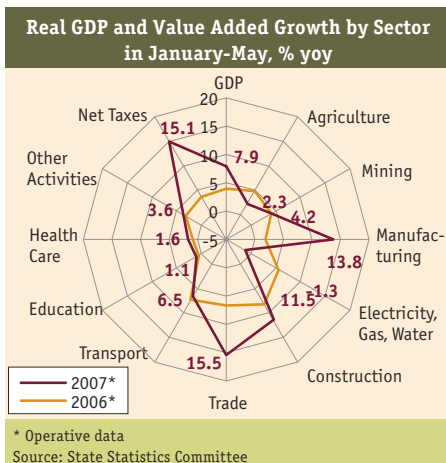


Olga Pogarska, Edilberto L. Segura

Summary

- The Ukrainian economy has continued to show robust growth, demonstrating a solid immunity to political instability.
- For January-May, real GDP grew by 7.9% yoy. Due to the droughty weather, the grain harvest is expected to be notably lower than previously expected. However, poor agricultural performance is unlikely to have a substantial effect on total GDP growth in 2007.
- For the first five months of the year, the state budget ran an unusually high surplus for this period due to higher than expected budget revenues and under-execution of budget expenditures.
- Despite a high fiscal surplus so far, the government resumed issuance of external and domestic debt in June to secure enough funds for the planned budget deficit.
- The consumer price index keeps reporting double-digit growth; however, the government forecast of 7.5% year-end inflation may still be realistic.
- Ukraine continued to demonstrate very strong export performance this year; however, buoyant import growth resulted in further widening of the merchandise trade deficit. A modest service trade surplus and a larger deficit in the income account caused the current account deficit to widen by almost 70% yoy in 1Q 2007.
- Robust capital inflow covered not only the CA gap, but also helped replenish the gross international reserves of the National Bank of Ukraine.
- In mid-June, the EU and Ukraine officially started negotiations on a new enhanced agreement.

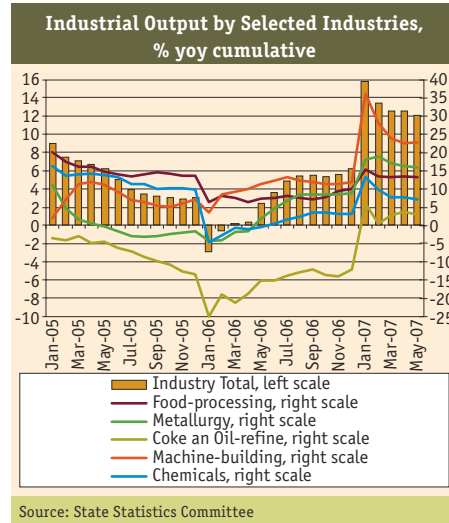
Economic Growth



The Ukrainian economy grew by a real 7.7% yoy in May, up from 7.6% yoy a month before. Notably, the acceleration of economic growth was achieved on a rapidly waning low statistical base effect (in May 2006, economic growth accelerated to real 8.5% yoy, up from about 2.7% yoy over the first four months of the year) and a tense political environment. As a result, cumulative real GDP growth remained unchanged from January-April's level of 7.9% yoy. Economic growth was primarily led by double-digit growth in manufacturing, wholesale and retail trade, construction and net taxes.

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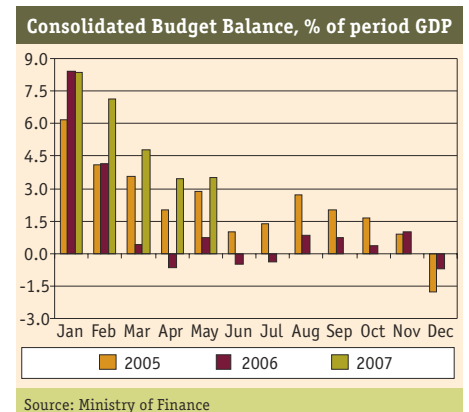
According to preliminary data of the State Statistics Committee of Ukraine, value added in manufacturing (accounting for about 18% of total GDP) grew by 13.8% yoy over the five months of the year, slightly down from 14.2% yoy over January-April. Despite slowing output growth in almost all industries, which is mainly attributed to an increased statistical base, the growth of industrial production remained high and broad-based. The major contributors to the 12.1% yoy growth in industrial production were increases in machine-building, metallurgy, food processing and chemicals. Unlike other industries, the cumulative growth in machine-building accelerated to about 23% yoy, driven by a substantial increase in production of transport equipment. The latter, responding to buoyant domestic and external demand, advanced 36.7% yoy in May, bringing cumulative growth to 29.3% yoy. Supported by rising world prices for steel as well as by strong domestic demand from dynamically growing machine-building and construction, metallurgy posted 15.8% yoy growth over January-May. Increasing real household disposable income (up 10.5% yoy over January-April) and a favorable external environment triggered 13.3% yoy increase in food processing. However, droughty weather during May-June and growing food imports may exert downward pressure on further growth in the industry. High international prices on chemicals, which helped to compensate for the higher energy prices, prompted 7.1% yoy growth in the energy-intensive chemical industry. The improving performance of the utility generating sector (up by 6.6% yoy in May, compared to 5.3% yoy in April and a 4.1% yoy decline over the first quarter) also made a weighty contribution to the overall industrial output figure. Growing international prices on iron ores triggered a 12.8% yoy increase in the extraction of non-energy materials, which helped compensate for the weaker demand for domestic coal. As a result, output growth in the mining sector decelerated to 4.4% yoy in January-May.



