due to the special (lower) pension contribution paid by agricultural producers. Therefore, the total transfer to the Pension Fund remains high at 4.7% of GDP, being a serious burden for the state coffers especially during the crisis. However, even such high transfer might not be sufficient to cover losses in revenues due to downfall of economic activity. In this case the Ministry of Finance might provide loans to the Pension Fund at the expense of funds at the Unified Treasury Account in 2009.

Despite likely revenues shortfall, the pension duty paid on non-cash currency exchange operations was reduced from 0.5% to 0.2%. Such reduction, though being a positive step, does not comply with the Memorandum signed between Ukraine and the IMF. The document required the Ukrainian Government to eliminate such contribution in 2009.

The Government submitted to the Parliament a draft Law aimed at restricting the growth of the Pension Fund's expenditures and broadening the pension contribution base. In particular, it envisaged setting the maximum pension at 12 sizes of subsistence minimum set for individuals that lost ability to work. Besides, it was suggested to eliminate special (lower than general) pension contribution rate paid by participants of fixed agricultural tax scheme. The Verkhovna Rada failed to approve the proposed changes.

Pension Fund Expenditures



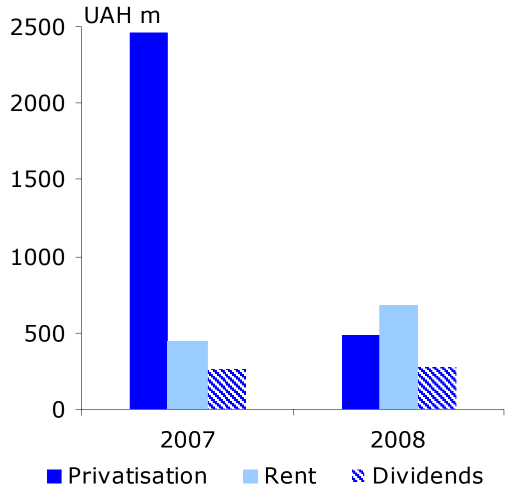
Note: * plan
Source: the Pension Fund of Ukraine

Privatisation: In 2008 revenues from privatization made up 5% of the plan adopted at the beginning of the year

Privatisation in 2008. The privatization policy of the Government was very task-oriented and proactive in the beginning of the year. Nevertheless, the lack of consensus among political forces had hampered the privatization process in 2008 again.

In January, the Government adopted the list of companies, state shares in which are to be sold straight away, and the list of companies that should be prepared for sale this year[lxxx]. The list of companies for sale contained nineteen enterprises, including such blue chips as "Ukrtelecom" (67.79% of shares), "Odessa by-port plant" (99.57%) and six – Lviv, Odessa, Poltava, Sumy, Prykarpattya, Chernigiv – oblenergos (25% and more). Next month the Cabinet of Ministers (CMU) approved the list of objects for privatization in 2008 that contained 387 enterprises[lxxxi], including the abovementioned blue chips. Also, the CMU defined 14 objects to be sold together with land lots.

Revenues from privatisation and management of state property objects by the SPFU



Source: SPFU, State Treasury Fund reports

The sale of enterprises earmarked for privatisation by the CMU would ensure enough receipts to meet the target for planned and extra privatisation revenues set in State Budget Law for 2008. The fiscal plan for privatization receipts was set at UAH 8.6 bn (0,96% of GDP)[lxxxii]. Additional privatisation revenues at UAH 12 bn were foreseen for compensation of Sberbank savings (see *Social policy*). Totally, projected revenues amounted to about UAH 20 bn in 2008.

To fulfil these plans the CMU also passed several orders on the procedure of sale of Uktelekom[lxxxiii], Odessa by-port plant[lxxxiv], on transmission of management rights for oblenergoes to the State Property Fund of Ukraine[lxxxv], and several other acts.

Nevertheless, the actions of the Government were not supported neither by the President, nor by the Head of the SPFU. The President suspended the privatization of strategic objects, requiring the prior adoption of the State Privatization Program and the compliance of privatisation process with Ukraine's economic security and development[lxxxvi]. The Security and Defense Council of Ukraine adopted the concept aimed at ensuring national interests and security in privatization[lxxxvii]. Although in June the Parliament passed State Privatization Program for 2008-2012 in the first reading[lxxxviii] , no further progress was achieved. This program replaced the pervious draft for years 2008-2010 and was not considerably different from it.

The State Property Fund, headed by Mrs. Semenyuk-Samsonenko, fully supported the President's position and suspended the privatization of proposed objects, thus hampering the CMU's activities in this sphere. Almost all year long the Government attempted to change the Head of the SPFU. Finally, on December 26, the Verkhovna Rada dismissed Mrs. Semeyuk-Samsonenko and the next day Dmintiy Parfenenko was appointed the acting head of the SPFU. However, this appointment was almost immediately suspended by the President.

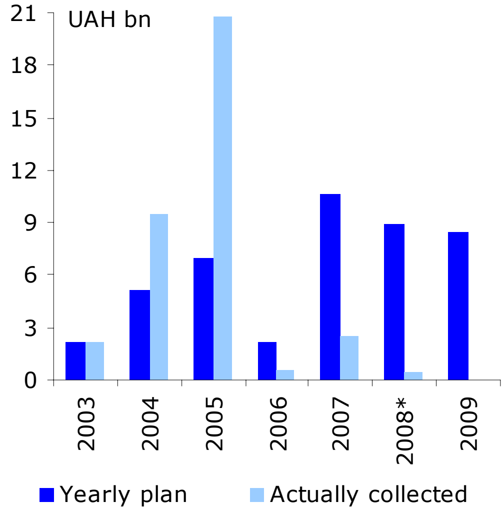
These quarrels resulted in de-facto collapse of privatisation process in 2008. Only UAH 0.48 bn were received for the twelve months of 2008, or 5.4% from initially set annual plan. Admitting the obvious fail of privatization plans, in December the Parliament adopted changes to the State Budget lowering the revenues from privatization to UAH 0.6 bn[lxxxix].

Privatization in 2009. Privatization received special value for anti-crisis activities having become one of key sources for the Stabilization Fund established by October Anti-crisis Law[xc] .According to the State Budget Law for 2009[xci] revenues from privatization and from the sale of non-agricultural land-lots under the objects for privatization should be at UAH 8.5 bn and UAH 1.2 b, respectively. For the year 2009 the Cabinet of Ministers approved the list of objects for privatization almost identical to the list of 2008[xcii], immediately blocked by the President[xciii] . The Cabinet of Ministers also obliged the SPFU to ensure the revenues from privatization at UAH 3 bn in the first quarter of 2009 (35% from the plan)[xciv]. But this amount remains unachievable unless the CMU and the President come to unified understanding of a privatization strategy in Ukraine.

