

UKRAINE

Investment Climate

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Impact of the Political Situation

- The March Rada elections were recognized as free and fair by international observers: Ukraine has moved forward in its democratic transformation.
- Due to strong competition among political parties, the activities of the Rada will be based on checks-and-balances. This is in contrast to some CIS countries where one party has the monopoly on power.
- To avoid a stalemate in reforms, the Coalition has already ensured that its future work be based on agreed upon economic and political program. This program includes the following:
 - Economic policy will continue to reflect the model of a free and competitive market economy (including deregulation and liberalization of business activities, foreign trade and capital)
 - WTO accession will be completed.

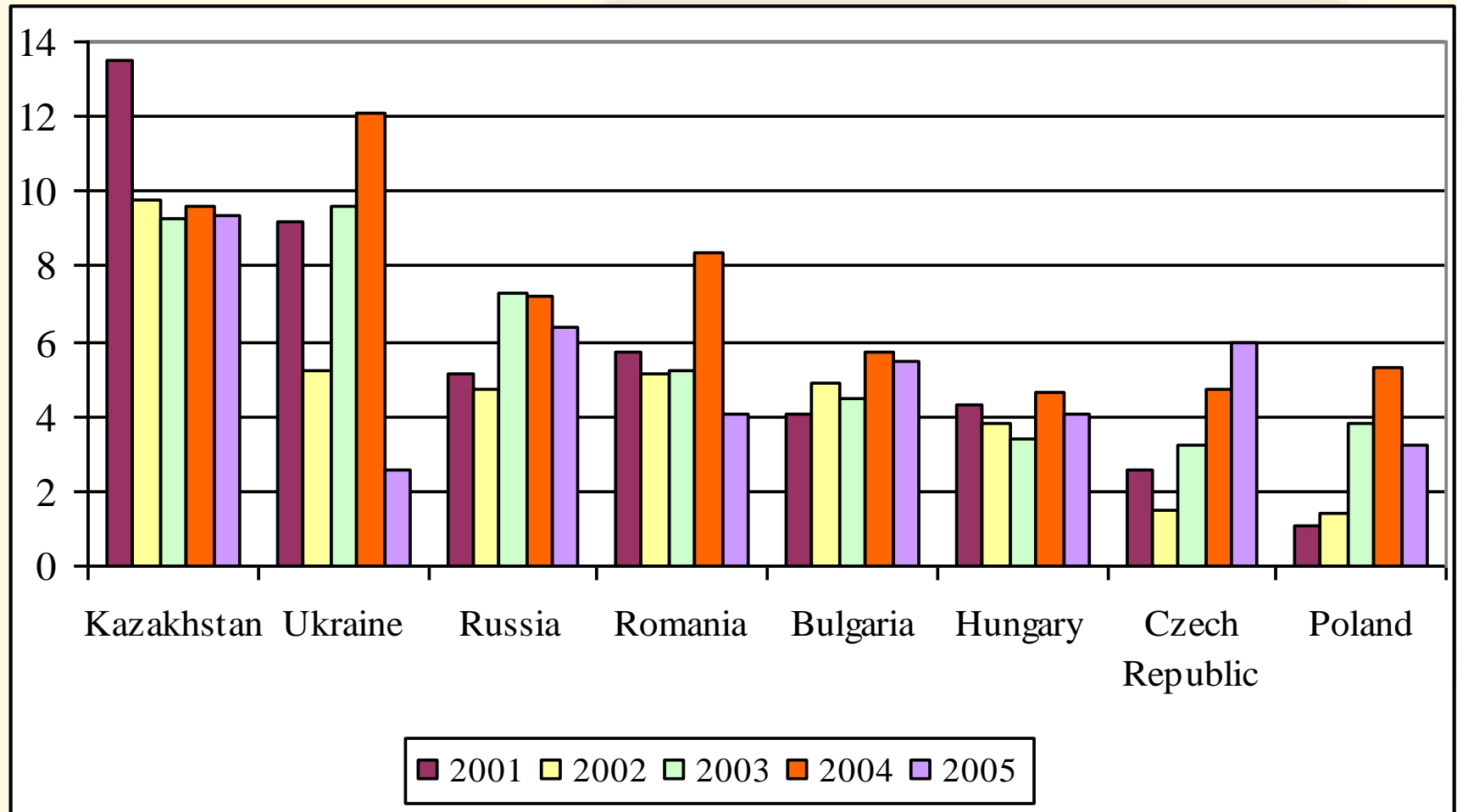
... Political Situation Continued....

- Ukraine's foreign policy will reflect a pro-European orientation.
 - Relations with Russia will be formed based on national interests and equal partnership.
 - Privatization will continue and re-privatization will not revive.
 - The Fiscal Budget deficit will be contained while decreasing taxes and securing the financing of social commitments (e.g., pension payments)
 - A decisive fight against corruption will be conducted.
 - Public Administration reform, and decentralization and development of the villages will be emphasized.
- The above developments and agreements bear well for the future of economy and the likely reforms in the regulatory environment.

Economic Performance

	2000	2001	2002	2003	2004	2005
Real GDP Growth	5.9%	9.2%	5.2%	9.6%	12.1%	2.6%
Fiscal Balance (% GDP)	0.6%	-0.3%	0.7%	-0.2%	-3.2%	-1.84%
Consumer Inflation (eop)	25.8%	6.1%	-0.6%	8.2%	12.3%	10.3%
Exchange Rate (Hr/\$, eop)	5.43	5.30	5.33	5.33	5.31	5.05
Current Account (\$bn)	1.5	1.4	3.2	2.9	6.8	2.5
(as % of GDP)	4.6%	3.7%	7.5%	5.8%	10.6%	3.1%
International Reserves (\$bn)	1.5	3.1	4.4	6.9	9.5	19.4
Foreign Public Debt (% GDP)	32.9%	26.6%	24.0%	21.3%	18.7%	14.1%

From 2001 to 2005, real GDP Growth (%) in Ukraine compared favourably with other Economies:



Outlook for 2006

- The early 2006 increase in the price for imported gas will dampen the expected rate of growth for GDP on 2006.
- GDP is now expected to grow by about 2.5% yoy in 2006 compared to the original forecast of 5%.
- On the other hand, the successful implementation of plans to introduce energy saving technologies may boost GDP growth.
- Ukraine badly needed the incentives to save energy as the country consumes almost 3 times more energy per unit of GDP than Western Europe.
- The process of acquiring more efficient equipment has already started.
- In fact, in from January to May, GDP actually increased 4% yoy.

