INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING

Year 2011: Economic Summary for Ukraine

Recovery is still fragile

EXECUTIVE SUMMARY:

In 2011 Ukraine's economy continued recovering from the crisis. The economic growth was supported by domestic demand, while external demand remained weak. The year was marked by large number of negotiations, major of which did not resulted in favourable results for the country. The Government did not continue implementation of reforms in most sectors. Political instability again became one of the major risks for future development of Ukraine. Another risk further related to global economic slowdown.

Politics. Over the year Ukraine tried to manoeuvre between European and Eurasian economic integration projects. Cooperation with the IMF was stagnating due to unwillingness of Ukrainian government to conduct required reforms.

Real Sector. Real GDP grew by 5.2% in 2011 due to strong domestic demand. External demand remained weak. As a result, output in all export-oriented sectors remained lower than before the crisis. Real gross fixed capital accumulation increased by 10.1%. Investments grew due to higher commercial construction and purchase of machine and equipment primarily attributed to the preparation to EURO-2012.

Agriculture. Agricultural policy continued to be ad hoc and unfair, which harmed investment climate in the sector. Agricultural output increased by 17.5% due to record harvest of most crops.

Energy policy. Ukraine became a member of the European Energy Community, which requires implementing gas market reforms. As Ukraine failed to negotiate with Russian Gasprom reduction in gas prices the Government announced a strategy to decrease an energy dependency on Russia.

Infrastructure. Major infrastructure projects were related to the preparation to the EURO-2012. They include renovation of airports, railroads and stadiums. The National Commission for Public Utility markets was created with responsibility to define utility tariffs.

Balance of Payment. The consolidated balance of payment was in deficit at USD 2.5 bn (1.5% of GDP). Increase in trade deficit resulted in widening of current account deficit to 5.5% of GDP.

Income: Improved financial stance of companies and raised minimum wage stimulated increase in real disposable income at 6.1%. Real income from social assistance payments and pensions grew only by 2.7% due to high fiscal pressure.

Fiscal policy. The Government amended the Tax Code during the year, even though it was introduced only in the beginning of the year. Tax administration burden was heavy, while automatic VAT refund was not fully implemented. The central fiscal expenditures were executed at only 93.8% of plan as the Government was not able to finance fiscal gap.

Business climate. Throughout the year managers' assessment of overall economic conditions was quite pessimistic. Excessive taxation, insufficient demand, lack of financing and unfavourable regulatory climate were among major impediments to business development.

Monetary policy. Average consumer inflation decelerated to 8.0% primarily due to slowdown in food prices. The monetary policy was tight as the NBU attempted to diminish pressure on the currency exchange market.

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Politics: Ukraine manoeuvres between European and Eurasian economic integration projects

Ukraine – EU.

In relations with the EU the first half of the year 2011 was marked by a determination to complete talks on the Association Agreement (AA), which have been going on since 2007. Ukraine showed commitment in particular in social and economic areas. However, the political situation in the country led to a significant deterioration of its relations with Brussels in the second half of the year.

In February 2011 Ukraine became a full member of the European Energy Community (EEC), which signalled about the recognition of the preliminary steps towards open gas market made by Ukraine in 2010. However, in 2011 Ukraine did not approve any new steps in order to harmonise its legislation with the EU acquis communautaire. As a result, Ukraine is not likely to receive financial support for the modernisation of its gas transit system in the nearest future, the possibility of which was discussed by the European Commission and the EBRD already in 2010.

Besides, during the year the European Commission suspended budget support programs in Ukraine, and resumed them after the amendments to the Law on Public Procurement were introduced in order to make the procedures more transparent. Nevertheless, in 2012 budget support programs for more than EUR 160 mln were suspended due to inefficient distribution of funds provided.

The major outcome of 2011 was the completion of negotiations on the Association Agreement, including creation of Deep and Comprehensive Free Trade Area (DCFTA). In the political chapter of the AA the EU recognises Ukraine's European identity, but the text does not provide the EU membership prospect. Despite previous expectations the Association Agreement was not initialled during the EU-Ukraine summit in December 2011, but only in March 2012. Such delay was likely to be explained by Ukraine's backsliding on democracy and rule of law, which raised concerns in the EU.

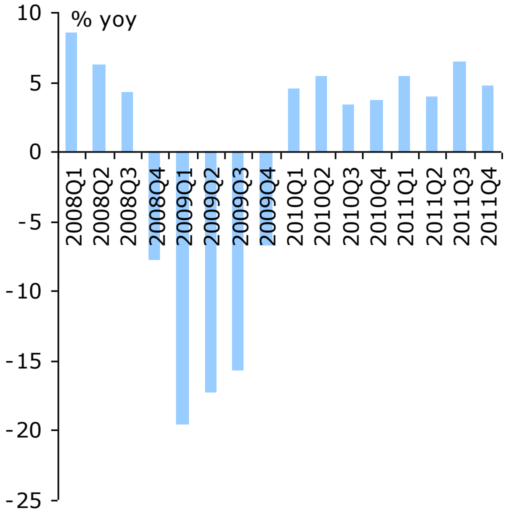
The tensions at the level of EU-Ukraine political dialogue increased significantly with the arrest of former Prime-Minister Yulia Tymoshenko, who was sentenced to seven years in jail in October 2011 for power abuse while signing gas contracts with Russia in 2009. Tymoshenko's trial was criticised by the European Commission (EC) and the majority of EU member states and was qualified as a selective prosecution of political opponents in Ukraine. The arrest of Yulia Tymoshenko was the main subject of discussions between the EU and Ukraine's President Viktor Yanukovych at the Second Eastern Partnership summit in Warsaw in September, as well as during a number of his meetings with EU high officials.

In October the European Parliament adopted resolution on current developments in Ukraine. It asserted the necessity of transparent and fair judicial proceedings as a major precondition for realisation of Ukraine's European perspective.

Given the fact that the EU sees Ukraine's compliance with the democratic values as a precondition for the conclusion of the Association Agreement, including creation of the DCFTA, the increase in non-democratic trends in Ukraine in 2011 raised questions as to the prospects of the AA further signature and subsequent ratification by national parliaments of the EU member states.

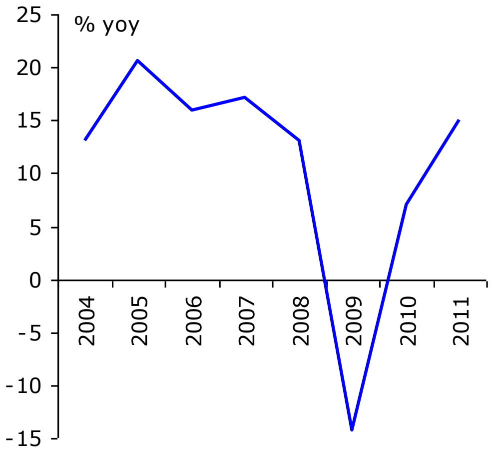
Ukraine - IMF. In 2011 Ukraine failed to implement the policy steps required for the disbursement of new instalment of the loan under the Stand-by Arrangement (SBA) signed in 2010. The IMF mission visited Kyiv twice to hold discussions on the second review under the Stand-By Arrangement. Admitting Ukraine's implementation of the pension reform, IMF experts advised the government to solve the problem with non-performing loans and inter alia adopt legislation on insolvency, as well as to strengthen the investment component of the economic policy and improve the banking system.

Real GDP growth



Source: Ukrstat

Real households' final consumption

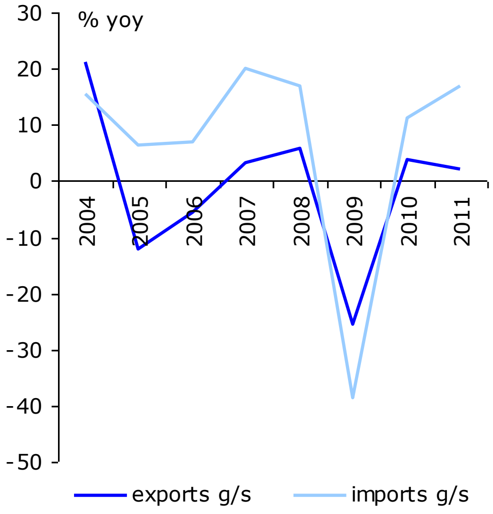


Source: Ukrstat

However, the major topic for discussion was increase in gas tariffs for population, which is required for fiscal consolidation purposes. Nevertheless, the Government did not raise tariffs as it would increase social tensions. Besides, it hoped for receiving lower imported gas prices from Russia. Eventually IMF did not adopt any formal decision as to the release of the third tranche under SBA in the amount of USD 1.3 bn. As a result, foreign investors started perceive Ukraine as a more risky investment.

Ukraine – Russia. Negotiations aiming to review gas supply contracts between Ukraine and Russia were the major topic of the bilateral agenda of two countries. However, Moscow was willing to provide concessions only in case Ukraine agrees to participate in the Customs Union of Russia, Belarus and Kazakhstan (CURBK). The pressure from Moscow has increased with the progress in Ukraine-EU talks on Deep and Comprehensive Free Trade Area (DCFTA). As participation in the CURBK is not compatible with the Ukraine's WTO membership and expected DCFTA, Kyiv suggested cooperation with the Custom Union in the format of free trade area between Ukraine and the Customs Union. Moscow remained reluctant about this initiative.

Real exports and imports



Source: Ukrstat

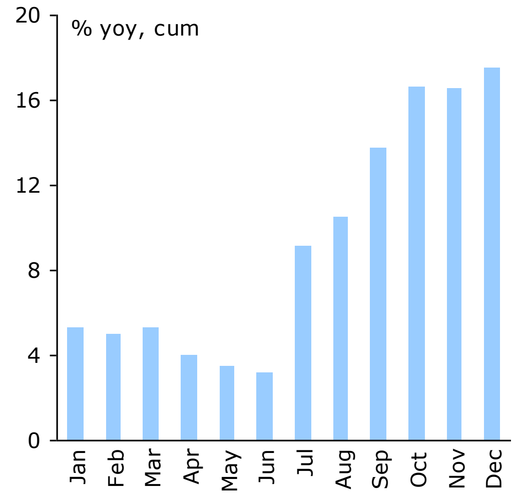
In December, Ukraine intensified talks with Russia on the revision of gas contracts to ensure decline in base price. However, the agreement was not reached in 2011. According of some preliminary official statements Russia could lower gas prices only in turn of decline in gas transit fee as well as participation in the gas consortium, which requires restructuring of the NJSC 'Naftogaz of Ukraine'.

Ukraine – CIS. In October Ukraine joined the Agreement on Free Trade Area among CIS member countries (excluding Azerbaijan, Uzbekistan and Turkmenistan), which is to be ratified by the Verkhovna Rada in 2012. This agreement does not de facto bring advantages to Ukraine as it mainly replicates norms and procedures envisaged in effective bilateral agreements on FTA between CIS countries. It also maintains existing exclusions. The major advantage could be the intention to govern the trade in goods within the CIS in compliance with the WTO principles and practices.

GDP: Continued recovery in 2011

Ukraine continued recovering from the economic crisis in 2011, when real GDP grew by 5.2%. Strong demand of households was the major driving force of economic growth. External demand for Ukrainian products also increased but remained weak throughout the year.

Agricultural output, 2011



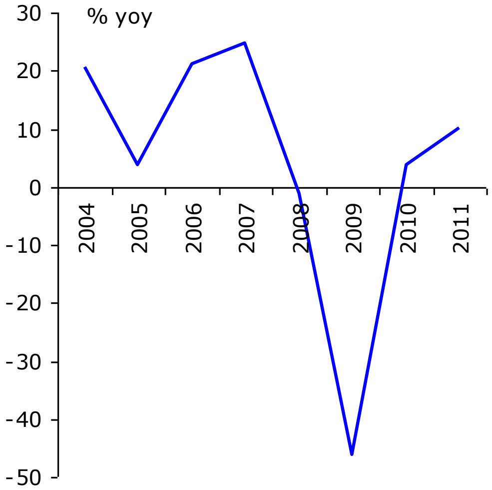
Source: Ukrstat

On demand side, real final household consumption increased by 15% due to several factors. First, real disposable income increased due to higher income from all major components (*see Wages and income)*. Second, household indebtedness increased in 2011 after two years of declining. Consumption loans outstanding somewhat increased by 2.6%. Overall, saving rate declined due to higher purchases of durables after several years of postponed demand as well as improved consumer sentiment. It was likely to contribute to higher real consumption of food items. In particular, purchases of food and non-alcoholic beverages grew by 21.3% in real terms likely due to decline in prices for fruits and vegetables.

Improved corporate finances resulted in growth of real gross fixed capital accumulation by 10.1% (see *Investments*). Increased demand for investments and consumption was satisfied by real imports growth, which reached 16.8% in 2011. In particular, imports of equipment and cars increased by more than 40% in real terms. At the same time, external demand for Ukrainian goods increased only by 2.2% and exports fell in the second half of the year as compared to the same period of 2010. Lower exports in the second half of 2011 were primarily attributed to the worsening of economic situation in the world, particularly in the EU. Another important reason is restrictions of grain exports (see *Agricultural policy*). Overall, negative contribution of net exports to real GDP growth more than doubled reaching 7.9 p.p.

On production side, real gross value added (GVA) fell in education and 'other types of economic activity'. Agriculture demonstrated the highest growth (at 17.6%) due to record harvest of most crops, including grain (see *Agricultural output*). GVA in construction grew by 10.9% from low statistical base. Industry increased its GVA by 7.7% due to higher domestic demand (see for details *Industrial output).* GVA growth in trade decelerated to 5.9% in 2011 despite higher consumption due to lacklustre growth of wholesale trade volumes. At the same time, higher industrial growth and larger trade volumes resulted in increase of GVA in transports at 6.8%.

Real gross fixed capital accumulation



Source: Ukrstat

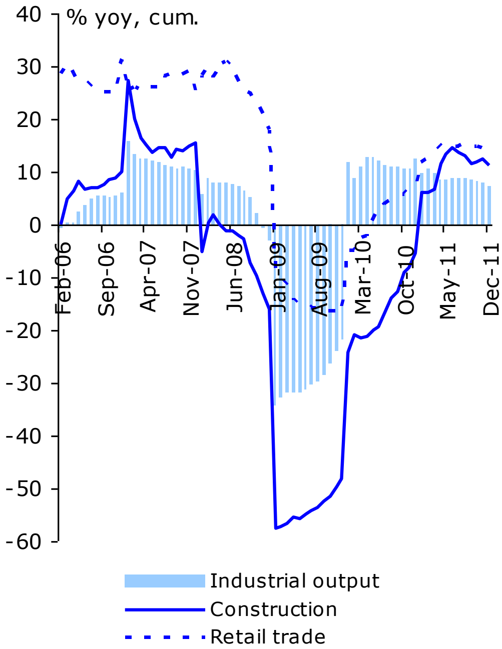
Investments: Small recovery in 2011

After slow growth in 2010 real gross fixed capital accumulation increased in 2011. Largest growth was observed in investments in commercial construction and machine and equipment. The former is attributed to the EURO-2012 projects especially in the end of the year, while the latter could be explained by modernisation projects of some companies. Still, real gross fixed capital accumulation was lower than in 2004 marking deteriorating capital stock in Ukraine. According to the Ukrstat reporting, inventories sharply increased in 2011, but are likely to be revised downwards during the final revision.

