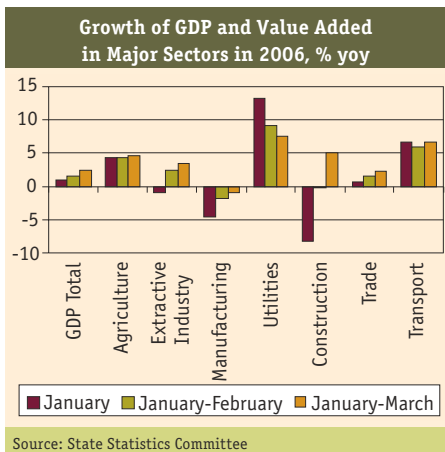


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Summary

- The Ukrainian economy continued to revive; over the first quarter of 2006, real GDP grew by an encouraging 2.4% yoy.
- Over January-March, the consolidated fiscal balance posted a surplus of 0.4% of GDP; however, considerable recurrent social expenditures on the back of decelerating budget revenues raise concerns.
- Since the government suspended the issuance of new debt instruments in autumn last year, the stock of Ukraine's total public debt continues to decline.
- In March, consumer inflation decelerated to 8.6% yoy; however, this is a temporary phenomenon, as the government has already approved price increases on gas and electricity and is considering further increases in order to bring service tariffs to cost-covering levels.
- The National Bank of Ukraine (NBU) continued the policy of de-facto pegging the hryvnia exchange rate to the US dollar. Since the beginning of the year, the NBU's gross international reserves declined by 11% to \$17.3 billion, but were comfortably above the three-months of imports threshold.
- The merchandise trade balance continued to worsen, registering a \$1 billion deficit over January-February 2006; however, some positive developments were observed in the commodity structure of Ukraine's foreign trade flows.

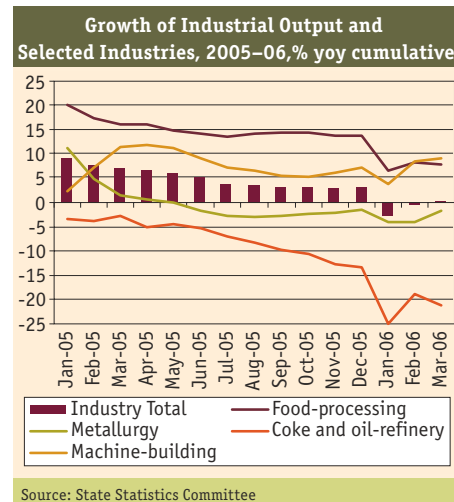
Economic Growth



In March, economic activity in the country continued to revive. Real GDP grew by 2.4% yoy during January-March, significantly accelerating to 4% yoy in March compared to 2.2% yoy in February. Unlike in previous years, the largest contributors to economic growth were services. In particular, value added in transport accelerated to 6.7% yoy over the period, up from 5.9% yoy over January-February. Growth of value added in distribution of electricity, gas, and water (utilities) decelerated to 7.4% yoy (down from 9% yoy in January-February), but remained the second largest contributor to GDP growth. Domestic trade continued to recover this year; value added in the sector accelerated to 2.2% yoy over the first quarter, up from 1.6% yoy over January-February.

January-March data signaled the revival of construction and the extractive industry. For the first time since the beginning of 2005, value added in construction increased by 5% yoy, a significant improvement from -0.2% yoy in January-February. The acceleration occurred primarily on account of higher growth in residential construction and infrastructure works, with the latter enhanced by improved budget financing. Following the price hike for imported gas, the increasing demand for domestic energy resources contributed to the acceleration of value added growth in the extractive industry (up by 3.4% yoy over January-March, compared to a 2.5% yoy increase in the previous period).

Positive developments were also observed in manufacturing, which reported a 0.8% reduction in value added over January-March, a notable improvement compared to the first months of the year (-1.8% yoy in January-February). The improvement in industrial performance was primarily driven by food-processing and machine-building. Food-processing demonstrated a solid 7.7% yoy increase in output over January-March, encouraged by 24.1% yoy real income growth of households. Production expansion in machine-building accelerated to 9.1% yoy, up from 8.6% yoy over the first two months of the year, which may reflect the recovering external demand for Ukraine's machinery and increasing investment demand in the country stemming from the need for technical renovation of existing production capacities.