Corporate governance: Step forward – the law on the joint stock companies was adopted

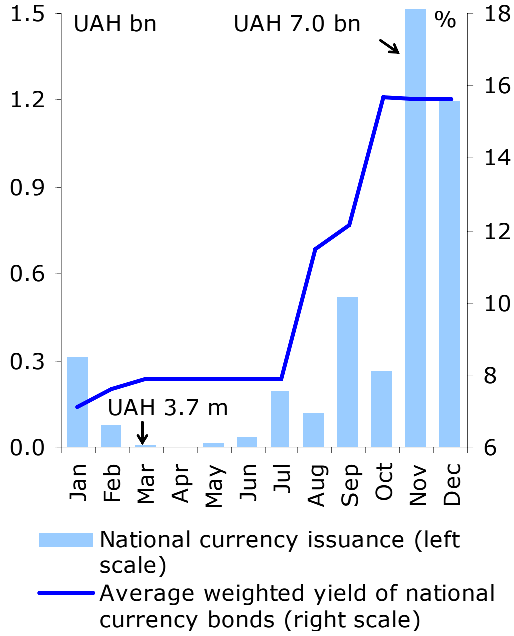
In September the Verkhovna Rada adopted the Law On Joint Stock Companies[xcv] that had been on agenda for more than seven years. The current legislation has been outdated not covering all necessary issues regarding JSC activities. The adopted law covers all the main issues of corporate governance in Ukraine, setting the framework for the functioning of the JSCs, and guaranteeing protection of shareholders', employers', and creditors' rights. It should also stimulate the development of stock market and counterfeit raiding. The law will come into force on April 30, 2009. The provision on the mandatory book-entry form of emitted stocks of the JSC comes into force only in 2010.

Privatisation receipts



* plan as of December 28, 2007 (plan was revised downwards to UAH 607 bn)
Source: State Treasury reports, SPFU

Additional placements of 2005-06 state bonds in 2008



Source: NBU, the Ministry of Finance

State debt: Skyrocketing the domestic borrowings as a response to financial crisis

The Ministry of Finance started the year by carrying out additional placement of the five-year domestic state bonds maturing in 2010-2011. The Ministry was gradually raising the weighted-average yield from 7.1% p.a. in January to 7.9% in March. However, such conditions were uncompetitive for investors, and the state bonds were placed at the total amount of UAH 628 m only between January and July.

In July the Ministry of Finance has failed to issue five-year Eurobonds amounting to USD 500 m. The process was suspended at the road show stage that was leading by the consortium of BNP Paribas, JP Morgan and Standardbank. The main reason was the sharp deterioration of borrowing conditions on the international debt market as the world financial crisis had started to unfold.

At the second half of 2008 the Ministry of Finance resumed gradual increasing the yield on the five-year domestic state bonds maturing in 2010-2011 from 7.9% to 15.6% p.a. Yield increase resulted in intensified state bonds placement on primary market, which totally accounted UAH 3.1 bn between August and December.

Due to sharp deterioration of economic conditions as a result of world financial crisis the domestic borrowing got higher priority as the Government needed to cover the fiscal deficit and to recapitalise the state banks to increase the funding of large state projects. The major placements to finance the fiscal deficit were made on November 6 and November 13 as three- and four-year domestic state bonds at UAH 3.0 bn each at the average yield at 15.6% p.a. These issues were bought by state banks (Oschadbank and UkrEximBank) and then sold to the NBU at the secondary market (PFTS). In the last two months of the year the Ministry of Finance also issued seven-year state bonds at the total amount of UAH 13.8 bn with 9.5% p.a. yield to increase the authorized capital of two state banks – Oschadbank and UkrEximBank.

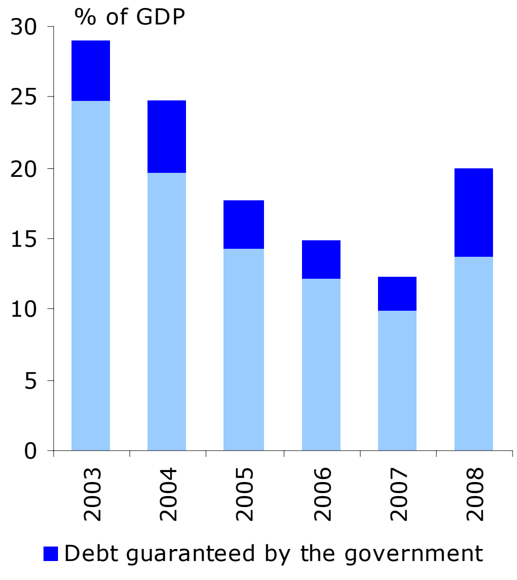
Overall state bonds placement in 2008 reached UAH 23.5 bn comparing with UAH 10.8 bn plan set in the Budget Law 2008[xcvi] due to Government quasi-fiscal operations in fourth quarter aimed on the fiscal deficit financing and support the national economy entering into the recession. As of December 31, the direct state debt increased by 83.3% up to USD -130.7 bn or 13.8% of GDP. Simultaneously, Ukraine's guarantied debt hiked by more than three times up to USD 58.7 bn or 6.2% of GDP as IMF provided the first 'stand by' loan to Ukraine in November at the total amount of SDR 3 bn. As a result, the total state debt constituted UAH 189.4 bn or 19.9% of GDP at the end of 2008.

Inflation: Consumer inflation accelerated to 22.3% in 2008

In 2008, consumer prices increased by 22.3% in December over December terms displaying the highest growth since 2000. Price growth was also distributed more evenly over different components of consumer basket than in previous few years. Ten out of twelve CPI components displayed the highest growth since 2000, while utility tariffs and communication prices grew faster only in 2006. However inflation dynamics in the first half and the second half of 2008 was distinctively different.

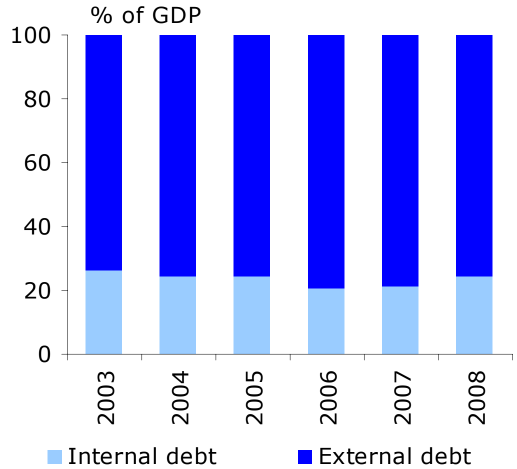
In the first half of 2008 inflation sharply accelerated from 16.6% yoy in December 2007 to stunning 31.1% yoy in May 2008. If such inflation had been sustained for rest of 2008 and 2009, Ukrainian companies would have been able to apply hyperinflationary accounting along with Zimbabwe, Myanmar, Guinea, Haiti, Venezuela, Iran, and Zambia. In particular, food prices responsible for half of consumer basket jumped by almost a half displaying 48.5% yoy growth while other CPI components also grew fast.

