

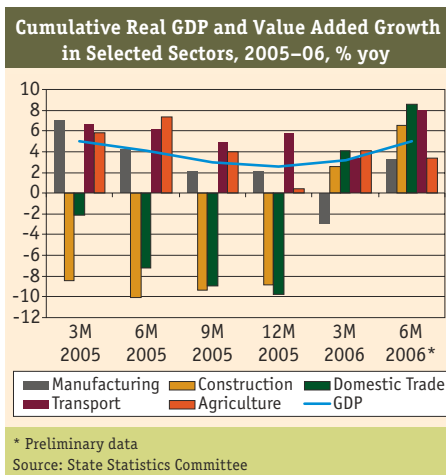
Macroeconomic Situation

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Summary

- Over January-June, real GDP grew by 5% year-over-year (yoy), suggesting that early concerns regarding the negative impact of the imported gas price increase, political uncertainty and unfavorable external conditions did not fully materialize.
- Stronger economic growth allowed the government to meet its budget revenue targets for January-June. For the first half of the year, the consolidated budget deficit was at a controllable 0.5% of period GDP.
- Consumer inflation continued to decelerate as the higher cost of services was compensated for by decelerating food prices. Although CPI growth was lower than expected for the first half of the year, the forecast for end-of-period inflation was left unchanged at 11.4% due to further upward adjustments of service tariffs in the second half of the year.
- For the first time since fall 2005, merchandise exports reported growth in May (11.4% yoy.) However, despite encouraging export developments, the merchandise trade balance continued to deteriorate.
- According to preliminary NBU estimates, the current account (CA) deficit accounted for \$0.9 billion over the period, which translates into 2.1% of period GDP.
- At the beginning of August, the Ukrainian Parliament endorsed Mr. Yanukovich as Prime Minister and appointed new Cabinet of Minister.

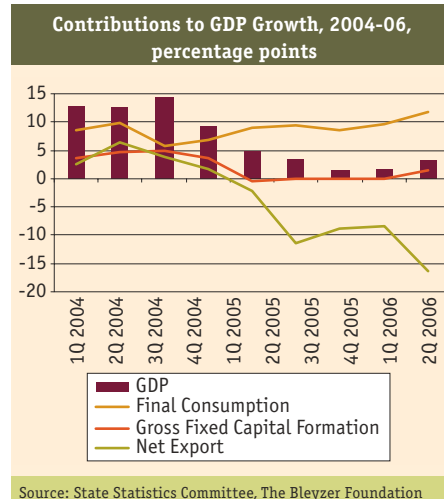
Economic Growth



According to preliminary data from the State Statistics Committee (SSC), the Ukrainian economy continued its remarkable acceleration in June. Following the rather unexpected acceleration of 8.5% yoy in May, real GDP growth picked up by a marked 9.3% yoy in June, bringing the cumulative January-June figure to 5% yoy. Although these figures are preliminary and may be revised, current real sector developments suggest that early concerns about the economic situation in 2006 related to the impact of the imported gas price increase, political uncertainty, and forecasted worsening of external conditions, were exaggerated. The expansion of the economy in the first half of the

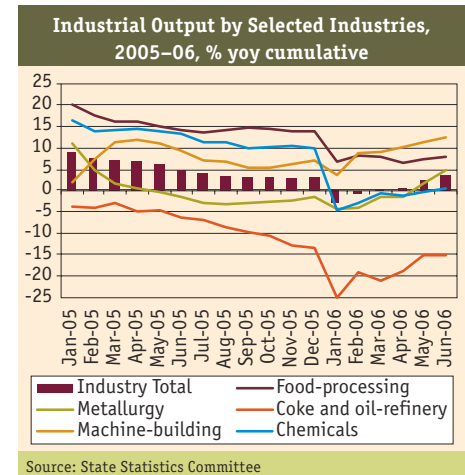
year may be attributed to stronger domestic demand for both consumer and investment goods and better than expected external conditions (particularly, resumption of the ascending trend of world steel prices in February, contrary to expectations of their gradual decline during 2006, and stronger external demand for Ukraine's machine-building products).