.....Outlook for 2006 ...

- Gas price increases would also result in:
 - a somewhat higher rate of inflation -- about 13%, and
 - a current account deficit of 2-3% of GDP
- The exchange rate may depreciate somewhat due to the size of the current account deficit, but only slightly to 5.2 UAH/\$ by the end of the year (thanks to plentiful international reserves and large FDIs).
- We expect that after lower GDP results in 2006 (a good time to acquire assets), GDP should pick up to about 5% pa by mid-2007.
- Further acceleration of economic growth will depend on the willingness of the new government to implement reforms to improve Ukraine's business environment.

Mr. Yushchenko's Presidency

- Since the beginning of 2005, the Yushchenko government undertook a number of reforms to improve the investment climate:
 1. On March 25, 2005, the amended Fiscal Budget for 2005 eliminated most tax privileges and exemptions.
 2. Steps were taken to reduce the size of the shadow economy (extensive anti-smuggling campaign -- Smuggling-STOP – carried out by customs authorities.
 3. These measures reduced the potential fiscal deficit from 5% of GDP to a reasonable deficit of 1.84% of GDP in 2005.
 4. On the path to foreign currency market liberalization, the NBU abandoned its regulation requiring the mandatory sale of 50% of export proceeds starting April 1, 2005.
 5. On April 29, 2005, the NBU cancelled its regulation #482 that required multiple conversion of currencies for non-residents.

..Mr. Yushchenko's Presidency

6. The Privatization strategy was revised, with the disputed privatization deals contested in courts and the re-sale of already privatized companies limited to the successful Kryvorizhstal sale, which brought in \$4.8 billion.
7. Ukraine advanced in its WTO bilateral negotiations and adopted several laws important in view of WTO accession. In connection with WTO requirements, a number of reductions in import duties and changes in customs procedures were made.
8. The government reduced the number of business-related regulations, eliminating many that were damaging business development.
9. A number of efforts were made to bring legislation to western standards, as well as reduce corruption and the size of informal economy.
10. The country has developed a good working relationship with the West.
11. There is more freedom of speech and political liberties.
12. There is increased interest and support from international institutions (EC, WB, IMF and EBRD).

..Mr. Yushchenko's Presidency

- On the other hand, during 2005 controversial measures taken by the government and slow progress in many areas affecting business environment, caused concerns to investors. In particular:
 1. There were a number of government interventions on market pricing, including gasoline prices, meat prices, and sugar prices.
 2. The plan to undertake a massive “re-privatization” program triggered much concern among businesses, especially foreign investors.
 3. Little progress was made in improving public governance, corporate governance, the judiciary system, reducing the cost of operating a businesses, combating corruption, and others key reforms needed to improve the business environment.

Further growth will require a stronger commitment to the implementation of market-based reforms to increase investments, particularly FDIs.

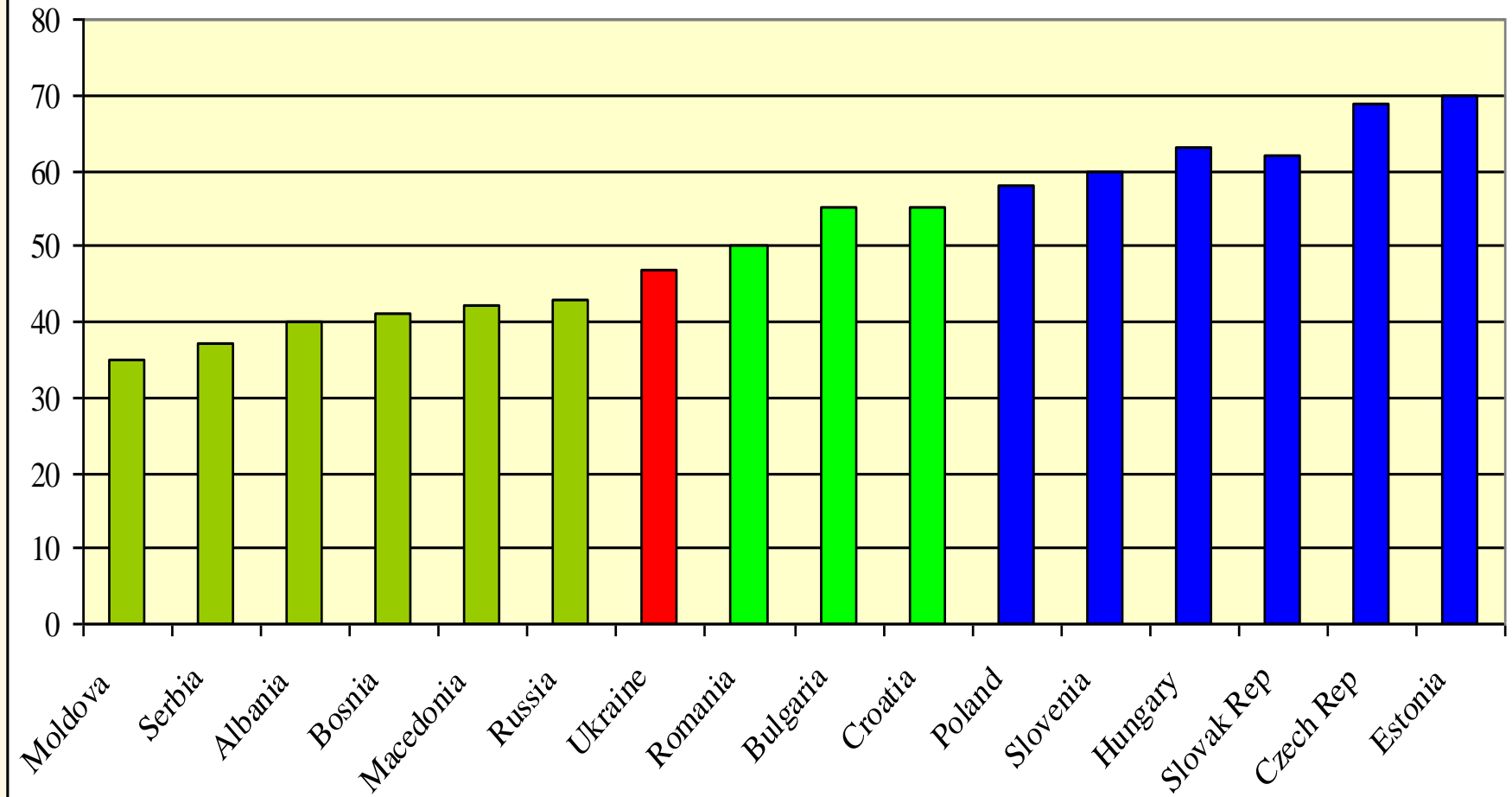
Improving the Country's Business Environment

