INVESTMENT CAPITAL UKRAINE
INVESTMENT BANKING

Focus
Ukraine

Scope
Economics

Quarterly Report

Walking a tightrope

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Executive summary

Our macroeconomic view on Ukraine is based on the key ideas regarding the upcoming developments in the economy in 2H11 and 2012-13. They are the following:

- **Global economy.** Past and current imbalances of trade and capital flows between major economies are not finding a resolution of coordinated policymaking to decisively increase aggregate demand in the global economy. As an example, the US economy is being propped up by sizable fiscal and monetary stimuli which have failed to reduce unemployment and caused a side-effect of rapidly rising prices for commodities, especially of crude oil. Larger EM economies and the Euro-zone economy are being cooled down by central banks due to inflation rising above comfortable levels. With slower global demand and US unemployment still high, monetary conditions in the US will still feature an extension of the Fed current policy of historically low interest rates, as well as an additional quantitative easing programme later in 2011 and likely into 1H12. This will bolster commodity prices, which, as we note below, are likely to trend lower as global demand growth slows.

- **Commodities.** Among commodities most vital for Ukraine—crude oil and steel—we expect the price of crude oil to recede after the 1H spike, as demand conditions this trend. However, a geopolitical factor (Lybia, unrest on one of the major oil exporters) may undermine this notion as it would send price for crude oil upward. Steel prices are factored into our macro model as being relatively stable in the forecasting period and broadly equal to the average of past several months – indeed CIS export steel prices (HR coil) reported by Bloomberg rose substantially, repeating the highs of 2008. Importantly, higher energy prices will drive this year's inflation and the policymakers' reaction. Indeed, higher energy prices is encouraging faster shift of the NBU towards targeting inflation and allowing greater flexibility of the USD/UAH exchange rate to range within a likely 7.8-8.0/USD band, i.e. a 2% deviation from the current FX rate.

- **IMF.** Due to the nature of Ukraine's current economic conditions—which feature twin deficits in public finance (elections loom on the horizon) and external balance (high and sticky energy prices)—its dependence on external financing is still a major factor shaping other developments. Ukraine's tendency to have a diversity of financing sources eventually makes the IMF story (i.e. implementation of conditions for the next tranches under the current Stand-By Arrangement with the IMF) as not so dire as perceived at the end of 1Q11, when a number of issues appeared stalled. Privatisations may appear unlocked in time for BoP support. In the face of persistent high crude oil prices that push imports higher, growing risks to the authorities arise from extending a greater subsidy to Naftogaz as inflationary pressure retail market gasoline prices higher, leading to expected tariff hikes that will also put pressure on the CPI.

- **Domestic economy.** Prospects of softer global growth provides little hope for external demand to boost growth in Ukraine in 2H11. External demand acceleration is likely to be very gradual in 2012. We expect the growth rate of real GDP to fall below 5% this year, followed by a gradual acceleration in 2012 to 5.2% YoY primarily because of infrastructure spending for Euro-2012, which will boost fixed-investment as one of the key drivers of GDP growth.

- **Local rates and currency.** Domestic interest rates should rise alongside a tighter stance by the central bank, shifting upwards the short part of the local currency yield curve. The current inflation bout in Ukraine's economy has a short-lived nature as it was caused by external factors like the energy commodity price surge, which is already reversing its trend downwards. Inflationary pressures should subside later this year or in early 2012, primarily because of a moderate rebound of demand from the deep recession in 2008-09. Meanwhile, the USD/UAH exchange rate is poised to be a bit more volatile reaching the weaker edge of the allowed corridor of fluctuations (the 8.2/USD side) quite shortly when these fluctuations become tolerable by NBU. However, eventually the UAH should strengthen in nominal terms back to 8.0/USD and possibly 7.8/USD thanks to the hawkish stance by the NBU on inflation, which ultimately spells higher interest rates that could be attractive to foreign portfolio investors.

Global economy

"What matters are the prospects… Nothing that is now happening suggests [that the global economy] will be managed competently, let alone smoothly."

Martin Wolf, FT chief economics commentator, April 2011

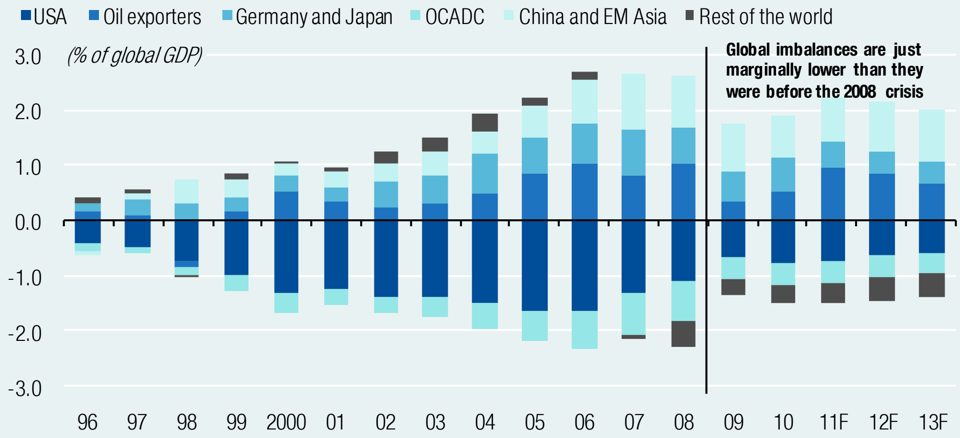
The global economy is slowing into the 2H11. High commodity prices are weighing on monetary policies in most of economies. In this regard, the US economy stands out by being forced to extend its monetary stimulus till the end of 4Q11, and likely into 1H12, as the largest global economy and one of the key victims of the recent economic and financial crises still grapples with its recovery (May brought a weak jobs creation report and forward-looking report on economic activity). The developed economies' twin issues—the debt of the Eurozone's economies and the debt of the US—are likely to weigh on the exchange rate pairing of the US dollar and Euro each time these twin issues replace each other as a key concern for FX markets. Employment and inflation statistics (for the Eurozone, we refer to Germany's economic conditions) provide ground for a further extension of the period of USD weakness versus major global currencies, due, too, to the US' intention to rebalance its economy towards more prominence of its manufacturing sector.

Global imbalances

They are still there

Chart 1. Global imbalances: 1996-2010 actual data and forecast for 2011-12

Current account balances as a percentage of global GDP



Notes: OCADC stands for the group of following countries – Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey, and United Kingdom.

Source: IMF.

Global imbalances between major economies are still sizable…

In its latest semi-annual publication regarding the state of the global economy[2], the IMF acknowledged that global imbalances—the uneven spread of global demand across major economies that subdivide them into two sizable groups of countries with external deficits and surpluses—are not being reduced, and that a required rebalancing of the global economy "is not progressing". Indeed, the IMF's projections for 2011-13 on the global

[2] IMF World Economic Outlook: Tensions from the Two-Speed Recovery: Unemployment, Commodities, and Capital Flows (April 2011).

current account balance (see chart above) show that across the major economies, there is only a marginal reduction in the size of the imbalances, while they remain quite sticky.

…as major economies apply the same policies of preventing themselves…

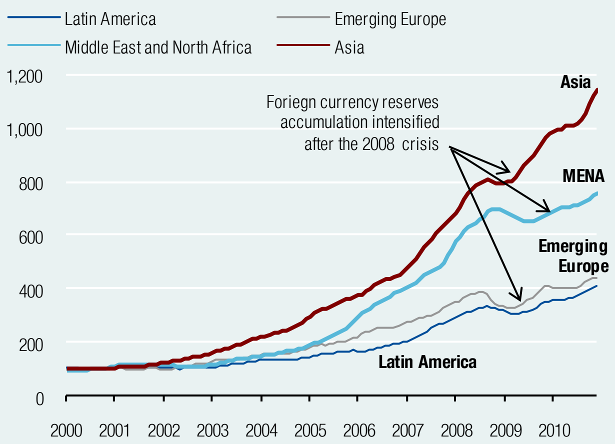
In the words of the IMF, there have indeed been some economic policies realised in the surplus economies that have helped to strengthen domestic demand in these countries (a prerequisite for imbalances smoothing out); however, this shift has had a modest impact on rebalancing, and then there has been "little realignment in emerging-market economies with large surpluses".

…from capital flight and loss of external competitiveness

In this regard, the previous policies preventing external competitiveness via FX market interventions are still prevailing among certain large EM economies. Primarily, this refers to China; as for the other emerging Asia countries, as IMF puts it, they are "reluctant to allow revaluation as long as systemic surplus economies are not moving decisively". This provided a further boost to international reserve accumulation right after the global recession of fall 2008 (see Chart 2). During the last 12-month period as of the end of May 2011, there have been the same names as in the past among top international reserves accumulators, the list topped by China and then followed, as far as EMs are concerned, by Brazil and Russia, which have a more flexible FX rate policy stance by their national central banks, and by a squad of commodities-exporting countries and fast-growing, emerging Asia countries (see Chart 3 below and Table 1 on page 13).

Chart 2. International reserves accumulation by different groups of emerging and developing country regions

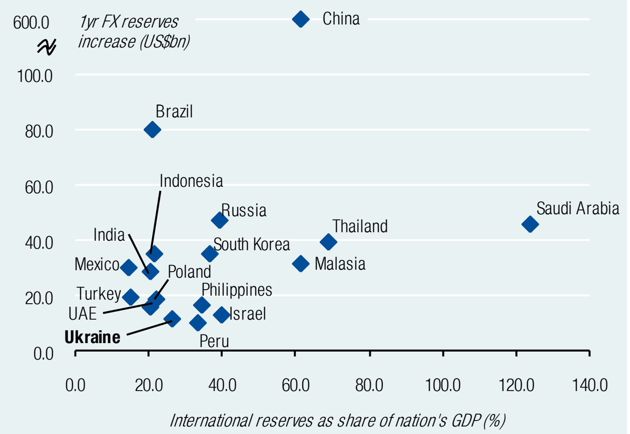
In relative terms. Starts at 100 points as of 1 January 2000



Source: IMF.

Chart 3. Top countries by FX reserves accumulation in the last 12-month period (vertical axis) scattered by FX reserves size

One-year FX reserves increase (US$bn) versus country's share of FX reserves to economy's size (% of GDP)



Note: [1] data on Ukraine is from local sources, while data on other countries is from Bloomberg; [2] this chart was built on the data from Table 1 on page 13.