On the demand side, rising income and declining interest rates boosted private consumption growth to a record high 19.7% yoy in the first quarter of 2006. In addition, GDP growth was supported by recovered investment demand, as gross fixed capital investment increased by an encouraging 8.2% yoy for the period. Such a strong rebound of investment activity amid political uncertainties related to parliamentary elections and the formation of a government coalition was largely surprising. At the same time, it may be explained by the need to modernize existing production capacities and introduce energy-saving technologies, with the latter especially acute following the recent price hike on imported gas and its likely increases in the future, as well as by the improving business climate in Ukraine. Preliminary data on real sector performance for the first half of the year suggests further acceleration of investment activity in the second quarter. On the downside, robust domestic demand stimulated imports, which coupled with sluggish export performance resulted in considerable worsening of Ukraine's foreign trade balance. At the same time, the negative contribution of net exports may be lower in the second quarter due to favorable external conditions for Ukraine's major export-oriented industries (metallurgy, machine-building, chemicals and transport vehicles).



On the supply side, GDP growth was primarily driven by the service sector over January-June. The growth of value added in domestic trade (8.6% yoy), transport (8% yoy), healthcare (2.6% yoy) and education (1.8% yoy) together explains about 45% of GDP growth over the first half of the year. The growth of value added in construction and agriculture (3.4% yoy and 6.5% yoy respectively) explains another 10% of GDP growth over the period. At the same time, no-

table acceleration over May-June should be mainly attributed to robust growth in the industrial sector over these months. Although industrial output growth slightly decelerated from the 10% yoy surge a month before, it remained at a high 9.6% yoy in June, bringing the cumulative growth to 3.6% yoy.



Growth resumption in world steel prices and its acceleration over the last two months triggered recovery of metallurgy. Following a 12.4% yoy increase in May, metals production surged by almost 22% yoy in June, bringing the cumulative growth to 4.8% yoy. Strong external demand for chemicals helped the industry to adjust for more expensive energy resources (particularly gas, which accounts for about 25% on average in the production costs of chemicals). As a result, the chemical industry demonstrated 0.4% yoy growth over the first half of the year. Benefiting from buoyant investment demand as well as recovered metallurgy, output in machine-building increased by 15.7% yoy in June, which translated into 12.2% yoy growth to date. On the downside, coke and oil-refining continued to decline, reporting a 15.2% yoy decrease in output for the first half of the year.

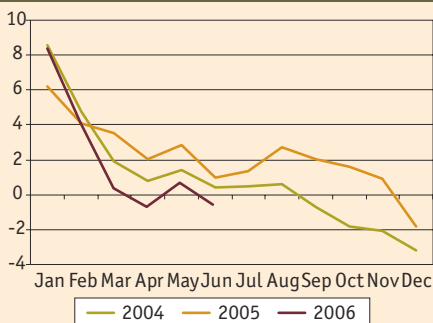
At the end of June, the price of imported gas, one of the principal determinants of Ukraine's economic development, was officially confirmed to stay unchanged at \$95 per 1,000 m3 at the Russian-Ukrainian border through the end of September. Moreover, in mid-July Ukrainian officials declared the price will stay unchanged through the end of the year. These assurances, plus acceleration of industrial production in recent months and robust growth in the service sector give reason to expect that GDP growth will be considerably higher than originally expected. Although the official forecast has not yet been upgraded, acting Prime Minister of Ukraine expects acceleration of GDP growth to 7% yoy over the first nine months of the year. However, considering the vulnerability of Ukraine's real sector to external conditions (particularly, evolution of world steel prices and cost of imported energy resources), the anticipated slower growth of real household income in the second half of the year and a more moderate harvest than last year, we expect GDP to grow by a real 5-6% yoy in 2006.

Macroeconomic Situation

Fiscal Policy

Acceleration of economic growth in May-June allowed the government to collect revenues to the general fund of the central budget in an amount that exceeded January-June's target by 2.2%. In particular, tax revenues were over-fulfilled by 1.5% over the period, primarily thanks to VAT proceeds that were almost 14.1% above the target. Unlike previous months, receipts from the enterprise profit tax (EPT) were 19.3% yoy above the target in June. Higher EPT collections can be attributed to faster economic growth in recent months, which positively affected enterprises' profitability. Indeed, according to SSC data, profits before taxes of Ukrainian enterprises were up by 11.5% yoy in May, while the share of profitable enterprises increased to 61.8% for January-May (up from 60.2% in January-April). However, due to poor enterprise performance over the first months of the year, EPT revenues were 13.3% below target for January-June. High growth of household income also contributed to 23.2% yoy growth of consolidated budget revenues over January-June, which constituted UAH 72.1 billion (\$14.3 billion).