- **Only a “big-bang” reform program will have chance to succeed!** Step-by-step reforms do not work over time as too much resistance is created and vested interests are able to stifle reforms.
- Key Reforms
 1. Public Governance
 2. Macroeconomic Stability
 3. Stable and Predictable Legal Environment
 4. Liberalization and Deregulation of Business Activities
 5. Corporate Governance
 6. Removal of International Capital & Foreign Trade Restrictions
 7. Facilitation of Business Financing by the Financial Sector
 8. Reduce Corruption
 9. Minimization of Political Uncertainties and Improving Country Promotion and Image

1. Improve Public Governance

- *Why Ukraine has been slow in improving its investment climate?* The major problem today in Ukraine is the **low institutional capacity of their public administrations** to implement the required reform agenda.
- Institution-building aimed at strengthening this Government's capacity is the most desirable route to change this situation and should be pursued vigorously: Ukraine must de-sovietalize its public institutions!!!
- A fundamental public administration reform will include:
 - Clearly defining the Objectives/Role of the Government limiting it to “public” goods and support - not substitution – of the private sector
 - Undertaking a comprehensive “audit” of government activities to either redefine, eliminate, or transfer them to the private sector or local administrations
 - Developing the concept of well-defined ‘Programs and projects’ for all government activities (this will help to improve administrative efficiency, deal with corruption and also bring equilibrium to the fiscal budget)
 - Improving transparency and access to Government information
 - Clarifying the government’s policy on Privatization

Public Governance



2. Macroeconomic Stability

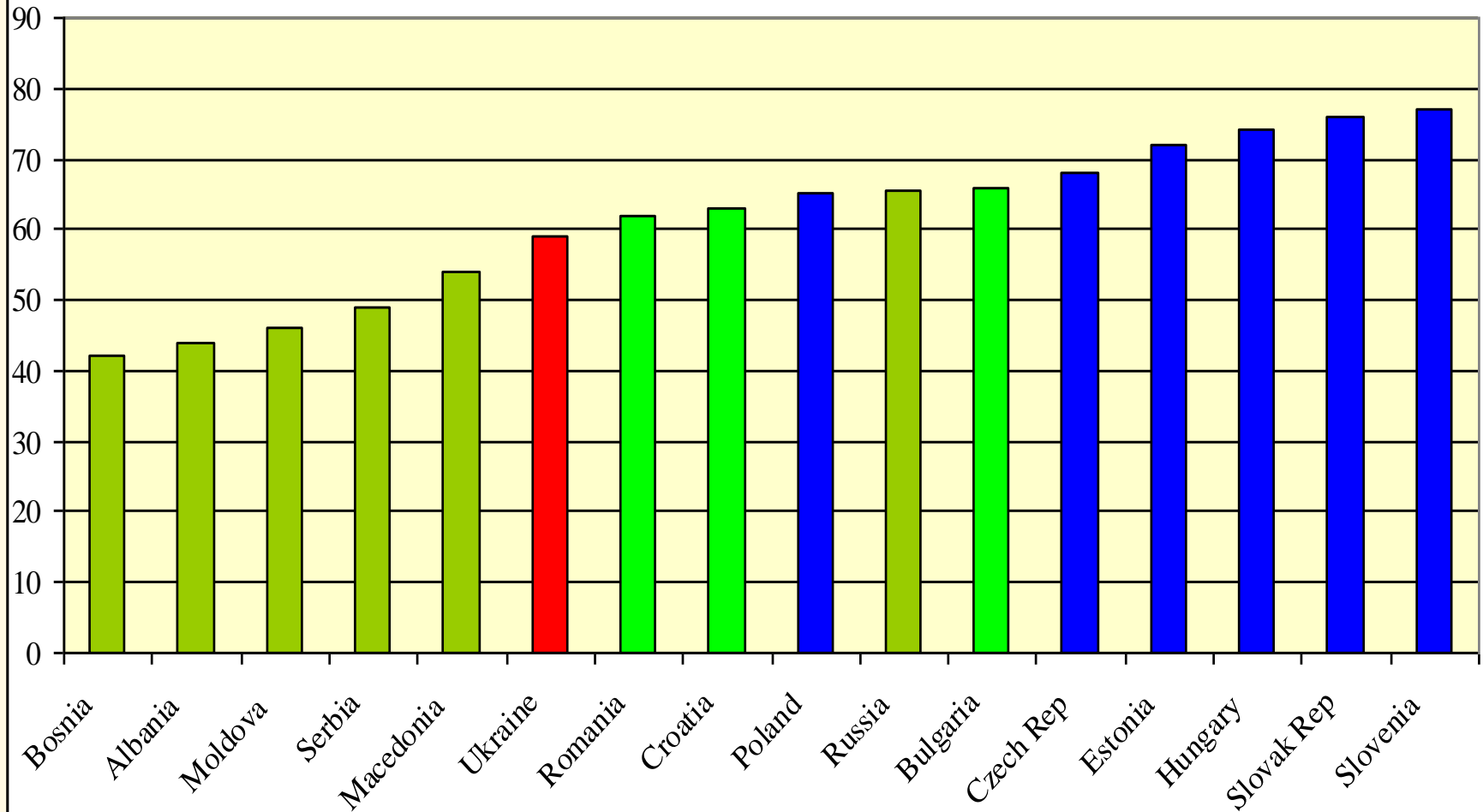
One of Ukraine's most significant achievements in economic policy-making in the past years was taking control of the country's fiscal budget system.

- Before 1998, lack of fiscal discipline was at the root of the macroeconomic instability, with fiscal deficits in excess of 5% of GDP. After financial crisis of 1998 the authorities kept the fiscal deficit below 1% of the country's GDP.
- Unfortunately, the decisions made since September 2004 on pension payments and minimum wages have changed the outlook for the fiscal budgets.