Direct and guaranteed state debt



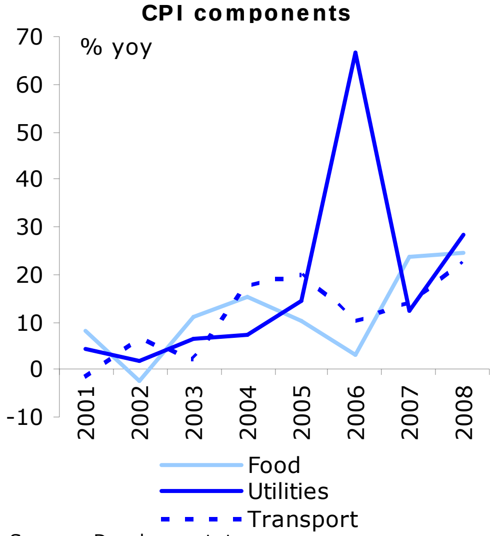
Source: the Ministry of Finance

Internal and external state debt



Source: the Ministry of Finance

CPI components



Source: Derzhcomstat

On the demand side, strong foreign capital inflows expanded money supply as the NBU was accumulating international reserves and selling hryvnia. Consumption boom was further exacerbated by the availability of easy credits and continued growth of wage and social transfers (see *Wages and incomes*).

On the supply side high external demand caused increase in prices for agricultural products, energy, metals and other commodities. Despite attempts by the government to limit exports and regulate prices high external prices for agricultural products with high share in CPI were reflected on domestic market prices. Low grain harvest of previous year added up to food price pressures. High inflation expectations, increases in minimum wage and high export revenues supported wage growth driving up labour costs. Lastly, higher energy costs also contributed to the prices growth.

Government response to the high inflation included usual mix of price regulation, talks with producers to extract the commitments to limit price growth, and increased zeal in antitrust law enforcement. As usual these measures had little effect on prices.

In the second half of 2008 good harvest contained food prices growth, and inflation started to decelerate. Since September 2008 consumption boom drew to a halt as banks froze lending and wages stopped growing. On the supply side inputs and labour costs subsided further limiting inflation pressure. High statistical base in the end of 2007 also helped CPI growth to decelerate. Hryvnia depreciation that started in September and reached 52.4% over 2008 created upward inflation pressure. However, direct effect of depreciation is limited on the CPI as imported goods comprise approximately fifth of the consumer basket while border price is usually only a fraction of the final consumer price due to high transport and marketing costs. Direct and indirect effects of 2008 depreciation will be more prominent in 2009 as increased prices of imported components will work their way up through production chain.

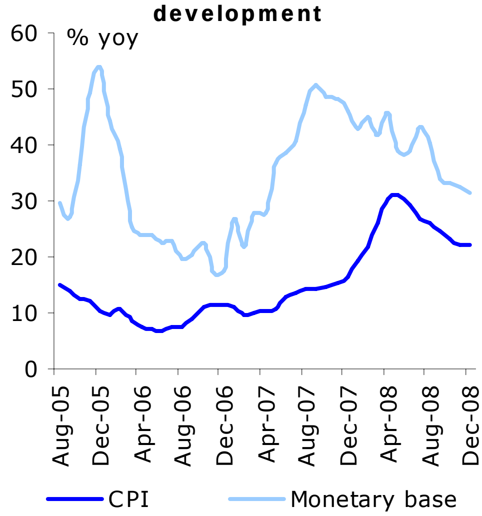
Monetary policy: Financial crisis called for large changes in NBU monetary policy

In 2008 money supply growth slowed significantly to 30.2% yoy as compared to 51.7% in 2007 due to relatively restrictive monetary policy of the NBU and run on deposits in the last quarter of 2008. The slowdown would be more impressive[xcvii] if effect of hryvnya depreciation on foreign currency part of money supply is excluded. However, cash (M0) growth slowed down only to 39.3% yoy in 2008 from 48.2% in 2007 thanks to high budget payouts to population and run on deposits.

Starting from March 2008 the NBU increased flexibility of the exchange rate but it continued to buy foreign currency on the interbank market and accordingly hryvnya infusions remained quite large. However, other factors caused gradual decrease in the liquidity of the banking sector. Government slowly but steadily increased funds at Treasury Account withdrawing money from circulation, while the NBU kept interest rate on its overnight refinancing at 15% p.a. Besides sharp increase in nominal incomes of households including social transfers that started in 2007 and continued in 2008 washed the liquidity out of banking sector as payments didn't completely return to banks in form of deposits or payments for goods and services. Thus liquidity fell while interest rates on the interbank market started to grow and fluctuate widely. They reached 20% p.a. and more on some days in March. In April interbank interest rates were sometimes higher than 30% p.a. Wide fluctuations of interest rates continued further.

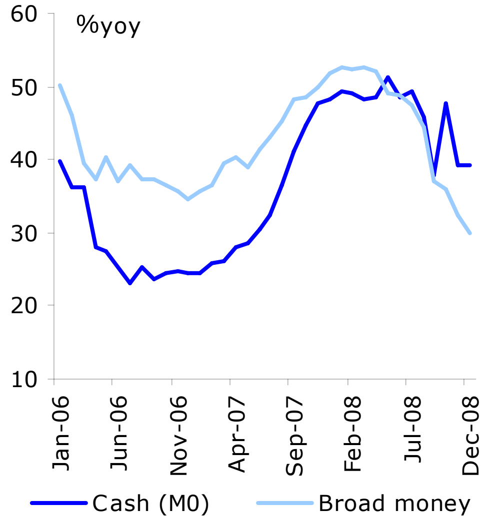
The NBU also tried to limit foreign currency lending through increased reserve and regulatory requirements, including short-lived 20% reserve requirement on short-term foreign currency borrowing[xcviii]. However banks still faced large maturity and currency gaps and were highly dependent from wholesale financing.

CPI and monetary base development



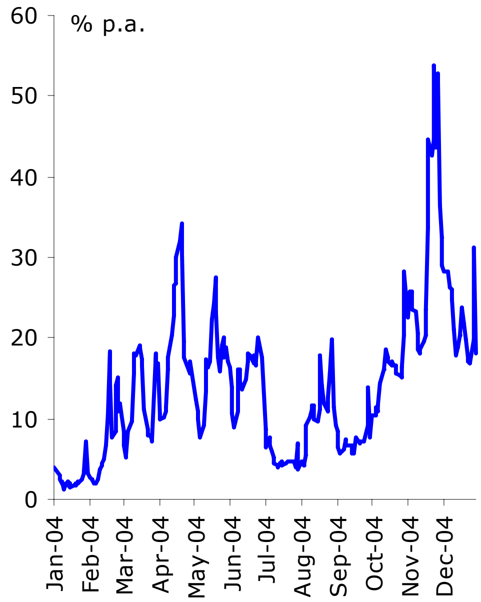
Source: Derzhkomstat, NBU

Monetary aggregates growth



Source: NBU

Interbank interest rate in 2008



Source: NBU

In September 2008 Ukraine's banking system faced a run on one of the largest banks Prominvestbank, decelerated export revenues and partial cut-off from external financing (see *Financial markets*). Later depreciation of hryvnya (see *Foreign exchange policy*) stimulated withdrawals of hryvnya deposits and impaired quality of foreign currency loans. This factors created large liquidity gaps for a lot of banks and threatened solvency of some of them. The NBU responded with confusing mix of actions that included administrative restrictions of bank operations such as prohibition on the new lending and term deposit withdrawal before maturity, capital controls. NBU also provided lavish refinancing of banks accepting almost all available collateral. Most of these actions were laid out in NBU Resolution 319[xcix] approved on October 11 that was later amended many times creating uncertainty for banks and economic agents. In December, it was replaced by Resolution 413[c] that cancelled most restrictions on bank operations except restrictions on foreign currency lending and early term deposit withdrawal moratorium (see *Financial markets*).