Buoyant economic activity, growing household income and active commercial bank lending operations formed strong demand for new construction facilities (construction of both residential and commercial real estate, particularly retail, industrial and office spaces). At the same time, value added growth in construction continued to decelerate, reporting 11.5% yoy over January-May, down from 13.1% yoy over January-April. The deceleration may be attributed to the completion of several infrastructure projects (mainly gas and oil pipelines, power supply and communication circuits). Robust growth in industry and construction and the population's growing propensity to consume prompted acceleration in value added growth to 15.5% yoy and 6.5% yoy in the wholesale and domestic trade and transport sectors, respectively. Solid consumption growth, which stimulated both domestic production and imports, was reflected in the 15.1% yoy increase in net taxes on produce. Holding about 13% of total GDP, it notably contributed to real GDP growth over the period.

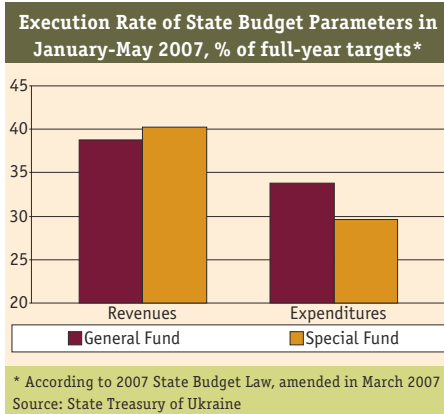
Despite the encouraging real sector performance, economic growth is expected to slow down through the rest of the year. This will partially occur due to the growing statistical base, which became fully apparent in the fourth quarter of the year. Deteriorating agricultural performance is among the main causes of the potential economic growth slowdown in the coming months. Over January-May, value added growth in agriculture slowed to a modest 2.3% yoy, down from about 5% yoy growth in the first quarter 2007 and during the respective period last year. According to recent estimates of the Ministry of Agriculture, 27-28 million tons of grain are expected to be harvested, about 20% lower than in 2006. On a positive note, the share of agriculture in total GDP has been declining in recent years (from 13.5% in 2002 to less than 8% in 2006). In addition, a smaller than expected grain crop may be compensated for by the usually good harvest of vegetables. Hence, poor agricultural performance is unlikely to have a substantial effect on total GDP growth, expected at 6.5% yoy in 2007.

Fiscal Policy



For the first five months of the year, the state budget surplus amounted to UAH 3.67 billion (\$727 million),

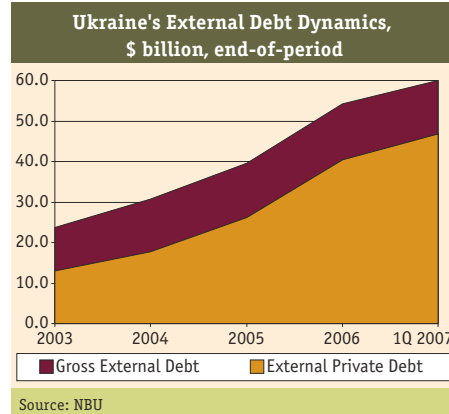
which is equivalent to 3.5% of period GDP. High rates of economic growth helped the government to secure enough budget revenues. Over the period, state budget revenues reached UAH 46.85 billion (\$9.3 billion), 31.1% higher than in the respective period last year, which fully corresponds to nominal GDP growth (about 40% yoy over January-May, according to operative data of the State Statistics Committee). According to State Treasury information, state budget revenues were 4.8% above the targeted amount. At the same time, May's target was developed based on 2007 State Budget Law as of March 2007, while the budget was amended at the beginning of May increasing the target for state budget revenues in 2007 by 2.5%. The over-fulfillment of tax revenues to the state budget during January-May was primarily achieved on account of corporate profit tax collections, VAT proceeds and rent payments for crude oil extraction and natural gas transportation.