In order to maintain confidence in public finances, the following is needed:

- Rationalize the Tax System (reduce some taxes, introduce some others)
- Reform the Pension System to make it financially viable
- Improve Tax Administration
- Increase the Tax Base by further reducing the informal economy
- Decentralize social services (health & education) to improve efficiency and accountability
- Eliminate questionable government programs by carrying out a comprehensive audit of them
- Adopt a monetary policy based on inflation targeting

Macroeconomic Stability

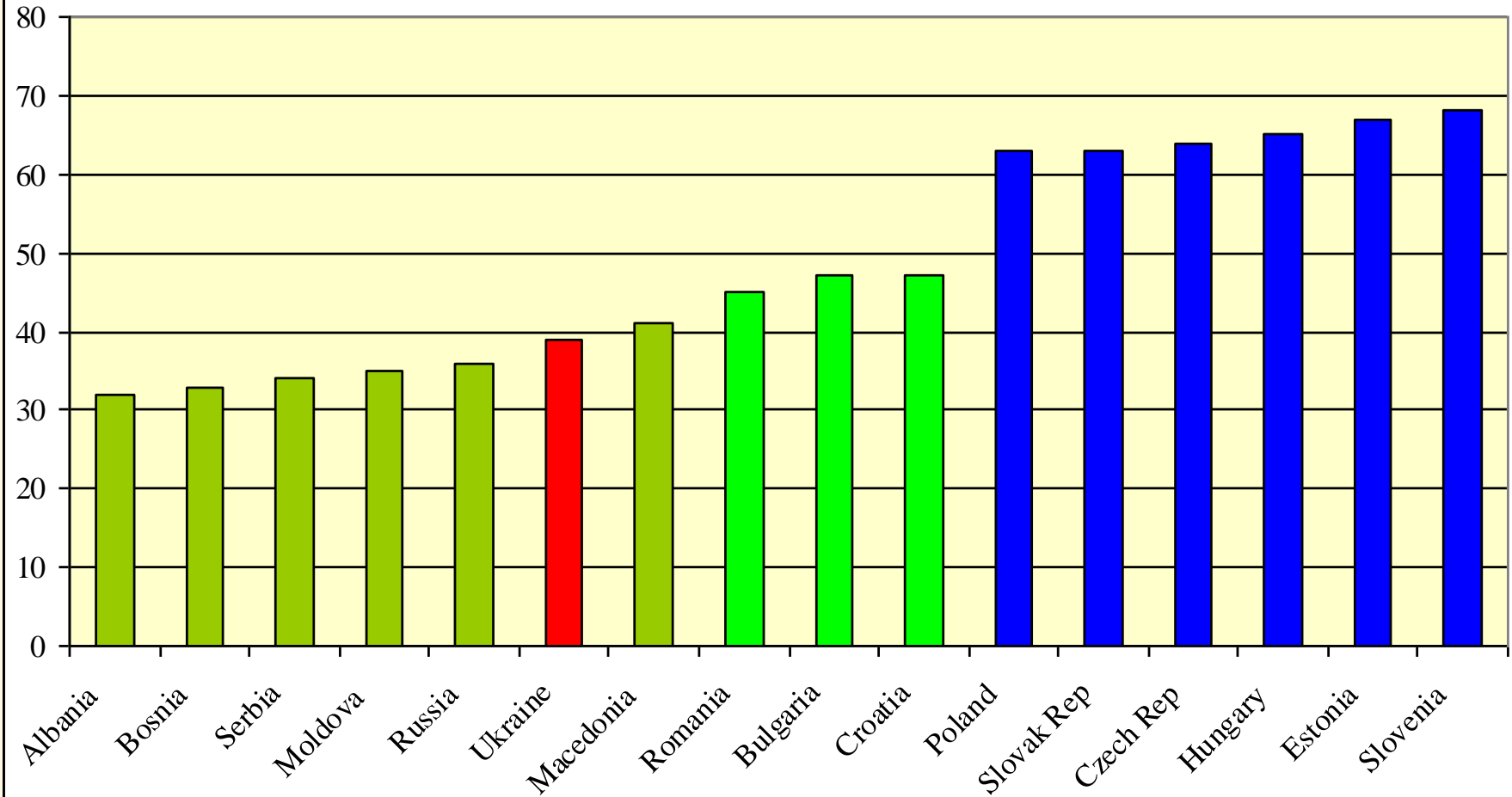


3. Stability and Predictability of Legal Environment

The lack of stability and predictability of the legal system is a major deterrent to foreign investments. To remedy this, the following actions are recommended:

- Improve the drafting and review of new legislation
- Ensure consistency of new laws with the existing legislation
- Improve the existing Law on Intellectual Property Rights Protection, including its procedures and its enforcement.
- Improve enforcement and reform of the judiciary system:
 - Improve financing of courts to ensure their independence and provide them with adequate facilities
 - Simplify the procedures for enforcement of court decisions and impose penalties for non-compliance
 - Encourage creation of “legal clinics”
 - Develop sound computerized databases for court decisions and legislation that can be accessed by judges across the country.