According to the sectoral structure of investments in fixed capital (which is a narrower category than gross fixed capital accumulation and based on different reporting model), higher investments in transport thanks to Euro-2012 and increased investments in extractive industry were offset by lower investment by real estate developers and stagnant investment by manufacturing enterprises. Overall, 54% of all investments were financed at the expense of own funds, while banks financed 17.9% of all projects. Share of consolidated fiscal financing increased to 10.4% likely due to implementation of projects conducted in the framework of preparation to the EURO-2012.

Industrial output: Industrial production did not reach pre-crisis levels

Real sector trends



Source: Ukrstat

In 2011 industrial production continued recovering against the background of higher external demand. At the same time, external demand was volatile and declined in the end of the year resulting in the deceleration of recovery in export-oriented sectors. Moreover, domestic-oriented sectors did not respond to higher domestic demand mainly due to its substitution by imports. Overall, industrial output increased by 7.6%.

Higher production in metallurgy and construction materials as well as larger domestic demand for coal supported growth of extractive industry by 7.2%. Exports of iron ore also contributed to growth.

Manufacturing production grew by 8.2% due to higher recovery in export-oriented sectors. Output in machine-building increased on average by 17.2%. In particular, production of railcars and locomotives grew by 28.4% and vehicle production increased by 26.7%. External and domestic demand also fuelled growth of other sub-sectors of machine building.

Chemical industry increased its output by 18.4%. It was explained by higher demand for fertilisers, which was supported by high global food prices.

Metallurgy increased its output by 8.1% leaving production well below pre-crisis level as external demand did not recover from the crisis. The situation in the sector worsened in the end of year due to slowdown in major trading partners, including the EU.

The problems in oil refinery sector resulted in decline of its production at 17.2%. Also, food production remained at the level of 2010. Even though food consumption increased, it was partially satisfied by imported products. In particular, share of domestically produced food items in retail declined by 2.4 p.p. to 61.9%.

Overall, recovery in industry remained weak due to volatile and weak domestic and external demand. Industrial production remain by 11.4% lower than in 2007.

Agricultural output and trade: the highest sector performance since independence

Agricultural performance improved in 2011. Output in the sector increased by 17.5%, which was one the highest growth rates since independence. As in previous years, production grew faster in agricultural enterprises than in households' subsistence farms, which resulted in further increase of enterprises' share in total agricultural production. This is likely to result in better quality and higher competitiveness of Ukraine's agriculture on domestic and international markets.

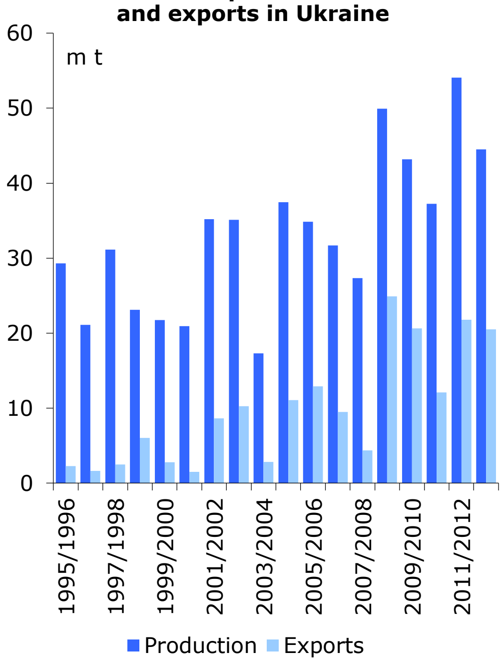
Crop production. The growth in agriculture was primarily driven by record harvest of many crops. Grain production grew by 44.3% to 56.7 m t contributing the most to total crop production. The productivity of crop production increased in 2011. The harvest of sugar beets and potatoes grew by 36.2% and 29.6%, respectively. Sunflower seed production increased by 27.9%. Overall, crop production increased by 28.2%.

The rapeseed production was the only crop reported to decline in 2011. By the end of marketing year 2011/12 its exports to production ratio is expected to decline by 26 p.p. to 70% of production primarily due to higher domestic demand. Contrary to expectations, new EU certification requirements have not influenced the export quantities. At the same time, the shares of soybean and sunflower seeds are likely to increase in total crop exports especially taking into account restrictions of grain exports that further decreased the profitability of grain production in Ukraine as compared to oilseeds (see *Agricultural policy*).

Increase in harvests was attributed to record yields and higher harvested areas. Total grain yield was at 3.7 t/ha being by 37.5% higher than in 2010. Favorable weather made an essential contribution to the crop production growth. The dependence on weather conditions is one of the major vulnerabilities of crop production development in Ukraine, especially taking into account restricted access to financing for purchase of required inputs, equipment and technologies.

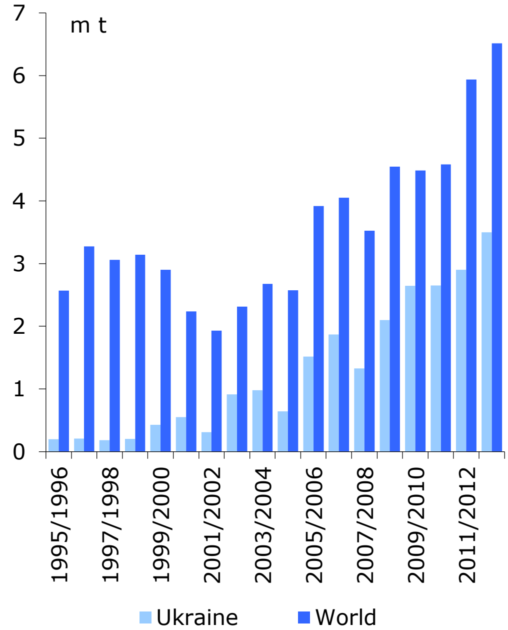
Livestock production. The growth of livestock output remained moderate at 2.5% due to improved performance of agricultural enterprises (by 6.2%). Growth was supported by higher production of meat and eggs. Egg production remained mostly concentrated in three large Ukrainian agriholdings. At the same time, milk output declined due to its lower production by households, which produced 79.7% of all milk produced. Currently exports to production ratio of dairy products in Ukraine remains at 1%. The yields in the livestock production, including milk yields, increased in 2011, which reflects improved competitiveness of the sector. At the same time, the growth was suppressed by decline in head number of all livestock, including poultry.

Grain* production and exports in Ukraine



Source: USDA
Note: only wheat, baley and corn. Their common production share is above 90%

Ukraine's share in sunflower oil exports in the World



Source: USDA

Agricultural policy: still ad-hoc and interests driven

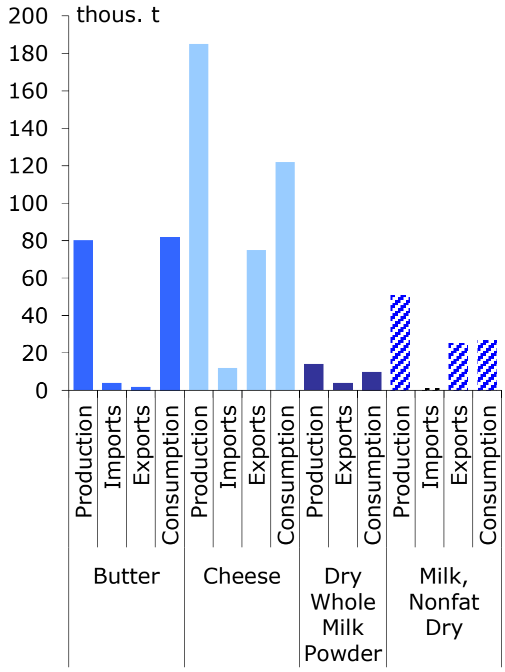
The agricultural policy in 2011 continues to be ad hoc and uneven. This did not result in higher incentives for agriculture development. Major policy changes concerned restrictions of grain exports, land market reform and amended VAT system.

Grain exports. Grain export restrictions were effective until the late fall of 2011. Export quotas for wheat, barley and corn applied between January and May, while quotas for buckwheat and rye were imposed for first half of the year. Quotas were distributed twice during this period through unfair and non-transparent procedures. Large international traders were de facto excluded.

In July 2011 the Government introduced grain export duties restricting exports further and ensuring additional fiscal revenues.[i] Export duties were cancelled only in late October. Export restrictions had significant negative economic consequences. By depressing domestic grain prices, export restrictions reduced grain producers' revenues. Such ad hoc restrictive measures resulted in further deterioration of investment incentives in the sector.

Land reform. The Government attempted to move forward the land reform in 2011. In particular, in July 2011 the Law of Ukraine "On the State Land Cadastre" was adopted.[ii] In December 2011 another law required to lift the moratorium, namely the Law of Ukraine "On the Land Market", was adopted in the first reading. This law is likely to be approved in 2012 meaning the shift to the completion stage of the land reform. However, the institutional basis for a well-functioning land market is still missing. Besides absence of the freedom to buy and sell agricultural land, it misses such components as a land cadastre monitoring system, a system of rights on land registration and conflict resolution, etc. Taking such deficiencies into account the Parliament again postponed the cancellation of the moratorium on agricultural land sale until 2013. This again negatively impacted the investment attractiveness of the sector.

Dairy balances in Ukraine in 2011



Source: USDA

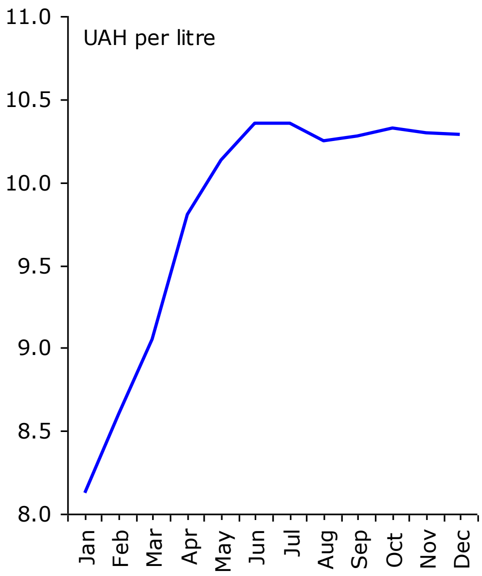
Tax regime. VAT remained to be a problematic issue for agricultural producers and exporters in 2011. According to the special value-added tax (VAT) regime for agriculture, producers are entitled to transfer the VAT from their sales to special bank accounts. These funds are then to be used for VAT refund on inputs and for other production purposes[iii]. From January 1, 2011, the VAT from sales of meat and dairy products is transferred onto a special account at the State Treasury. The VAT proceeds are used to finance direct payments to agricultural producers on per-head basis (from April 2011 – on per kilo of milk basis). Before, these funds were transferred directly to producers by meat and dairy processors.

In line with international practice and to avoid double taxation, agricultural exports are subject to a zero VAT rate. Thus, an exporter is entitled to a refund of the VAT paid when procuring the goods exported. However, in Ukrainian practice this VAT refund for exports has been very difficult to secure. In an attempt to tackle these problems and to create a level playing field, the Government temporarily banned VAT export refunds for grain, sunflower seed and rapeseed exports until January 1, 2014.

Energy policy: Start of gas market reform

Imported gas prices. A sharp increase in price of imported gas forced Ukrainian government to intensify negotiations with Russia on lowering the price of imported natural gas. Two rounds of negotiations with Gazprom finished unsuccessfully for Ukraine and the talks were expected to resume in 2012.

Retail price of petrol A-95 in 2011



Source: Energobusiness

Fuel market. At the beginning of 2011, the Antimonopoly Committee of Ukraine (AMCU) finished investigating the reasons for sharp increase in the price of petrol at the end of 2010 by major market operators. After bitter accusations between the oil market operators and the Energy Ministry[iv] and involvement of the Prime Minister[v] new memorandum was signed on mutual partnership between the Ministry, oil traders and the refining industry to increase oil processing by the refineries. Such memorandums became the traditional outcome of similar disputes and could be considered as only temporary and inefficient solution of the problem. At the same time, the AMCU still does not have capacities to impact the competition on the market.

Later, the Verkhovna Rada temporarily reduced excise duty on petrol[vi] by EUR 50 per tonne and on diesel fuel by EUR 20-30 per tonne until July 31, 2011 to stabilize the situation on the fuel market. As a result, the retail price of petrol A-95 averaged UAH 10.35 per litre in June and July and then decreased to UAH 10.25 per litre in August after steady increase in the first five months of the year.

In mid-year, the Derzhspozhyvstandart, state certification agency, prolonged Euro 2 and Euro 3 standards for petrol and diesel fuel until December 31, 2011[vii] and later prolonged them further until July 2012. At the same time, Lysychansk oil refinery completed modernisation of machinery to switch to the production of petrol under Euro 4 standard. Prompt introduction of new standards would increase the supply of high-quality fuel imports and, thus, increase competitiveness of Ukrainian refineries. Another delay with this step hampers development of this market segment.

Oil transit. On January 17, the Ukrtransnafta and Belarusian Oil Company agreed on guaranteed annual transit of 4 m tonnes of oil through the Odesa-Brody oil pipeline for 2 years[viii]. Overall, in 2011 Ukraine transported 988,000 tonnes of Azeri oil to Belarus. The agreement with Belarus and Azerbaijan increases Ukraine's status as a transit country.

Gas market. From February 1, Ukraine became a full member of the Energy Community and took an obligation to reform its energy market. The gas market reform started with the liquidation of the Gaz Ukrainy, subsidiary of the state monopolist on the gas market NJS Naftogaz of Ukraine, at the end of 2011.[ix] All the agreements on the supply of natural gas with gas and heat supply companies were re-signed with the Naftogaz.

Another requirement related to improvement of financial stance of the Naftogaz. In particular, debts of heat supply companies before the Naftogaz (at UAH 1.0 bn) resulted in request of the Gaz Ukrainy to disconnect 13 heat supply companies from gas pipelines. In particular, failure of local authorities to compensate losses acquired by heat generators due lower than cost-covering level heating tariffs resulted in high indebtedness of the latter before the Naftogaz. To resolve the situation, the Verkhovna Rada wrote off debts between fuel and energy enterprises for natural gas and electricity for 1997-2010 worth over UAH 24 bn[x]. To improve financial stance, the NERC also increased the tariff for transportation of natural gas by 6.1%. However, such steps without complete reform of the sector as well as rapid increase in gas tariffs for population are not likely to improve significantly the Nartogaz's financial sustainability. In December, the President of Ukraine announced losses of the Naftogaz to reach almost USD 6 bn.