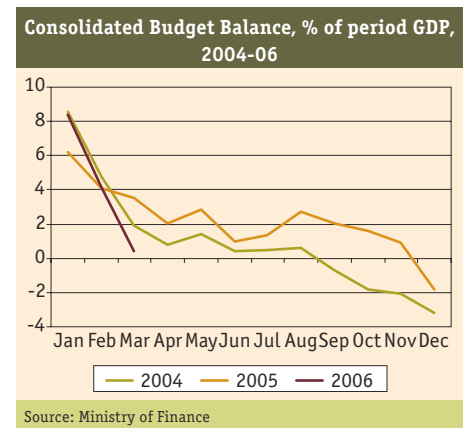


Ukrainian metallurgy, which is energy intensive and vulnerable to changes in external demand, showed signs of recovery after an increase in gas prices, a fall of world steel prices and a shortage of gas supplies in the winter months. In March, metallurgical output increased by an encouraging 2.7% yoy, but fell by 1.7% yoy in the three months to date. Metallurgical production may continue to rebound in the coming months as world steel prices have been on an upward trend since mid-February. On the downside, coke and oil-refining production fell by 21.3% yoy over January-March, a reflection of lower demand on the side of metallurgical enterprises and the reduction of import tariffs on oil products introduced in 2005.

Despite recent improvements, GDP and industrial output are forecasted to show moderate growth in 2006 — 2.8% yoy and 3% yoy respectively, according to the recent forecast by the Ministry of Economy. The forecast looks quite realistic as real sector performance this year will be negatively affected by higher prices on energy resources, sluggish investment activity in the first half of the year due to political uncertainty (related to parliamentary elections and a formation of a coalition government), and worsening of external conditions for Ukrainian exports. On the upside, the driving force of economic growth in 2006 will be domestic consumption stimulated by further increase in household real income.

Fiscal Policy

According to preliminary data, the consolidated budget posted a small surplus of UAH 380 million (\$75 million) in January-March, which is equivalent to about 0.4% of period GDP. The consolidated budget usually runs a surplus at the beginning of the year due to under-execution of expenditures, turning to a deficit closer to the end of the year. This year, however, the trend is much steeper, suggesting that the consolidated budget balance may reverse into a deficit in the coming months. Actually, for the first quarter 2006, the state budget has already reported a deficit of UAH 1.6 billion (or 1.7% of period GDP) while it was in surplus of UAH 2.1 billion (about 2.5% of period GDP) in the corresponding period last year.



Consolidated budget revenues increased by a nominal 29% yoy to UAH 32.9 billion (\$6.52 billion) at the end of March; however, their rate of increase was slightly lower than expected considering the low base effect (amendments to the 2005 budget, eliminating a number of tax privileges and exemptions as well as free economic zones, became effective in April 2005). According to State Treasury information, revenues of the general fund of the state budget were just 2.7% above the target for the period. Tax receipts, accounting for about 70% of total state budget expenditures, were fully in line with target, while non-tax revenues were over-executed by 15.3%. At the same time, data suggests some deterioration of fiscal discipline. In particular, revenues from enterprise profit tax (EPT) were under-fulfilled by 21.6%, which may

Macroeconomic Situation

be attributed to sluggish economic growth, reduction of enterprise profitability in the industrial sector and increasing tax evasion. However, the shortfall in EPT collections was compensated for by 17.1% over-execution of value added tax (VAT) receipts. High growth of VAT proceeds is primarily attributed to booming imports, stimulated by robust domestic demand. In addition, fiscal authorities reported a decline in VAT refund arrears by about 4% in the first quarter to UAH 616.3 million (\$122 million).

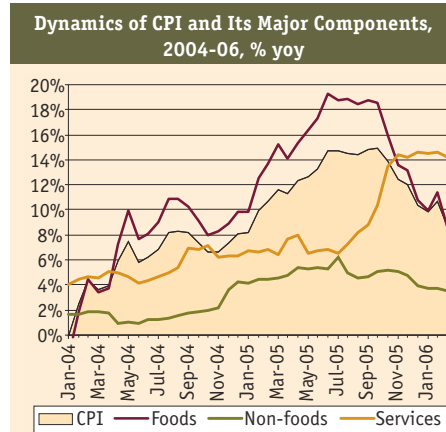
Over the period, consolidated budget expenditures grew by about 45% yoy to UAH 32.6 billion (\$6.45 billion), significantly up from 36% yoy a month before. At the same time, the acceleration occurred on the back of under-execution of expenditures (typical for the beginning of the year.) According to State Treasury information, expenditures of the general fund of the state budget were under-fulfilled by 8.7% over January-March 2006 compared to 7% in the respective period last year. The acceleration may be explained by considerable social liabilities and a low base effect as a number of recurrent social payment increases came into effect in April last year.