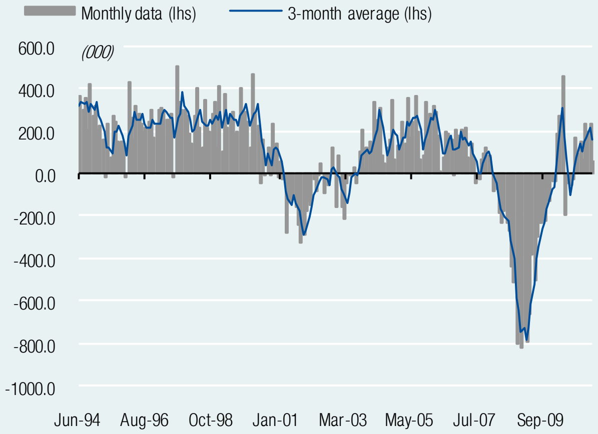
Sources: Bloomberg, National Bank of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Rebalancing of the US economy is painful, as job losses and high unemployment persist

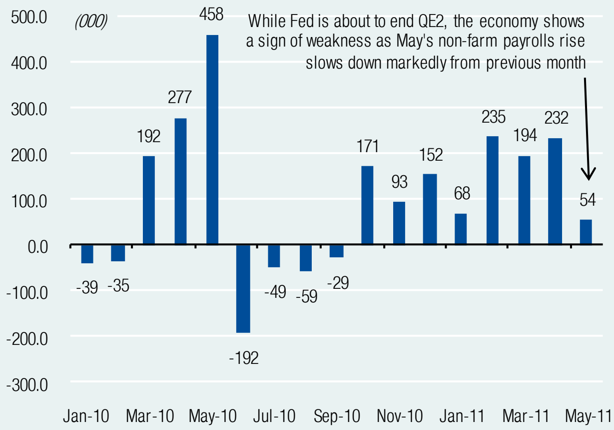
To a sizable extent, this has been a reaction by EM countries' authorities, specifically, by monetary authorities, to a recent wave of monetary stimulus in the developed-market economies. This mainly concerns the US economy, which remains in a lengthy phase of fiscal and monetary easing, while a number of other major developed economies have switched into tightening policies (see Table 2 on page 14). And, it is expected that US policy easing conditions are to stretch well into 2012 after a lengthy period of fiscal and monetary stimulus job creation as the largest global economy faltered in May (see next chart).

Chart 4. US economy struggles to recover from a deep recession of 2007-08: monthly changes in non-farm payrolls

History since June 1994 till May 2011



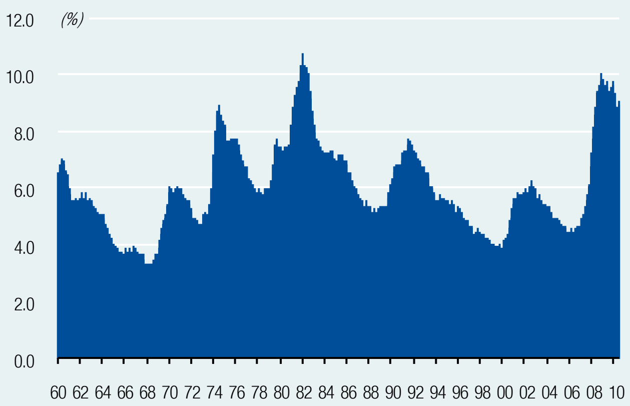
History since January 2010 till May 2011



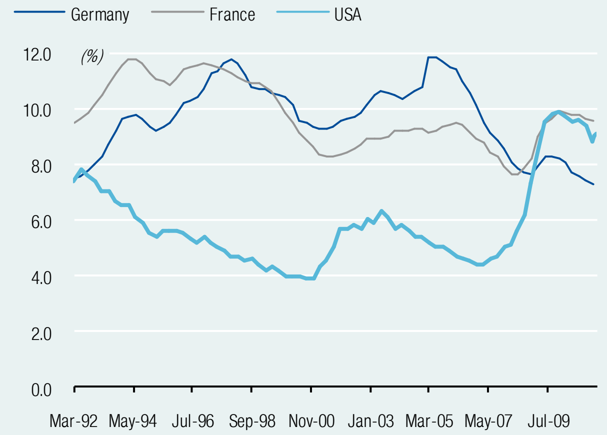
Source: Bloomberg.

Chart 5. Unemployment rates in the leading developed economies – the US versus Germany and France, the two largest economies from Euro-zone

US unemployment rate
Monthly history since January 1960 till May 2011



Unemployment rate in the US versus Germany and France
Quarterly history since 1Q92 till 1Q11



Source: Bloomberg.

Likely future-mid-term adjustment

The global economy is on a bumpy path…

Indeed, the developments of the past year and this one, too, underline the bumpy readjustments of global supply and demand across major global economies of scale, while they have been the main, systemic deficit or surplus economies since the early 2000s.

…trying to level aggregate global demand across developed and emerging economies

On one hand, there is a long-term trend in the Chinese economy (the so-called systemic surplus economy) on refocusing its growth from an export-driven model towards one that is more reliant on household consumption. However, the authorities in China view this shift as a gradual transitory path along which they would like to maintain the status quo in terms of the political system set-up (read: one party rule that keeps the domestic economy in line on a five-year plan, regularly approved by a party congress). In practice, this means a very gradual appreciation of the Chinese currency against the US dollar (see Chart 6).

On the other hand, there is another long-term trend (that accompanies the above-mentioned one, effectively balancing the entire picture), which is a story of the US economy (the so-called systemic deficit economy), the largest and most dynamic globally. This story nowadays features a deep hollow of public finances (the budget deficit has been above

10% of GDP in the past, and is projected for this year too) and sizable political pressure to address the unemployment issue. The latest reading of non-farm payrolls statistics for this May showed that the US unemployment rate rose to 9.1%, up 0.1ppt from 9% a month ago (see Chart 4 and Chart 5 above).

The US economy is set to restore employment via the manufacturing sector…

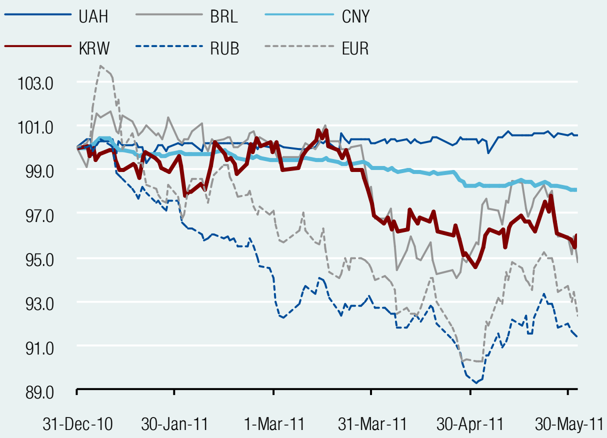
Due to a number of reasons that relate to the institutional set-up of the US economy—such as the democratic system that rotates the country's leadership in a 4-year frequency through presidential elections and elections of lawmakers not synchronized with the presidential elections—there are incentives for the US policymakers as well as pressure on them to carry out decisions decisively and in a manner that outpaces policymaking under other major jurisdictions. However, there is evidence (out of the last economic crisis) that the above-mentioned notion is not always a hard guarantee against failure. Nevertheless, having presidential elections next year and with elections campaigns that have already started, there is expectedly sizable pressure on US authorities to reduce unemployment.

…for this to take place, the US needs external competitiveness gains…

Chart 7 below has two lines depicting the seasonally-adjusted volume of US exports, reflecting the pace of output in the manufacturing sector of the economy, and the trade-weighted index of the US dollar (plotted against an inverted scale). This provides a text-book clue to the link between the US dollar index and US exports: the lower the former, the more impetus for growth is being injected into the US manufacturing sector.

Chart 6. Relative nominal changes in FX rates to US dollar

Rebased at 100 points as of 31 December 2010



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 7. US-dollar index and US exports: history 2001-11

US-dollar index is potted upon inverted scale

Sources: Bloomberg, Investment Capital Ukraine LLC.

…which will come as a result of a combination of factors like US dollar weakness versus major currencies…

President Obama's statement[3] in March 2010 on "doubling US exports and creating two million jobs in five years has strong chances of being realised if the US manufacturing sector further increases its external competitiveness. This, in turn, is dependent on a number of factors, including internal devaluation and/or external appreciation. Hence, it appears that outward-looking rather than inward-looking sectors of the domestic economy will be the prime focus of support from policymakers of the largest global economy.

…and higher inflation outside the US

The latter sectors, such as real estate construction, finance, and financial intermediation aimed at real estate as well as the consumer retail sector were for too long the key engines of US economic growth. Hence, to make the US economy more balanced, the manufacturing sector, which supplies tradable goods abroad, should seek more prominence in the structure of the US economy. Obama's call on exports doubling reflects the genuine need for the US economy to act as a source of its own rebalancing; hence, this

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[3] Obama unveils plans to double US exports -- March 11 2010, Financial Times. Click here to read the article at ft.com.

call, in fact, having a bipartisan consensus among US lawmakers, should survive the next presidential elections as a policy choice for the president in office after 2012.

There are tensions along this path, as another major global economy has allowed only mild appreciation of its currency

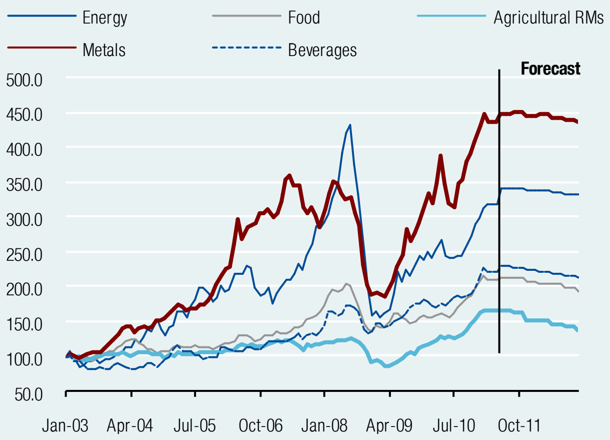
To sum this all up, the resolution of the issue of global imbalances, or rather a smoothing out of the imbalances, is lagging behind the desired and required pace that is needed to make economic growth and international capital flows more evenly matched.. In the case of China, its gradual, allowed appreciation by the country's authorities last summer is the least nominal appreciation that has been observed among the EM economies, particularly among the selected EM economies depicted in Chart 6 above; while on the subject of the Chinese currency, Ukraine's hryvnia (UAH), which has been managed by the local central bank as firmly pegged to the US dollar, has remained largely stable in relative terms of other EM currencies. In effect, by resisting faster appreciation of its currency, China does not compensate for the portion of global demand which was lost due to the crisis in developed economies, primarily the US.