However, an unusually high fiscal surplus for this period was achieved mainly due to the under-execution of expenditures. According to the State Treasury, over the first five months of the year expenditures from the general fund of the state budget were 9.7% below the targeted amount for this period. As the government declared that it met all social liabilities, it is likely that under-execution mostly relates to state budget transfers to local budgets, credits from the state budget, and some infrastructure programs. In addition, execution of expenditures from the special fund of the state budget remains rather poor. Under-execution of state budget expenditures at the beginning of the year then catching up in the last few months of the year is a typical situation in Ukraine. However, this year, the larger magnitude of under-spending may be attributed to little hope for collecting privatization receipts in the targeted UAH 10.6 billion (\$2.1 billion). According to the State Treasury, privatization proceeds came in at UAH 1.19 billion, just 11.2% of the annual target. Hence, to secure enough funds for the planned budget deficit, the government resumed issuance of external and domestic debt.

In particular, on June 18th, Ukraine issued \$0.5 billion Eurobonds maturing in 2012. Though Ukraine planned to attract \$1 billion, the placement can be considered successful as the yield on the newly issued bonds

(6.385%) was 195 bps lower than the yield of 10-year Eurobonds placed in November 2006. In addition, the placement occurred shortly after the political crisis in Ukraine and on the back of growing yields on US-Treasury bonds during that period. Fitch assigned a 'BB-' rating to these securities, which was in line with Ukraine's long-term foreign currency sovereign debt rating. In June, for the first time this year, the government started issuing domestic debt securities. On June 25th, the government placed 1.5-year bonds with a 7.2% yield, receiving UAH 801.2 million (\$158.7 million) to the state budget. Considering the loose liquidity in the banking sector and the large interest in Ukraine's domestic bonds from non-residents, the attracted amount could have been much higher. Since the attracted amount represents only 21% of the targeted UAH 3.8 billion set by the 2007 state budget law, issuance of domestic debt is expected to continue in the coming months.

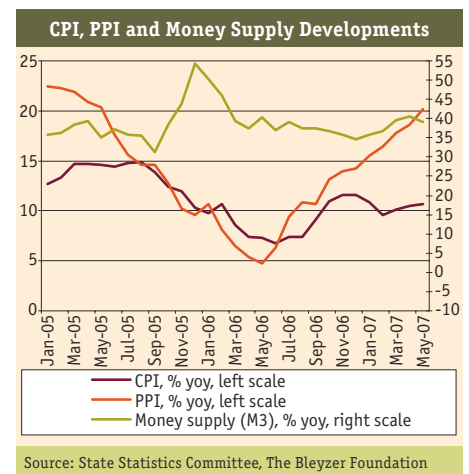


In May, however, the stock of public and public guaranteed debt continued to decline. Since the beginning of the year, domestic debt has fallen by 7.8% to \$3.03 billion, while external debt has diminished by 5.7% to \$11.9 billion. As of the end of May, total public and publicly guaranteed debt fell to 9.3% of forecasted full-year GDP, down from 9.8% at the beginning of the year. Unlike public and publicly guaranteed debt, external private debt continued its rapid expansion. According to NBU data, external private debt grew by 65.6% yoy in 1Q 2007 to \$46.8 billion. As a result, the gross external debt of Ukraine approached \$60 billion.