Consolidated Budget Balance, % of period GDP, 2004-06



Source: Ministry of Finance

The growth of consolidated budget expenditures continued to slow (28.7% yoy over January-June compared to 36% yoy for January-April) but considerably outpaced that of revenues. As a result, the consolidated budget reported a deficit of UAH 1 billion for the first half of the year, which translates into 0.5% of GDP. The deficit was financed by the remainder of the funds received from last year's privatization of Kryvorizhstal, as privatization receipts were rather modest for the period and new borrowings were considerably lower than interest and principal public debt payments. For the first half of 2006, receipts from privatization amounted to just UAH 162 million, or 7.6% of the targeted amount. External public debt has declined by 5.3% since the beginning of the year, while in the absence of new issuance of domestic debt instruments in the first half of the year, domestic public debt has declined by almost 6% since the beginning of the year. As a result, total public debt declined by 5.5% year-to-date to \$14.6 billion.

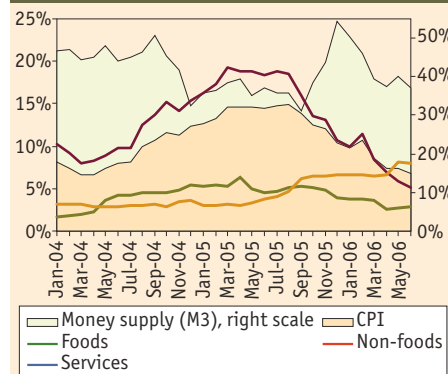
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Monetary Policy

Consumer price inflation continued to decelerate in June despite growing inflationary pressure from rising service tariffs. Following a 25% increase in gas and electricity tariffs in May, the government raised the cost of public railway transportation by 26.6% in June, contributing to 1.1% month-over-month (mom) growth of service prices in June. Rising international prices on crude oil over June and Russia's increase of the crude oil export duty to almost \$200/ton (up by 7.2%) starting June 1st resulted in a 2.9% mom increase in gasoline prices, driving the non-food price index up by 0.3% mom. Overproduction of some food products (e.g., meat, milk and dairy products, eggs) on the back of the unresolved trade relationship with Russia resulted in a 0.3% mom reduction of food prices in June. Since food has the most weight in the consumer basket (almost 65%), consumer prices reported just a 0.1% mom increase in June.

Dynamics of Money supply, CPI and Its Major Components, 2004-06, % yoy



Source: State Statistics Committee

Annual growth of consumer prices made up 6.8% yoy in June, decelerating from 7.3% yoy a month before. Benefiting from monthly deflation over the four consecutive months and a high base effect, the growth of food prices slid to 5.1% yoy, down from 5.9% yoy in May and 11.4% yoy in February. Non-food prices sped up to 2.8% yoy in June, while the service price index slightly decelerated from 17.8% yoy in May to 17.6% yoy. Despite deceleration, attributable to a high base effect, the growth of service tariffs was among the highest for the last five years and is expected to accelerate substantially in July. Starting July 1st the government increased gas prices for households by 85% while tariffs on communication services were raised as of mid-July. Further upward adjustments of service tariffs in the second half of the year will be the main reason for acceleration of inflation. Thus, despite moderate inflation in the first half of the year, the government forecast for year-end inflation was left unchanged at 11.4% yoy.

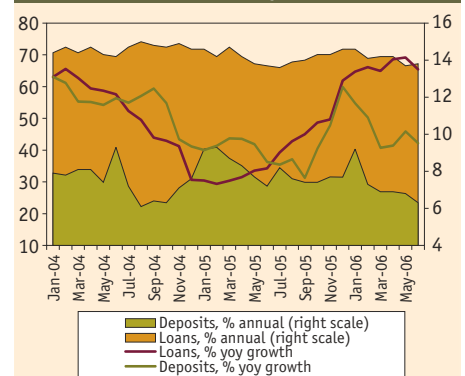
Consumer price development in June was also favored by decelerating growth of monetary aggregates. The growth of money supply (M3) slowed to 37% yoy, down from 40.2% yoy in May, reflecting slower growth

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of deposits and monetary base. In particular, deposits decelerated from 46% yoy in May to 42.2% yoy in June. Deceleration of the growth of deposits should be attributed to the declining deposit rate and expected acceleration of inflation in the near future, which make deposits a less attractive form of money holding. The growth of the monetary base slid to 22.4% yoy in June, down from almost 24% yoy a month before, which is explained by a high base effect. In monthly terms, the monetary base grew by 4.5% due to larger buyouts of foreign currency by the central bank on the interbank forex market and the decline of government deposits with the central bank by 16.1% mom.