The NBU also temporarily allowed banks to use all funds in correspondent accounts at the central bank by allowing using cash in vaults to satisfy reserve requirements[ci]. In the end of November the NBU cancelled this provision but at the same time NBU reduced national currency reserve requirements to zero softening the effect[cii].

In the end of December the NBU decided to increase reserve requirements on foreign currency deposits trying to limit dollarization[ciii]. However, deposit run concentrated in national currency deposits and appreciation of foreign currency deposits in hryvnya terms due to hryvnia depreciation so far had opposite results, i.e. greatly increased dollarization. The share of foreign currency deposits in money supply increased from 22.7% in the end of 2007 to 30.6% a year later.

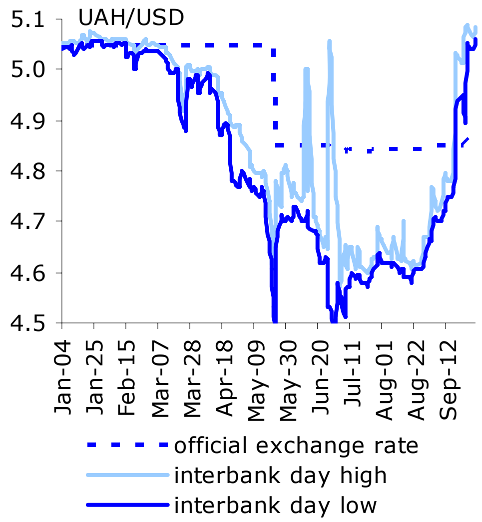
Intensified liquidity scarcity was associated with a fact that large amounts of hryvnya were used to buy foreign currency for population, importers and foreign currency borrowers. The NBU increased its loans to commercial banks from UAH 6 bn in the end of August to more than UAH 60 bn by the end of the year to compensate the shortfall and prevent payment system from breaking as some banks' correspondent accounts at the NBU ran out.

Foreign exchange policy: Managed floating of hryvnia started in March

Year 2008 was marked by important change in exchange rate regime. Reacting to the appreciation pressures the NBU allowed hryvnya to start appreciating in March. Despite the financial crisis in the US and Europe foreign capital inflows were strong enough to cover the current account deficit and create large supply of foreign currency (See *Balance of payments*). Inflation pressures were mounting (see *Inflation*), and the NBU lacked effective instruments to sterilise its interventions in the interbank foreign exchange market and offset hryvnya infused in the economy. Thus, the NBU decided to start its long-planned transition to the more flexible exchange rate. From March to July 2008 hryvnya appreciated from UAH 5.05 per USD to the level close to UAH 4.50 per USD despite the NBU interventions totalling USD 5.5 bn. Later hryvnya started to depreciate gradually as foreign capital inflows slowed and imports continued to surge returning to UAH/USD 5.05 exchange rate by the end of September.

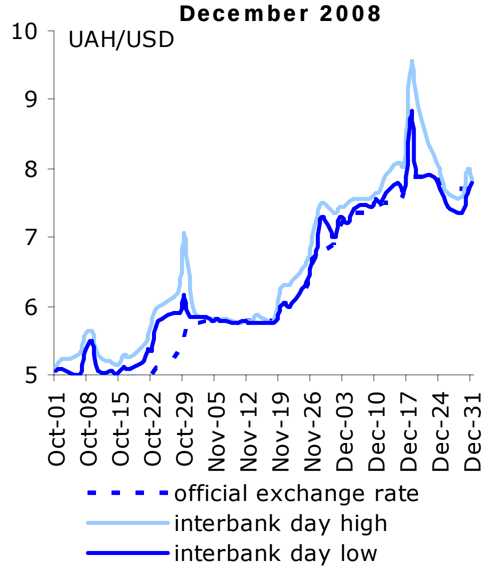
The escalation of global financial crisis mounted the pressures on hryvnia. Foreign capital inflows reversed, while export revenues suffered greater than imports. Deposit withdrawals in foreign currency, purchases of cash dollars by population speculators, and maintained current account deficit created large demand. Tight regulation of cash and non-cash foreign exchange rate operations expanded black market for foreign currency and made exporters and other owners of foreign currency very reluctant to part with it. Selective nature of foreign currency interventions in October and November made interbank market illiquid and thus prone to large

Exchange rate in January-September 2008



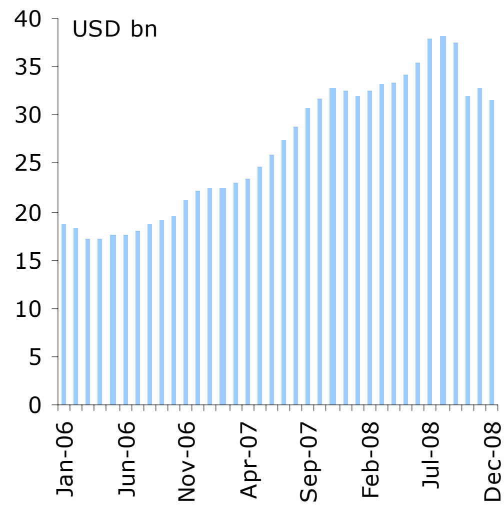
Sources: Reuters Investor, NBU

Exchange rate in October-December 2008



Sources: Reuters Investor, NBU

International reserves



Source: NBU

swings exacerbating hryvnya devaluation expectations. Thus, a half of USD 10.3 bn in interventions made in the fourth quarter of 2008 had to be spent to finance deposit withdrawals and purchases of cash foreign currency by population. The NBU also squandered the possible stabilising effect of the USD 16.5 bn IMF loan, of which USD 4.5 bn it already received in 2008.

Overall in the fourth quarter hryvnya depreciated from 5.06 UAH/USD to the low of 9.55 UAH/USD on December 18 to appreciate to 7.7 UAH/USD in the last days of the year due to reversal of market fluctuation and end-of-year effects. Failure by the NBU to develop credible response to the crisis undermined its credibility while drastically increased political pressure limiting its ability to react to the new developments.

Financial markets: Banking system stability was hit severely

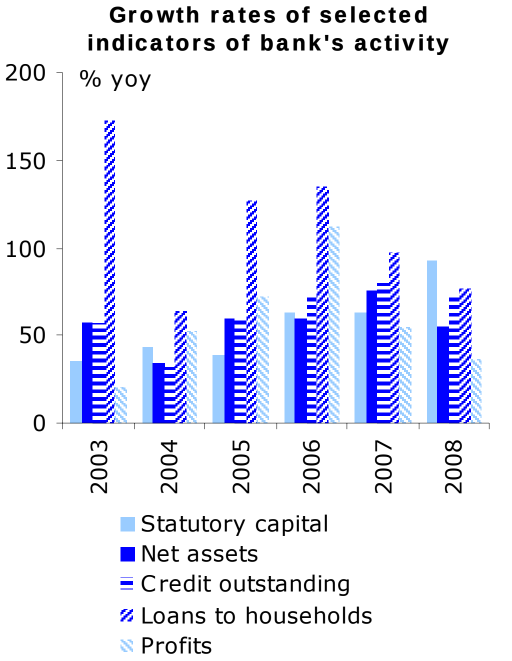
Banking. Whereas in the first half of 2008 the Ukrainian banking system continued expanding though at slower pace than a year ago, September world financial collapse seriously damaged it by reducing disposable external financing. The shock was further amplified by problems of one of the largest Ukrainian banks – Prominvestbank (PIB). The overall banking stability and credibility was undermined.