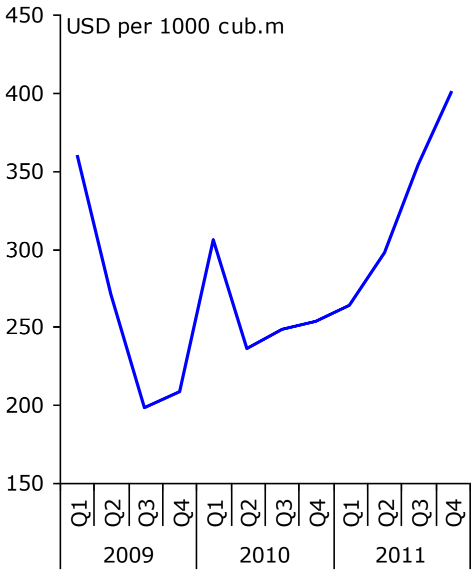
To lessen the dependency on imported natural gas and diversify gas and oil supplies the Government attempted to attract private investment to the industry. It permitted Ukrainian Chornomornaftogaz and Russian Lukoil to explore and extract jointly oil and natural gas on Black Sea shelf[xi]. A number of companies opened new gas wells[xii]. To increase the volume of oil and gas extraction the Parliament passed amendments to the law on production sharing agreements[xiii] aimed at attracting leading oil and gas extracting companies. However, these measures might lead to energy savings only in the long-run perspective and for the time being Ukraine should either find additional financial resources to pay for Russian gas or decrease its gas consumption.

Electricity. The National Energy Regulatory Commission (NERC) continued to approach electricity tariffs for households towards the cost-covering level. It took a decision to define bloc-tariffs, which are aimed to stimulate energy saving by population. From February the tariffs were increased by 30% for households that consume more than 150 kWh of electricity per month. The tariffs were further increased by 15% starting April.

Competition on the electricity market remained subdued in terms of access to the exports possibilities. As in previous year, the electricity grids operator – state company NEC Ukrenergo –blocked applications for export capacities of companies other than affiliated with corporation 'DTEK'.[xiv]

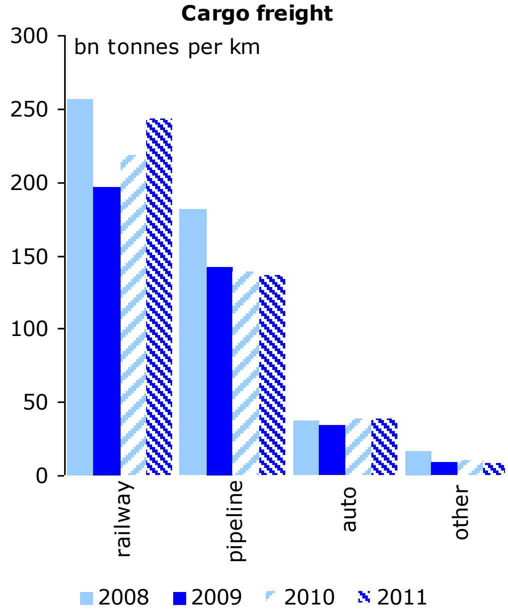
The nuclear energy sector development was marked by several important events in 2011. First, the Energoatom and Russian Atomstroyexport signed an agreement on construction of two

Price of imported natural gas



Source: Naftogaz

Cargo freight



Source: Ukrstat

additional reactors at the Khmelnytsky Nuclear Power Plant. The cost of the construction was estimated at UAH 33 bn. Second, the construction of a facility producing containers for nuclear waste was finished in Slavutych, being financed under the EU TACIS nuclear safety program (EUR 5.6 m). Third, Ukrainian Nuclear Fuel and Russian nuclear fuel producer TVEL set up a private joint-stock company Nuclear Fuel Production Plant with production facilities in Smoline, Kirovograd region. The plant is planned to produce nuclear fuel for pressurised water reactors. As prices for imported gas used at combined heat and power plants (CHP) continue to grow the importance of nuclear energy development increases despite the safety issues raised by the Fukushima accident.

Coal. In 2011, the Government proceeded with the restructuring of the coal mining sector, which is largely inefficient. In July, the Verkhovna Rada adopted a law on the leasing and concession of state mines[xv] aimed at attracting private investment for mines renovation and improving their financial state. As a result, Rovenkyantratsyt and Sverdlovantratsyt coal mines were provided into the concession to the DTEK in December for 49 years. In October, the Ukrainian Cabinet permitted the liquidation of 5 unprofitable state mines[xvi]. The Government also decided to subsidize state coal mines under lease and concession terms if they incur losses[xvii]. Policies attempted to increase coal extraction are approved in line with the official strategy to lessen the dependence on imported natural gas. Increased share of private coal enterprises in 2011 from 48.89% to 53.11% of total coal extracted should improve efficiency of the sector and help attract much needed investments.

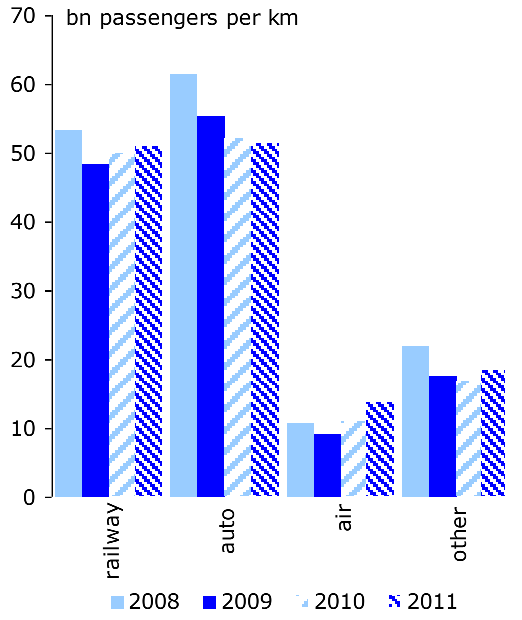
Renewable energy. To promote the development of renewable energy in Ukraine the Government permitted imports to Ukraine of solar and wind power stations at about EUR 705 m without payment of customs duties and VAT[xviii]. It also approved a list of energy efficient and energy saving products, producers of which receive tax benefits[xix]. The Parliament also approved state guarantees on the purchase of electricity generated at renewable energy facilities[xx]. Such incentives against the background of non-transparent provision of state aid in this segment resulted in completion of the construction of Central Europe's largest solar power station by Austria-registered Activ Solar near the town of Okhotnykove in Crimea with capacity of 80 MW in Crimea and Perove Power Plant with the same capacity. At the same time, alternative energy sources still account for around 1% of the total volume of electricity produced in Ukraine.

Transport: Sector revival

Market trends. In 2011, rail freight turnover increased by 8.6% against the background of industrial output growth and higher imports. The passenger transportation by the Ukrainian railways operator Ukrzaliznytsya (UZ) increased by 3.2%. Tariffs for passengers' transportation remained lower than cost covering level and were not fully cross-subsidised by higher freight tariffs. Moreover, local authorities did not compensate fully the provision of services to privileged categories of population. As a result, losses of the UZ reached UAH 6.1 bn (or 11% of total revenues). To decrease losses the company attempted at streamlining passenger transportation. In particular, it changed the frequency of passenger trains circulation, accelerated passenger trains, and cancelled certain stops and the most unprofitable routes.

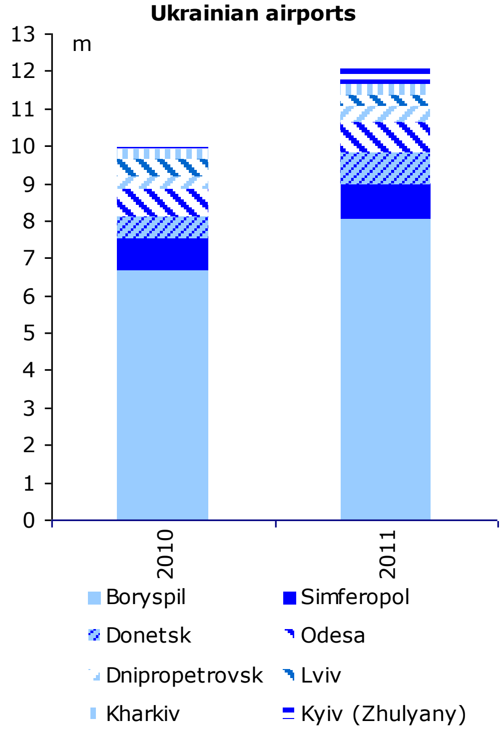
Ukrainian air carriers increased international passenger air transportation by 42% and domestic transportation by 24.8% primarily due to improved economic situation. In total, nine largest Ukrainian air companies served 7.5 m passengers. Besides, the route network was expanded by additional 13 routes, while flights frequency on existing destinations was increased. The number of low-cost air companies working in Ukraine reached 5 companies, namely "Fly Dubai", "Wind Jet", "Wizz Air Ukraine", "Wizz Air Hungary", "Air Arabia". So far, their share of the market remains low at 7% due to

Passenger transportation



Source: Ukrstat

Passenger traffic through Ukrainian airports



Source: Ministry of Infrastructure

high service costs for air carriers at Ukrainian airports among other reasons.

Transportation policy. In compliance with the EU legislation the Cabinet of Ministers adopted a Resolution on safety and technical policy in freight[xxi].

NewAir Code of Ukraine was finally approved.[xxii] It complies with principles of the International Civil Aviation Organization (ICAO), the European Civil Aviation Conference (ECAC) and the EUROCONTROL. The code offers a new approach to passenger rights, noting specific reasons, terms and compensations for denied boarding, cancellation of flight, long flight delays and lower class of service. Moreover, passengers of charter flights can also be compensated for flight delays.

The Government continued attempts to stimulate freight development. The Ministry of Infrastructure reached an agreement to increase quotas for international freight with a number of countries: Romania, Turkey, Hungary, Slovakia, Finland, Czech Republic, Greece, Italy, Slovenia, Serbia, Latvia, Azerbaijan and Macedonia. As a result, exports of transportation services by Ukrainian companies might increase.

In October 2011, the UZ approved a USD 20 bn five-year rail electrification plan envisaging electrification of 1,500 km of railways between 2011 and 2016. Rail electrification will allow to use high-speed trains. To facilitate execution of this plan the Ministry of Infrastructure introduced a new classification of trains[xxiii] and developed a pilot methodology of tariffs calculation for trains with speeds up to 160 km/h.

The Ministry expects to attract investments of USD 20-30 bn to build 5,000 km of highway in Ukraine. The Ministry is ready to involve foreign investors in the realisation of the projects, including international financial institutions.

The EBRD announced its readiness to continue financing road renovation and upgrading projects in Ukraine in the framework of EUR 450 m loan. The 15-year loan will be provided to the State Road Administration (Ukravtodor) for the rehabilitation of 400 km of road approaches to Kiev.

The state has abandoned the 10% restriction on foreign workers and the requirement to make up 70% of the value of the road project in domestically produced supplies. This measure will reducing burdens on firms picking up concessions in the country.

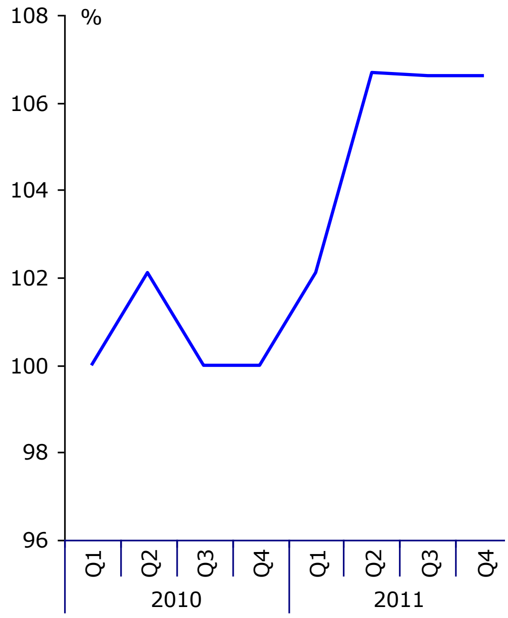
Tariffs. The Ministry of Infrastructure introduced discounts to marginal rates for handling transit cargo in ports[xxiv] for 2012 to promote increase in transit cargo through Ukraine. According to the Ministry of Infrastructure, these measures helped to increase transit of cargo in ports by 20.8% in 2011.

The Ministry cancelled the discount offered to Derzhkomreserv for rail transportation of grain. Tariffs for rail freight were increased in 2011 by 13.3%. The highest increase of tariffs was for ferrous metals transportation (by 14.7%), iron ore (by 14.6%), coke (14.4%) and mineral construction materials (by 13%) which discounted tariffs in the first half of 2010.

Infrastructure projects. Major infrastructure projects in 2011 were conducted in the framework of preparation to the EURO-2012 football championship. During 2011, 5 airports (in Boryspil, Donetsk, Kharkiv, Lviv and Kyiv) were renovated. The Darnytsya railway-road bridge in Kyiv was finally opened, which is likely to facilitate transportation in Ukraine's capital. In 2011, Ukraine built and renovated a record number of roads – more than 2,000 km. In comparison, in 2008 there were only 111 km of roads renovated and in 2010 – 973 km. The main western transport corridors for the Euro-2012– roads M-05 and M-06 – were fully renovated.

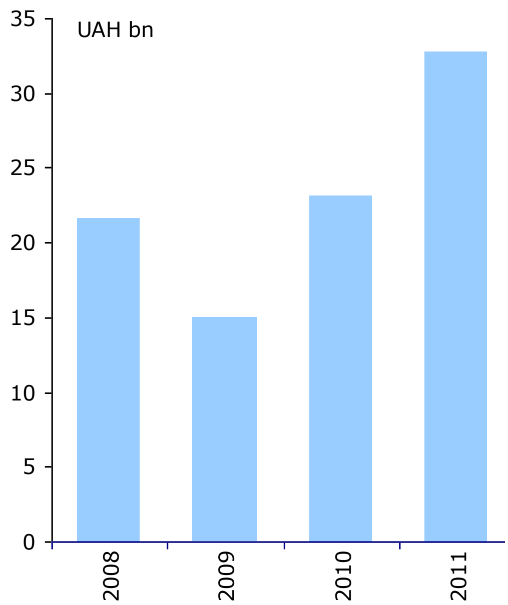
The World Bank has granted a loan to Ukraine's road sector under the Roads and Safety Improvement Project for Ukraine. The bank has

Freight rail tariffs index



Source: Ukrstat

Investments in fixed assets of transportation sector



Source: Ukrstat

approved USD 400 m in funds for the project, and it is hoped this will reduce the number of accidents on Ukraine's roads.

Ukrainian ports are undergoing a high level of expansion, with plans now in place to deepen the three ports of Odesa, Illichivsk and Yuzhny. This will allow the ports, while also catering for domestic trade, to develop into a maritime gateway for Belarus. However, the development of any port into a transhipment hub is unlikely as Romania's Port of Constantza already serves that market. Furthermore, Russia, which could also be served by the Ukrainian ports, already has its own maritime facilities on the Black Sea.

Telecommunications. Stable growth in 2011

Empowerment of NCCRI. In November, the President of Ukraine renamed the National Commission for Communications Regulation of Ukraine as a state collective body, subordinated to the President of Ukraine and accountable to the Verkhovna Rada of Ukraine adding to its responsibilities regulation of the IT sector[xxv]. The NCCRI is responsible for supervision in the sector including provision of licenses to the telecommunication companies. The Commission additionally should elaborate policies aimed at development of the IT sector.

Starting 2011[xxvi], the NCCRI should increase the competition in the telecommunication market by ensuring equal and transparent business environment. However, so far efforts of the Commission in establishing fair competition have been fragmented.

