Despite political uncertainty, net FDI inflow to Ukraine amounted to a record high $6.8 billion in the first nine months of the year. Though export performance remained strong over the same period last year, the harvest of wheat was about 1% higher than in the respective period last year. However, the sector is expected to post a moderate decline in value added this year.

According to the SSC, Ukraine had harvested about 25.5 million tons of grain by the end of September, which is about 16% lower than in the respective period last year. Though the harvest of wheat was about 1% higher than in the respective period last year (primarily thanks to about a 10% larger sown area), it was out-paced by the extremely poor harvest of barley. Barley holds the second largest share in total grain production after wheat (41.6% and 51% respectively as of August 2006). At the end of summer 2007, Ukraine had collected only 6.3 million tons of barley, which was almost 50% lower than in the same period last year. As of the end of September, Ukraine had also produced about 50% and 15% lower amounts of sugar beets and vegetables respectively. However, this was partially compensated for by the rich harvest of corn. Ukraine harvested a 2.3 times larger amount of corn than in the same period last year, while the harvest of fruits was 26.6% yoy higher. The sharp increase in grain prices, and thus fodder, on both domestic and foreign markets, is likely to result in a decline of cattle stock and output of the majority of livestock products, exerting downward pressure on agricultural performance. On the back of good harvest of corn, fruits and sugar beets and the winter sowing campaign, agricultural performance may slightly improve through the end of the year. However, the sector is expected to post a moderate decline in value added this year due to a higher price on imported natural gas.

The shortfall in the agricultural sector was compensated for by continuing double-digit growth in wholesale and retail trade, construction and manufacturing. Industry and service sectors continued to demonstrate remarkably good performance, underpinned by robust demand and good export performance. According to the State Statistics Committee preliminary data, private consumption advanced by 15.5% yoy in 2Q 2007, up from 14.7% yoy in 1Q 2007, fueled by continuing growth of real disposable income (up by 10.8% yoy in 1H 2007) and the credit boom. The rising cost for energy resources (and thus the need to introduce energy-saving technologies), outdated production capacities and intensifying competition on both domestic and external markets feeds investment demand. Gross fixed capital formation grew by about 24% yoy in 1H 2007, up from 19.5% yoy in the respective period last year. Thanks to a favorable external environment, exports reported decent growth of 5% yoy in real terms.

Strong domestic demand favored domestically oriented industries. Output growth in food processing grew by 13.3% yoy in January-September. Slight deceleration from 14% yoy growth in January-August may be linked to poor agricultural performance. High domestic and external demand underpinned robust growth in machine-building. Over January-September, production in this industry grew by about 25% yoy, further accelerating from 24% yoy registered in the first eight months of the year. The growth in machine-building was driven by 33.1% yoy, 22.5% yoy and 15.6% yoy increases in production of transport vehicles, electric machines and machinery respectively. At the same time, growth in metallurgy (10.5% yoy in January-September vs. 11.3% yoy in January-August) may be explained by descending world steel prices on the European markets since May 2007. The latter accounts for about 30% of Ukrainian export of metallurgical products. The growth in the chemical industry decelerated to 4.3% yoy in January-September, from 5.4% yoy in January-August. The slowdown may be a result of declining international prices on fertilizers during March-August and ammonia during March-July. At the same time, the rebound of world steel and chemical prices in August-September will help to maintain high growth in these industries and is expected to be reflected in industries’ statistics in the coming months. So far, due to the slowdown in metallurgy and chemicals, which together account for about 1/3 of total industrial production, industrial output growth slightly decelerated to 10.7% yoy in January-September from 11.2% yoy in January-July.

During January-September, vigorous domestic demand and strong exports supported impressive 17.1% yoy growth in wholesale and retail trade, up from 16.7% yoy in January-August. Value added growth in the construction sector accelerated to 11.6% yoy in the first nine months of 2007, up from 10.9% yoy in January-August. Successful economic performance in January-September 2007 despite a higher price on imported energy (the price on imported natural gas almost twice as high as in 2005, plus skyrocketing international prices on crude oil) and political instability support a positive outlook for the Ukrainian economy for the rest of the year.
of 2007 and 2008. The nine month evolution of the main macroeconomic indicators supports the government forecast of 6.5% yoy GDP growth for 2007. At the same time, despite a high statistical base due to impressive economic growth in 4Q 2006 (9.5% yoy vs. 6.1% yoy over the first nine months of 2006), we believe real GDP growth may reach 7.0% yoy. In 2008, the government expects GDP to grow by 7.2% yoy as assuming moderate increase in imported gas prices and benign external conditions for Ukraine's main export commodities. However, considering the expected world economic slowdown in 2008, less favorable conditions for Ukraine's external private borrowing (due to the recent turmoil on international financial markets related to the US sub-prime mortgage crisis) and exports (international steel prices are expected to stabilize or moderately decline in 2008), 6%-6.5% yoy real GDP growth looks more realistic.