October bank run of deposits in hryvnya at around UAH 22.8 bn or 9.6% mom of hryvnya stock was further exacerbated in November when national currency deposits drooped by 5.2% mom. Banks decision to increase deposit rates was moderately effective, resulting in stabilization of national currency deposit amount in December. In total, national currency deposit growth rate plummeted to 5.0% yoy in December 2008 as compared to 67.1% yoy a year before. However, total deposit growth rate stayed high due to devaluation effect which pushed up the amount of foreign currency deposits if denominated in hryvnya.

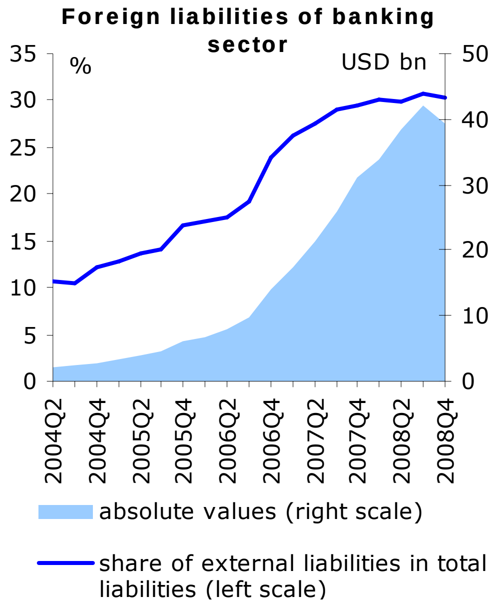
A sharp hryvnya depreciation that started late September (see *Foreign exchange policy*) had major consequences for banking system. The depreciation not only worsened banking indicators, but also increased risks of credits defaults by households and real sector. Sporadic unilateral changes in terms of existing lending contracts by banks that wanted to compensate for increased deposit interest rate only added to troubles damaging credit payments. In response, the Parliament prohibited unilateral lending contract terms revisions[civ]. As loan defaults aggravated banks intensified sales of collateralized property, continuing damaging financial stance of bank lenders.

To stabilize banking system, in October the NBU issued Resolution 319[cv] which prohibited early withdrawals of term deposits and restricted active operations in foreign currency (see *Monetary policy*). The resolution also foresaw improvement in banking liquidity through programs of financial enhancement that envisaged up to one year long credits to banks. Banks that lost no less than 2% of deposits in five working days and have capital no less than UAH 500 bn became entitled for NBU refinancing under fast-track procedure. As on end of 2008, the NBU provided banks with UAH 169.5 bn of refinancing credits while as on 1 of January 2009 debt on refinancing constituted only UAH 60.5 bn. To immediately increase liquidity of banking system the NBU ceased requirements on passive operation in national currency. In December Resolution 319 was replaced with NBU Resolution #413[cvi] still banning early withdrawals of term deposits[cvii], but allowing active operations and suggesting credit prolongation taking into account lending history of borrowers. Also the NBU reduced requirements on passive operation in foreign currency.

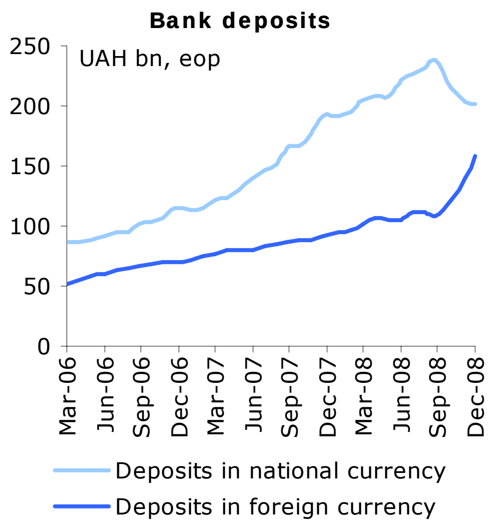
The Verkhovna Rada reacted to financial system crisis challenges already in the first Anti-Crisis Law passed in the end of October 2008 that established a frame procedure of "system" bank recapitalisation by the state[cviii]. Bank recapitalisation by the state could be initiated by the NBU, and financed from the Stabilization Fund. Later on the



Source: NBU



Source: NBU



Source: NBU

CMU issued Decree on procedure of state participation in banks capitalization[cix], according to which the NBU is to set criteria that trigger bank recapitalisation procedure. However, these criteria had not been set in 2008. Existing procedure has presumed direct refinancing of large banks by the NBU.[cx]

Also, Ukraine received the IMF 'stand-by' loan at the amount of USD 16.5 bn[cxi], one of the purposes of which has been to stabilise banking system. Among the performance criteria associated with the IMF loan there was more transparency of Ukrainian banking system including regular and frequent monitoring of different aspects of bank activities like balance and financial statement, structure of assets and liabilities, risks, liquidity etc. These requirements are likely to prompt important regulatory reforms in the sector in 2009.

Cumulative banking sector growth remained high in 2008 although lagged behind last year figures. Moreover, in the last quarter, banks' profits decreased on a quarterly basis due to sharp rise in expenditures, including reserves for possible losses from nonperforming loans. As on January 1, 2009, for the first time since 2004, expenses' annual growth rates outweighed the annual growth of incomes. And banks' profit at UAH 9.7 bn, which was 36.6% higher than in 2008, was assured by high growth rates in the beginning of the year.

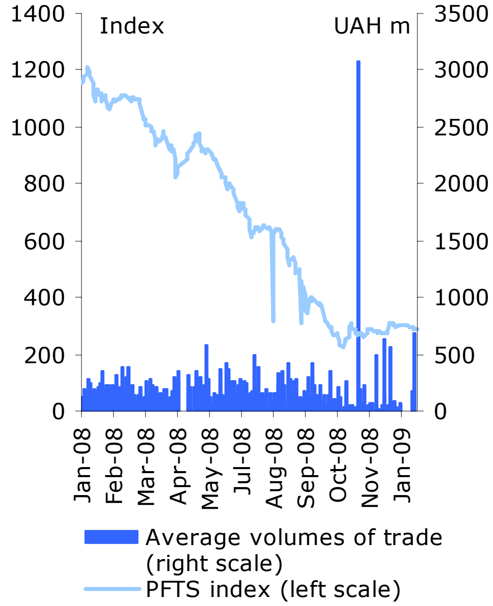
Thus, banking system started facing significant worsening, though problems will manifest in 2009.