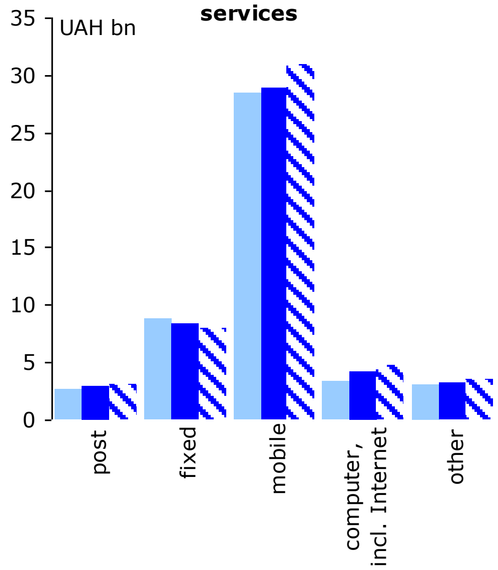
Market tendencies. By the end of 2011, Ukraine's mobile telephony market consisted of 55.6 m subscribers, equivalent to a penetration rate of 122%. The mobile customer base grew by 3.2% after two years of reduction. At the same time, revenues from providing fixed-line telephone services declined as a larger number of Ukrainians were opting for a mobile phone as a substitute for fixed connection. Other factor contributing to such reduction includes growing popularity of VoIP services.

The broadband sector in Ukraine is one of the most dynamic and competitive markets. The number of broadband subscribers increased almost twofold from 2.7 m subscribers in 2009 to 4.91 m subscribers in 2011. The largest provider on the market is the Ukrtelecom with 1.34 m subscribers; next go Volya with 0.48 m and Kyivstar with 0.41 m[xxvii]. In 2011, Ukraine entered the Top-10 countries with the fastest Internet access. The number of broadband subscribers is likely to rapidly grow in the future due to investments by operators in this segment development as well as higher probability of mobile broadband. In particular, the Ukrtelecom has announced plans to invest heavily in broadband infrastructure across Ukraine. Also VimpelCom invested in fiber networks covering an increasing number of Ukraine's towns. As a result, the competition in the broadband segment is likely to increase over the next years benefiting consumers.

Market access. To establish a transparent mechanism for providing national roaming services the NCCRI defined conditions for providing this service, obligations of telecom operators and procedure for disputes settlement between telecom operators.[xxviii] The national roaming procedure applies to providers of mobile telecommunications services and their consumers. It obliges the operators to notify the NCCRI in case of signing and terminating agreements with roaming partners within a month. This procedure is likely to improve competition in the telecom market.

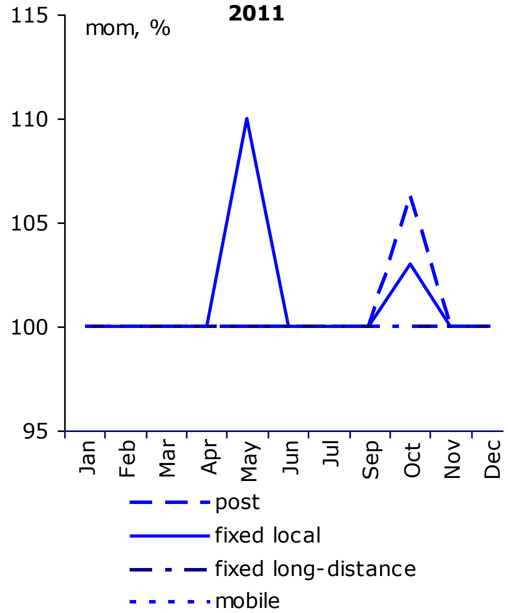
Consumer protection. The NCCRI introduced a procedure for registration of subscribers receiving telecommunications services without a written contract aimed to ensure a transparent mechanism for subscribers' registration and improve consumer protection[xxix]. The regulation complies with the EU regulation in terms of guaranteeing the subscriber a possibility to keep his phone number. This regulation is likely to improve the competition at the market but requires tighter cooperation between telecom companies.

Revenues from communication services



Source: Ukrstat

Communication tariff indices, 2011



Source: Ukrstat

Tariffs and fees. In April, the NCCRI increased marginal tariffs for public telecommunication services to adjust them to cost-covering level[xxx]. Higher tariffs were likely to improve the financial situation of telecom operators and create investment resources for development, technical upgrading and reconstruction of telecommunication networks.

At the end of 2011, the NCCRI increased marginal tariffs for universal postal services[xxxi]. The changes were based on planned costs of the universal postal service, volume of services and costs of their provision, including profit. The increase in tariffs was done in two stages: from October 10, 2011 and from January 1, 2012. New tariffs helped to increase revenues of the state-owned company 'Ukrposhta', Ukrainian monopolist on the postal services market.

Utilities: Year wasted on restructuring he control body in utility sector

The National Regulatory Commission for Public Utility Markets of Ukraine (NCPU) was created on July 8[xxxii]. However, *de facto* the Commission started its operation only in December after series of renaming and restructuring. The Commission was created to define tariffs, regulate and license activity in heating generation, transportation and supply as well as water supply and sewerage services. Before 2011 such tariffs were defined by local authorities, while for the most of 2011 the tariff-setting function was temporarily given to the National Electricity Regulatory Commission (NERC).

According to the approved regulation, the NCPU should define tariffs according to the requests of heating generating companies and water supply companies on the basis of approved formula. The tariff should account for operating costs as well as capital expenditures. However, the subjective factor, such as the ability of population to pay higher tariffs, is *de facto* taken into account. As a result, the tariff setting remains to be non-transparent and might be unfair.

From October 1, the NCPU increased tariffs for heating for budget and legal entities by 58% on average. Such decision was explained by an increase in gas prices for district heating companies[xxxiii]. At the same time, tariffs for population were only marginally changed for some districts. Therefore, the Government did not meet the IMF requirement to increase heating tariffs for population, needed for continuation of talks for another installment of loan under the SBA.

Balance of Payments: Consolidated balance of payment was in deficit

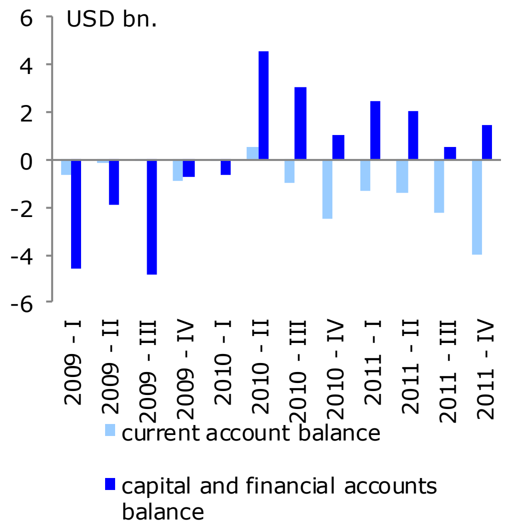
In 2011, the consolidated balance of payments was in deficit at USD 2.5 bn (1.5% of GDP), compared to a surplus of USD 5.0 bn (3.6% of GDP) in 2010. In particular, current account deficit amounted to USD 9.0 bn (5.5% of GDP), while the surplus of financial and capital account was at USD 6.6 bn (4.0% of GDP).

Current account. Economic recovery in main trade partners of Ukraine gave rise to increased demand for Ukrainian exports. In 2011 current account deficit increased to USD 9.0 bn (5.5% of GDP) from USD 3.0 bn in 2010. The increase was due to much stronger demand growth on the domestic market than on the external markets. Imports increased by 33.5% to USD 97.7 bn, while export increased by 28.3% to USD 88.8 bn in dollar terms thanks to higher export prices.

A surplus in trade in services of USD 4.9 bn was offset by sharp increase in net income outflows to USD 3.8 bn. Net income outflows increased due to improved performance of foreign-owned companies in Ukraine. Net current transfers at USD 3.7 bn exceeded precrisis level thanks to higher economic activity in Russia and other countries with Ukrainian emmigrants.

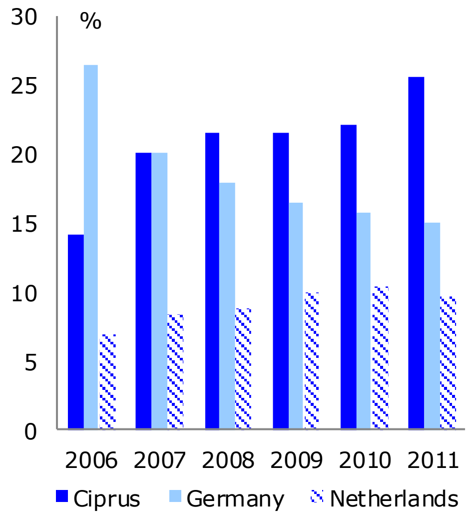
Financial account. In 2011, access to international capital markets for Ukrainian companies remained limited that reduced opportunities to obtain new loans and to restructure old debts. Still refinancing of debt and FDI inflows continued. Overall financial account surplus

Balance of Payments



Source: NBU

Structure of Foreign Direct



Source: Ukrstat

decreased to USD 6.5 bn.

One of the factors which had negative impact on financial and capital account was increase in outflows of foreign currency from banking sector to USD 11.4 bn from USD 5.6 bn in 2010. Besides, net repayments of bank debt increased to USD 3.8 bn. Government also had limited access to external markets.

However, increase in FDI, real sector borrowing and net inflow of USD 5.6 bn from trade loans supported financial account surplus.

FDI. According to NBU, net FDI inflows in 2011 increased to USD 7 bn, 80% of them came from the EU. 32% of FDI stock by the end of the year was concentrated in the financial sector. Another major recipient was steel industry, which received 19% of FDI stock. Overall, by the end of 2011 the total stock of FDI reached USD 64.5 bn.

Some changes took place in the geographical structure of incoming FDI. The share of investments from Cyprus, which were primarily made by affiliated companies of Ukrainian enterprises, increased by 3.4 percentage points to 25.6% of total FDI, probably because of the need to modernize industrial enterprises in Ukraine.

Other countries, that were largest sources of incoming FDI include Germany (USD 7.4 billion), the Netherlands (USD 4.8 billion), Russia (USD 3.6 billion) and Austria (USD 3.4 billion).

Merchandise Trade: Trade volume reached pre-crisis level

According to the State Statistical Committee of Ukraine, merchandise trade deficit widened USD 14.2 bn or 8.6% of GDP in 2011 due to faster growth in imports than exports.

In 2011, export rose by 33.0% to USD 68.4 bn and exceeded 2008 level in nominal terms. However, it became more diversified compared with 2008. While the share of exports of group XV "Nonprecious metals" decreased by 8.9 percentage points to 32.3%, the share of exports of mineral products, machinery, transport equipment and food increased.

The highest rate of growth was in group VI "Products of chemical and affiliated industries" (54.9%) due to increase in both demand and prices for products in this group. Exports of group V "Mineral products" increased by 52.4% mainly due to a significant increase iron ore prices and increased use of Ukrainian refineries for refining Russian oil. Increase in steel prices on the world market caused growth in export of steel and steel products by 28.2%.

The increase in CIS demand and prices for railway locomotives and cars caused export growth of group XVII «Vehicles, aircraft, vessels" by 49.3%. Also the export of machinery and equipment and tools, increased by 19% and the share of those products in the total exports reached 9.9%,

The exports of agricultural products (groups I - IV) increased due to the high harvest in 2010. In particular, crops had the highest export growth rate (46.6%). The share of that product increased by 0.5 percentage points to 5.3%. Meanwhile, a growth in export of grain was restrained by introduction of quotas, and later by export duties (see Agricultural Policy).

In 2011, imports increased by 36% to USD 82.6 bn primarily due to increased imports by group "Mineral fuels, mineral oils and products of their distillation" (by 45.9%), that accounted for 34.6%. In particular, volume of imported gas by 22.4% to 44, 8 bn cubic meters, while price grew USD 264 per thousand cubic meters in the first quarter of 2011 to about USD 400 per thousand cubic meters in 4Q2011. Rising domestic demand for machinery, especially cars, led to increased import of these products by 69.3% to USD 6.2 bn.

Thus, in 2011 the incresed prices for a number of commodities led the export growth in dollar terms. However, this growth was not enough to reduce the trade deficit due to Ukraine's energy

	Exports		Imports	
	USD m	% yoy	USD m	% yoy
Total	68394.2	133.0	82608.2	136.0
I - Live animals, animal products	936.6	121.4	1035.4	83.4
II – Vegetable products	5532.0	139.1	1815.9	116.1
III - Animal or vegetable fats and oils and their cleavage	3396.4	129.8	468.7	103.8
IV – Prepared foodstuffs	2939.1	114.3	3026.7	120.8
V – Mineral products	10259.7	152.4	30029.6	142.1
VI - Products of the chemical or allied industries	5390.3	154.9	8020.8	123.9
VII - Plastics, rubber and articles thereof	937.7	136.8	4498.4	122.7
VIII - Leathers, skins nd articles thereof	168.5	96.9	199.8	112.6
IX - Wood and articles thereof	1078.3	130.2	393.0	115.1
X - Pulp, paper, paperboard and articles thereof	1105.3	117.5	1836.7	110.3
XI - Textile and textile articles	863.8	117.4	1989.9	100.3
XII - Footwear, headgear, umbrellas	208.8	119.5	361.5	73.6
XIII - Articles of stone, plaster, cement, asbestos, glass	549.2	137.5	1156.1	129.9
XIV – Precious and semiprecious stones and metals	100.7	135.7	743.4	245.6
XV - Base metals and articles of base metal	22101.0	127.6	5697.1	138.0
XVI – Machinery and mechanical appliances, electrical equipment	6759.0	119.2	12795.1	156.5
XVII - Vehicles, aircraft, vessels and associated transport equipment	4854.8	149.3	6204.2	169.3
XVIII - Instruments and apparatus	281.5	111.6	1047.0	115.7
XX – Miscellaneous manufactured articles	556.2	133.5	847.5	123.0
XXI - Works of art, collectors' pieces and antiques	1.1	466.4	24.3	995.3
Goods purchased at ports	31.5	112.8	373.7	148.2
Other	342.5	111.0	43.4	99.1

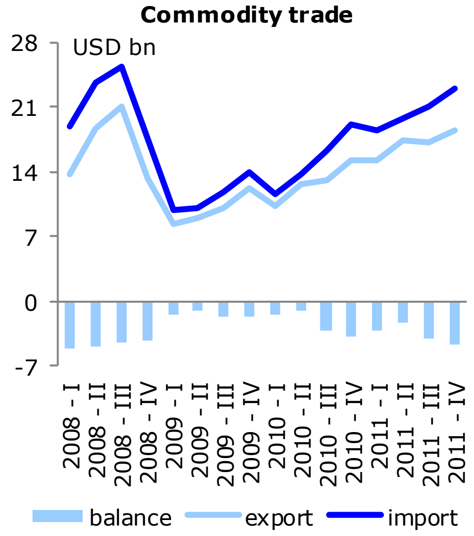
dependence and surge in consumer demand. Accordingly, the issue of increasing energy efficiency is important for Ukraine (see *Energy*).

Some changes happened in the geographical structure of trade. Although the main trade partners were the CIS and the EU countries, the share of goods exported to CIS was growing faster than the EU share. In particular, exports to CIS countries increased by 39.7%, while exports to the EU grew by 37.7%.