Stability and Predictability of Legal Environment

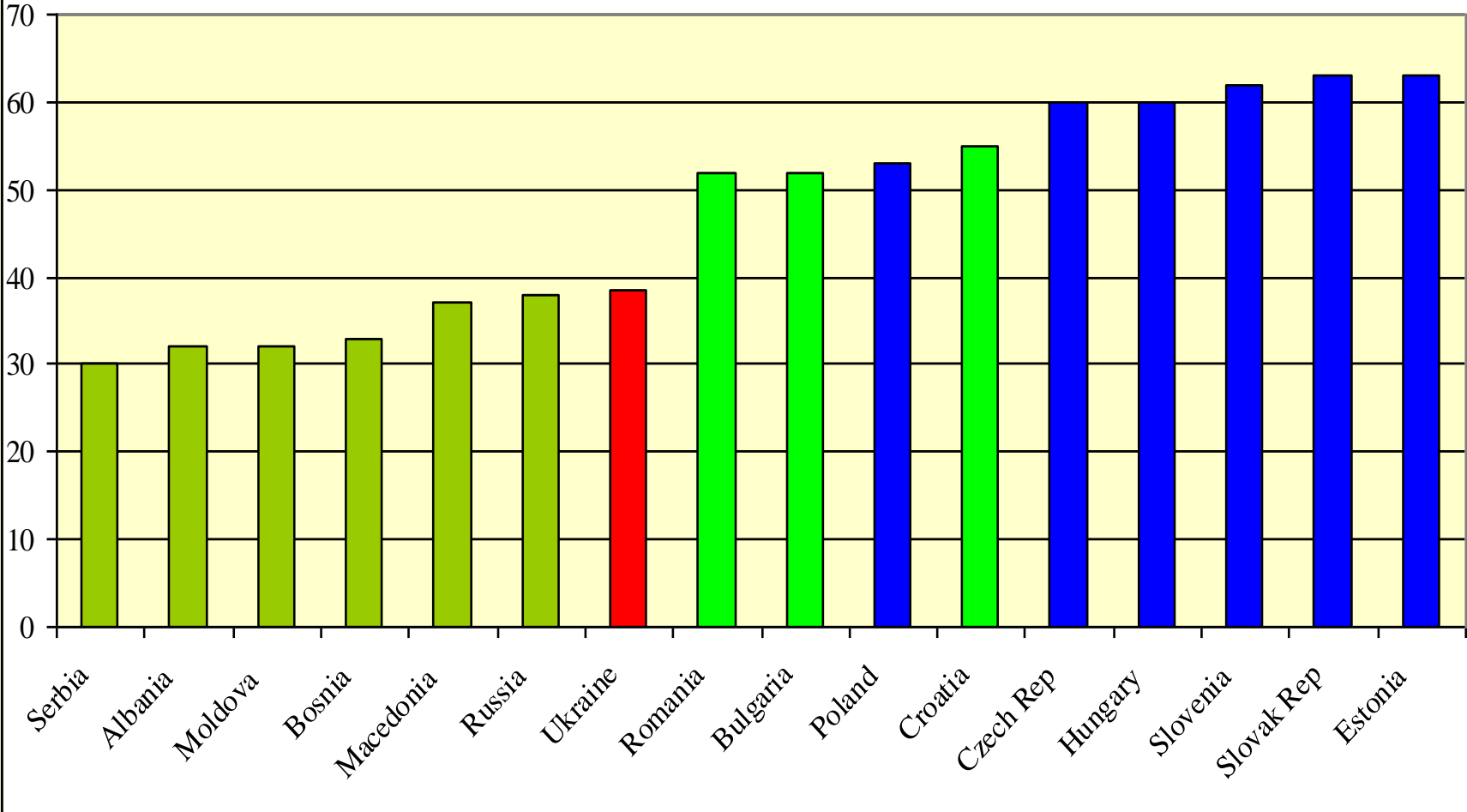


4. Liberalization and Deregulation of Business Activities

Despite significant progress in reduction of excessive government intervention in businesses activities, the major improvement is required in cutting still high costs of doing business in Ukraine

- The following measures are proposed:
 - Simplify the Tax System and eliminate the Tax Police
 - Make the Law of Ukraine on State Registration of Legal Entities and Self Employed operational
 - Ensure the effective introduction of the one-stop-shop system of business registration across the country
 - Simplify and reduce the number of inspections of private businesses
 - Develop transparent procedures Bankruptcy and for the liquidation of companies, including disclosure of information
 - Improve legislation and treatment of land, real estate and related construction activities in accordance with EU standards.

Business Liberalization and Deregulation

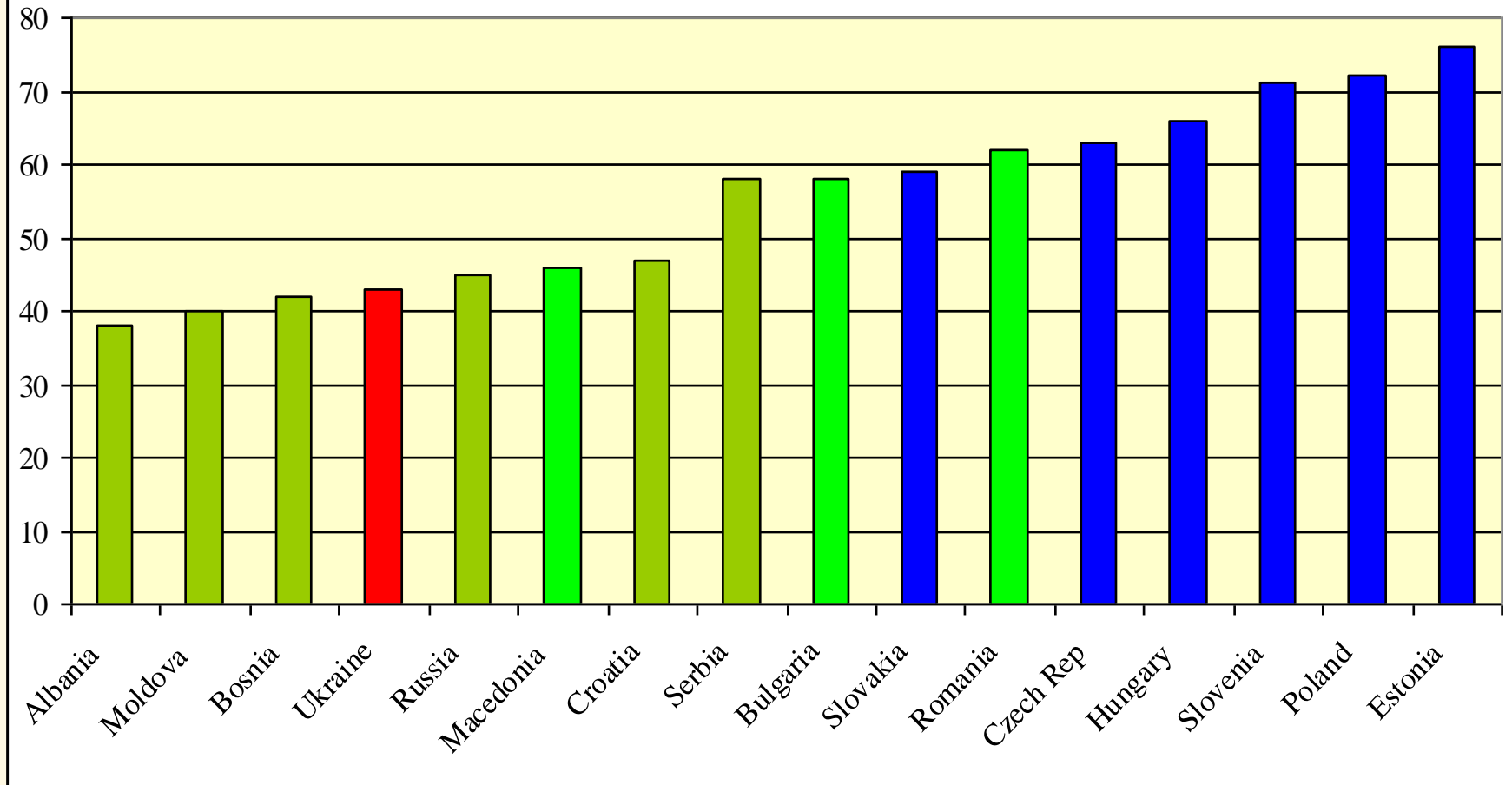


5. Corporate Governance

Ukraine ranks poorly on Corporate Governance with minority shareholders largely unprotected, and abuses such as insider trading, lack of information disclosure, asset stripping, voting fraud, etc. There is a need to:

- Accelerate the adoption of the Joint Stock Company Law, complying with international corporate governance standards, particularly regarding the rights of minority shareholders.
- Speed up the adjustment of Ukrainian accounting standards to international accounting standards.
- Remove inconsistencies between the Civil and the Commercial Codes by eliminating the Commercial Code and passing some of its provisions to the Civil Code

Corporate Governance

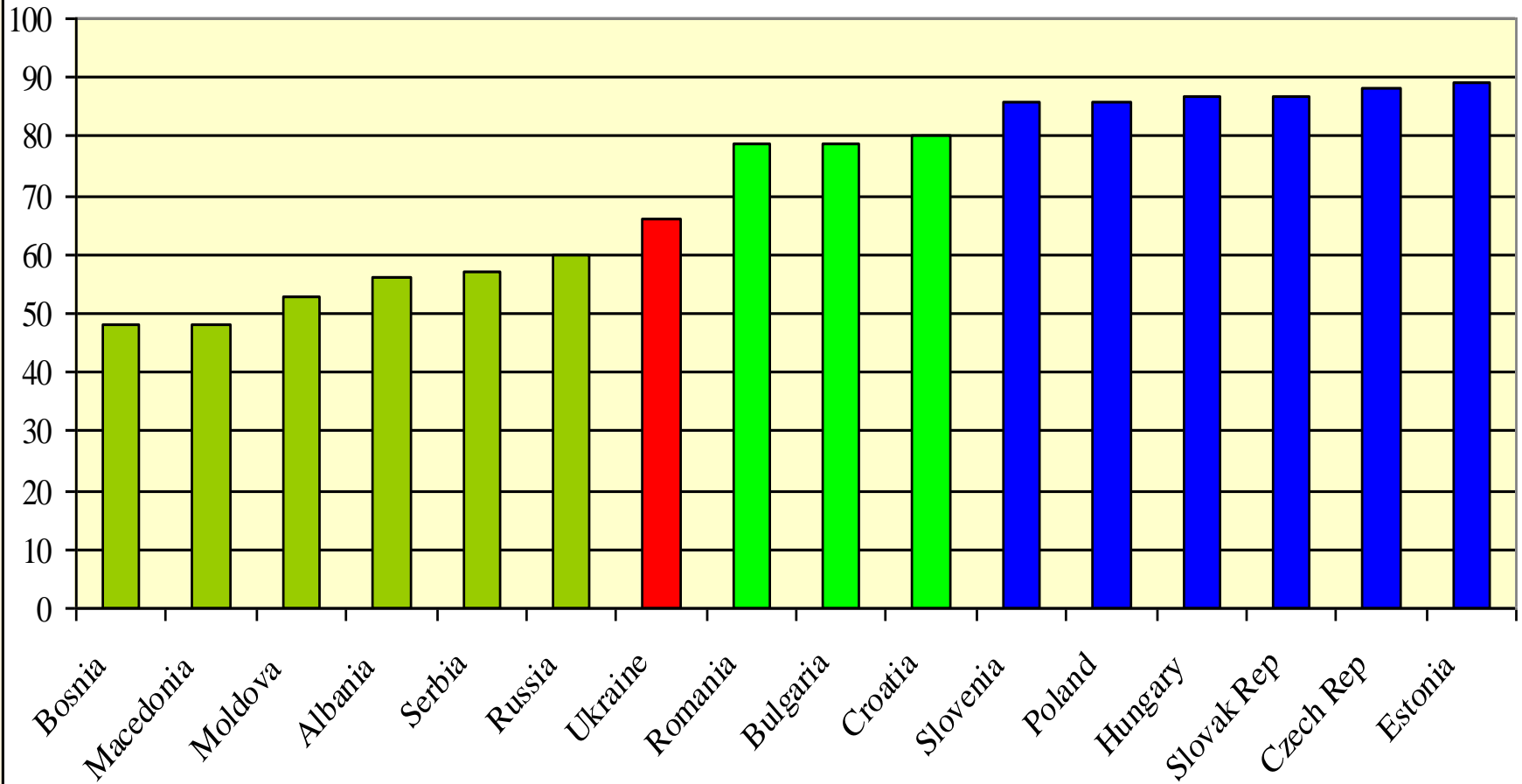


6. Liberalization of Foreign Trade and Capital

Since independence, Ukraine has significantly eased its foreign trade regime. However, to sustain export growth, Ukraine needs to act on some priority actions:

- 1) Accelerate enactment of laws to gain accession to the World Trade Organization (WTO)
- 2) Sign free trade agreements (FTA) with the EU, the CIS countries, and the US
- 3) Improve Customs Administration including streamlining the procedures for customs clearances and the application of import standards and accreditation.
- 4) Secure an agreement in principle with the EU to begin preliminary consultations on accession, including a date for the beginning of negotiations
- 5) Liberalize recently introduced regulation on foreign capital movements for foreign investors