Stock market. During 2008 the Ukrainian stock market has sharply contracted. While in the first half of 2008 the PFTS index downfall was mainly attributed to the echo of first stage of financial crisis in the USA, the drop in the second half of the year are explained by the next stage of global financial collapse augmented by problems of real sector. Downgrade of Ukrainian companies' ratings contributed to worsening of investors attitudes towards Ukrainian stock market.

The lowest record in 2008 was shown on October 27 at 222.3, but afterwards index started to grow up owing to speculative spirits caused by revival in stock indexes in the world on the back of governmental anti-crisis programs. Sharp kink in volumes of trade was observed on November 13, when the NBU entered the PFTS to buy state bonds.

On December 30, 2008 the PFTS index was equal to 301.4 thus decreased by 74.0% as compared to the beginning of the year. Tendencies prevailed in 2008 projected on downgrade in Ukrainian stock market capitalization to USD 47.5 bn (according to S&P as on the end of October of 2008), while worse performance of other frontier markets allowed Ukraine to occupy second place in the group after Kazakhstan.

Volumes of trade and PFTS index in 2008-2009



Source: PFTS

---

i Law of Ukraine, No.800-VI, from December 25 2008

ii Resolution of the Cabinet of Ministers, No.470, from May 21, 2008

iii EU commission resumed grain import tariff imposition on October 27, 2008 cancelled earlier on December 20, 2007

iv Resolution of the Cabinet of Ministers, No.271, from March 28, 2008

v Resolution of the Cabinet of Ministers, No.189, from March 12, 2008.

vi Decree of the President of Ukraine, No.478/2008, from May 26, 2008, Decree of the President of Ukraine, No.481/2008, from May 28, 2008,

vii Decree of the President of Ukraine, No. 875 from September 29, 2008

viii http://www.wto.org/english/news_e/pres08_e/pr511_e.htm

ix In fact, sugar market stood less protected as Ukraine agreed on 2% tariff rate within sugar import quota of 260 thousand tones for 2008 (that is to be increased to 267 thousand tones in 2010)

x Law of Ukraine, No.639-VI, from October 31, 2008

xi Decree of the President of Ukraine, No.725, from August 19, 2008

xii Resolution of the Cabinet of Ministers, No.925 from October 14, 2008 with amendments from December 27, 2008

xiii Resolution of the NERC, No.934, from August 7, 2008

xiv Resolution of the Cabinet of Ministers, No.938, from October 25, 2008

[xv] Resolution of the NERC, No.1239, from October 25, 2008
[xvi] Resolution of the MTCU, No.533, from May 13, 2008 (is not valid any more); Resolution of the MTCU, No.913, from July 22, 2008.
[xvii] Resolution of the MTCU, No.977, from October 29, 2007
[xviii] Resolution of the MTCU, No.306, from March 19, 2008; Resolution of the MTCU, No.1183, from September 25, 2008
[xix] Resolution of the MTCU, No.1037, from August 18, 2008
[xx] Resolution of the MTCU, No.43, from January 17, 2008; Resolution of the MTCU, from No.955, July 30, 2008
[xxi] Press service of UZ// http://www.uz.gov.ua/index.php?f=Doc.View&p=news_3179.0.news
[xxii] Resolution of the Cabinet of Ministers, from No.925, October 14, 2008
[xxiii] Ukrzaliznytsia has got UAH 1.6 bn profit for the 9 months of 2008, but at the end of 2008 it has already reported about UAH 186.5 m profit for the whole year// Press service of UZ: http://www.mintrans.gov.ua/uk/statical/10091.html
[xxiv] Resolution of the MTCU, No.773, from June 26, 2008
[xxv] Resolution of the MTCU, No.772, from June 26, 2008
[xxvi] Resolution of the MTCU, No.433, from April 14, 2008
[xxvii] Resolution of the MTCU, No.926, from July 24, 2008
[xxviii] Resolution of the Cabinet of Ministers, No.506-p, from March 5, 2008
[xxix] Resolution of the Cabinet of Ministers, No.1051-p, from July 16, 2008
[xxx] Resolution of the Cabinet of Ministers, No.1096-p, from August 20, 2008
[xxxi] Press service of UZ, http://www.uz.gov.ua/index.php?m=services.transcargo.calcvalue&f=Doc.View&p=news_3021.0.news&lng=ru
[xxxii] Decree of the Cabinet of Ministers, No.490, from May 28, 2008
[xxxiii] Decree of the President of Ukraine, No.534/2008, from June 10, 2008
[xxxiv] Decree of the President of Ukraine, No.708/2007, from August 15, 2007
[xxxv] Decree of the President of Ukraine, No.814/2008, September 9, 2008
[xxxvi] Resolution of the NCRC, No.1110, from September 12, 2008
[xxxvii] Resolution of the MTCU, No.1158, from September 19, 2008
[xxxviii] Press service of Ukrposhta, http://www.ukrposhta.com/www/upost.nsf/(documents)/EC7E9B138A01264FC225750F0029CD0D?OpenDocument&year=2008&month=11&
[xxxix] Resolution of the NCRC, No.1058, from June 10, 2008
[xl] Resolution of the Cabinet Of Ministers, No.932-p, from July 9, 2008
[xli] Resolution of the Cabinet of Ministers, No.527, from June 4, 2008
[xlii] Resolution of the Cabinet of Ministers, No.1062, from November 26, 2008
[xliii] Press-service of the Ministry of Housing and Utility Services// http://www.minjkg.gov.ua/index.php?id=1026
[xliv] Law of Ukraine, No.592-VI, September 24, 2008
[xlv] http://www.wto.org/english/news_e/pres08_e/pr511_e.htm
[xlvi] For instance, Memorandum of Understanding with enterprises of mining and metallurgy sector, from November, 10 2008 and Memorandum of Understanding with enterprises of chemical industry, from November, 17 2008
[xlvii] Law of Ukraine, No.779-VI, from December, 25 2008
[xlviii] Law of Ukraine, No.107-VI, from December 28, 2007
[xlix] Law of Ukraine, No.309-IV, from June 3, 2008
[l] Law of Ukraine, No.639-IV, from October 31, 2008
[li] Treasury report as of January 1, 2009
[lii] IER estimation of GDP figure for 2008
[liii] State Budget Law for 2008, No.107-VI, from December 28, 2007
[liv] Resolution of the Cabinet of Ministers, No.14, from January 16, 2008
[lv] Resolution of the Cabinet of Ministers, No.262-p, from February 6, 2008
[lvi] Resolution of the Cabinet of Ministers, No.146-p of January 23, 2008
[lvii] Draft Law, No.2709, from July 2, 2008 (was passed in the first reading on the 18th of September, 2008)
[lviii] Law of Ukraine, No.639-IV of October 31, 2008
[lix] Law of Ukraine, No.799-VI, December 25, 2008; Law of Ukraine, No.796-VI, December 24, 2008
[lx] Law of Ukraine, No.694-VI, from .December 18, 200
[lxi] Law of Ukraine, No.800-VI, from December 25, 2008
[lxii] Law of Ukraine, No.797-IV, December 25, 2008; Law of Ukraine, No.798-VI, December 25, 2008
[lxiii] Resolution of Cabinet of Ministers, No.1036, from November 26, 2008
[lxiv] Law of Ukraine, No.107-VI, December 28, 2007
[lxv] Resolution of the Cabinet of Ministers, No.74, from May 7, 2008
[lxvi] Law of Ukraine 'On Amendments to the State Budget Law for 2008', No.354-VI, from September 3, 2008
[lxvii] Minimum wage was at UAH 545 between October and November 2008.
[lxviii] Resolution of the Cabinet of Ministers, No.1, from January 9, 2008