Monetary Policy

According to the State Statistics Committee, the consumer price index advanced by 0.6% month-over-month (mom) in May. The largest increase in prices was registered in the weightiest group — food products. Food prices rose 1% mom, underpinned by 15.7% mom and 4.6% mom increases in prices for fruits and vegetables. Since monthly changes in prices are not seasonally adjusted, the upsurge in fruit and vegetable prices in May can be attributed to seasonal factors. However, in annual terms, which are relatively neutral to seasonality effects, prices on fruits were 45.4% higher than in May 2006 while vegetables

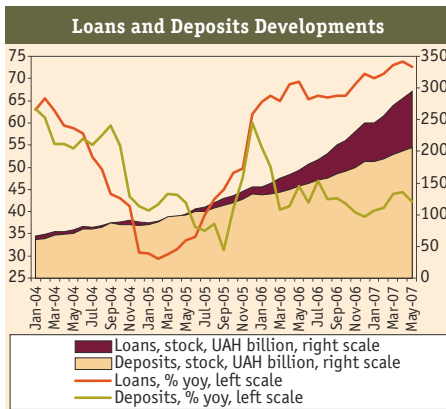
were 16.4% cheaper. An upsurge in fruit prices may be attributed to the robust growth of households' disposable income over the recent year, which triggered a gradual shift in consumer preferences towards more expensive (often imported) products. High international prices on grain and droughty weather in May prompted domestic prices for bread and bakery products to increase. In May, prices on these commodities were 10.5% higher than in the respective month last year. The ban on meat imports on a give-and-take basis, imposed by the government since May 1st, caused an increase in meat and meat product prices. Though in May it was rather moderate (0.2% mom), the effect of the ban is expected to manifest itself in the coming months. In annual terms, the growth of food prices accelerated to 2.8% yoy, up from 1.5% yoy in April.



Service prices, the main contributor to CPI growth in 2006, grew by 0.8% mom in May. Though utility tariffs reported a 0.8% mom decline that month (local authorities continue to revise downwards utility tariffs from the upsurge in the second half of 2006), it was outweighed by 3.3% mom growth in railway transportation tariffs and a 0.9% mom increase in prices for healthcare services. At the same time, due to an increasing statistical base, the service price index decelerated in annual terms (49.5% yoy in May vs. 53.7% yoy in April 2007). An increase in gasoline prices by 8.2% yoy was compensated for by a more moderate growth in prices for home appliances and computer equipment, clothes and footwear. As a result, the non-food price index decelerated to 1.8% yoy, down from 2.5% a month before. Though the consumer price index keeps reporting double-digit growth, the government forecast of 7.5% year-end inflation may be realistic considering the growing statistical base through the end of the year, the postponement of an energy price pass-through to consumers, and administrative price regulation of a number of socially sensitive commodities (e.g., bread).

Accelerating producer price inflation and monetary aggregates growth also contributed to faster growth of consumer prices. In particular, the producer price index sped up to 20.2% yoy in May from 18.2% yoy in

April, affected by high international prices for steel, chemicals, crude oil as well as increasing labor costs. Large-scale NBU interventions on the forex market (\$1.4 billion in May alone and \$2.7 billion since the beginning of the year) led to acceleration of monetary base growth to almost 37% yoy in May, up from 27.7% yoy a month before. Though the growth of money supply slightly decelerated to 39% yoy, down from 40.5% yoy in April, it remained rather high. The deceleration may be attributed to slower deposit growth (42.3% yoy in May vs. 44.3% yoy in April), which caused the money multiplier to decline from 2.84 to 2.74 respectively. At the same time, money supply growth was not a major force driving consumer inflation due to high money demand. Bank credits to the economy of Ukraine, which may be used as one of the indicators of money demand, expanded by 4.1% mom in May, despite a politically turbulent month. Although in annual terms, the growth decelerated to 72.6% yoy in May (down from 73.7% a month before), it was higher than the 69.2% yoy in May of last year; this deceleration may be attributed to a high statistical base effect.

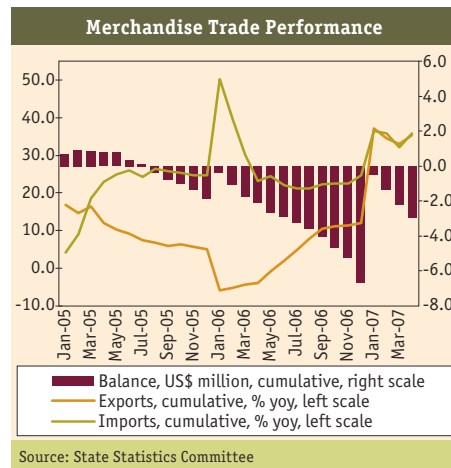


Source: NBU, The Bleyzer Foundation

International Trade and Capital

Ukraine continues to demonstrate very strong export performance this year, which is underpinned by robust world demand for Ukraine's traditional commodities. According to the State Statistics Committee of Ukraine, exports of goods surged by a record high 41.7% yoy in April, bringing year-to-date growth to 35.3% yoy. Exports of metals and chemicals, which together account for more than half of total merchandise exports, grew by 42.4% yoy and 29.4% yoy over January-April respectively, accelerating from 40.9% yoy and 28.8% yoy in the first quarter of 2007. A 53.6% yoy increase in exports of machinery and transport equipment was supported by robust economic growth in Ukraine's main trading partners (particularly Russia, the main outlet for Ukraine's machinery export).