While economic indicators in the US are still pointing to anemic growth…

In turn, the US authorities have been delaying their departure from fiscal and monetary stimulus, injecting liquidity into the financial system with borrowing costs at a historic low level, to revive economic growth, and they are likely to continue muddling this exit until firmer employment data resurfaces after May's soft job creation report (Chart 4 on page 8). These policies do have their side effects, which come home in the form of higher commodities prices (see Chart 8), which in turn provide inflationary pressure in the US and have been pressuring EM markets as well, where high commodities prices, together with past monetary stimulus, have had a multiple effect on inflation and have caused authorities to tighten demand, further curbing global demand. However, this has all served to create a bit of a vicious circle.

Chart 8. IMF commodity price indices

Past performance and forecast



Source: IMF.

Chart 9. Inflation expectations in the US: breakeven inflation rates

Spread between yields of nominal and inflation-linked 2-year and 10-year Treasury bonds

Source: Bloomberg.

…monetary conditions in the US are to be loose for an extended period

Nevertheless, against this background, inflation expectations in the US economy implied by the bond market are not elevated (see Chart 9), and they even receded in the beginning of June. This means that, alongside softer real economy data, US authorities may decouple even further from the rest of the global policymakers, which have refocused on fighting inflation, in their determination to revive the US economy.

The FT once made a point on the above mentioned issues, with its chief economics commentator putting it this way: "The US wants to inflate the rest of the world, while the latter is trying to deflate the US'[4]."

Conclusion

We draw the following conclusions from the current shape of the global economy:

- Rebalancing of the global economies is quite slow and is proceeding with quite some tension between major economies, which are systemic deficit and surplus economies. Recovery of global demand is not sufficient to compensate for loss in demand due to the collapse of real estate and consumer bubbles, primarily in many key developed market economies.

- The largest one, the economy of the US, is on a recovery trend, but propped up by a lengthy and sizable fiscal and monetary stimulus, which is already straining the country's creditworthiness. S&P, and recently, Moody's, two of the major credit rating agencies, have issued warnings on a US credit rating downgrade at some future time. Already, the key focus in the US is an issue of debt limitation and deficit reduction. Hence, the US is about to start fiscal tightening later this year or next. If May's soft job creation statistics extend into the summer months, then US monetary authorities may be left alone to work on the economy in the framework of its dual mandate of price stability and economic activity, where the latter task will take higher priority over the former, especially on the eve of presidential elections in the US in fall 2012. Hence, easy monetary conditions, albeit without an additional portion of quantitative easing (the so-called QE3 programme) being extended well until the end of 4Q11 and probably into 1H12.

- High commodity prices—as a result of quite strong growth in major EM economies and as a side effect of protracted US dollar weakness—do provide reasons for concern for a number of economies, from developed to emerging ones, especially those that are net importers of a certain commodity (Ukraine is vulnerable in quite a particular way; although the country is a net exporter of steel and soft commodities, its position as net importer of hydrocarbons is complicated by a long record of wasteful and insufficient consumption of natural gas). This provides concerns over an inflationary pressure build-up in a number of economies, including Ukraine and its trading partners.

- Some economies are experiencing overheating, which is due to inflation and the fast growth of bank lending, particularly for China and Brazil as far as major EM economies are concerned. This could lead to a sharp correction in the financial markets later this year or next. If such a correction were to materialise, it would have a negative effect on EM assets, as a risk-averse attitude among investors would force greater strength of the US currency and demand for US treasuries. At the same time, any concern over US creditworthiness may occasionally provide support to EM assets, if financial markets eventually start to listen to credit rating agencies' warnings of US debt mounting (to date, they have proven to act in the opposite manner, shrugging off the concerns over the top-notch safety status of US government bonds and buying them on the news).

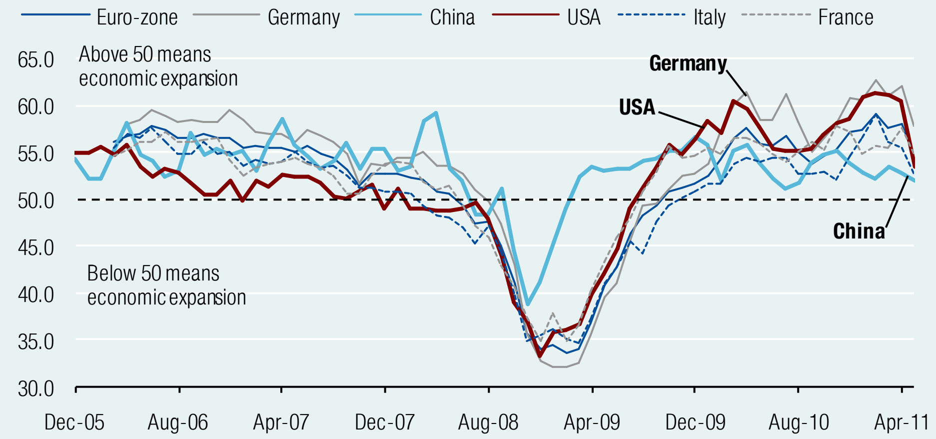
- In fact, most of the global economies, excluding the US for the time being (see Table 2 on page 14), have switched to a tightening stance of their fiscal and (in some countries) monetary policies. Because of this, aggregate demand of the global

[4] 'Why America is going to win the global currency battle' by Martin Wolf, 12 October 2010, Financial Times. Click here to read entire article.

economy is under pressure to slow down. The globalised nature of the commodities markets amid softer demand is likely to experience a reverse in price dynamics, i.e., after the price rally of 1H11 due to growing EM economies and increased geopolitical risk over the 'Arab spring'. This reversal will happen as a combination of two developments: firstly, commodity prices (mostly quoted in US dollars) are already being readjusted in trade-weighted terms (nominal and real); and secondly, they are likely to reverse in nominal terms under the weight of cooler demand. This notion we lay down in our forecast of crude oil and steel prices as a part of the Ukrainian economy's three-year prospects. Indeed, our base-case scenario stipulates that commodity prices reverse faster than depicted in the IMF forecast (in Chart 8, page 10).

- The latest reading of global PMI indices (see chart below) indicate that the major global economies are slowing into 3Q11, repeating the summer of 2010, when after a strong first half of the year, activity slowed well into most of the second half. However, this time, the slowdown has been faster, particularly in the US. While in other major economies the slowdown is a result of tighter monetary and fiscal policies, the US slowdown amid supportive (read: loose) policies underlines that recovery in this economy is still shaky, and will force policymakers, such as the Fed, to extend their current stance over the 'extended period,' which may last well into 1H12. This implies in our forecast the weakness of the US dollar against the major developed and emerging-market economies (like the Eurozone, Russia and China—the economies that are vital for Ukraine and constitute a sizable portion of its merchandise trade).

Chart 10. The latest readings of PMI indices of major economies point to slowdown of economic activity



Source: Bloomberg.

Table 1. Top countries by international reserve accumulation in the last 12-month period

Country	International reserves as of end May 2011 (US$bn)	Share of nation's GDP (%)	Change (%YoY)	12-month increase (US$bn)	Imports [2] (US$bn)	Imports coverage (months of imports)
Top 24 countries by 1-year international reserves increase in volume terms						
China	3,044.70	61.10	24.40	597.19	1,390.00 [8]	26.3
Switzerland	233.21	47.40	60.10	87.54	181.50	15.4
Brazil	329.78	20.70	32.00	79.95	244.32	16.2
Japan	1,057.68	20.90	6.50	64.55	636.51	19.9
Russia	483.23	39.20	10.90	47.50	321.01	18.1
Saudi Arabia	465.77	124.00	10.80	45.40	77.55	72.1
Thailand	182.19	69.10	27.80	39.63	179.63	12.2
Singapore	242.52	133.10	19.20	39.06	555.70	5.2
Taiwan	398.68	112.20	10.70	38.54	280.81	17.0
Indonesia	113.81	21.10	44.80	35.21	127.11 [4]	10.7
Korea	305.08	36.60	12.90	34.86	425.21	8.6
Malaysia	118.20	61.20	36.00	31.29	188.80	7.5
Mexico	127.98	14.60	30.60	29.99	328.65 [5]	4.7
India	277.20	20.10	11.50	28.59	428.25 [6]	7.8
Algeria	167.70	119.30	14.90	21.75	37.40 [9]	53.8
Turkey	91.40	14.90	27.20	19.54	196.74	5.6
Poland	94.53	22.00	25.00	18.91	198.96	5.7
Philippines	55.42	34.40	42.30	16.47	63.90	10.4
U.A.E.	46.48	20.20	49.90	15.47	225.07	2.5
United Kingdom	56.97	2.60	35.80	15.02	736.88	0.9
Hong Kong	272.50	129.40	5.30	13.72	488.06	6.7
Israel	77.40	39.60	20.00	12.90	73.05 [7]	12.7
Ukraine	**36.88**	**32.50**	**46.00**	**11.62**	**88.12 [1]**	**5.0**
Peru	43.57	33.40	31.50	10.44	34.81	15.0
Other selected countries						
Hungary	52.27	40.50	18.80	8.27	103.05	6.1
Romania	47.38	29.40	21.70	8.45	61.96 [4]	9.2
Belarus	1.44	2.90	-57.00	-1.91	40.52 [3]	0.4
Worldwide total	**9,857.75**					

Notes: (1) expected volume of imports goods and services for 2011; (2) full-year imports of goods and services for 2010;
(3) expected volume of imports goods and services for 2011, forecast for imports of goods (US$39bn) by Renaissance Capital, forecast for imports of services by ICU;
(4) imports of goods in full-year of 2010; (5) imports of goods and services for 2010, due lack of data for 1H10 it was assumed that FY data is double of 2H10 data;
(6) 12-month imports of goods and services for April 2010-March 2011; (7) imports of goods and services for the period of 4Q09-3Q10;
(8) estimation imports of goods for 2010 made by Li Keqiang vice-premier of China's government in FT (9 January 2011); (9) imports of goods and services for 2009.
Data on Ukraine includes the loans from IMF that were provided to Ukraine for the purpose of balance of payments support, which amounted in total to SDR4.9bn (US$7.5bn). In the last 12-month period the volume of IMF loans to BoP support purpose amounted to SDR0.9bn (US$1.4bn).