Fiscal Policy

According to the Ministry of Finance, the consolidated budget posted a surplus of almost UAH 5.8 billion (about $1.15 billion) in the first nine months of the year, which is equivalent to 1.2% of period GDP. Successful budget performance was achieved thanks to faster-than-expected nominal GDP growth and under-execution of expenditures. In nominal terms, consolidated budget revenues grew by 27.2% yoy to UAH 151.7 billion ($30 billion) over January-September with most tax collections above the targeted amount.

Collections from the personal income tax (PIT), the main source of local budget revenues, continued to grow at an accelerating pace. For January-September, PIT proceeds were 49.4% higher than in the respective period last year. High growth of PIT receipts is explained by the increase in the PIT rate from the previous 13% to 15% since the beginning of 2007 and a loose income policy, as a result of which nominal household income grew by about 28.5% yoy over January-September. Thanks to rapid growth in domestic household income grew by about 28.5% yoy over January-September. Thanks to rapid growth in domestic household income grew by about 28.5% yoy over January-September.

Consolidated budget spending grew at a much slower pace than revenues. Over January-September, expenditures grew by a nominal 24.7% yoy to UAH 145.5 billion ($28.8 billion). Though budget execution improved in September, cumulative spending from the general fund of the state budget was 5% below plan. The consolidated budget surplus was achieved primarily on account of local budgets, while the state budget reported a deficit of 0.6% of January-September's GDP. The rather cautious execution of the budget may be primarily attributed to poor privatization performance, which put targeted deficit financing at risk. As of the end of September, privatization receipts accounted for just 16% of the planned amount for 2007 (UAH 10.7 billion, $2.1 billion). Due to parliamentary elections and the process of formation of the new government, the privatization of telecommunication monopoly Ukrtelekom and chemical Odessa port plant were delayed, most likely until next year. As for debt financing, the government continues its fiscal discipline as a number of large state monopolies were allowed to pay their tax obligations in installments.

Consolidated Budget Revenues, January-September 2007

<table>
<thead>
<tr>
<th>Tax Revenues</th>
<th>UAH billion</th>
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<tbody>
<tr>
<td>PIT</td>
<td>24.3</td>
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<tr>
<td>EPT</td>
<td>20.3</td>
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<tr>
<td>VAT</td>
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<tr>
<td>Excises and Duties</td>
<td>14.3</td>
</tr>
<tr>
<td>Other Revenues</td>
<td>41.0</td>
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Monetary Policy

In September, consumer price inflation continued to accelerate. A monthly surge of 2.2% (mom) brought annual inflation to 14.4%. Acceleration of consumer inflation this year is attributed to both demand and supply-side factors. On the supply side, poor agricultural performance drove food prices up by 15.4% yoy in September. An 8.7% ytd increase in service tariffs may be explained by continuing pass through of higher energy prices to consumers and cost revisions in healthcare and education. In addition, faster consumer price growth reflects the spillover of producer prices into the retail market. In September, producer prices increased by 19.7% yoy, driven by high international prices on steel products and energy, as well as the growing labor cost and purchasing prices on agricultural products. On the demand side, inflation is boosted by robust growth of real household disposable income and the continuing credit boom. On the back of strong inflationary pressures, consumer prices are now expected to grow by about 14% in 2007.