Overall, the CIS countries accounted for 38.3% of total exports, while their share of imports was 45.1%. The most important trading partner in this group of countries remains Russia, which accounted for 29.0% of total exports in 2011, which is 2.9 percentage points more than in the previous year. The share of imports from Russia fell from 36.5% to 35.3% and trade deficit with Russia increased by USD 0.6 bn to USD 9.3 bn. 68% of total imports from this country were energy products, in particular natural gas. The biggest export items to Russia were the export of railway locomotives (16% of exports to the Russian Federation), machinery (11%), ferrous metals(12.3%), and mineral fuels (14.1%).

Exports to EU countries grew by 37,7% in dollar terms, while imports from the EU increased by 34.8%. The biggest trade partners of Ukraine among these countries were Poland (4.1% of total exports) and Italy (4.4%). Germany and Poland are the biggest importers among the EU member countries (8.3 and 3.9% of the total imports, respectively). Major export items to the EU were raw materials (agricultural products and non-precious metals), while imports consisted primarily of goods of the group XVI "Machinery and mechanical appliances, electrical equipment", as well as vehicles and pharmaceutical products.

Overall, in 2011 the foreign trade continued to recover. The main factors that had positive impact on import growth were increase in domestic consumption and investment, while the gradual economic recovery in EU trading partners helped to increase an export.

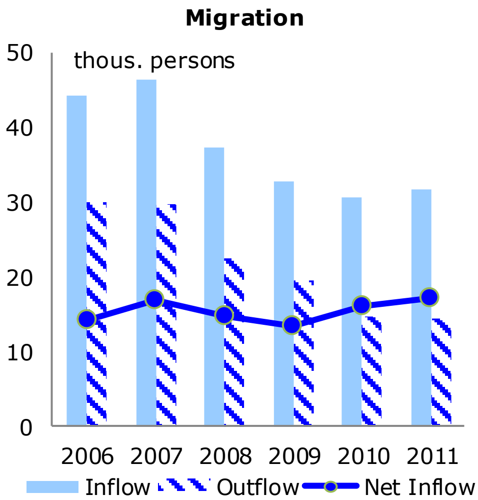


Source: Ukrstat

Migration: Clear migration policy was not approved

Regulation. In 2011, the Concept of National Migration Policy[xxxiv] was approved. It defines guidelines and principles of the public authorities' activities in the field of migration. The concept was declarative and does not provide any concrete measures. The Action Plan[xxxv] for the implementation of the Concept was also approved, but it did not include clear performance criteria. Even though most actions were planned to be implemented in 2012, the ambiguous and declarative formulations cast doubt on the potential effectiveness enhancement in the field of migration regulation.

Migration flows. According to the Ukrstat the net inflow of migrants in 2011 increased by almost 1.0 thousand to 17.1 thousand persons due to higher number of people who arrived to Ukraine. The outflow of migrants was 14.6 thousand as in the previous year. In general, migration flows remained lower than before the crisis. This, in particular, may be explained by unfavorable economic situation in countries that have been traditionally major recipients of Ukrainian labor migrants (Italy, Spain, and Portugal).

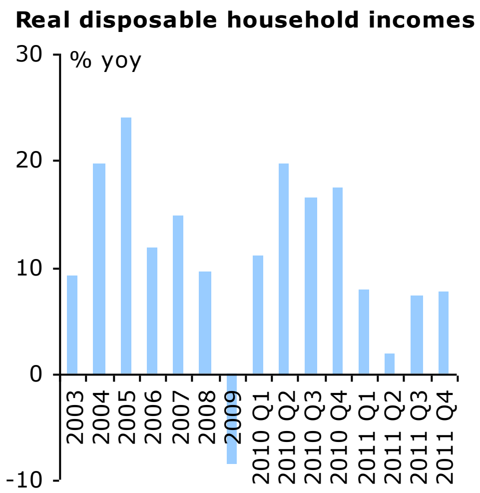


Source: Ukrstat

According to the Ministry of Social Policy, in 2011 84.5 thousands persons were officially employed abroad. 70% of them had sea-related occupations.[xxxvi] More than 90% of officially employed abroad people had jobs that require professional skills. More than 40% held managerial or administrative positions.

Wages and income: Disposable income continued growing rapidly

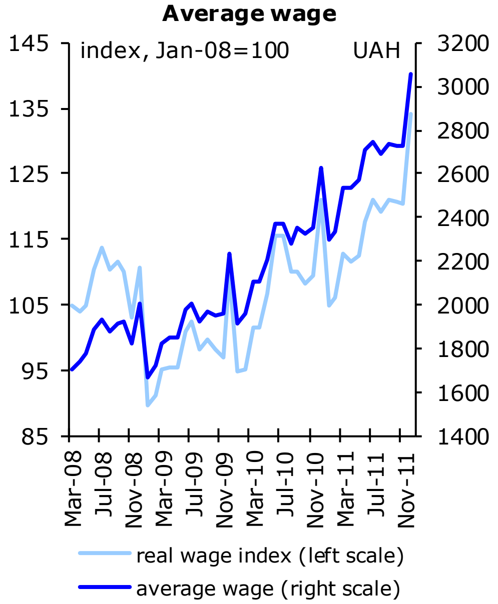
Improved financial stance of enterprises and increases in minimum wages stimulated households' income growth in 2011. Overall, disposable income increased by 14.5% in nominal terms and 6.1% in real terms. All income components grew with biggest contribution of real wage income, which increased by 7.4%.



Source: Ukrstat

Average wages grew by 17.6% in nominal terms and 8.7% in real terms. Wages grew rapidly in construction (by 28.3% in nominal terms) due to recovery in the sector although it was still lower in real terms than pre-crisis level. Record crop harvest enabled agricultural producers to increase wages by 25.9%. However, wages in the sector remained low exceeding on average only salaries in health care. Industrial companies increased wages more than average due to higher productivity as well as increased minimum wage. As export-oriented companies grew faster, wages were increased more in respective sectors.

Income from social assistance payments and pensions grew only by 2.7% in real terms primarily due to increase of major social standards in line with inflation. Improved financial situation in the country and record crop harvest resulted in surge of income received from entrepreneurs activity and subsidiary farming (by 15.0%). At the same time, income from interest on banking deposits and other property items declined by 7.1% due to decline in interest rates. Overall debt burden declined in 2011 as net bank lending (loans issued less than loans repaid) was negative.

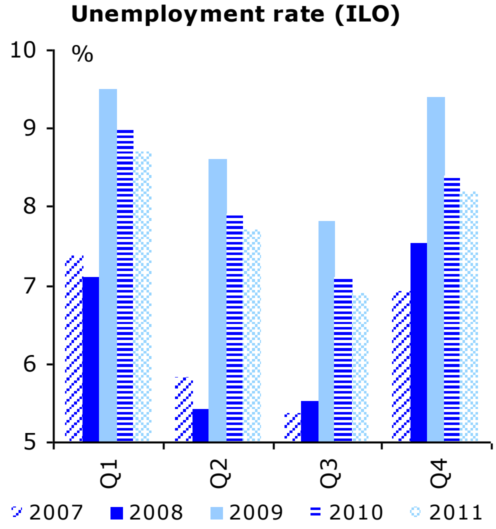


Source: Derzhkomstat

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

Unemployment rate (ILO). Labour market in 2011 remained weak. Unemployment rate (ILO methodology) edged down only by 0.2 p.p. to 7.9% of economically active population in age between 15-70 years old without increase in number of jobs. It was higher than before the crisis due to several reasons. First, many industrial sectors did not reach pre-crisis levels of output. Second, some industrial companies started to use of less labour intensive technologies and equipment after post-crisis restructuring. Third, some companies allowed number staff to reduce through attrition.

Unemployment rate remained unchanged from previous year for women at 6.8% of economically active population in age between 15-70 years old. At the same time, recovery of industry resulted in decline of unemployment rate for men by 0.5 p.p. to 8.8%. Due to the same reason unemployment rate declined in urban area by 0.6 p.p. to 8.0%. However, decrease in number of non-agricultural jobs resulted in increase of unemployment in rural area (to 7.5%). Such trends indicated once again that the Government should devote more efforts to stimulating job creation and rural development.



Source: Ukrstat

Fiscal Policy: public finances remained strained despite fiscal consolidation

Budget process 2011. The 2011 State Budget Law was approved in December 2010 with delay[xxxvii]. Fiscal parameters for 2011 were based on rather realistic macroeconomic assumptions of GDP increase by 4.5% and consumer inflation at 8.9%. Central fiscal revenues and expenditures were planned at UAH 281 bn (22.5% of GDP) and UAH 322 bn (25.7% of GDP), respectively, which is higher in nominal terms as compared to 2010. The central fiscal deficit was initially set at UAH 38.8 bn or 3.1% of GDP, which generally complied with Ukrainian liabilities in the framework of the Stand-by Agreement with IMF[xxxviii]. The deficit was expected to be financed primarily at the expense of borrowings and privatization receipts[xxxix].

In June, fiscal parameters targets were changed in line with upgraded macroeconomic forecast. Planned central fiscal revenues increased by 4.9% to UAH 299 bn due to higher than previously expected VAT and EPT receipts. Simultaneously, the target of central fiscal expenditures was raised by 3.5% to UAH 337 bn. In particular, additional spending was allocated primarily for wage payments (See *'Social policy'*) and state aid. Central fiscal deficit (not taking into account recapitaliation of banks and Naftogaz) was reduced by UAH 3.5 bn (to UAH 35.3 bn), but the planned recapitalisation of the NJSC Naftogaz was increased by the same amount. By such changes the Government has tried to keep the planned general government deficit (including the deficit of the Naftogaz) in line with the provisions of the Stand-by Arrangement.

Execution of the Budget 2011. Ukraine improved its fiscal stance in 2011. Central fiscal revenues grew by 30.8% (to UAH 315 bn) due to economic recovery, tighter tax administration and changes in taxation. EPT revenues augmented by 37.0% mainly due to improved financial state of enterprises, substantial tax overpayments and tax inspections during entire year. VAT collections increased by 50.7% due to growing domestic production and imports. At the same time, VAT refunds grew as well, reflecting the increase in export and decline in VAT refund arrears.

Receipts from rent payments and excise duties increased due to higher rates. The excise revenues were partially suppressed by the substantial increase in the share of illegal excise goods.[xl]

At the same time, non-tax revenues fell by 24.6%. It was explained by lower NBU profits transferred to central coffers (by 23.5%) and changes in budget classification.[xli]

Central fiscal revenues were fully executed in 2011, while central fiscal expenditures accounted for only 93.8% of annual plan due to difficulties in deficit financing. Capital spending doubled as compared to previous year, though they were financed at 71.4% of the amended plan. Traditionally, capital expenditures were under-executed due to delays in financing allocation.

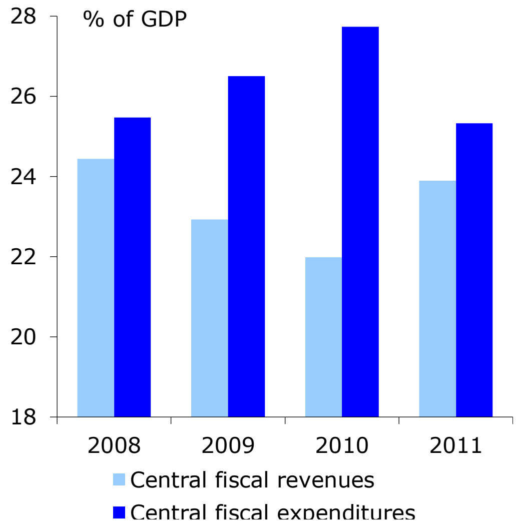
As a result, central fiscal deficit (without Naftogaz and banks recapitalisation) narrowed to 1.8% of GDP in 2011, which was substantially below the target. However, general government deficit including deficits of the Naftogaz and the Pension Fund accounted for near 5% of GDP, which was above the IMF target (3.5% of GDP). The deficit was primarily financed at the expense of Ukrtelecom privatization proceeds and government borrowings (see *'State debt'*).

Tax policy in 2011. On January 1, 2011 The Tax Code of Ukraine came into force, while the EPT chapter was enacted in the second quarter. The most significant changes of tax system included reduction of EPT and VAT rates, elimination of a number of inefficient local taxes and fees, fewer differences between commercial and tax accounting, further harmonization of depreciation rules with the EU norms. In particular, EPT rate declined from 25% in 2010 to 23% in 2011 and then will gradually drop to 16% in 2014. The VAT rate will be reduced from 20% to 17% in 2014. At the same time, PIT rate became slightly progressive with 17% rate for income over 10 sizes of minimum wage. The Document envisaged the automatic VAT refund for taxpayers with good tax record and changes in VAT rules for agricultural sector (see *Agricultural policy*). Besides, 16 groups of fixed assets were defined, however, most assets fall under four groups. At the same time, the Tax Code introduced new tax exemptions[xlii]. Some of them, such as 10-year EPT-break for hotels and restaurants were economically unjustified.

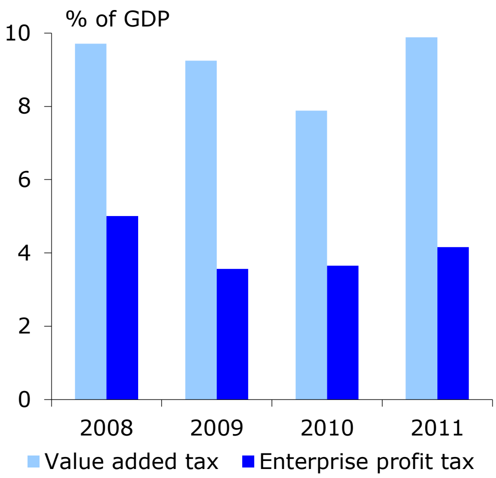
The automatic VAT refund mechanism (regime) was introduced in March. During the year the share of VAT refund made automatically increased from 37% of tax reimbursements to 57% (as of January 1, 2011), which is by 13 p.p. lower than the IMF target. It generally had positive effect on the reduction of VAT refund arrears. According to the Ministry of Finance VAT refund arrears reduced from UAH 11.1 bn in January to UAH 4.6 bn in December 2011[xliii]. However, the mechanism of automatic refund was used in rather discriminatory way, as the priority for reimbursement were given for large and close to the ruling party enterprises, while middle - and small-size companies had fewer opportunities to receive the refund.

Grain export quotas introduced in October 2010 were considered by traders as discriminatory and non-transparent and were replaced with export duties in May 2011. In October 2011, the Parliament eliminated export duties on wheat and maize. However, uncertainty over regulation of external grain trade remained (see *Agricultural policy)*.