Sources: Bloomberg, Investment Capital Ukraine.

Table 2. Policy stances in major developed and emerging economies

	Fiscal policy			Monetary policy			
	Fiscal balance		Policy stance	Key rate (%)	Latest revision	Next meeting	Policy stance
	2010	2011F					
Selected major developed economies							
US	-10.60	-10.80	Loose	0.25	Dec-08 (of 75bp cut)	22-Jun-11	Loose
Euro-zone	-6.10	-4.40	Tight	1.25	Apr-11 (of 25bp rise)	7-Jul-11	Tight (early stage)
Japan	-9.50	-10.00	Loose	0.10	Dec-08 (of 20bp cut)	14-Jun-11	Loose
UK	-10.40	-8.60	Tight	0.50	Mar-09 (of 50bp cut)	7-Jul-11	Loose
Selected major emerging economies							
China	-2.60	-1.60	Tight	3.25	Apr-11 (of 25bp rise)	not disclosed	Tight (since 4Q10)
Brazil	-2.90	-2.40	Tight	12.00	Apri-11 (of 50bp rise)	20-Jul-11	Tight (since 2Q10)
Russia	-3.60	-1.60	Tight	8.25	May-11 (of 25bp rise)	not disclosed	Tight (since 1Q11)
Notes							
Ukraine	**-5.80**	**-3.30**	**Tight**	**7.75**	**Aug-10 (of 75bp cut)**	**not disclosed**	**Loose (late stage)**

Sources: Bloomberg, national central banks.

IMF and Ukraine: 'It takes two to tango'

"Christine Lagarde is the frontrunner, but she needs to reassure the developing world that she won't be soft on Europe."

Arvind Subramanian of the Peterson Institute for International Economics on 25 May, 2011[5]

IMF under new leadership

There are two things that tie the IMF and Ukraine together in a bond

In our view, there are two elements that tie the IMF and Ukraine together with a close bond. Firstly, Ukraine needs the IMF as a lender of last resort, because its balance of payments is vulnerable to any sudden stop in private capital inflow, and to counterweight the Russian government. The latter has plenty of financial resources these days, and could answer a call for assistance (and would readily respond to such a call), but such assistance comes at a cost (in the form of political and economic concessions). Secondly, as of today, Ukraine is one of the largest borrowers of IMF funds, just behind Greece and Romania by volume on the list of countries that tap the Fund's emergency loans, and Ukraine's share in the total payments to the IMF expected in 2011-15 will reach in one year (2012) nearly 20% (see charts next page). As for the second notion, the Fund's own performance depends on the existing programmes, including that of Ukraine's.

The IMF, under new leadership, is expected to review its assistance programmes with at least a little more scrutiny

The peculiar thing this year regarding the IMF is the louder voice of the leading emerging markets, which during the last crisis contributed to the Fund's pool of funds available for lending to the economies in need. They now find it legitimate to demand at least greater authority in the Fund's top management body, the executive board. This movement has intensified as of late, at a time when the Fund is looking for someone capable of replacing its former head, namely, Dominique Strauss-Kahn, with a new leader. The burgeoning emerging-countries club has a weakness, though: lack of a unified approach to produce the right individual for the post, to confront Europe's quick and decisive approach to back the incumbent French finance minister, Christine Lagarde, who is equally highly regarded among the international policymakers for her hard-working and consensus-building capabilities as well as her straightforward, plain-speaking and sometimes blunt manner of delivering her views. At the time of the writing this report, i.e., the last week of May 2011, she was headed on an EM trip to shore up support from these countries for her bid to lead the Fund.

The irony of today's IMF is that its past and harsh prescriptions for Asian countries to recover from the financial crisis of the late 1990s were quite draconian. The disguise and pain that characterised the imposed prescriptions by the IMF led these countries to be highly enthusiastic about the policies that would genuinely prevent new crises. In the end, these countries' macroeconomic policies were about enhancing their strength towards withstanding any such a crisis in the future (via excessive build-up of foreign reserves and development of local bond markets, to name a few). Now, being economically much stronger than they were 10 years ago, these countries are contributing to the global recovery from the economic and financial crisis of the late 2000s. They view the IMF's attitude towards dealing with troubled economies these days, most of which are from Europe's East and West, as quite soft (the crisis has been effectively ongoing for its third year now). This is contrary to the attitude on the part of the IMF of a sweeping resolution on the Asian crisis back in the late 1990s.

This is why it is important to note the following on Ms Lagarde as the most likely candidate for the top job at the IMF: in particular, while talking to the leaders of large EM countries,

[5] Click here for a full interview with Arvind Subramanian (link http://www.iie.com/publications/interviews/interview.cfm?ResearchID=1836).

she is likely to bring forward her well-known personal qualities—which she described in a few words by saying that she is a "very firm and no-nonsense person"—to assure them that the IMF under her leadership would be dealing with troubled economies proactively so as to safeguard their contributions to the IMF.

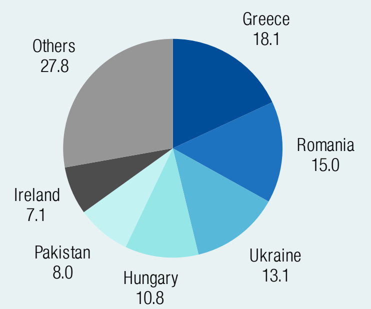
Ms Lagarde appears to fit the new IMF stance required by its increasingly mighty members from EM economies

Even despite the fact that she is not an economist but a corporate lawyer by training, Ms Lagarde has the highest chances of all candidates to take the IMF head job. This is thanks to her view on how the global economy has to develop in order to reduce global imbalances, which is in line with mainstream thinking in the West, particularly in Washington. It was she who brought into the financial media prominence the phrase that 'it takes two to tango'[6], while talking on complex economic issues like global imbalances (between the US and China, referring to China's need to permit greater flexibility of its own currency and ultimately allowing its appreciation), Eurozone imbalances, and the Eurozone debt crisis.

In the end, the IMF, with its new leadership of Ms Lagarde as managing director and a reshuffled squad of deputy managing directors (in order to reflect greater say on the part of EM economies such as the BRIC countries) will be quite a different thing to deal with than in the past. Under the new leadership, the IMF is going to be eager to lead–and there is ample room for this, starting from Greece and other indebted countries of the Eurozone–and to be more decisive in terms of implementation of the rescue programme. This matters greatly to Ukraine.

Chart 11. Breakdown of IMF credit outstanding by countries (%)

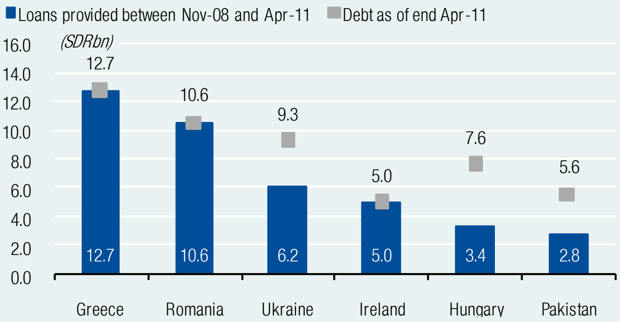
As of April 30, 2011. 100% = SDR70.4bn



Source: IMF.

Chart 12. Top 6 borrowers of IMF funds (SDRbn)

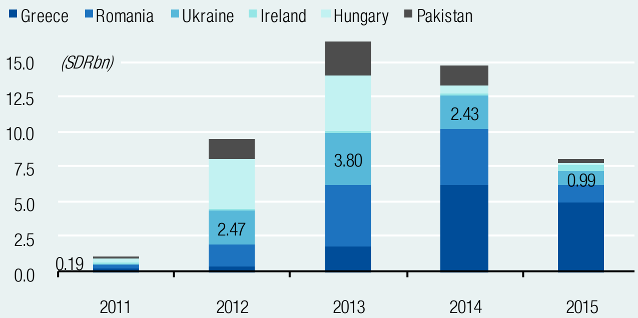
In billions of special drawing rights (SDR)



Sources: IMF, Investment Capital Ukraine LLC.

Chart 13. Top 6 borrowers' payments in 2011-15 (SDRbn)

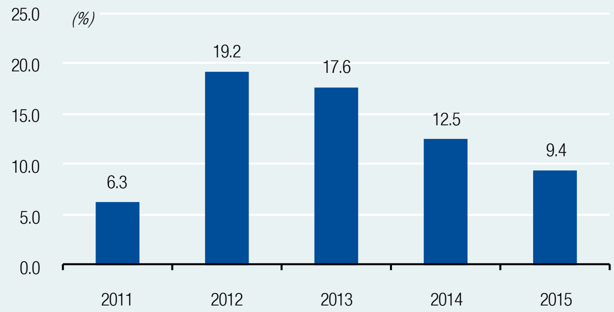
As of April 30, 2011. Payments include principal and interest.
In billions of special drawing rights (SDR)



Sources: IMF, Investment Capital Ukraine LLC.

Chart 14. Ukraine's share in total payments to IMF in 2011-15

As of April 30, 2011. Payments include principal and interest.



Sources: IMF, Investment Capital Ukraine LLC.

[6] Click here for a full interview by the FT with Christine Lagarde on 15 March 2010. (link http://www.ft.com/intl/cms/s/0/78648e1a-3019-11df-8734-00144feabdc0.html#axzz1NoKFFzuy).