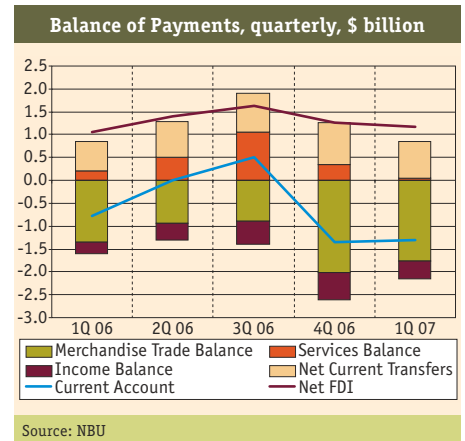
Despite good export performance, imports of goods grew even faster. In April, the growth of imports accelerated to 47% yoy, driven by faster growth for mineral products imports. Over January-April, imports expanded by 35.9% yoy. This commodity group account for about 1/3 of total merchandise imports. High crude oil price and larger volumes of natural gas, gasoline and coal imports drove imports of fossil fuels up by 33.7% yoy in January-April. On a positive note, imports of machinery and transport equipment were also on the rise, indicating strong investment demand in the country. Increasing by 43.5% yoy in the first four months of the year, the share of machine-building products reached 28.3% in total imports. Despite remarkably strong export performance, buoyant growth of imports resulted in further widening of Ukraine's foreign trade deficit. In the first four months of the year, the deficit reached almost \$3 billion, representing a 42% increase over the same period last year.



Source: State Statistics Committee

Driven by merchandise trade balance dynamics, a modest service trade surplus and larger deficit in the income account, the current account deficit widened to \$1.3 billion in the first quarter of 2007, up by almost 70% yoy. According to NBU data, exports of services grew by a moderate 14% yoy due to lower natural gas transit to the EU (lower natural gas consumption was the result of an unusually warm winter this year). The growth of import of services accelerated to 24% yoy in 1Q 2007, driven by strong domestic demand for travel, transport and financial services (up by 30% yoy, 21% yoy and 70% yoy, respectively). As a result, the surplus of foreign trade of services declined 4.4 times to just \$50 million. Higher dividend payments on foreign investments in Ukraine and interest payments on foreign credits drove the income account deficit to \$400 million, up by 60% compared to the first quarter last year. On a positive note, the surplus in the net transfer account (which primarily consists of work remittances) continued to increase, reaching \$790 million in 1Q 2007, up by 27% yoy.

The widening CA deficit, however, is not alarming so far as FDI inflows constituted \$1.2 billion in the first quarter of the year, covering almost 90% of the CA gap. In addition, the record high inflow of foreign capital due to private sector borrowing from abroad allowed replenishing NBU international reserves to \$23 billion, which is enough to cover 4.3 months of future imports of goods and services (as of the end of May, NBU gross international reserves constituted \$24.75 billion).



Source: NBU

Other Developments and Reforms Affecting the Investment Climate

At the end of June, the National Bank of Ukraine tightened regulations on foreign currency transactions by Ukrainian residents in an attempt to decrease the dollarization of the Ukrainian economy. In particular, the NBU shortened the period of holding foreign currency previously bought by residents on the interbank forex market to repay loans denominated in foreign currency to 5 days. In addition, the NBU forbade using foreign-currency denominated household deposits as a mortgage when taking foreign-currency denominated loans.

In mid-June, the EU and Ukraine officially started negotiations on a new enhanced agreement. As a first step towards it, the countries signed agreements on visa facilitation and readmission. The agreements are aimed at easing travel of Ukrainian citizens across the EU countries, at the same time fighting illegal immigration.

In mid-June, Ukraine and the EU signed an agreement envisaging an increase in the EU quota for Ukrainian steel products by 31.4% (from the current 1.005 million tons to 1.32 million tons per year). The quotas are effective until Ukraine joins the WTO. An increase in the quarter will help to further boost Ukraine's exports, as metallurgical products traditionally hold a significant part of Ukraine's merchandise exports.