Central fiscal revenues and expenditures

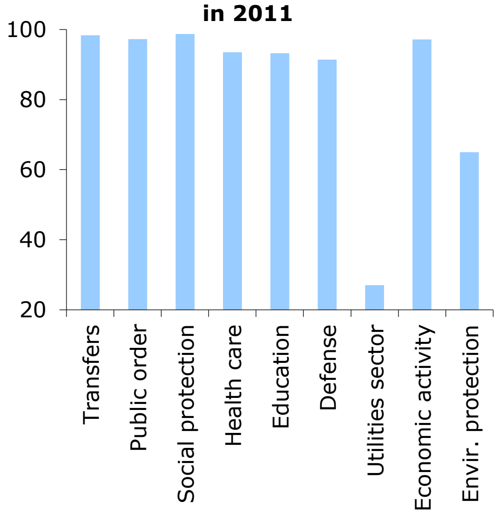


Key tax revenues



Source: State Treasury, Derzkomstat

Execution of central fiscal expenditures in 2011



Source: State Treasury

In November, the Parliament finally approved the chapter of the tax Code on the simplified taxation system[xliv]. Four grades of the simplified taxation were established according to criteria of incorporation, annual turnover and number of employees[xlv]. Besides, according to the provisions of the new chapter payers of single tax received back the right to work with companies working on general taxation system[xlvi]. It cannot be fully considered as positive change, as this right can be used only by entrepreneurs of the second and third grades. At the same time, several activities were excluded from simplified taxation, pushing the entrepreneurs to switch to general taxation system or pay taxes as self-employed[xlvii]. Besides, introduction of quarterly recalculation of the tax rates became inconvenient for the taxpayers as the rates were tied to minimum wage.

The most striking event of tax policy in 2011 was the decision to write off tax arrears of fuel and energy sector, accumulated on December 31, 2010 (see Energy policy). In addition, the Government continued to increase fiscal pressure through increase in rates for rental payments and excises on specific goods in 2011.

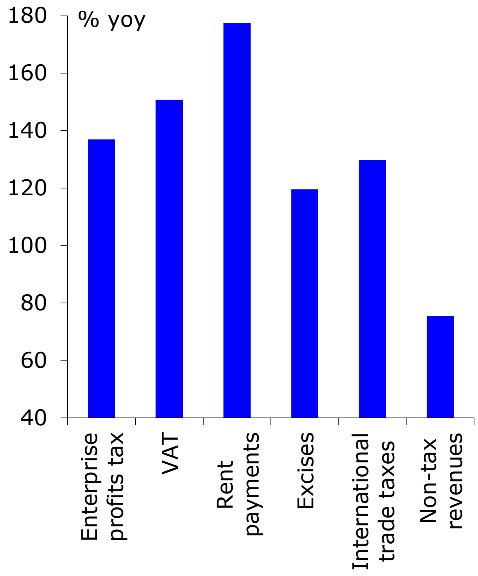
The implementation of the property tax was postponed from January 1 to July 1, 2012, as local authorities were not ready for effective administration of this tax. At the same time, since 2012 companies will have to conduct the third type of reporting on reconciliation of discrepancies between two forms of reporting.

The Tax Code was initially planned as consolidated document, which would harmonize tax legislation of Ukraine with the EU norms and facilitate business activity in the country. However, implementation of the Code had rather negative impact on business. Tax administration was tightened and remained complex, which worsened business climate in Ukraine.

State Procurement regulation. The long-debated reform of public procurement was continued in 2011. In July the President signed the amendments to the State Procurement Law approved in 2010[xlviii]. The key novelties of the Law included changes to the rules of state procurement with one bid procedure and reduction in number of goods and services the purchase of which were excluded from the Law regulation. The inclusion of procurement of housing and utility services under the Law can be considered as a positive step. However, the amended version of the Law still does not fully correspond to the best practices of procurement regulation. In particular, state and municipal enterprises, which do not receive budget support and perform procurement on account of their own working capital, are actually removed from the scope of the Law. As the law on state aid has not yet been approved in Ukraine the decision whether to conduct a tender or not is made at own discretion of such enterprises. Besides, lack of control over the procurement procedures with single participant can also result in higher corruption as the Ministry of Trade and Economic Development is not currently responsible to authorize such procurement procedure.

Approval of the Budget 2012. The State Budget Law for 2012 was approved in December 2011 with a delay, explained by attempts of the Government to negotiate reduction in natural gas prices with Russia[xlix]. Fiscal parameters are based on optimistic macroeconomic forecast. Central fiscal revenues and expenditures are planned at UAH 333 bn and UAH 358 bn, which is by 5.8% and 7.4% higher than 2011 figures respectively. Central fiscal deficit is planned at 2.5% of GDP (including recapitalization of the Naftogaz), which complies with the fiscal target envisaged in the SBA[l]. However, such plans are subject to substantial risks. The major risk for revenue part is related to slower recovery in the key trading partners that may result in lower than currently planned collections to the budget. Besides, the current expenditures may grow significantly due to Parliamentary elections in October, 2012. Naftogaz's deficit is likely to grow[li]. All these factors may cause higher than planned central

Growth of Central fiscal revenues in 2011



Source: State Treasury report

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

Criteria	Group			
	1	2	3	4
Incor-poration	Indivi-duals	Indivi duals	Indivi-duals	Legal per-sons
Max annual turnover (thd UAH)	150	1 000	3 000	5 000
Max number of empls	0	10	20	50
Tax rate	1-10% of min wage	2-20 of min wage	3% of turnover incl. VAT (or 5% without VAT)	3% of turn-over incl. VAT (or 5% with-out VAT)

Source: Tax Code amendments as of October 20, 2011 fiscal deficit (including recapitalization of the Naftogaz). Finally, the Government may face problems with deficit financing due to difficulties with borrowing on external and domestic markets as well as to the under-fulfillment of privatization plan (see *State debt* and *Privatization*).

Social policy: Social standards remained almost unchanged in real terms

Social standards and minimum wage in 2011. After a swift increase in social standards and minimum wage in 2010 the Government took more gradual approach. On average in 2011 general level of subsistence minimum increased by 8.4% in nominal terms and by 0.4% in real terms. Minimum wage, which is defined at the level of subsistence minimum set for working able individuals increased at the same rate. As of December 2011 minimum wage reached UAH 1004 but decline in relation to average wage by 3.1 p.p. to 38.0%. Minimum pension was raised to UAH 800 as of December.

Wages in the public sector. The differentiation in public sector wages in 2011 remained low. In particular, the first tariff rate in the Unified Tariff Scale (UTS) was raised in line with minimum wage. As a result, it remained at 65.1% of minimum wage for entire year. Therefore, the employees of lower qualification were all receiving minimum wage.

Subsistence minimum, UAH

	2011		2012	
	Jan.	Dec.	Jan.	Dec.
General level	894	953	1017	1037
In particular:				
For children less than 6 years old	816	870	893	961
For children of 6-18 years old	977	1042	1112	1197
For working able individuals *	941	1004	1073	1134
For individuals that lost ability to work**	750	800	822	884

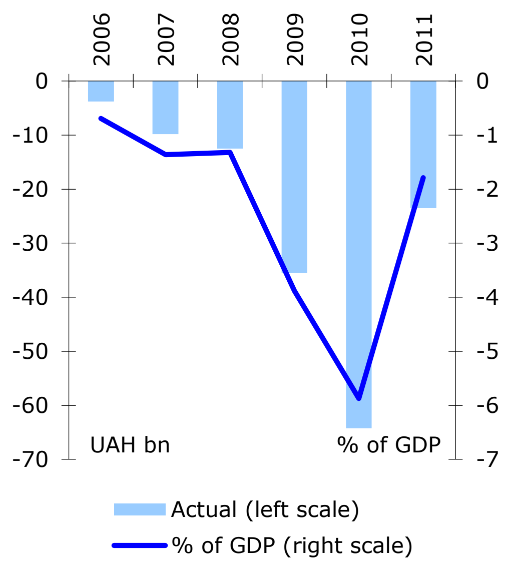
Note: * minimum wage
** minimum pension
Source: the State Budget Law for 2011, the State Budget Law for 2012

Pension system: The Pension Fund's deficit remains high

Pension Fund's Budget 2011. The Pension Fund's sustainability raised more concerns in 2011. Pensions were financed by pension insurance contributions and central fiscal transfer. In particular, Fund's revenues reached UAH 198 bn in 2011 (15.1% of GDP) with UAH 139 bn financed from pension insurance contributions. As usual they were not sufficient to pay pensions in full. Pension Fund's deficit was financed by additional budget transfer as well as off-budget Treasury loans. Central fiscal transfer reached UAH 58.3 bn including UAH 17.7 bn earmarked for financing the Fund's deficit. Overall deficit reached UAH 30.0 bn. It should be noted that the Treasury loans were required as the Government underestimated the Fund's deficit for three years in row while approving the budget of the Pension Fund.

Pension reform. The Government was able to push several measures in the framework of pension reform in 2011. First, approved law envisages gradual increase in retirement age for women. It is to be gradually increased from 55 years old to 60 years old within 10 years (starting September 2011). Second, minimum insurance period, which enables individuals to receive pension when they reach retirement age grew from 5 years to 15 years. Minimum insurance record for receiving old-age pension at least at subsistence minimum level was increased to 25 years for women (from 20) and 35 years for men (from 30). At the same time, special pensions mainly remained in place despite some changes. Moreover, the formula of pension calculations was not revised. As a result, as previously calculated pensions for large share of pensioners remains lower than statutory minimum pension, what requires additional central fiscal transfer to the Pension Fund.

Central fiscal balance

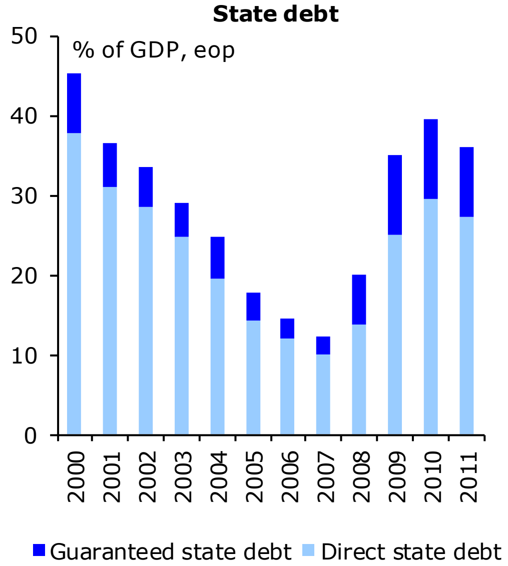


Source: State Treasury Reports

State debt: Access to international capital markets remained restricted

In 2011, state borrowings were lower than planned.[lii] While domestic borrowings were restricted by low banking liquidity, Eurobonds placement was lower than planned due to limited access to international capital markets. Total state debt (direct and guaranteed) declined in relation to GDP from 39.5% in 2010 to 36.0% of GDP in 2011. However, in nominal term it grew by 9.4% to UAH 473 bn (USD 59.2 bn).[liii] The structure of the debt remained stable with larger share of foreign state debt (63.3% of the total debt). Although the debt level remained moderate by international standards, all state borrowings were spent on debt repayments and servicing. Besides, a significant share of new borrowings was short-term raising the vulnerability of fiscal stance to economic shocks.

Domestic borrowings. The value of domestic state bonds outstanding increased by 15.8% yoy as of the end of December 2011 to UAH 158 bn[liv]. The bonds were issued primarily for redeeming previous issues of bonds, financing fiscal expenditures, as well as increasing statutory capital of banks and of the NJSC Naftogaz. The short-term borrowings remained dominant, however the share of bonds with maturity up to one year decreased substantially compared to previous year (from 56.7% in 2010 to 33.6% in 2011).



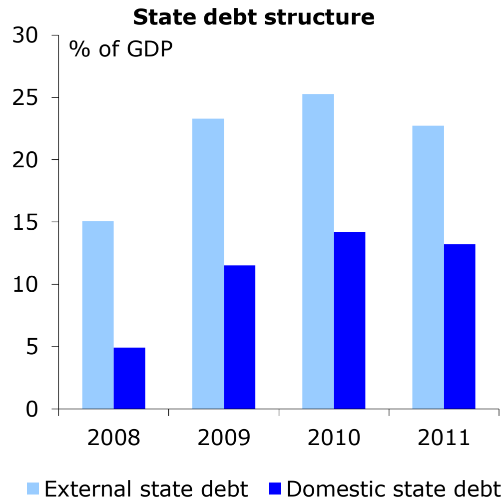
Source: Ministry of Finance

The low banking sector liquidity and expectations toward hryvnia depreciation suppressed the demand on the domestic capital market. To stimulate market the Government introduced USD-indexed bonds in the end of September and USD-denominated domestic bonds in December. These new financial tools, aimed to reduce currency risks of investors, helped the Government to attract significant funds to the budget (near UAH 8.6 bn and USD 413 m, respectively) and conduct redemptions of principal and interest repayments in time. However, they increased the country's exposure to exchange rate risks. As all of the issued USD-denominated domestic bonds had short-term maturity, depreciation pressures might increase in 2012[lv].

The structure of bondholders changed in 2011 reflecting the tight capital market conditions. The share of bonds owned by the NBU grew by 7.3 p.p. to 53.8% of the total bonds value as it purchased recapitalization bonds and new government bonds to support state banks and state companies[lvi]. At the same time, non-residents started to withdraw the funds from the local bond market. Their share dropped to 2.8% from 8.2% in 2010.

The weighted-average yields declined from 10.4% p.a. in 2010 to 9.2% p.a. in 2011, which reflected unwillingness of the Government to increase rates on the primary market.

External borrowings. The external borrowings were significantly below the 2011-target (68.6% of the plan) due to restricted access of the Government to the international capital market[lvii]. At the same time, the prompt actions of Government in the beginning of year enabled Eurobond placement at USD 1.5 bn. Another placement (USD 1.25 bn) was made in June[lviii]. In late August the Cabinet of Ministers received a loan of USD 150 m from the World Bank to finance the second project for export development and supplement the existing credit line[lix]. However, in the second half of 2011, Ukraine faced more difficult financing conditions. The intensification of the risks of sovereign debt crisis in the Euro area increased the costs of borrowing and tightened access to foreign financing on international financial markets.



Source: Ministry of Finance reports

In addition, Ukraine managed to extend the maturity of USD 2 bn loan received from the Russian VTB Bank in 2010 till June 2012[lx]. It allowed the Government to reduce the debt reimbursement burden in the end of 2011. According to negotiations after maturing this loan is to be replaced by long-term state Eurobonds.

Summing up, the Government faced difficulties in obtaining needed funds on domestic and external markets in 2011, which will likely be the challenge for the next year[lxi]. In 2012 the debt payments will grow substantially. The Ministry of Finance will have to redeem UAH 65.9 bn of state debt and pay UAH 29.6 bn of interest, accounting cumulatively to 6.4% of GDP.

The Debt Management Strategy. In early March the Cabinet of Ministers approved the Medium-Term Government Debt Management Strategy for 2011-2013. The Document envisages the increase in the share of domestic debt in direct state debt to 46% in 2011-2012 and to 48% in 2013[lxii]. Besides, direct state debt relative to GDP were planned to be reduced by 2% of GDP annually to 28% of GDP in 2013. To reach these targets the Government plans to improve market infrastructure and introduce wide range of new debt instruments, such as inflation-linked and amortized bonds as well as bonds with the possibility of early repayment. Besides, the strategy aimed at selling the domestic government bonds to the population. These tools are widely used in international practice and can be applicable in Ukraine, however, they are not sufficient to increase substantially the domestic debt share.