Loan and Deposit Growth and Interest Rate Dynamics



Source: National Bank of Ukraine

Throughout 2006, the National Bank of Ukraine (NBU) continued to pursue the policy of a de facto fixed exchange rate. The official exchange rate has remained stable at 5.05 UAH/\$ since April 2005. Following weaker demand on cash foreign exchange and improving export performance, net foreign exchange interventions by the NBU were positive and made up \$247 million. However, due to scheduled foreign debt payments, \$/euro rate fluctuations and gold price differentials, gross international reserves declined slightly by \$73 million to \$17.6 billion, which translates into 4 months of future imports.

In June, the banking system continued to improve liquidity as demand for the NBU's refinancing credits dropped to UAH 760 million (down from UAH 1.3 billion in May and UAH 3.5 billion in April) and the money market interest rate continued to decline. This allowed commercial banks to further expand their credit operations. In June, commercial bank loans increased by 5.3% mom, bringing year-to-date growth to 25.4%, the record high level for the last four years. However, the cost of bank lending slightly increased by 10 basis points to 13.8% per annum (pa), while the average deposit rate continued to decline to 6.3% pa, down from 6.7% pa a month before.

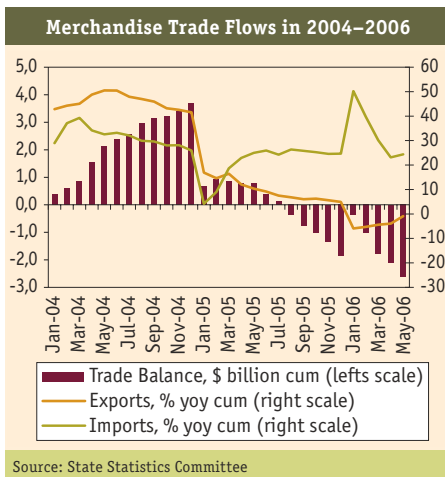
International Trade and Capital

In May, Ukraine's export performance continued to improve. Increasing for the first time since fall 2005,

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merchandise exports reported 11.4% yoy growth. Favorable export dynamics were achieved thanks to stronger external demand for Ukraine's machinery, equipment and vehicles and acceleration of world metal price growth. In particular, the export of ferrous metals, which still comprise the largest share in total exports (34.1%), increased by 1.3% yoy in May (for the first time since mid-2005.) As a result, exports of metallurgical products reported a 4.6% yoy decline over January-May, which is a considerable improvement compared to the 7.4% yoy decline in January-April. Exports of machinery and transport vehicles continued to expand at a strong 14.6% yoy over January-May. The increase in the share of high value-added products in total exports (export of machine-building and transport equipment account for 13.3% in total exports, up from 11.5% yoy for the respective period last year) indicates a positive trend towards export diversification.



At the same time, the growth of imports considerably outpaced that of exports. In May alone, merchandise imports went up 30% yoy, bringing the cumulative growth to 24.4% yoy. The high growth of commodity imports was primarily driven by more expensive energy resources. Accounting for more than one-third of total merchandise imports, the import of fossil fuels grew by 17.6% yoy over January-May, reflecting higher export duties on crude oil raised by the Russian Federation in April. Strong consumer and investment demand supported by high growth of population income and extensive commercial bank lending activities contributed to acceleration of imports as well. In particular, imports of machinery and transportation equipment, accounting for about 27% of total merchandise imports, grew by more than 40% yoy in January-May 2006, up from 38.8% yoy in January-April.

Despite improving export performance, Ukraine's merchandise trade balance continued to deteriorate. Over the first five months of the year, the foreign trade deficit increased to \$2.6 billion. The widening foreign trade deficit was the primary reason for the negative current account balance in the first half of the year. According to preliminary NBU estimates,

the current account (CA) deficit accounted for \$0.9 billion over the period, which translates into 2.1% of period GDP. At the same time, this data suggests substantial narrowing of the CA deficit in the second quarter of the year on the back of resumed export growth in May-June. Because of better-than-expected export performance in the first half of the year, we upgraded our estimates of the CA deficit for 2006 to \$2 billion, or 2.1% of expected GDP, which will be securely covered by the financial account surplus.