Table 3. Projected payments to the IMF under the outstanding credit arrangements as of 30 April 2011
for all members of the Fund and for top 6 selected countries that are largest borrowers

Country	Type of payment	2011	2012	2013	2014	2015
All countries						
	Principal	1,717.30	11,253.90	20,251.60	18,728.90	10,121.30
	Charges/Interest	1,258.70	1,663.80	1,312.40	749.00	318.7
	Total	**2,976.00**	**12,917.70**	**21,564.00**	**19,477.90**	**10,440.00**
Top 6 borrowers of IMF funds						
Ukraine	Principal	0.00	2,234.38	3,656.25	2,390.63	968.75
	Charges/Interest	186.27	240.35	144.02	42.49	16.27
	Total	186.27	2,474.72	3,800.27	2,433.11	985.02
Greece	Principal	0.00	0.00	1,471.81	5,917.34	4,896.09
	Charges/Interest	274.04	385.79	424.08	338.72	84.44
	Total	274.04	385.79	1,895.89	6,256.06	4,980.52
Romania	Principal	0.00	1,307.25	4,051.75	3,881.13	1,232.75
	Charges/Interest	232.85	327.40	276.30	84.85	13.40
	Total	232.85	1,634.65	4,328.05	3,965.97	1,246.15
Ireland	Principal	0.00	0.00	0.00	0.00	417.70
	Charges/Interest	77.94	102.85	102.76	112.55	109.64
	Total	77.94	102.85	102.76	112.55	527.35
Hungary	Principal	0.00	3,220.19	3,818.50	598.31	0.00
	Charges/Interest	155.15	184.96	70.00	7.26	1.58
	Total	155.15	3,405.15	3,888.50	605.57	1.58
Pakistan	Principal	129.21	1,418.11	2,399.61	1,379.29	303.04
	Charges/Interest	87.48	108.18	57.39	19.40	3.86
	Total	216.69	1,526.29	2,457.00	1,398.69	306.90
Share of each country of top 6 borrowers in total projected payments to the IMF						
Ukraine		**6.26**	**19.16**	**17.62**	**12.49**	**9.44**
Greece		9.21	2.99	8.79	32.12	47.71
Romania		7.82	12.65	20.07	20.36	11.94
Ireland		2.62	0.80	0.48	0.58	5.05
Hungary		5.21	26.36	18.03	3.11	0.02
Pakistan		7.28	11.82	11.39	7.18	2.94
Total (% of all countries total)		**38.41**	**73.77**	**76.39**	**75.84**	**77.08**

Sources: IMF, Investment Capital Ukraine LLC.

IMF-Ukraine duo: The count of outstanding issues

Fiscal Balance

Cooperation with the IMF resumed in 2010

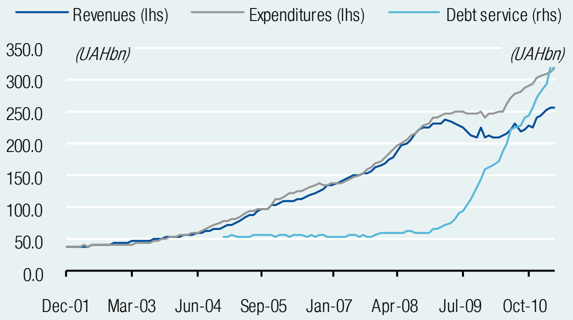
Overall, the current government, headed by PM Mykola Azarov, has remained more cooperative with the IMF than the previous government of Yulia Tymoshenko, in terms of fulfilling the Fund's requirements. Due to such improved discipline seen on the part of the new government, especially in 2010, the Fund in fact made some concessions to the country, effectively waiving the fulfilment of some requirements. The IMF tolerated Ukraine's exceeding its 2010 budget deficit target: the level of the country's budget deficit, at 5.9% of GDP, was still lower than the EU average of 6.3%, and lower than the general government deficits of France, the UK, and Poland compared with other European countries. In addition, for Ukraine, the 5.9% level of deficit was a considerable improvement over the 2009 year, when the actual budget deficit reached 11-15% of GDP, according to different estimates. At the same time, for 2011, the IMF set an even stricter target for the public deficit, at under 3.5%.

The glaring deficit of Naftogaz remains one of the biggest outstanding issues, but the government fears raising the natural gas tariffs for the population

In Ukraine's first memorandum with the IMF, dated 16 July, 2010, it was promised to the IMF that the loss-making state oil and gas monopoly Naftogaz will end 2011 with a zero deficit, but in fact, in March 2010, the government approved the company's financial plan with a UAH8.5bn deficit for 2011. In order to achieve the zero deficit, the government had initially promised to make a one-time, 50% rise in the gas tariff from April 2011, but then in February, renegotiated this issue with the IMF, effectively spreading the tariff rise over time: natural gas prices for the population had to be raised by 20%, and heating tariffs by 26% from 15 April 2011 (but this has not been done as of end-May), and then the gas tariff had to be additionally raised by 10% from 30 June, and the heating tariff by 26% from 1 October 2011. It becomes more and more obvious that the tariff increase will perhaps not take place till year-end, as the government now lacks the political will to resolve the Naftogaz deficit issue this year, as it has some capacity to cover the Naftogaz deficit via the incumbent scheme.

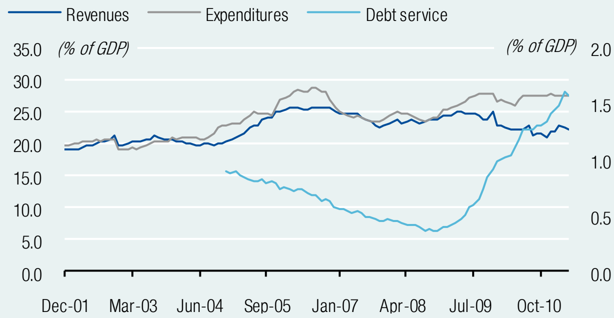
Chart 15. Annual state budget revenues, expenditures and debt servicing: history from December 2001 till April 2011

In billion of Ukrainian hryvnia (UAH)



Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

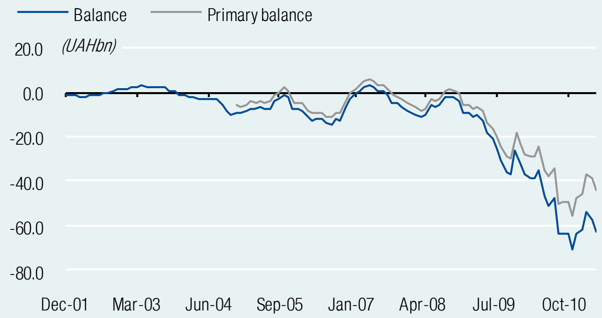
In percentage of GDP



Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

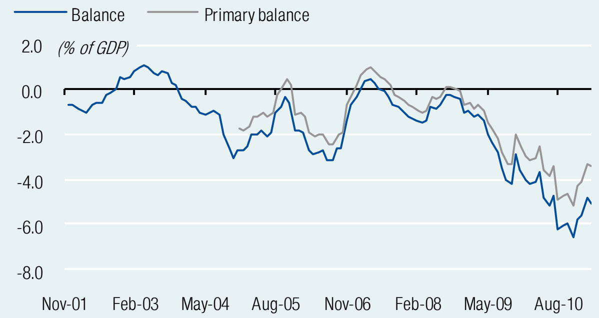
Chart 16. Annual state budget balance and primary balance: history from December 2001 till April 2011

In billion of Ukrainian hryvnia (UAH)



Note: primary balance is balance net of debt servicing.
Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

In percentage of GDP



Note: primary balance is balance net of debt servicing.
Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

VAT refunds and recapitalisation bonds

Eliminating VAT arrears and the automatic redemption of VAT is another requirement of the IMF yet to be instituted

Another outstanding issue at end-2010 was the unredeemed VAT rebates: the IMF required that the government not only pay all the outstanding VAT arrears which were accumulated during 2Q10-4Q10, but also launch a system of automatic VAT compensation by end-January, so that at least 60% of the total volume of VAT be automatically returned to working enterprises by end-December, 2011. In March, the system of automatic VAT redemption was finally launched; however, only 24 out of the total of 2,000 enterprises which applied happened to be eligible for the new automatic regime, and on 16 and 17 March, the State Tax Service reported having made the first VAT redemptions in the amount of UAH456.5m. Later in May, 82 companies received VAT refunds, totalling UAH1.2bn. Although this is still less than a half of the UAH2.5-2.7bn which is being redeemed on average each month, and of the UAH3.13bn which is planned to be redeemed on average each month in 2011, the very fact that the automatic system of VAT redemption has finally started operating is noteworthy. At the same time, the IMF expects it will progress in due course.

By setting specific eligibility criteria for automatic VAT redemption, the government is inducing companies to bring salaries out from the "grey" zone

The majority of companies which applied for the automatic VAT redemption did not meet the set of eligibility criteria required by the State Tax Administration (STA), which include: a minimum of 20 employees, with salary levels of 2.5 official minimum salaries, i.e., UAH2,352.5 (US$295.17); also, the company applicant must not have other tax arrears or be bankrupt. By setting such a set of requirements, the STA not only wants to prevent illegal VAT claims from fake firms, but also intends to induce the Ukraine's companies to come out of the grey economy and thus increase the volume of official taxes paid. In particular, around 80% of those companies which applied for automatic VAT redemption in March did not meet the criteria on the level of salaries paid officially to their employees, reflecting Ukraine's wide-spread practice of paying a larger portion of salaries under-the counter, or "in the envelope," to use the local term, i.e., without paying any taxes.

The law cancelling the NBU's obligation to buy out the government's recapitalisation bonds has been adopted, so another of the IMF's requirements will soon be fulfilled

One more requirement by the IMF is the cancellation of the NBU's obligation to buy out in a 5-day term the government bonds issued for the purpose of recapitalisation of state-owned banks. During the crisis of 2008-09, to support the banking system and increase its capitalisation, the government of Ukraine introduced a mechanism of acquiring stakes in the troubled banks through exchanging their shares for the so-called "recapitalisation bonds," which the Ministry of Finance issued specifically for this purpose. The NBU then had the obligation to buy out these bonds. Because this mechanism limited the independence of the NBU in conducting its monetary policy, the IMF required Ukraine to cancel it. On May 19, the law stipulating such a restriction for the NBU was adopted by Parliament in the first reading. The law passed through Parliament rather easily, and a shortened procedure for its preparation for the second reading was also approved. This gives us reason to believe that the law will be adopted in the final reading without delays, and signed by the president, thus fulfilling another of the IMF's requirements.

Pension reform

Implementing the pension reform is another major requirement of the IMF...