Consolidated Budget Balance, % of period GDP

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Acceleration of money supply growth has also contributed to mounting inflationary pressure. The growth of monetary aggregates was driven by sizable central bank interventions and continuing rapid expansion of domestic credits. Due to strong export performance and private sector borrowing from abroad, net foreign exchange purchases by the NBU on the interbank market amounted to $2.4 billion over August-September. Though the forex purchases were almost fully sterilized by the NBU through issue of deposit certificates, the growth of the monetary base and the money supply continued to accelerate, reaching 50.6% yoy and 48.3% yoy in September. This occurred due to continuing rapid expansion of bank loans. Although credit growth slightly slowed in September, it still constituted an impressive 75.1% yoy. With the exception of 2004, the average growth of commercial bank loans to the private sector grew on average by 65% per annum over 2002-2007. To a large extent, such rapid credit expansion became possible thanks to commercial banks active borrowing from abroad. For 2.5 years, the banking sector’s external debt grew eight times and reached $21.2 billion at the end of June 2007. Access to cheap financial resources abroad allowed commercial banks to provide foreign currency loans cheaper than domestic currency loans. This formed strong demand for foreign currency-denominated loans, with the growth of the latter considerably outpacing the growth of foreign currency loans. This formed strong expectations that the hryvnia will be allowed to strengthen in the near future. However, the prospects of hryvnia appreciation are still unclear. The most probable explanation of the NBU’s reluctance to liberalize its exchange rate policy is that greater exchange rate flexibility in the short run will cause hryvnia appreciation with respect to the US dollar. This will contribute to the deterioration of Ukraine’s foreign trade balance. A further widening CA deficit will form downward pressure on the exchange rate. Considering also the possibly less benign external environment in the coming years given still underdeveloped financial markets, the shift to inflation targeting is likely to be carried out rather gradually. We believe that the hryvnia exchange rate will be maintained stable at the current 5.05 UAH/$ rate until the end of the year. The hryvnia may be allowed to moderately appreciate in 2008; however, the trend is likely to reverse in late 2008-2009.

International Trade and Capital

Over January-August, Ukraine’s export of goods grew by 30% yoy, primarily on account of exports of metals (32% yoy increase), chemicals (17.7% yoy) and machinery and transport vehicles (58% yoy). Except for machine-building and transport vehicles, exports of other goods continued to decelerate. Deceleration of all other commodity groups during April-August may be the result of a lagged response to declining international prices on fertilizers during March-mid August. Export of agricultural products somewhat accelerated in July, driven by globally soaring prices on agricultural products. At the same time, due to the introduction of new quotas on export of cereals harvested in 2006 and 2007 and a high base effect, cereal exports fell almost 15% yoy over January-August, explaining the deceleration of agricultural exports to 37.1% yoy. On the upside, strong investment demand in neighbouring countries, particularly Russia, stimulated export of machinery and transport.

At the same time, strong consumption and investment activity triggered 33.8% yoy growth in CFP imports over January-August, driven principally by energy and equipment imports. In particular, import of mineral products grew by 29.3% yoy over the period. A deceleration from 31.4% yoy growth in January-July may be attributed to slower natural gas imports, which decelerated from 54.6% yoy in 1H 2007 to 37.4% yoy in January-August. Faster fill-up of Ukrainian gas storages in the previous months may explain the gas imports deceleration during July-August. Strong investment demand and growing household disposable income on the back of the continuing credit boom supported 34.4% yoy and 54.4% yoy growth in imports of machinery and transport equipment respectively. As the growth of imports considerably outpaced exports, the FOB/CIF merchandise trade deficit continued to widen, approaching $6 billion.
mation toward an open and democratic society. As in the previous parliament, five political parties and blocs passed the 3% threshold to the Verkhovna Rada. In addition, four out of these 5 parties were also present in the previous Parliament.

Since no single political party obtained a majority of votes, the new government will be formed by a majority coalition. Shortly after the preliminary election results were announced, the two former allies of the "Orange Revolution" — Yulia Tymoshenko and Our Ukraine-People's Self Defense — announced that they will have enough seats to form a majority coalition and a new government. They signed a coalition agreement on October 17th. However, together these blocs obtain a rather thin majority of 228 votes. In addition, the blocs have different positions on a number of issues such as the timing for lifting the moratorium on the sale of agricultural land, the conversion of mandatory military service to a professional service, compensation for past lost banking savings of the population, the implementation of an imperative mandate for members of Parliament, and the composition of the Cabinet of Ministers. Hence, whether this coalition will actually be formed depends on the bloc representatives' ability to make compromises. In addition, the president required adoption of key legislation such as the Law of the Cabinet of Ministers before nominating the prime minister. At the same time, we believe that regardless of the coalition that is formed, the current balance of political forces in the Parliament will ensure greater transparency, checks-and-balances and accountability in the future. Moreover, as the economic programs of the three leading parties were very similar, the new government is likely to focus on macroeconomic stability, deregulation and liberalization of the economy, tax reform, completion of WTO accession, and deeper relationships with the EU, including agreement on an enhanced Free Trade Agreement.