As the Ministry of Finance did not issue new debt instruments on both domestic and external markets in the first quarter of this year, the stock of public debt (guaranteed and non-guaranteed) declined by 3.6% year-to-date (ytd) to \$14.9 billion at the end of March, which translates into 15.8% of forecasted full-year GDP. External debt declined by 4.4% ytd to \$11.2 billion (or 11.2% of forecasted 2006 GDP) as the government met the interest and principal payments on Eurobonds due in March. Domestic debt diminished by 1.3% ytd to \$3.6 billion due to repayment of domestic bonds (auctions of domestic securities were suspended in mid-2005). According to the 2006 state budget law, the government plans rather low new borrowings (about \$61 million and \$230 million on domestic and external markets respectively), while the forecasted full-year budget deficit of 2.5% of GDP will be primarily financed by "Kryvorizhstal" privatization receipts accumulated on the treasury account. At the same time, considering faster than expected shrinkage of the consolidated budget surplus and the sluggish privatization process (the proceeds from privatization amounted to UAH 53.1 million as of the end of March, or 2.5% of the targeted amount for 2006), the government may have to resort to larger borrowings. In any case, the budget is likely to be amended shortly after the new government is formed.

Monetary Policy

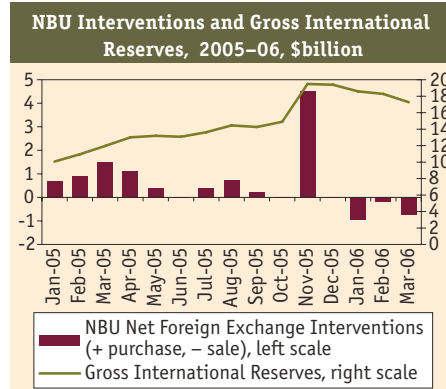
In March, the consumer price index (CPI) decelerated to 8.6% yoy, down from 10.7% yoy a month before. The price growth slowdown was the result of money supply growth deceleration, government measures to stabilize the situation on particular markets (sugar and gasoline), and deceleration of service tariffs, albeit temporary. By components, the driving force of the consumer price deceleration was the descending

prices on food products, which account for more than 60% in the consumer basket.



Source: State Statistics Committee

The food price index decelerated to 8.5% yoy, considerably down from 11.4% yoy in February, primarily thanks to lower price growth on sugar, meat and milk. A surge in sugar prices by 25% month-over-month (mom) in February was caused by an increase in sugar prices in Russia (which, in turn, were affected by soaring world prices for white and raw sugar), which stimulated Ukraine's sugar exports to Russia. However, due to licensing of sugar exports introduced by Ukrainian authorities in February, sugar prices started to decelerate in March, advancing by a moderate 0.7% mom. Meat and milk prices continued to decelerate to 2.7% yoy and 11.6% yoy (down from 9% yoy and 14.2% yoy respectively), which is explained by domestic market saturation after Russia introduced bans on these products at the beginning of the year.



Source: National Bank of Ukraine

Non-food prices continued their moderate descending trend posting a 3.6% yoy increase, down from 3.8% yoy in February. Despite soaring world crude oil prices, non-food price developments are unlikely to change considerably in the coming months due to a high base effect, the low share of this group in the non-food consumer basket (about 4.5%), and an agreement between the government and oil-traders to keep from abrupt increases in gasoline prices during the

spring sowing campaign. Services tariffs decelerated slightly to 14.2% yoy in March (down from 14.6% in February), but the trend will reverse in the coming months as the government declared intentions to bring service tariffs to cost-covering levels in two years. Gas and electricity prices, for instance, were kept unchanged since 1999, at a level considerably below the cost-covering level. The first wave of administered price increases will occur in May as the government has already approved a 25% increase in gas and electricity prices starting May 1st.

In March, the growth of the monetary base and money supply continued to decelerate as a result of considerable sale interventions by the NBU and slowing growth of deposits to the banking system. In particular, the growth of the monetary base declined sharply to 25.2% yoy, down from 36.4% yoy in February, while money supply growth decelerated more moderately to 49.2% yoy compared to 52.1% yoy a month before. The developments of monetary aggregates were primarily driven by NBU measures to balance the foreign exchange market. During March, the NBU sold \$724.4 million to keep the hryvnia exchange rate stable at 5.05 UAH/\$. As a result, NBU gross international reserves declined to \$17.3 billion, or 11% since the beginning of the year. At the same time, the import coverage constituted 4.1 months of future imports at the end of March, notably above the three-month benchmark.

Commercial bank deposits continued to decelerate, advancing by 40.8% yoy (down from 50.3% yoy in February), reflecting the effect of an increasing statistical base, declining deposit rates (which are below the annual inflation rate) and political uncertainty related to parliamentary elections. Despite deceleration, the growth of deposits, together with March's easing of monetary policy, was high enough to support commercial banks' lending activities. Slight deceleration of the growth of bank loans to the real sector to 65% yoy from 66.1% yoy a month before is attributable to a high statistical base (in the corresponding period last year, commercial banks resumed their lending programs with the end of political instability).