Another large, outstanding issue in terms of fulfilling the memorandum with the IMF is pension reform. The reform was initially set to be adopted before end-December 2010, but did not raise enough political consensus, and then the deadline was postponed to mid-April. But, at end-March President Yanukovich announced that there first needed to be a profound public discussion of the proposed reform in all of Ukraine's regions; which could take another couple of months. Judging from the statements made by several highly placed officials, including Minister of Social Policy Serhiy Tyhypko, the pension reform legislation could realistically be adopted not earlier than end-June or the beginning of July, which means that the next IMF tranche will perhaps come to Ukraine around August. The IMF is apparently more interested in Ukraine's adopting the pension reform in a proper and socially compatible way, even though at a later date, rather than pushing the deadline and gathering social unrest, as was already the case at the end of 2010, when the new Tax Code was adopted. So, the Fund will closely monitor how the process of implementation of the pension reform proceeds to ensure that it will finally come to its completion.

... but this issue is highly socially sensitive, so the government keeps postponing it

Now it is clear that the government softened its commitment to the implementation of the pension reform, and that it will take longer than thought earlier, and perhaps with some modifications to the shape of what was earlier agreed upon with the IMF: because raising the pension age is a measure bearing high social sensitivity, the government is likely to search for other measures to cut the glaring deficit of the pension fund, and in this way lift the burden of subsidies to the pension fund from the state budget. For example, trade unions and other opponents of the pension reform in its current shape propose to raise pension fund revenue by bringing "grey" salaries into the official zone, i.e., to increase the tax base, rather than cutting the pension fund's expenses by painful measures like raising the pension age.

Our view on Ukraine's commitment to the IMF, the new tranche

On May 31, the government resubmitted the revised law on pension reform to the parliament, and several high-ranking officials have reiterated publicly that the pension reform has to be adopted by July at the latest, so that Ukraine can receive the IMF's next tranche in August. This shows that the government has lately reactivated its effort to fulfill the IMF's requirements, but whether or not the pension reform will be adopted (and natural gas tariffs raised) depends solely on the political will of the country's authorities. The president's recent announcement that Ukraine will finish 2011 with a balanced budget may also be a sort of advance before the IMF: the government will likely attempt to put such an excellent fiscal performance on the table as an argument to waive the forced pension reform adoption and raising of natural gas tariffs, both measures having been set earlier in the memorandum of cooperation with the Fund, but unfulfilled so far on fears that they might cause social unrest.

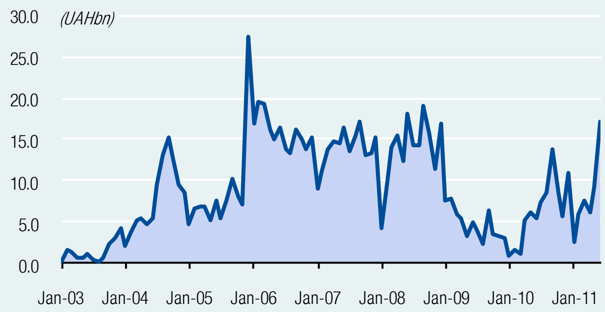
As the government is not so much dependent on the IMF's tranche now, it might continue delaying the required reforms, so the US$3bn tranche may also be postponed from August until the IMF sees progress on the reforms

Based on the timeline of expected pension reform adoption, the next IMF tranche will come not earlier than August. Because the previous one was delayed, this time, Ukraine may receive two tranches at the same time, totaling approximately US$3bn. However, this will only happen if Ukraine's government demonstrates the political will to adopt the pension reform and raise natural gas tariffs for the population, both measures being expected by the IMF. However, both these required measures are highly unpopular among the Ukrainian population, so the government has so far been delaying their fulfillment. An additional factor at the government's disposal is the better-than-expected budget revenue generated in 4M11, and good results of the government's bond placements, which attract sufficient demand at low rates, due to high banking sector liquidity. With these spare budget resources available, the government is in fact not so dependent on the IMF's money anymore. So, it can continue maintaining its position, rather than obliging to the IMF's requirements. Therefore, there are chances that the political considerations (the upcoming parliamentary elections in 2012) will overwhelm the need for additional, cheap foreign-currency loans from the IMF, and in that case, the next tranche can be delayed further, until at least this fall.

The government's fiscal position remains quite strong and liquid in 2011, and will not be damaged if the IMF funds are not received in the nearest months

However, the delay in receiving the IMF tranche will not affect the government's financial position: according to the memorandum, from 2011, all IMF's tranches were anyway scheduled to be directed to the National Bank's international reserves, and not the state budget. In addition, the government's fiscal position has been quite liquid this year (see chart below). For example, in February, it received US$1.5bn from a Eurobonds issue, and raised UAH16.15bn (US$2bn) from the local market in 4M11. As of 1 June, the government had UAH17.18bn (US$2.15bn) in its treasury account. And, it also had approximately US$3bn in its foreign currency accounts, according to our calculations, as of 1 May. The trend of having local funds available for the government's borrowing is likely to continue in the coming months, as banking liquidity keeps staying at healthy levels (banks' correspondent accounts with the NBU stand at UAH19.5bn, or US$2.44bn, on average in 2011). In addition, local media reported that Ukraine has been in the final stage of negotiations with the Russian banks in order to issue a rouble-denominated Eurobond. While there has been no rush on the part of Ukraine's government to tap the Russian bond market with a RUB-denominated bond, this shows that it (the Ukraine's government) has widened its options for obtaining financing.

Chart 17. Monthly balance of the state consolidated treasury account in the local currency (UAHbn, eop)



Source: State Treasury of Ukraine.

Chart 18. Monthly balance of the state consolidated treasury account in the local currency (% of GDP, eop)

Sources: State Treasury of Ukraine, Investment Capital Ukraine LLC.

During 2010 and 1Q11, external capital inflows were sufficient to cover Ukraine's current account deficit and build up international reserves to US$39bn

The delay in the arrival of the IMF's next tranche has not affected the country's external currency position to a large extent up until present. Ukraine has continued to receive sufficient currency inflows from banking and corporate channels as of late, in turn allowing the NBU to continuously raise the level of the country's international reserves. In 2010, the capital account of the BoP generated a surplus of US$7.9bn, and stayed positive even if netted of the two IMF tranches of US$3.4bn in total. Even without the IMF's funds, the capital inflows were sufficient to cover the current account deficit, which equaled US$2.89bn in 2010. So, the resulting overall BoP surplus stayed at US$5bn in 2010. The central bank's international reserves reached US$34.58bn, having grown from US$26.5bn at end-2009, and by 30% during 2010. The same dynamics continued in 1Q11 (a BoP surplus of US$1.1bn in 1Q11, US$2.1bn in 4M11, and international reserves reached their historical maximum of US$39bn by mid-May), even though no IMF money came into the country in 2011 at all.

There is a certain risk that without the IMF tranche, investors might increase aversion to Ukraine's assets

However, the possibility of delaying the next IMF tranche for too long this year could have a negative external effect on the country, i.e., a loss of investor confidence and rising risk aversion, amidst growing uncertainty in the financial markets and economies around the world following recent macroeconomic disturbances in Europe and Japan, and political turmoil in the North Africa. The delay in the IMF tranche can be taken by the investors' community as a signal of the escalation of the country's risks.

Chart 19. CDS spread on Ukraine's 5-year sovereign debt (bp)

Source: Bloomberg.

Chart 20. Yields on 10-year sovereign bonds (%)

Source: Bloomberg.

And indeed, the longer the delay, the greater the chance that this is increasingly at risk of happening, and having an impact on the country's economic future going further. Now (as of the time of writing this report) Ukraine has access to the capital markets for new borrowings. However, over a bit longer time frame, a persistent non-compliance by Ukraine's authorities with the mutually agreed-upon conditions of the assistance programme is to add to the country's risk premium, which is ultimately determined by financial markets that trade sovereign debt.

Table 4. Schedule of IMF tranches under Stan-By Arrangements for Ukraine

Date	Volume (SDRm)	Volume (US$m)	Status
IMF loan tranches under the SDR11bn, 24-month SBA			
Nov-08	3,000	4,471	Approved
May-09	1,900	2,846	Approved
Jul-09	2,120	3,279	Approved
IMF loan tranches under the SDR10bn, 29-month SBA			
Jul-10	1,250	1,852	Approved
Dec-10	1,000	1,530	Approved
Mar-11	...	...	Review postponed
Jun-11	2,000	3,060	Subject to review
Sep-11	1,000	1,530	Subject to review
Dec-11	1,000	1,530	Subject to review
Mar-12	1,000	1,530	Subject to review
Jun-12	1,000	1,530	Subject to review
Sep-12	1,000	1,530	Subject to review
Dec-12	750	1,147	Subject to review
Total (Approved)	**9,270**	**13,978**	
Total (Subject to review)	**7,750**	**11,857**	
Total	**17,020**	**25,835**	

Sources: IMF, Investment Capital Ukraine LLC.

Conclusion

In this regard, we draw the following conclusions from the recent developments inside the IMF and with regard to the IMF lending programme assisting Ukraine:

- By not meeting its commitments under the existing Stand-By arrangement with IMF Ukraine's authorities are risking to lose investors' confidence in improvement of creditworthiness of the government and see the country's risk premium rising upwards. This risk, if it were to materialize, would have compounded by another risk of tightening of monetary policy by the US monetary authorities. The latter risk has chances to materialise in 4Q11 or in 1H12, depending on the pace of economic growth in the US.
- The IMF's new leadership, which is likely to be handed to Christine Lagarde of France, with wider representation of EM countries in the top management, will be at least a bit more stringent with borrowers of its emergency funds than the IMF under Dominique Strauss-Kahn, who was friendly with the Ukrainian leadership.
- Hence, Ukraine's government, which is not enthusiastic about being fully dependent on the financial backing of the CIS entities, which are respectively almost completely funded by the Russian government, is likely to proceed with fulfilling its previous promises (on pension reform, regulated tariffs, VAT refunds) in order to secure backing from the IMF. But, the pace of this progress will depend on how consistent the internal sources are in filling the government's coffers, which, in turn, will depend on how fast Ukraine's economy recovers and whether it would be capable of avoiding a second wave of recession (due to either internal or external factors).
- In our view, based on current facts (like the economic recovery of the first four months of 2011 of about 5% YoY, which buys the system time, and lack of political will to implement sweeping reforms, albeit socially painful ones) Ukraine has a high chance of

missing June's programme review, as its mix of commitments is yet to be delivered. This has consequences for Eurobond market investors, as the opportunities for further spread compression between Ukraine's sovereign bonds and benchmarks gradually disappear.