[lxix] At the same time, after March 27, the compensations were paid only in hryvnya.
[lxx] The news at Economic Pravda, from December 12, 2008 http://www.epravda.com.ua/
[lxxi] Resolution of the Cabinet of Ministers, No.407, from January 9, 2008
[lxxii] Law of Ukraine, No.799-VI, from December 25, 2009
[lxxiii] Resolution of the Cabinet of Ministers, No.30, from January 30, 2008
[lxxiv] Law 'of Ukraine, No.107-VI, from December 28, 2007
[lxxv] Law of Ukraine, 345-VI, from September 2, 2008
[lxxvi] The State Budget Law for 2009, No.835-VI, from December 26, 2008
[lxxvii] Resolution of the Cabinet of Ministers, No.374, from April 17, 2008
[lxxviii] Resolution of the Cabinet of Ministers, No.654, from July 16, 2008
[lxxix] Law of Ukraine, No.345-VI, from September 2, 2008
[lxxx] Order of the Cabinet of Ministers, No.81-p, from January 16, 2008
[lxxxi] Order of the Cabinet of Ministers, No.367-p, from February 22, 2008
[lxxxii] Law of Ukraine, No. 107-V, from December 28, 2007
[lxxxiii] Order of the Cabinet of Ministers, No.249-p, from February 6, 2008
[lxxxiv] Order of the Cabinet of Ministers, No.261-p, from February 11, 2008
[lxxxv] Resolution of the Cabinet of Ministers, No.66, from February 22, 2008
[lxxxvi] http://www.president.gov.ua/news/8725.html
[lxxxvii] Decision of the SDCOU, from February 15, 2008
[lxxxviii] Draft Law of Ukraine, No.2330, from April 7, 2008
[lxxxix] Law of Ukraine, No.659-VI, from December 12, 2008
[xc] Law of Ukraine, No.639-VI, from October 31, 2008
[xci] Law of Ukraine, No.835-VI, from December 26, 2008
[xcii] Order of the Cabinet of Ministers, No.1517-p, from December 3, 2008
[xciii] Order of the President of Ukraine, No.1178/2008, from December 19, 2008
[xciv] Art. 11 of the Order of the Cabinet of Ministers, No.1036, from November 26, 2008
[xcv] Law of Ukraine, No.514-VI, from September 17, 2008
[xcvi] The plan figure for internal borrowings is taken according to the State Budget Law 2008 with amendments as of December 12, 2008.
[xcvii] According to the IER estimates money supply growth in 2008 would be 16.5% if depreciation effects are excluded.
[xcviii] NBU Resolution, No.171, from June 18, 2008
[xcix] NBU Resolution, No.319, from October 11, 2008
[c] NBU Resolution, No.413, from December 4, 2008
[ci] NBU Resolution, No.319, from October 11, 2008
[cii] NBU Resolution, No.396, from November 25, 2008
[ciii]. NBU resolution, No.419, from December 22, 2008
[civ] Law of Ukraine, No.661-VI, from December 12, 2008
[cv] NBU Resolution, No.319, from October 11, 2008
[cvi] NBU Resolution, No.413, from December 4, 2008
cvii The norm was abolished on 12 of May, 2009
[cviii] Law of Ukraine, No. No.639-VI, from October 31, 2008
[cix] Resolution of the Cabinet of Ministers, No.960, from November 4, 2008
[cx] NBU Resolution No.405, from December 1, 2008
[cxi] IMF Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding, from October 31, 2008.

Economic Trends		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
GDP growth (real)	% yoy	4.9	6.7	6.5	6.7	7.2	5.4	7.3	10.9	5.5	-2.1	-14.4	…
GDP growth (real)	% yoy cum.	4.9	5.8	6.0	6.2	6.4	6.3	6.5	7.1	6.9	5.8	3.6	2.1
Industrial production (real)	% yoy cum.	5.7	8.8	7.8	8.0	8.0	7.5	7.3	6.3	5.1	2.2	-0.7	-3.1
Agricultural production (real)	% yoy cum.	0.0	0.7	0.2	0.4	0.2	-0.3	10.9	21.0	15.1	17.6	18.0	17.5
CPI	% yoy eop	19.4	21.4	26.2	30.2	31.1	29.3	26.8	26.0	24.6	23.2	22.3	22.3
PPI	% yoy eop	23.3	25.6	31.8	37.5	39.4	43.7	46.3	46.9	42.7	37.7	27.4	23.0
Exports of goods (USD)***	% yoy cum.	14.0	26.0	28.5	30.9	35.8	40.7	46.6	48.5	50.1	48.4	41.7	35.9
Imports of goods (USD)***	% yoy cum.	24.8	38.6	45.1	50.3	52.3	55.3	57.5	58.3	60.2	56.5	49.4	41.1
Merchandise trade balance	USD bn cum.	-1.0	-2.7	-5.0	-7.4	-8.8	-9.8	-11.1	-12.5	-14.3	-16.1	-17.7	-18.5
Gross international reserves	USD bn eop	31.8	32.5	33.2	33.3	34.4	35.5	37.9	38.1	37.5	31.9	32.7	31.5
Monetary Base	% yoy eop	42.7	44.9	41.4	45.6	38.8	38.9	41.6	40.2	33.8	33.1	32.2	31.6
Lending rate on UAH credits **	% pa, aop	13.9	14.6	15.2	16.9	17.5	17.3	17.1	17.3	16.8	19.1	22.6	21.6
Exchange rate (interbank)	USD aop	5.06	5.05	5.00	4.93	4.74	4.68	4.61	4.62	4.83	5.56	6.11	7.76
Exchange rate (official)	USD aop	5.05	5.05	5.05	5.05	4.99	4.85	4.84	4.84	4.85	5.04	6.00	7.58
Exchange rate (official)	EUR aop	7.42	7.63	7.81	7.96	7.76	7.45	7.64	7.29	6.99	6.75	7.65	10.24