According to NBU data, there is evidence of a growing financing gap in the banking system (the difference between the banks' loans disbursed to the real economy and attracted deposits), which may signify liquidity difficulties in the future. Already in March, the interest rate on interbank credits, the closest indicator of banks' liquidity and monetary stance, started to rise and reached 4.9% per annum by the end of the month (up from 2.8% per annum at the beginning of the month). This happened despite the relaxation of monetary policy in March through the NBU's fine-tuning instruments (since the beginning of the month, the daily requirement for the amount of commercial bank funds to be kept on the correspondent account with the NBU was reduced from 90% to 70% of the previous month's obligatory reserves). Thus, the NBU may

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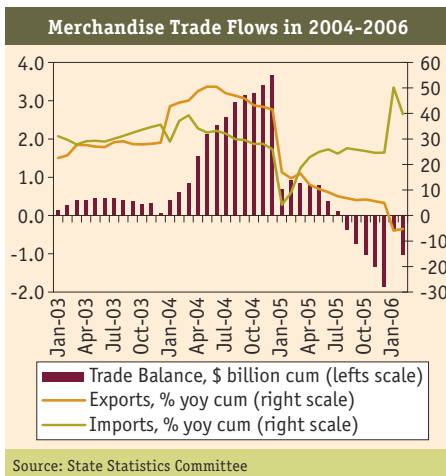
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take additional measures to support commercial banks liquidity in the coming months.

International Trade and Capital

Over January-February, Ukraine's merchandise foreign trade performance continued to deteriorate on the back of declining exports and booming imports. In particular, goods exports declined by a cumulative 5.4% yoy over the period, while imports surged by an impressive 39.6% yoy. As a result, the two-month merchandise trade balance registered a deficit above \$1 billion.



Exports was negatively affected by a weak industrial sector, declining world steel prices, and bans on Ukraine's meat and milk products exports introduced by the Russian Federation at the beginning of the year. Export of metallurgical products, the largest

item group in goods exports (42%), declined by 9.6% yoy due to weakening external demand and higher production costs (mostly energy). On the positive side, recovering external demand for Ukraine's machinery and transportation vehicles stimulated export of these commodities, which grew by 10.4% yoy and 22.5% yoy respectively over the period.

The high growth rates of commodity imports were primarily driven by more expensive energy resources, which account for more than one-third of total merchandise imports, continuous expansion of domestic demand supported by growing population income and extensive commercial bank lending activities. Import of energy materials soared by 42.2% yoy over the first two months of 2006, which may be explained by a 41.5% price hike on imported natural gas at the beginning of the year, larger volumes of imported gas due to very cold weather, and Russia's increase of export duty on crude oil in December 2005. On a positive note, imports of investment goods have been posting a further increase in 2006. In particular, imports of machinery and transportation equipment grew by 35.6% yoy and 100% yoy respectively in January-February 2006 (up from 33.8% yoy and 29.1% yoy in 2005).

Tensions in the trade relations with Russia and higher prices for imported energy resources drove the changes in the geographical structure of Ukraine's merchandise foreign trade. In particular, Russia's share in exports has been declining since the beginning of the year, constituting 20% at the end of February (compared to 22% in 2005). The CIS countries' share in total merchandise imports increased from about 47% in 2005 to more than 50% at the end of February 2006, while the share of goods imported from Russia slightly declined to about 34% from 35.5% in

2005. This development may reflect the substitution of Russia's more expensive fossil fuels with those from other CIS countries (in particular Turkmenistan).

Other Developments and Reforms Affecting the Investment Climate

Ukraine continues to make progress in improving its legal environment and bringing legislation to western standards. At the end of March, the president signed the law "On Securities and Stock Market" adopted by the parliament at the end of February. The law improves regulation of professional activity on the stock market, sets uniform requirements for organization of trading and disclosure of information, describes procedures for IPO and private placement of securities, tackles problems with insider trading and transferring the right of ownership for securities. The law will encourage stock market transactions, thus stimulating the development of Ukraine's financial sector.

At the end of March, Ukraine completed WTO negotiations with Panama. It became the 43rd country with which Ukraine signed the bilateral agreement on joint access to the market of goods and services. Ukrainian authorities declared that Ukraine can still become a member of WTO in summer-autumn 2006. However, Ukraine still has to adopt a number of politically sensitive laws and complete negotiations with the remaining countries, the toughest of which are expected to be with Australia. Due to the pause in the legislative process (as a result of parliamentary elections) and the prolonged process of formation of a government coalition, the more realistic date of Ukraine's entry to WTO looks like the end of 2006.

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