Key global indicators vital for Ukraine's 3-year forecast

Traditionally, we start our forecast with key external indicators that are vital to Ukraine's economy

Our model on forecasting Ukraine's macroeconomic indicators for the 3-year period ahead incorporates four global indicators which are vital to the domestic economy.

Firstly, that is demand globally, and particularly in Russia, which accounts for one-third of Ukraine's total merchandise trade (a 32.9% share as of March 2011), alongside a 26.7% share of total exports of goods.

Secondly, there are crude oil and steel prices that are vital to the shape of the external balance of the country. Imports of hydrocarbons, the value of which is linked to the crude oil price, constitute a 36.4% share of the 12-month import bill to March 2011 (US$67.5bn, according to our calculations). Steel exports have a 33.8% share of the total exports of goods (US$56.5bn in the last 12-month period to March 2011).

Crude oil and steel price forecast

Commodity prices, especially for crude oil, are forecast to recede from their recent high

As we noted above, high commodity prices, especially in relation to the crude oil price, which has nearly reached the neighbourhood of the pre-crisis high of about US$120/bbl in quarterly average terms, are a burden to most of the world's economies. As consumption is scaling back in response to this development, the future path of energy commodities will be a downward correction towards the US$90-100/bbl range, which also reflects EM economies' higher demand for energy on the back of ever-expanding economies, albeit at a slower pace, this year will provide some floor to this downward correction.

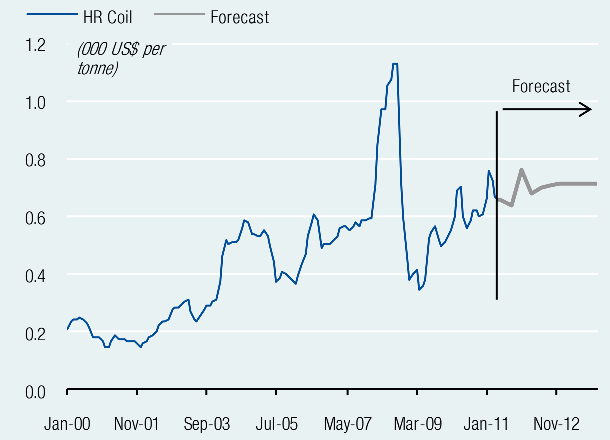
Chart 21. Crude oil price and forecast

Quarterly average spot price of WTI crude oil in US dollar per barrel

Source: Bloomberg, Investment Capital Ukraine

Chart 22. Steel price and forecast

Quarterly average price of CIS export HR coil price in thousand of US dollar per tonne



Sources: Bloomberg, Investment Capital Ukraine.

As for steel prices, the available data on CIS export steel prices show that their recent rally has been lagging far behind that of crude oil price; to put it crudely in comparison, this would require a 72.3% increase in the steel price from its current level to reach the high level seen in 3Q08, while it would require just a 4.9% increase for the crude oil price to repeat its high seen in 2008 (all these measurements are derived from historical quarterly averages depicted in the charts above). Therefore, we do expect some correction in the steel price for Ukraine's key exports, but it would be quite small, as the price is forecast to stabilise close to the recent average observed in the last four-month period.

Economic activity globally and in Russia

We rely on the IMF's view on the pace of economic activity globally and in Russia

We base our projections on economic activity globally, and particularly in Russia, on the IMF's projections that were laid down in the recent *World Economic Outlook* publication. As in a year ago, we factor in a slowdown of economic activity into the 2H11, when a rebound of activity into the middle of 2012 as economic cycles will evolve (see table below). Above, we noted a possible shaky development in some EM economies that now look overheated, but a disorderly resolution of these excesses is not in our base-case scenario, but rather our worst-case scenario, would see an even more noticeable slowdown of economic activity and steeper commodity price corrections to the downside than the base-case scenario envisages.

As for Russia, there is the issue of political risk, as 2012 presidential elections are gradually approaching, uncovering the capital flight from the country. In light of this factor, Ukraine's economic dependence on Russia as a main consumer of its export products (food, machinery) as well as services (of transporting natural gas to European Union) and at the same time, supplier of energy (crude oil, oil products and natural gas) has some stake in Russia's political risk. In the past, natural gas wars and trade bans on certain of Ukraine's food stuffs did have a factor in Ukraine's economic activity. These stories may surprise investors by resurfacing, but again, they are a part of a worst-case scenario for the Ukraine's economy.

Table 5. 3-year quarterly and yearly forecast on the global economy's key indicators, on which Ukraine's macroeconomic forecast is based

	Quarterly forecast												Yearly forecast		
	1Q11	2Q11E	3Q11F	4Q11F	1Q12F	2Q12F	3Q12F	4Q12F	1Q13F	2Q13F	3Q13F	4Q13F	2011F	2012F	2013F
World real GDP (%YoY)	4.8	4.5	4.3	4.0	4.8	4.5	4.3	4.5	4.8	4.5	4.3	4.5	4.4	4.5	4.5
Russia real GDP (%YoY)	4.5	5.0	5.0	4.7	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.8	4.5	4.5
Crude oil price (US$/bbl)	105.48	118.02	100.00	95.00	95.00	95.00	95.00	95.00	95.00	95.00	95.00	95.00	104.62	95.00	95.00
Steel price (US$/tonne)	709.00	662.00	635.00	760.00	680.00	700.00	705.00	710.00	710.00	710.00	710.00	710.00	691.50	698.75	710.00

Notes: crude oil price is WTI, steel price is HR coil price.
Source: Investment Capital Ukraine.

Politics

"…the forecasting ability of experts on politics is at least as limited as that of economists."

Martin Wolf, FT chief economics commentator, March 2011

The reformist stance of the Ukraine's authorities has somewhat faded as of late, as public approval ratings of the country's leaders and economy dropped (see Chart 23 below). Despite this, in our view, there are chances that a minimal package of reformist steps—to be precise, those which were agreed upon with the IMF—will be attempted to be adopted by lawmakers and implemented. A total stalemate in terms of realising these reforms is possible, but currently, this has a very low probability of happening (within a single-digit range). We do expect that some steps on reforms (see more on outstanding issues with the IMF in the section "IMF-Ukraine duo: The count of outstanding issues" on page 17) will be realised by the current Cabinet of Ministers or by the reshuffled one.

Popularity loss as a squeeze

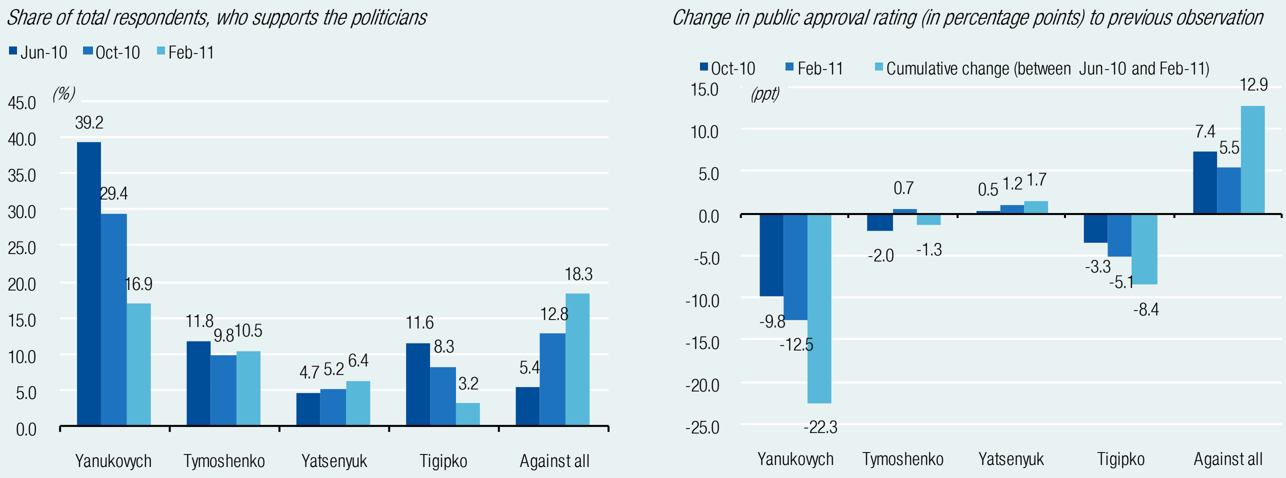
President Yanukovych suffered a loss of public approval rating…

President Yanukovych, who regained full presidential powers on the back of the constitutional revamping last year, is now catching his stride in being the top man in the country, though the public tends to view his leadership with great deal of scepticism and distrust.

According to the latest available poll results from a trusted pollster company, Kyiv International Institute of Sociology, Yanukovych's popularity among voters shrank the most in comparison with other prominent political names (see chart below).

Chart 23. Win-lose game of Ukraine's top politicians: Evolution of public approval rating past year

The poll was carried out by Kyiv International Institute of Sociology on (KIIS) 9-8 February 2011 with 2040 respondents. Previously, KIIS carried out the poll back in June and October 2010



Sources: KIIS, *Zerkalo Nedeli* newspaper.

Sources: KIIS, *Zerkalo Nedeli* newspaper, Investment Capital Ukraine.

…but still remains the most popular out of the top prominent politicians

However, he remains the most cherished of the country's prominent political figures among dissatisfied voters, with a 16.9% share of those polled approving his governance. Though a year ago, Yanukovych enjoyed a 39.2% share in approval ratings. In cumulative terms, from June 2010 and February 2011, the poll showed that Yanukovych lost 22.3ppt of votes, being relegated back to the low ratings that increase his risk of rivalry by opponents who are close at hand to him, particularly if they decided to unite against him.

His arch rival, Yuliya Tymoshenko, comes second in popularity, with a 10.5% share of respondents supporting her. She has managed to maintain her public approval rating without a sizable loss, as her rating shrank by 1.3% since June 2010.

Yanukovych's ally Tigipko suffered a huge loss, too

Alongside Yanukovych, Tigipko also suffered a loss. After joining Yanukovych as deputy prime minister responsible for economic reforms, his rating came down from a level of 11.6% (nearly at par with Tymoshenko at the time of the poll, in June 2010) towards as low as 3.2%, according to KIIS.