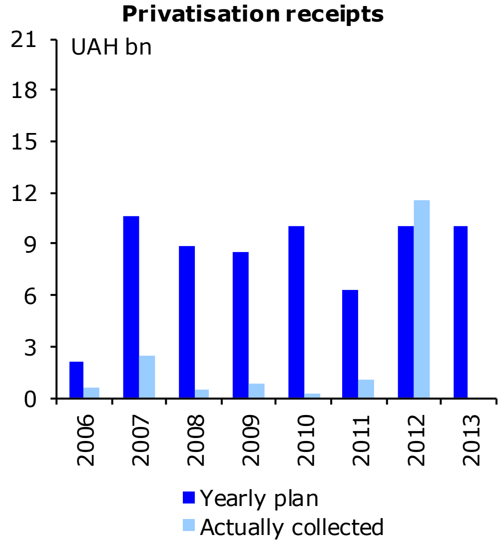
Summing up, the approval of the Strategy as the first strategic document in the sphere of public debt management in Ukraine can be considered as positive. However, its main disadvantage is the uncertainty about the sources of the future reduction of public debt, (i.e. ways of achieving goals defined by the Strategy).

Privatisation: Activation of privatisation

Execution of the Privatization targets 2011. State Budget[lxiii] privatization target for 2011 was set at the level of UAH 10 bn. Ukrtelekom became the key object to fulfill the plan in the first quarter (the enterprise was sold in March 2011 for UAH 10.6 bn). In total, privatization brought to state budget UAH 11.5 bn.

In April SPFU adopted monthly privatization plan[lxiv] for 2011 from 144 companies. The majority of those were to be sold via competition and at the auction, the rest was to be offered at the stock exchange. Energy objects were not included in this list, although respective CMU Order[lxv], allowing sale of energy companies had been issued in February. However, in the second half of the year the respective schedule was approved by SPFU, allowing to proceed with ownership restructuring in energy sector. At the same time, the list of privatization lots was expanded with objects of aviation industry, railway machinery production, port infrastructure, some enterprises of NC "Khlib of Ukraine", titan industry enterprises, spirits industry by elimination of ban for their sale.

Privatisation receipts



Source: State Budget Laws, SPFU

Ukrtelekom privatization. Sale auction for one of the most attractive Ukrainian blue chips was held on December 28, 2010.[lxvi] The key feature of the action was the only one bidder - company of Austrian concern Eris - ESU, which offered UAH 10 more from the start price in its bid. According to Ukrainian legislation for such one-bidder cases, independent assessment to define the company's real price was held. The new estimated price of Ukrtelecom was UAH 10.6 bn. As the winner of the competition agreed to pay this price the sale agreement was signed on March 11. Thus, ten year long search for the most suitable time for sale and the most efficient owner for one of the top Ukrainian assets is settled quickly but not very efficiently.

Launch of energy sector privatization. The Cabinet of Ministers approved[lxvii] the list of 4 energy generating and 7 distribution companies for privatization in 2011, following its order[lxviii], which excluded 24 energy companies from the ban list. Thus, property restructuring in energy sector was launched. Clearly, key potential investors will be existing domestic market players.

The size of shareholdings for sale in 2011 varied from 25% to 50%. According to SPFU schedule the auctions should have been completed by the end of October, 2011. The SPFU also requested oblenergoes to submit their financial reports for further financial analysis required for the estimation of the starting price for the auction. The CMU forbid participation of foreign companies.

First energy company for sale became - Zakhidenergo. However, this auction had the key feature of new auctions – single participant – DTEK company, who offered for the 43% stake UAH 1.9 bn (with UAH 100 thous. price premium). Thus, the object was sold after the estimation of independent assessment price. Second enterprise – Kyivenergo- was sold after more vivid competition – at the two-bidder auction to the same DTEK Holding LTD, which paid for 25% stake UAH 450 m with UAH 18,2 m price premium.

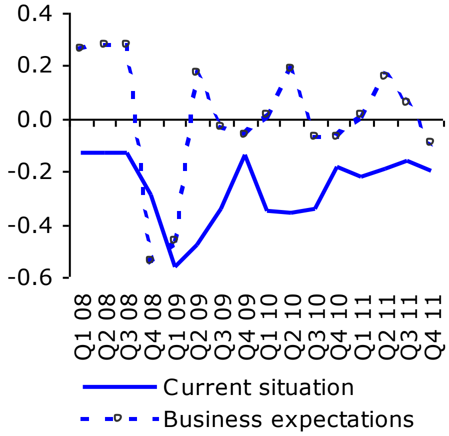
As in 2011 only two energy companies were sold, the Government prolonged period of sale till the end of 2012. The SPFU is preparing for sale 13 shareholding of energy generating and distribution companies for 2012 auctions. The privatization of energy companies should ensure substantial part of planned privatisation receipt in 2012.

Business climate: Assessments and expectations trends of business in 2011

Overall business climate. According to the results of the IER quarterly industrial enterprises survey managers' assessment of the current overall economic conditions in Ukraine during 2011 was quite pessimistic. Throughout entire year the number of enterprises managers that reported an improvement of business environment remained lower than the number of those, who pointed to the worsening of business climate in the country.

In February 2011 the managers' assessment of current overall economic conditions/business climate slightly worsened compared to October 2010: the value of the respective index decreased from -0.18 to -0.22. In April and July the value of the index rose to -0.19 and to -0.16, respectively. However, this was not a trend towards the improvement in business climate assessment as in October the value of the corresponding index dropped again to -0.20. In terms of shares of respondents in October almost every third respondent (32.4%) reported worsening of the business climate, and only 9.1% of managers assessed the climate as good for their enterprises' activity.

Indices of Overall Business Climate

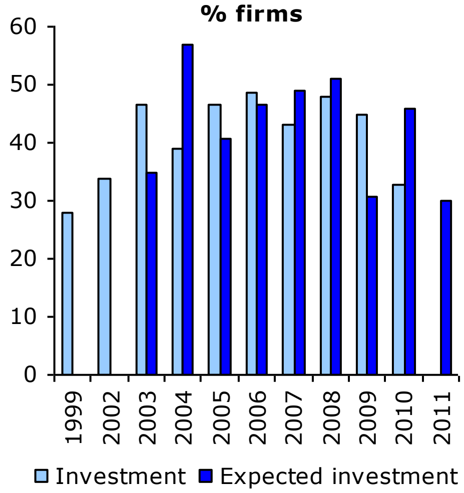


Source: IER Surveys

In respect to the trends of changes in the managers' expectations concerning the future overall business climate, in 2011 two periods could be observed: the first one — between January and June - was characterized by the growth of business optimism and positive expectations among the business community; the second one — between July and December - when the decline in optimistic moods was observed and the tendency to deterioration of business expectations appeared.

The index of business expectations, which reflects the respondents' assessments of overall economic conditions changes in the next six months, increased from -0.07 in October 2010 to 0.01 in February 2011. In April the value of the index rose by 15 points (up to 0.16). However, already in July its decline to 0.06 was recorded. In October the tendency towards smaller business optimism continued: the value of the respective index fell to -0.09. A simultaneous drop in the share of "optimists" (from 17.6% to 14.3%) and the significant growth in the share of "pessimists" (from 10.2% to 24.4%) occurred. However, the majority of respondents (61.3%) did not expect any changes of the overall economic conditions during the next six months.

Investment activity, % firms



Source: IER Surveys

Impediments to business development. According to the results of the survey, conducted in October 2011, the excessive taxation, insufficient demand, lack of finance (liquidity problems) and unfavorable regulatory climate, large competitive pressure and high interest rates were on the top of the list of impediment of business development in the country.

An excessive tax burden took the first place in the ranking of impediments in October 2011 regardless the introduction of the Tax Code in the beginning of the year. The importance of this barrier was increasing throughout the year, and, finally, in October it was reported by 65.8% of respondents.

Low demand, which led the list in July, in October was ranked the second major barrier for business development. Its absolute value, after increase in July, slightly declined from 64.5% to 61.3% in October, but still remained too high.

Problems of liquidity took the third place in the list. Although the importance of this barrier decreased in April compared to February from 50.2% to 45.4%, but in July and October its urgency was growing: the percentage of respondents who reported this obstacle made up 47.9% and 51.0%, respectively.

Unfriendly regulatory climate was at the forth place by importance. Fluctuation of this indicator shows that pick of the issues has been recorded in April 2011. The share of managers stating regulatory climate as a major obstacle to their business activity increased in February 2011 compared to October 2010 from 48.3% to 53.7%. it reached 63.9% in April, which is a record peak for 15 years of observations. It is important to stress that in contrast to previous time this problems was important for firms of all size. Thus, the urgency of the problem of unfriendly regulatory climate was reported by 62.5% of surveyed managers in small firms, 64.5% — medium and 65.3% — large enterprises. In July and October share decreased to 54.5% and to 39.6%, respectively. Fluctuation of the indicator during year depended on the size of the enterprises. Thus, in July there was a significant reduction of number of managers, who indicated this problem in groups of small and medium-sized enterprises — up to 49.5% and to 52.9%, respectively. In contrast among the managers of large-scaled enterprises this share remained virtually unchanged compared to April and made up 63.6%. In October the number of managers considering regulatory climate as a significant impediment for business development declined for all groups of companies. The value of this indicator was the largest for small businesses (44.5%). The unfriendly regulatory climate became less significant problem for medium-sized and large-scaled enterprises: 35.8% of polled managers in medium-sized enterprises and 37.8% of managers in large ones confirmed this.

The absolute value of the barrier "high competitive pressure" was constantly rising throughout the year and in October equaled 30.5%. During 2011 the barrier “high interest rates” remained relevant for enterprises, and the importance of the problem of the availability of bank loans, after growth in April (17.2%) and July (19.3%), decreased in October to 14.7%.

The absolute values of other impediments after fluctuation during a year diminished in October, except for the „shortage of skilled workers”. The latter was considered by managers as more important in October comparing to the beginning of the year.

Investment activity. The results of the study, focused on the investment activity of enterprises, which is conducted in January and February every year, showed that among all surveyed managers more than two thirds (69.9%) did not plan to make investments throughout 2011. Only 30.1% of managers intended to invest during 2011, that is slightly lower than the figure in 2010, when the share of firms, that made investments, amounted 32.7% of the polled.

Among the managers of enterprises, who planned investments for 2011, more than a half of respondents (51.4%) indicated, that the number of investments would not change compared to 2010, 29.2% — considered, that they would be lesser than in the previous year, and only 19.4% of the enterprises managers intended to increase investments. Managers of small and medium-sized enterprises planned to reduce the number of investments, while the managers of large companies did not intend to change investment volumes compared to 2010.

The vast majority of the polled enterprises managers (74.6%) estimated 2011 as unfavorable for the purchase of equipment. In 2010 this share was slightly lower — 73.3%. Meanwhile, the share of managers, who evaluate the current period as more or less favorable for the purchase of equipment, did not practically change (24.5% in 2010 and 25.4% in 2011).

According to the results of the survey, among the main obstacles, that impeded managers in planning investments in 2011, top three positions were occupied by insufficient income (58.0%), unclear legislation (25.2%) and unstable political situation (21.8%).

Monetary policy: Consumer inflation remained in single digits

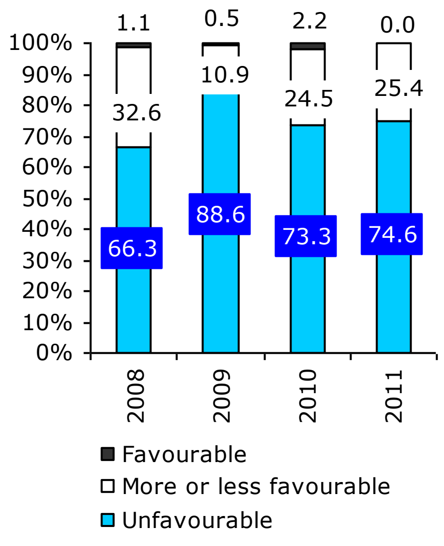
In 2011, average consumer inflation remained in single digits and decelerated to 8.0% as compared to 9.4% in 2010. Food prices

Impediments to business development, % of respondents

	Feb 11	Apr 11	Jul 11	Oct 11
Excessive taxation	49.8	56.3	56.9	65.8
Low demand	56.2	57.0	64.5	61.3
Liquidity problems	50.2	45.4	47.9	51.0
Unfavorable regulatory climate	53.7	63.9	54.5	39.6
High regulatory burden	**40.4**	**54.0**	**42.8**	**32.2**
Changes in economic legislation	**17.8**	**13.6**	**21.7**	**11.6**
Corruption	**9.1**	**7.6**	**5.9**	**6.8**
High competitive pressure	22.6	25.2	28.6	30.5
High interest rates	27.3	28.5	28.6	29.5
Shortage of raw materials	23.2	22.5	27.6	20.2
Problems with energy supply	14.8	10.3	18.6	15.1
Access to credits	12.5	17.2	19.3	14.7
Shortage of skilled workforce	8.4	8.6	10.7	13.0
Unstable political situation	8.4	7.6	14.8	12.7
Outdated technologies	15.5	12.3	21.7	12.7
Shortage of capacities	5.7	3.6	8.6	5.1

Source: IER

Is it favourable time for investment?, % of firms



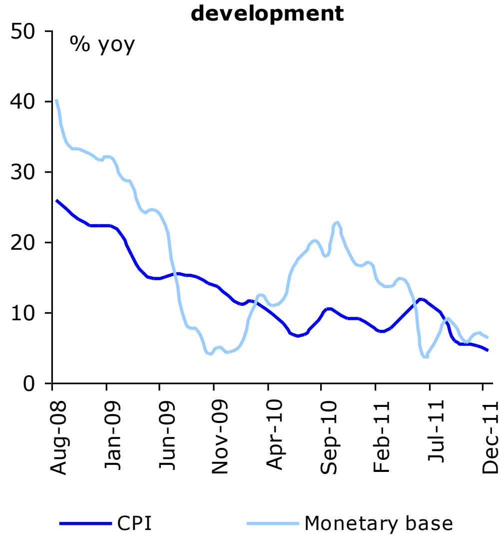
Source: IER Surveys

growth slowed down to 6.4% from 10.9% in 2010, but food prices remained volatile throughout a year. Slowdown in food prices was offset by higher utility prices.

Overall, during the year the NBU monetary policy was tight in 2011. It was aimed to diminish pressure on the currency exchange market through restricting liquidity of commercial banks. As a result, interest rates on the interbank market were on increasing trend during the year. In particular, interbank lending rate reached 14.5% p.a. in the fourth quarter.

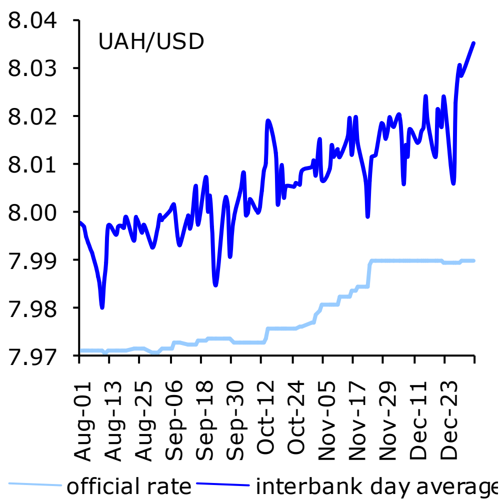
Besides, the NBU continued tight control over the exchange rate despite depreciation pressure in the second half of 2011. During the year interbank UAH/USD exchange rate depreciated by 0.9% to UAH 8.02 per USD, while official exchange rate was allowed to depreciate only by 0.5% to UAH 7.99 per USD. International reserves declined by USD 3.3 bn during year primarily due to interventions at the foreign exchange market.