Liberalization of Foreign Trade and Capital Movements



7. Financial Sector Development

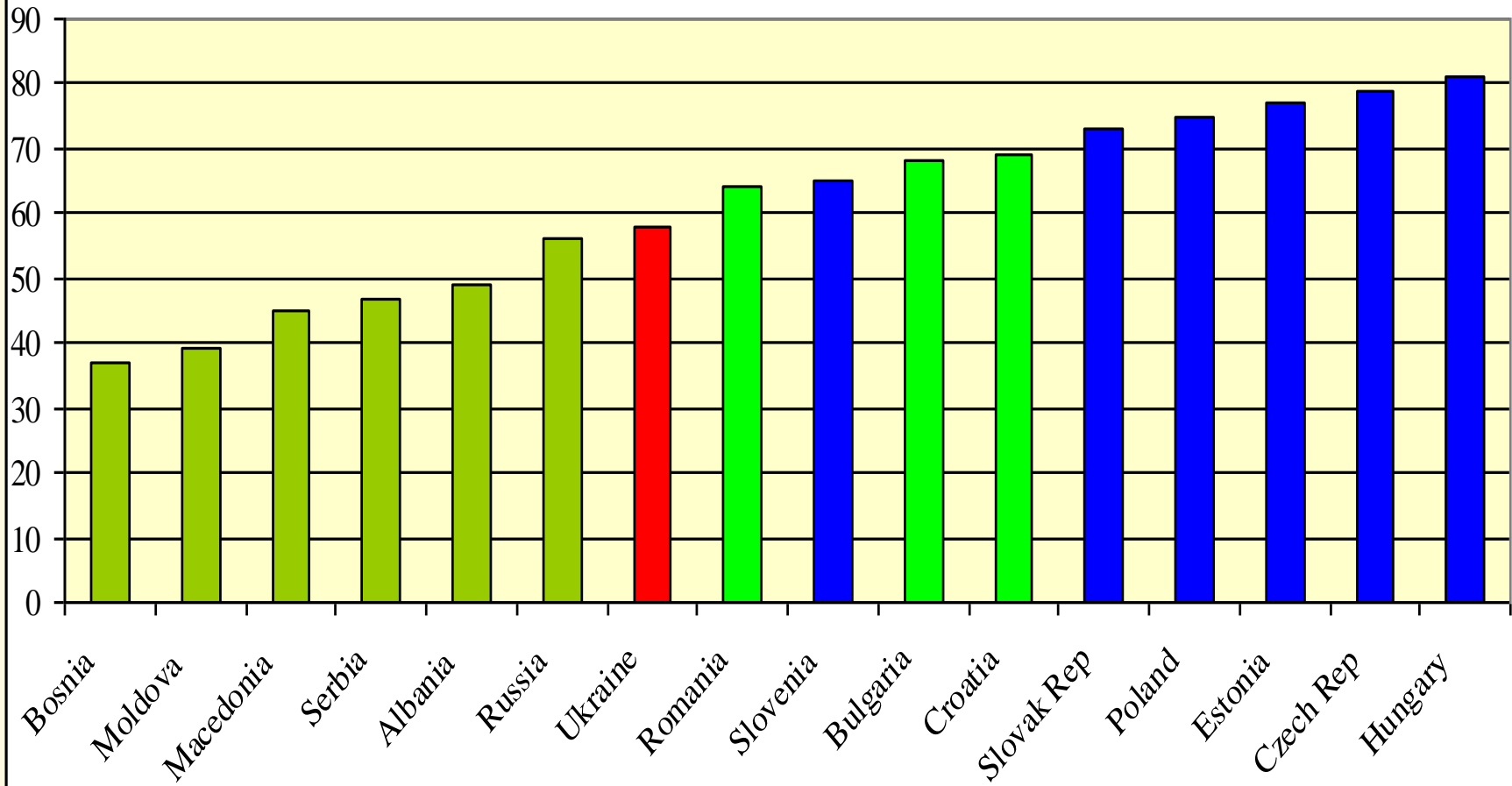
Ukraine does not yet has the financial infrastructure needed to sustain economic growth. To facilitate its development the following is needed:

- Ensure equal "playing conditions" for domestic and foreign financial institutions by adopting specific amendments to current laws.
- Better enforce banking regulations to force disclosure of ownership, limit related-party lending, ensure capital adequacy, ensure proper dealing with unsecured debts issued by commercial banks, and clarify the financial services that institutions can provide.
- Encourage Stock Market transactions to be made on the organized markets.
- Encourage Leasing Operations by improving its legal framework and its tax, accounting and depreciation treatments.

7.Financial Sector Development

- Improve the operation of the regulatory framework (Commission) for non-banking financial institutions.
- Stimulate development of other non-banking financial institutions by introducing a frame law on non-banking financial institutions.
- In the Insurance Sector,
 - Harmonize Insurance legislation with EU standards
 - Improve the regulatory framework for insurance companies to:
 - Modify the provisions for brokers commissions
 - Clarify tax liabilities for intermediaries
 - Revise the concepts of compulsory versus non-compulsory classes of insurance
 - Ensure compliance with prudential regulations
 - Regulate and develop the Actuarial profession
 - Improve consumer protection