Sources: Derzhkomstat, Ministry of Finance, NBU, IFS, Reuters, 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		2000	2001	2002	2003	2004	2005	2006	2007	2008
Nominal GDP	UAH bn	170.1	204.2	225.8	267.3	345.1	441.5	544.2	720.7	949.9
Nominal GDP	USD bn	31.3	38.0	42.4	50.1	64.9	86.2	107.8	142.7	180.2
GDP growth (real)	% yoy	5.9	9.2	5.2	9.6	12.1	2.7	7.3	7.9	2.1
Industrial production	% yoy	13.2	14.2	7.0	15.8	12.5	3.1	6.2	10.2	-3.1
Agricultural production	% yoy	9.8	10.2	1.2	-11.0	19.7	-0.1	0.4	-5.2	17.5
CPI	% yoy aop	28.2	12.0	0.8	5.2	9.0	13.5	9.1	12.8	25.2
CPI	% yoy eop	25.8	6.1	-0.6	8.2	12.3	10.3	11.6	16.6	22.3
PPI	% yoy aop	20.9	8.6	3.1	7.6	20.5	16.7	9.6	19.5	35.5
PPI	% yoy eop	20.8	0.9	5.7	11.1	24.1	9.5	14.1	23.3	23.0
Exports (gs, USD)	% yoy	17.9	9.5	10.7	24.0	42.6	7.5	13.2	27.5	33.8
Imports (gs, USD)	% yoy	18.9	14.1	4.9	28.7	31.3	20.4	22.0	35.5	38.6
Current account	USD bn	1.2	1.4	3.1	2.9	6.9	2.5	-1.6	-5.3	-12.9
Current account	% GDP	3.8	3.7	7.6	5.9	10.6	2.9	-1.5	-3.7	-7.2
FDI (net)	USD bn	0.6	0.8	0.7	1.4	1.7	6.5	5.3	9.2	9.7
International reserves	USD bn	1.5	3.1	4.4	6.9	9.7	19.4	22.4	32.5	31.5
Fiscal balance'''	% GDP	-0.7	-1.9	0.8	-0.2	-3.0	-1.9	-0.7	-1.1	-1.5
Total state debt	% GDP eop	45.3	36.5	33.5	29.0	24.7	17.7	14.8	12.5	19.9
External state debt (total)	% GDP eop	33.0	26.3	24.1	21.4	18.6	13.4	11.7	9.8	15.0
Monetary base	% yoy eop	39.9	37.4	33.6	30.1	34.1	53.9	17.5	46.0	31.5
Exchange rate	USD aop	5.44	5.37	5.33	5.33	5.32	5.12	5.05	5.05	5.27
Exchange rate	USD eop	5.44	5.30	5.33	5.33	5.31	5.05	5.05	5.05	7.70
Exchange rate	EUR aop	5.03	4.81	5.03	6.02	6.61	6.39	6.34	6.92	7.71
Exchange rate	EUR eop	5.10	4.67	5.53	6.66	7.22	5.97	6.65	7.42	10.86

Sources: Derzhkomstat, NBU, Ministry of Finance, own calculations
''' "Minus" denotes a consolidated fiscal deficit
° 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
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

Contact information:

Institute for Economic Research
and Policy Consulting
Reytarska St. 8/5-A, 01034 Kyiv
Tel. (+38044) 278-6342
Fax (+38044) 278-6336
E-mail: institute@ier.kiev.ua
http://www.ier.kiev.ua

Head of the Board-Director

Igor Burakovsky
burakovsky@ier.kiev.ua

Chief Executive

Oksana Kuziakiv
kuziakiv@ier.kiev.ua

Academic Director

Veronika Movchan
movchan@ier.kiev.ua

German-Ukrainian Policy Dialogue in Agriculture

Heinz-Wilhelm Strubenhoff
Team leader
Strubenhoff@ier.kiev.ua

Iryna Slavynska
slavinska@ier.kiev.ua

Oleg Nivyevs'kiy
nivyevs'kiy@ier.kiev.ua

Justyna Jaroszewska
Jaroszewska@ier.kiev.ua

Anna Kuznetsova
Kuznetsova@ier.kiev.ua

Serhiy Kandul
kandul@ier.kiev.ua

Centre for Economic Studies

Oleksandra Betliy
betliy@ier.kiev.ua

Vitaliy Kravchuk
Kravchyk@ier.kiev.ua

Olga Megeda
megeda@ier.kiev.ua

Dmytro Naumenko
naumenko@ier.kiev.ua

Kateryna Pilkevich
pilkevich@ier.kiev.ua

Alla Kobylyanska
kobylyanskaya@ier.kiev.ua

Roman Voznyak
voznyak@ier.kiev.ua

Natalia Sysenko
sysenko@ier.kiev.ua

Kateryna Kutsenko
kutsenko@ier.kiev.ua

Anna Chukai
chukhai@ier.kiev.ua

Center for Political Studies

Yevgeniy Razdorozhny
razdorozhny@ier.kiev.ua

Kateryna Shynkaruk
shynkaruk@ier.kiev.ua

Center for Contemporary Society Studies

Iryna Fedets
fedets@ier.kiev.ua

Yana Dvorak
dvorak@ier.kiev.ua

INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING PRODUCTS

Monthly Economic Monitor Ukraine (MEMU) with supplement

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.

Economic Summary for Ukraine

Economic summary is a review and brief analysis of the key economic indicators and policy measures of the year. It is published in January using the available statistics and annual estimates and updated in May when the most of previous year data becomes publicly available. The product is distributed among subscribers.

Business Tendencies Survey

Business Tendency Surveys are comprised of two surveys. The first one – Industries – is prepared on the basis of quarterly surveys of industrial enterprises managers. The second – Banking – is based on the survey of banks managers. There are four publication for each of the component of the Business Tendencies available and participants of the surveys and to subscribers.

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. The list of the most recent policy papers includes:

- The Role of Trade Policy in Reducing Ukraine's Current Account Deficit - Lessons from Abroad, by Christian Helmers, Veronika Movchan, Ricardo Giucci and Kateryna Kutsenko, policy Paper 01, March 2009
- Developing the market for foreign exchange derivates in Ukraine: Sequencing the reform steps, by Robert Kirchner, Ricardo Giucci, and Alla Kobylyanska, Policy paper 09, January 2009
- Assessing the impact of the protracted economic slowdown on the pension insurance in Ukraine: Hope for the best, but prepare fort he worst! by Lars Handrich, Oleksandra Betliy, Policy Paper 09, November 2008
- Deposit Insurance in Ukraine: Time for Reform?, by Ricardo Giucci, Robert Kirchner, Policy Paper 08 November 2008
- Principles and methods of targeted social assistance: Policy recommendations for Ukraine, by Lars Handrich, Oleksandra Betliy, Policy Paper 07, October 2008
- How to deal with 'European gas prices' in Ukraine?, by Ferdinand Pavel, Inna Yuzefovych, Policy Paper 06, October 2008
- Inflation in Ukraine: Results and Policy Implications of an Empirical Study, by Robert Kirchner, Enzo Weber, Ricardo Giucci, Policy Paper 05, October 2008
- The Housing Construction Sector in Ukraine: Reasons for the Current Recession and Policy Implications, by Ricardo Giucci, Robert Kirchner, Roman Voznyak, Policy Paper 04, October 2008
- The Policy Interaction between the Government and the National Bank of Ukraine: Assessment of the Current Framework and Policy Recommendations, by Ricardo Giucci, Robert Kirchner, Vitaliy Kravchuk, Policy Paper 03, June 2008
- Inflation Expectations: Importance and Measurement, by Robert Kirchner, Ricardo Giucci, Yaroslava Suchok, Oksana Kuziakiv and Veronika Movchan, Policy Paper 02, June 2008