CPI and monetary base development



Source: Ukrstat, NBU

Exchange rate



Source: NBU

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i Law of Ukraine № 3387-VI from May 19, 2011. Export taxes were equal to 9% but no less that 17 euro per ton for wheat, 12% but no less than 20 euro per ton for corn and 14% but no less than 23 euro per ton for barley.

ii The Law of Ukraine No.3613-VI "On state land cadastre" from July 7, 2011 (with amendments from December 31, 2011)

iii Article 209 of the Part V of the Tax Code of Ukraine.

iv In February, the Union of Oil Market Operators of Ukraine accused oil refineries and the Energy Ministry of manipulating information in order to introduce fuel import duties. In response, the Ministry accused the importers of speculation on the background of increasing world fuel prices.

v In March, the Ministry was instructed by the Prime Minister to increase crude oil supplies to oil refineries in order to displace an expensive imported fuel with a cheaper domestic one.

vi Law No.3221-17 from April 7, 2011

vii order of Derzhpotrebstandard, No.240 from July 1, 2011

viii The agreement with Azerbaijan on oil transportation was signed at the World Economic Forum in Davos.

ix Announcement at Uryadovy Kurier newspaper from 18.11.11

x Law "On some questions of indebtedness for consumed natural gas and electric energy", No.3319-VI from May 12, 2011.

xi CMU Resolution No.2361-r from December 20, 2010

xii Kulczyk Oil Ventures Ltd. started drilling the Olhivska-14 well, Chornomornaftogaz drilled new wells at the Holitsynske gas condensate field, Ukrgasvydobuvannia started gas production from well #360 on the Yablunivske gas condensate field with output of 117,000 cm of gas per day. In September, the Ukrgazvydobuvannya opened the Borove gas field in Kharkiv region with estimated reserves of 1.2 bn cubic meters and Kuzmichyvske gas field in Kharkiv region with estimated reserves of 1.5 bn cubic meters.

xiii Law "On amendments to the Law "On production sharing agreements" about improvement of the mechanism of signing production sharing agreements", No.4053-VI from December 11, 2011

xiv Bila Tserkva TPP appealed the results of an auction held on December 14, 2010 for the right to access the Ukrainian power grid to export electricity in 2011. In July, the Higher Economic Court of Ukraine upheld the results and in December, DTEK again received the exclusive right to export electricity to several Eastern European countries in 2012.

xv Law "On specifics of leasing and concession of state mining enterprises", No.3687-VI from July 8, 2011

xvi CMU Resolution No.912-r from September 28, 2011

xvii CMU Resolution No.1247 from October 31, 2011.

xviii CMU Resolution No.36 from January 24, 2011.

xix CMU Resolution No.1005 from September 28, 2011.

xx Law «On amendments to the Law "On electric energy" about guaranteeing state obligations for stimulating usage of alternative sources of energy", No.3486-VI from June 26, 2011.

xxi CM Resolution, No. 738, June 9, 2011.

[xxii] Law of Ukraine, No. 3393-VI, May 19, 2011.

[xxiii] Order of the Ministry of Infrastructure, No. 586, December 1, 2011.

[xxiv] Order of the Ministry of Infrastructure, No. 638, December 26, 2011.

[xxv] Presidential Decrees, No. 1065/2011, 1067/2011, November 23, 2011.

[xxvi] With coming into effect in January 2011 of the Law of Ukraine of 02.12.2010 № 27551-VI «On Amendments to the Law of Ukraine "On Telecommunications" (for the market of telecom traffic crossing services)»

[xxvii] According to the NCCRI report for 2011.

[xxviii] Resolution of the NCCRI, No. 429, August 25, 2011.

[xxix] Resolution of the NCCRI, No. 393, August 11, 2011.

[xxx] Resolution of the NCCRI, No. 157, August 4, 2011.

[xxxi] Resolution of the NCCRI, No. 540, October 6, 2011.

[xxxii] The Order of the President,No.743from08.07.2011.

[xxxiii] http://jkg-portal.com.ua/ua/publication/one/tarifi-na-teplo-dlya-byudzhetnikv--bznesovix-struktur-zblshili-vpolovinu19160

[xxxiv] Source: http://zakon2.rada.gov.ua/laws/show/622/2011

[xxxv] Source: http://zakon2.rada.gov.ua/laws/show/1058-2011-p

[xxxvi] http://www.mlsp.gov.ua/labour/control/uk/publish/article?art_id=142324&cat_id=107177

[xxxvii] Law of Ukraine, No. 2857-VI, from December 23, 2010.

[xxxviii] However, it didn't include possible issues of domestic state bonds for financing deficit of NJSC Naftogaz.

[xxxix] large share of new borrowings were envisaged for debt redemption and interest rates on old debts.

[xl] In particular, according to State inspection of Ukraine for consumer rights protection (Derzhspozhyvinspektsiya), the share of trade outlets and shops, which sell illegal tobacco goods increased from 23% in 2010 to 39% in 2011 [Web-site of Derzhspozhyvinspektsiya: http://www.dssu.gov.ua:1080/control/uk/publish/article/main?art_id=162154&cat_id=32908;http://www.dssu.gov.ua/control/uk/publish/article/system?art_id=140461].

[xli] As a result of modernization of budget revenues classification some types of revenues (e.g., rental payments), previously classified as non-tax, were moved to the tax revenue category.

[xlii] In particular, zero EPT rate was introduced for small start-ups for five years. Companies of light, aircraft and shipbuilding industries, machinery for agriculture, hotels and restaurants; as well as electric power enterprises, which sell electricity produced from renewable energy sources, were allowed 10-year EPT-break. Besides, excise duty on petroleum products used by chemical companies as raw material was abolished. Favourable conditions were provided for taxation of operations related to the EURO-2012.

[xliii] the official figures include so-called 'passive' refunds, which are the amounts of VAT refunds under the court consideration.

[xliv] The Law of Ukraine On Amendments to the Tax Code of Ukraine and other legislative acts of Ukraine on the simplified system of taxation, accounting and reporting, No.4014-17 from November 4, 2011. Before the approval of these amendments the entrepreneurs, working on the simplified system of taxation, were exempted from inspections.

[xlv] Maximum turnover for simplified taxation was set at UAH 3 m for entrepreneurs and at UAH 5 m for legal entities.

[xlvi] as the companies working on general taxation system were allowed to include costs on goods and services purchased from individuals who chose simplified taxation system for the calculation of the EPT tax base.

[xlvii] including consulting, accounting, information technology, etc.

[xlviii] The Law of Ukraine On Amendments to Certain Legislative Acts of Ukraine on State Procurement, No. 3681-17 from July 8, 2011. Initially the Law was approved in June 2010 after state procurement was regulated by the Cabinet of Ministers for two years. Previous amendments to the Law were vetoed by him as it wasn't much supported by the EC and the WB. The main reason for that was the unjustified expansion of the list of entities to which the Low does not apply.

[xlix] The Budget Law-2012 was based on the current gas price of USD 416 per thousand cubic meters.

[l] However, central fiscal deficit is projected at 1.7% of GDP.

li in case the Government does not increase gas prices for population and heating generating companies in 2012.

lii According to the State Treasury, state borrowings were executed at 69.5% of the amended plan.

liii According the Ministry of Finance.

liv According to the NBU.

lv As the government demand for foreign currency to redeem these bonds in 2012 will grow.

lvi namely, NJSC Naftogaz of Ukraine.

lvii According to the State Budget Law for 2011 the Government expected to attract USD 4.5 bn through Eurobond issues and USD 500 m from the World Bank.

lviii In mid-February the Government placed USD 1.5 bn Eurobonds at 7.95% p.a. with a maturity of 10 years. Besides, in June it placed USD 1.25 bn of five-year Eurobonds at 6.25% p.a.

lix The loan was provided to the Ukreximbank for 30 years, including a 6-year grace period at floating rate tied to LIBOR.

lx The VTB extended the loan twice during 2011 (for six months each time). First -in June until December 2011, second - in late November until June 2012.

lxi due to difficult situation on foreign financial markets and low possibility for resumption of the IMF program before parliamentary elections.

lxii from 42% as of March 1, 2011.

lxiii Law of Ukraine, from 23.12.2010 № 2857-VI

lxiv SPFU Order No.567 from 18.04.2011

lxv CMU Order No.162 from February 23, 2011

lxvi SPFU Order from September 28, 2010 N 1405

lxvii CMU Order No.310 from April 11, 2011

lxviii CMU Order No.162 from February 23, 2011

National accounts		**Q1 09**	**Q2 09**	**Q3 09**	**Q4 09**	**Q1 10**	**Q2 10**	**Q3 10**	**Q4 10**	**Q1 11**	**Q2 11**	**Q3 11**	**Q4 11**
GDP	UAH bn	189.0	214.1	250.3	259.9	217.3	256.8	301.3	307.3	261.9	314.6	376.0	364.1
GDP (real)	% yoy	-19.6	-17.3	-15.7	-6.7	4.5	5.4	3.3	3.7	5.4	3.9	6.5	4.7
Household consumption (real)	% yoy	-14.5	-14.5	-14.3	-16.2	0.2	6.8	7.8	12.8	13.8	15.3	17.8	12.8
State consumption (real)	% yoy	0.2	-1.6	-4.3	-3.7	3.8	-4.0	5.8	10.0	3.5	4.0	-10.5	-5.7
Gross fixed capital formation (real)	% yoy	-58.0	-55.9	-53.2	-33.7	-5.7	-3.2	9.5	10.5	2.1	5.2	11.0	16.9
Exports of goods and services (real)	% yoy	-22.2	-34.1	-30.9	6.9	0.4	13.2	2.0	0.9	17.0	2.9	-2.2	-5.6
Imports of goods and services (real)	% yoy	-37.4	-52.3	-47.6	-11.1	-6.2	17.2	20.2	13.2	37.2	23.1	12.0	3.3
Agriculture, hunting, forestry (real)*	% yoy	-1.1	3.4	2.2	-11.6	5.4	0.5	-3.2	0.9	5.4	2.0	17.4	28.9
Manufacturing industry (real)*	% yoy	-33.7	-26.1	-25.6	6.5	10.9	10.1	7.6	7.6	13.3	8.9	10.2	2.2
Construction (real)*	% yoy	-54.2	-42.7	-43.6	-32.8	-7.7	-5.8	9.6	3.9	6.4	19.4	7.3	9.8
Trade, repair services (real)*	% yoy	-15.6	-15.7	-22.0	-16.4	6.1	9.6	10.1	4.7	8.9	2.8	6.8	5.8
Transport (real)*	% yoy	-13.4	-9.2	-5.7	-0.4	1.3	1.8	3.0	0.1	7.2	7.5	3.4	9.4
Balance of payments													
Current account balance	USD bn	-0.6	-0.2	-0.1	-0.9	0.0	0.5	-1.0	-2.5	-1.6	-1.7	-2.6	-4.4
Current account balance	% of GDP	-2.6	-0.6	-0.2	-2.7	-0.1	1.6	-2.6	-6.5	-4.8	-4.3	-5.5	-9.5
Trade balance in goods	USD m	-882	-622	-1396	-1407	-1236	-697	-2870	-3585	-3084	-2267	-3928	-4526
Trade balance in services	USD m	116	432	1256	550	930	1115	1536	823	1007	1227	1686	967
Current transfers	USD m	632	667	640	722	608	728	797	842	1039	878	988	803
Direct investment (FDI)	USD m	883	1279	1210	1282	923	1196	1470	2170	882	2284	2100	1275
Portfolio investments	USD m	-350	-351	-2286	1428	-307	804	2532	1288	1163	1838	-938	-506
Gross international reserves	USD bn	25.4	27.3	28.2	26.5	25.1	29.5	34.7	34.6	36.4	37.6	35.0	31.8
Exchange rate (interbank), UAH/USD	aop	8.09	7.76	7.99	8.06	8.00	7.91	7.90	7.96	7.95	7.98	7.99	8.01
Exchange rate (official), UAH/USD	aop	7.70	7.66	7.82	7.99	7.99	7.91	7.90	7.93	7.94	7.97	7.97	7.98
Fiscal indicators													
Consolidated fiscal revenues	% of GDP	34.8	30.6	25.5	36.0	30.9	30.4	23.3	32.3	32.2	29.7	29.0	30.6
Personal income tax	% of GDP	5.2	5.3	4.4	4.7	4.9	4.8	4.4	4.8	4.9	4.8	4.1	4.7
Enterprise profits tax	% of GDP	3.9	3.3	3.7	3.6	4.3	3.0	3.4	4.2	4.4	4.5	3.6	4.4
Value-added tax	% of GDP	11.7	8.3	6.4	11.0	9.8	9.8	8.5	9.9	7.5	12.7	9.5	9.6
Excise tax	% of GDP	2.0	2.3	2.5	2.6	2.4	3.0	2.5	2.6	2.1	3.0	2.7	2.4
Consolidated fiscal expenditures	% of GDP	34.4	36.6	29.6	34.5	33.0	38.7	30.3	37.6	32.3	32.8	26.5	35.6
Current expenditures	% of GDP	33.5	34.9	27.0	31.4	32.4	37.4	26.6	32.8	31.0	30.4	23.5	30.1
Capital expenditures	% of GDP	0.9	1.7	2.6	3.1	0.6	1.4	3.7	4.8	1.2	2.3	2.9	5.5
Consolidated fiscal balance	% of GDP	0.0	-6.2	-4.5	1.1	-2.0	-8.0	-7.5	-5.6	-0.3	-3.3	-3.8	-5.5
Privatisation receipts	% of GDP	0.0	0.2	0.1	0.0	0.1	0.0	0.1	0.2	0.4	3.1	0.0	0.1

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

Sources: Ukrstat, NBU, Ministry of Finance, own calculations

''' "Minus" denotes a consolidated fiscal deficit

Contact information:

Institute for Economic Research
and Policy Consulting
Reytarska St. 8/5-A, 01030 Kyiv
Tel. (+38044) 278-6342
Fax (+38044) 278-6336
E-mail: institute@ier.kiev.ua
http://www.ier.com.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

Centre for Economic Studies

Oleksandra Betliy
betliy@ier.kiev.ua

Vitaliy Kravchuk
Kravchyk@ier.kiev.ua

Iryna Kosse
kosse@ier.kiev.ua

Kateryna Pilkevich
pilkevich@ier.kiev.ua

Artur Kovalchuk
kovalchuk@ier.kiev.ua

Serhiy Maksymenko
maksymenko@ier.kiev.ua

Dmytro Naumenko
naumenko@ier.kiev.ua

Svitlana Galko
galko@ier.kiev.ua

Kostiantyn Kravchuk
k.kravchuk@ier.kiev.ua

Centre for Agriculture, Food and Renewable Energy Studies

Oleg Nivyevs'kiy
nivyevskiy@ier.kiev.ua

Yuliya Ogarenko
ogarenko@ier.kiev.ua

Anna Kuznetsova
Kuznetsova@ier.kiev.ua

Centre for International Studies

Kateryna Shynkaruk
shynkaruk@ier.kiev.ua

Center for Contemporary Society Studies

Iryna Fedets
fedets@ier.kiev.ua

Inna Chenash
chenash@ier.kiev.ua

INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING PRODUCTS

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Notes:

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