Financial Sector Development

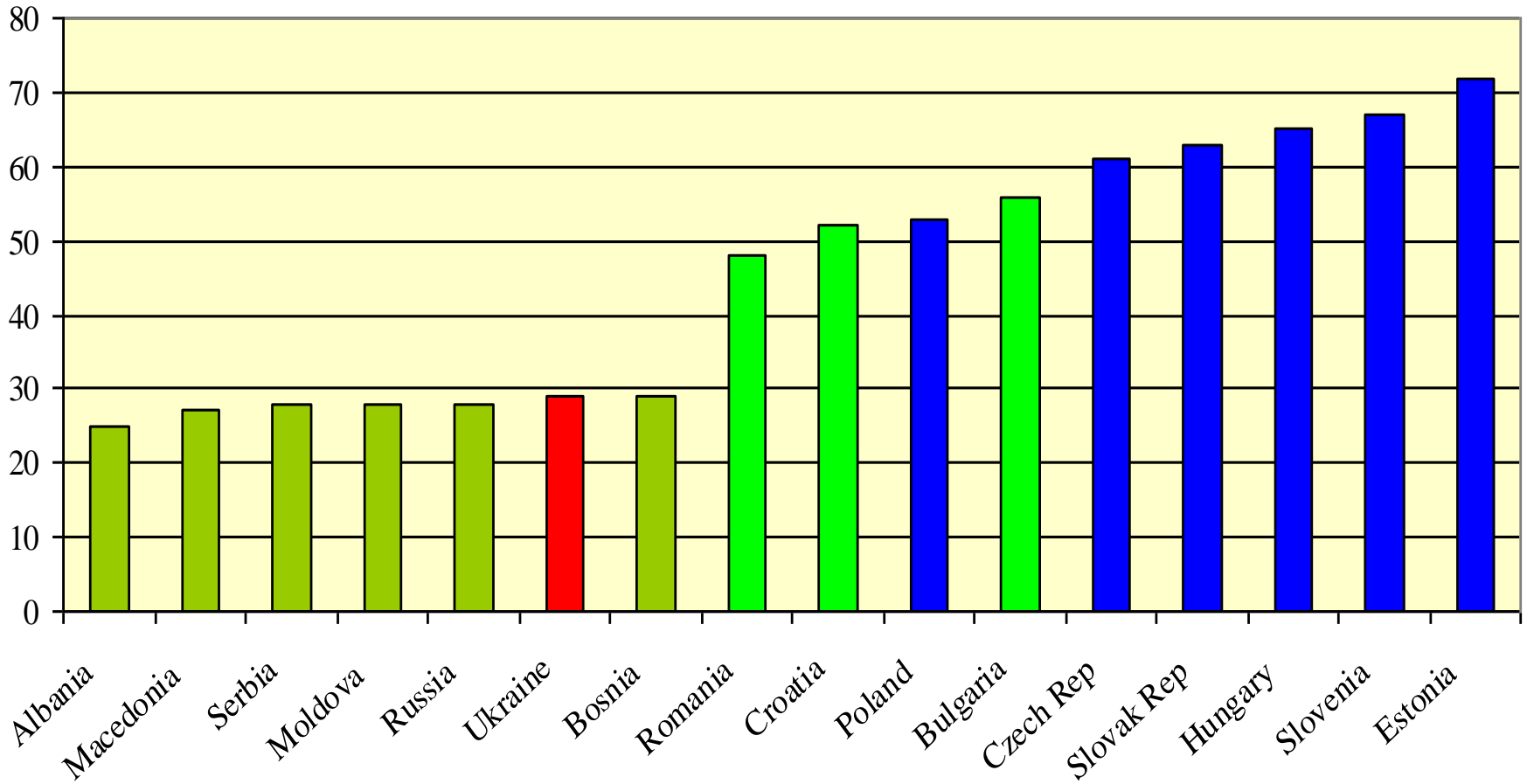


8. Reduce Corruption

As in many former centrally-planned countries, in Ukraine Corruption is a major issue for investors. To improve the situation, the following is needed:

- Implement public administration reform to reduce the opportunities for corruption, and improve transparency of decision making process and procurement procedures.
- Reduce the ambiguity and discretionarily of government regulations and raise accountability of the public servants for their decisions by introduction of e-governance resources.
- Strengthen the capacities of the internal audit and make it fully accountable for public.

Corruption Level



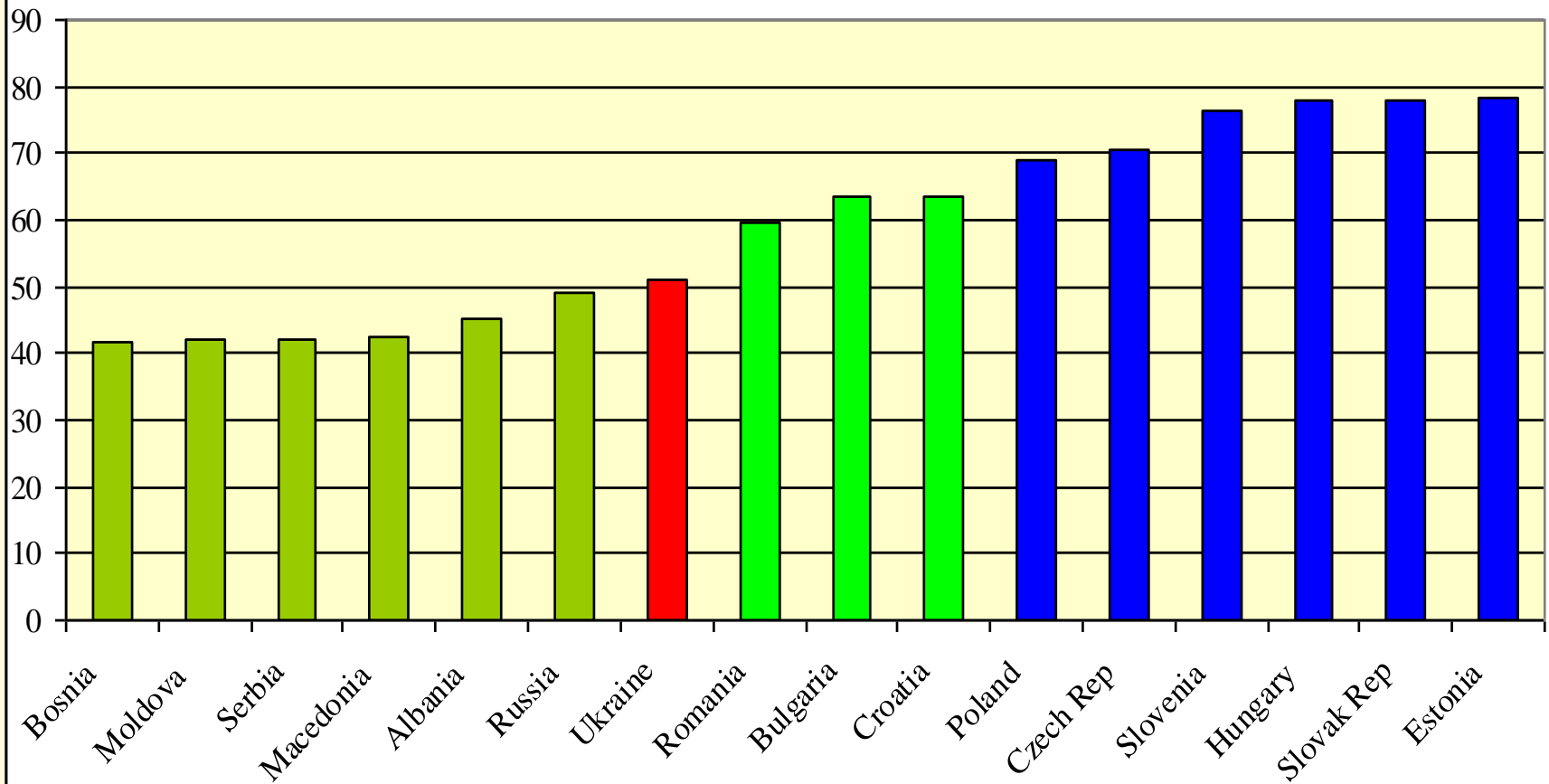
9. Minimization of Political Uncertainties and Improving Country Image

Political uncertainties have been reduced by the recent formation of a coalition in the Rada and the checks-and-balances that would come from its current “competition.

Further actions include:

- Ensure government stability.
- Take measures to eliminate power abuses at different levels of government.
- Resolve outstanding investment disputes with foreign investors; ensure fair treatment of foreign investors in courts.
- Engage the country's embassies and other missions to disseminate up to date information on Ukraine and its business opportunities.

Political Uncertainties and Country Image



Overall Investment Drivers – Country Ratings

Agregate Investment Climate Index