International Programs

A regular IMF mission visited Kyiv in late July to assess current economic challenges in the country. The mission acknowledged acceleration of economic growth in recent months despite continuing political uncertainties, the lower pace of inflation and the controllable fiscal deficit, and improved its forecast for Ukraine's real GDP growth to 5% yoy in 2006 (up from 2.3% yoy.) However, IMF representatives indicated a number of risks, in particular those related to the further rise in the cost of energy resources and deteriorating external conditions, which may worsen the outlook for the Ukrainian economy in the short-term. To secure macroeconomic stability and good performance, the mission recommended the following actions:

- (1) adjust service tariffs to the rising cost of energy sources, which will stimulate more effective budget and energy utilization;
- (2) take measures to secure the 2006 fiscal deficit not exceeding the targeted 2.5% of GDP and reduce the 2007 deficit to 2% of GDP;
- (3) gradually liberalize the exchange rate regime and strengthen commercial bank regulation and supervision;
- (4) speed up structural reforms, including adoption of legislation needed for WTO membership, the law on joint stock companies, repeal the moratorium on acquisition of agricultural land, and resume the privatization process.

Since there is no active lending program, cooperation between Ukraine and the IMF is limited to technical assistance. Moreover, the government intends to reform its relationships with other international financial institutions (IFIs) as it became evident from the Cooperation Strategy with IFIs for 2006–2008, approved by the Cabinet of Ministers in late June this year. In particular, the strategy envisages a gradual shift from projects supporting state budget and reform programs to investment projects that would enhance development of infrastructure and free-market instruments necessary to improve economic management of the country and increase competitiveness of Ukrainian goods and services. By adopting the strategy, the government hopes to seize available investment potential of IFIs, rather modestly realized so far in

Ukraine. This suggests more intense cooperation with the World Bank (WB), the European Bank for Reconstruction and Development (EBRD), a number of international investment banks and other IFIs.

As a part of the above-mentioned strategy, Ukraine and the World Bank signed a \$150 million loan agreement to support better access to financial services in Ukraine, especially small and medium enterprises in rural areas. Moreover, in late July the WB's Board of Executive Directors approved a \$154.5 million loan for the Second Export Development Project (EDP-2) to support export and real sector growth in Ukraine, by providing medium and long-term working capital and investment finance to Ukrainian enterprises. The project also aims to further improve the ability of the Ukrainian banking sector to provide financial resources to enterprises (through additional development of financial intermediation by providing a wider variety of better quality lending products.)

Other Developments and Reforms Affecting the Investment Climate

On August 3rd, Ukrainian President Viktor Yushchenko nominated Viktor Yanukovich as Prime Minister (PM). Mr. Yanukovich was PM of Ukraine from November 2002 to January 2005 and was the rival of Mr. Yushchenko during the presidential elections in the fall 2004. During March 2006's parliamentary elections, the Party of Regions, led by Mr. Yanukovich, obtained 186 seats in the Parliament (or 41.3%), however "supporters of the Orange Revolution" (Yulia Tymoshenko's Block, Our Ukraine and the Socialist Party) together obtained 242 seats (or 53.8%), which was enough to form a ruling coalition. Indeed, such a coalition was announced in late-June; however, lack of agreement between the participants resulted in the Socialist Party's withdrawal on July 6th and formation of the new coalition involving the Party of the Regions, the Socialist Party and the Communist Party. The new coalition nominated the head of the Party of the Regions, Mr. Yanukovich, as its candidate for Prime Minister.

The President took a constitutionally-permitted 15-day pause to decide whether to nominate Yanukovich as Prime Minister or dissolve the Parliament. On July 27th, in an attempt to solve the current political crisis, the Ukrainian President called for a round table, involving the leaders of key political forces and public figures, and proposed signing a declaration of national unity. Following tough consultations and a number of compromises regarding the issues of NATO membership, federalization, and language policy, the declaration was signed and President Yushchenko nominated Mr. Yanukovich as PM. The next day, he was approved by the Verkhovna Rada with 271 votes. In addition, Parliament swore in Constitutional Court judges that allowed the Court to resume operation, stalled since late last year due to the lack of a quorum. Late in the evening, Parliament approved the new Cabinet of Ministers as well. The

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majority of ministerial posts were given to the Party of the Regions, including the ministries of economy, finance and energy, while three ministries (of foreign and internal affairs and of defense) remain nominees of the President.

The formation of the new government ends four months of political uncertainty in the country. Ukraine can now expect smoother relationships with Russia, especially regarding gas price negotiations, and further progress towards WTO and EU membership.

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