Yatsenyuk was the only prominent politician who gained in popularity

The popularity of the youngest politician of these four, Yatsenuyk has grown, as he has managed to increase his public approval rating over the same period of June 2010 to February 2011 by 1.7ppt, to 6.4%. But still, he does not have the capacity to carry out his game to its full extent, and in order to gain further, he needs to unite with other politician. In terms of voter realignment, he has an equal chance of joining forces with Tymoshenko (this is due to the fact that his support base comes from the western part of the country) as with Yanukovych, because, in our view, Yatsenyuk's support base is rather more pragmatic than Tymoshenko's, whose constituents value him for his modernised view on governance, economy, and the financial markets, qualities that are also lacking on the part of Yanukovych.

Growing dissatisfaction in the leading politicians is reflected by a sizable rise in the 'against all' votes

The most staggering development in terms of changes in the public view on politics was how the public is dissatisfied with all prominent politicians; the share of respondents that do not support any politician rose by 12.9ppt to reach 18.3% as of February 2011 (see chart above).

Table 6. Ukraine's top 4 politicians by public approval ratings derived from KIIS's polls

Politician's last name	Jun-10	Oct-10	Change (ppt)	Feb-11	Change (ppt)
Yanukovych	39.2	29.4	-9.8	16.9	-12.5
Tymoshenko	11.8	9.8	-2	10.5	0.7
Yatsenyuk	4.7	5.2	0.5	6.4	1.2
Tigipko	11.6	8.3	-3.3	3.2	-5.1
Against all	5.4	12.8	7.4	18.3	5.5

Notes: change is measured in percentage points and it is to show at what pace politician's rating changes compared to previous poll.
Sources: Kyiv International Institute of Sociology, *Zerkalo Nedeli* newspaper.

Yanukovych's reformist drive is under pressure…

The above-mentioned developments in the public view on ruling politicians (namely, Yanukovych and Tigipko) could serve as a double-edged sword, first of all, towards President Yanukovych, whose presidential powers allow him to reshuffle the government without any sizable obstacles. On one hand, it is evident that the ruling party and its leader Yanukovych have lost a sizable chunk of their support base, having done very little in terms of economic reforms. On the other hand, muddling with economic reforms creates a country risk premium that could be manifested by repricing in the bond markets, making future borrowings costlier, and even, at some extremes, prohibiting access to the market.

…but it is very unlikely that reforms will be stalled altogether until the next elections

There is more than a year left before the next parliamentary elections, to be held in the fall of 2012. In our view, it is too early to consider Yanukovych to be in a sort of panic over his lower popularity rating and the rating of his party, though ultimately, it will be the party seeking re-election into the parliament, not him. Indeed, the last year showed a sizable growth in dissatisfaction with ruling parties among the public. However, this is not enough to make the case that economic reforms—those required by IMF as well as those highly advertised by Yanukovych during his election as president back in 1Q10—are to be stalled as early as the end of 2Q11.

Briefing on the Ukraine's economy

Post-crisis pattern of growth in 2010 and 2011

The year 2010 saw new momentum in the economy's recovery from the deep recession of 2008-09…

Ukraine's real GDP grew a healthy 5.2% in 1Q11, continuing the positive dynamics that the economy gained in 2010. In 4M11, however, the economy slowed down, posting growth of 5%, according to preliminary estimates. In 2010, real GDP grew 4.2%, to UAH1.095bn (US$137.7bn). The reported data are very close to the level that we expected for 2010, namely, 4.3% (see our October 2010 quarterly report). The actual data also considerably exceed the government's official forecast of 3.7% in 2010. In the following chapters, we review the economic dynamics of the post-crisis 2010, 4M11, and provide our outlook for the rest of 2011.

… on the back of reinstated political, macroeconomic and fiscal stability…

The three main factors favouring post-crisis economic development in 2010, ultimately bringing about economic revival to Ukraine, were the following:

- **Political stability**, accompanied by macroeconomic, financial, and fiscal stability. The presidential election in February brought the country a new head of the state, President Viktor Yanukovych, and a new government headed by PM Mykola Azarov, all seen as the old-guard professionals, albeit with a 'strong-arm' style of public and economic management, often deemed as too authoritarian.
- **A revival in the external demand for Ukraine's exports**, which was strong during almost three quarters, from 4Q09 throughout most of 1H10. Export-oriented industries contributed the most (7.6ppt) to 2010's overall industrial growth (11%), on the back of high external demand for steel, Ukraine's main exports, fertilisers (due to rising world demand for agricultural commodities), and increased sales of vehicles to Russia and the CIS countries, which were undergoing economic recovery. Steelmaking output rose by 12.3% YoY in 2010, chemicals 21.5%, and machine-building 34.5% YoY.
- **A recovery in domestic consumer demand**, starting from 2H10, on the back of growing incomes due to resumed economic activity of enterprises after the crisis.
- **Increased fixed capital investments** since 2H11, in the run towards the Euro-2012 tournament.

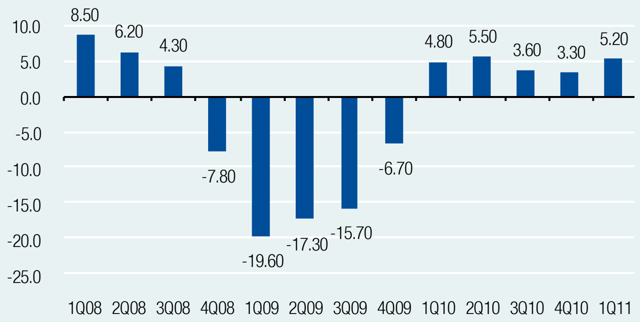
GDP growth since 4Q10 was driven by external demand, followed by recovering domestic demand in 2H10

In addition, 2010's growth was based on the low base effect of the crisis-laden 2009, which was especially prominent in the first three quarters of the year, whereas in 4Q10, real growth slowed down in YoY terms, because it was in 4Q09 when an industrial recovery started up at a fast clip after 1.5 years of recession. Overall, the 4Q10 was a rather strong quarter, and we see its effect spilling over into the 1Q11, but slowing down later in the year. The NBU assessed that real GDP grew 6% YoY in February; in 1Q11, real GDP growth posted 5.2% YoY, and due to April's slowdown, in 4M11, real GDP growth was estimated at 5%. Based on good economic performance in 1Q11, the Ministry of Economy announced that macroeconomic forecasts for 2011, currently at 4.5%, will be revised upwards.

Industry and mining were the leaders of the recovery, while the construction, agriculture, and financial sectors remained in decline in 2010

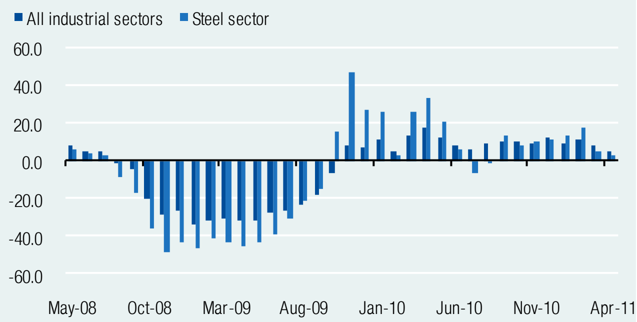
Analysing the dynamics and the changes in the structure of Ukraine's economy in the post-crisis period, using data from the State Statistics Committee, we note the following trends. Ukraine's recovery in 2010 was led by the industrial sector (up 11%), which gradually gave way to growth in the service sectors, whereas construction, agriculture, financial activity, and state management remained in decline. The processing industry rose 14.5% YoY, mining was up 3.3%, and water, energy, and gas production and distribution rose 8.1% YoY in real terms in 2010. The industrial sector remained the main contributor to GDP, producing 27.7% of the country's overall value-added in 2010, even though over recent years, its share in GDP has fallen (it comprised 31% of GDP in 2005), while the mining sector's share of GDP grew to 6.6% from 4% in 2007, helped by a climbing world price for iron ore. Later in the year, service sectors started taking over in terms of dynamics: the transport and communications sector grew 5.1%, and its share in GDP increased to 12.7% in 2010 from 11% in 2007. At the same time, agriculture fell 1.3% on the back of a poorer harvest and the government's price and export restrictions; financial activity dropped 3% as banks' credit activity was almost frozen throughout the year; and construction was the slowest sector to recover, posting a drop of 1.7%, as private investors were still very cautious about investing into the sector that demonstrated the most fragility during the crisis. The state's management sector decreased 2% due to the post-crisis fiscal rigidity.

Chart 24. Quarterly real GDP (% YoY)



Source: State Statistics Committee of Ukraine.

Chart 25. Monthly industrial production growth (% YoY)



Source: State Statistics Committee of Ukraine.

The retail sector started contributing to the economic rebound since 2H10, due to the revival of domestic demand and growth of real salaries

Ukraine's domestic demand started contributing to economic growth in 2H10, due to general financial stabilisation, economic recovery, and growth in real incomes. Real salaries grew 10.2% in 2010, after falling 9.2% in 2009. Real disposable income of the population grew 16% in 2010, while in nominal terms the population's income grew 23%. This was reflected in retail turnover, which grew by 7.6% YoY in 2010 in comparable prices. By comparison, retail turnover fell 20.6% in 2009. Another positive trend is the growing share of locally produced goods in retail turnover, prompted by the devaluation of the local currency at end-2008: in 2009, the share of locally produced goods in retail networks rose to 67.4%, from 63.1% in 2008, but then in 2010, with the currency devaluation effects absent, fell to 64.3%, according to the data from the State Statistics Committee. The recovery of domestic demand gave impetus to light industry, which grew 8.9% YoY in 2010, and to the food and beverage industry, which grew 3.2%.

Domestic demand will remain one of substantial growth factors in 2011 due to continued growth in real salaries and the resumption of bank lending

Domestic demand has continued to grow at stable rates in 2011, and partly offset the volatile external demand. In April 2011, retail trade turnover grew 15.3% YoY, and 13.8% in 4M11. The volume of services provided by Ukraine's enterprises rose 16.8% YoY in 4M11, and 19.7% YoY in April alone in comparable prices. Domestic demand will therefore remain one of the main drivers of economic growth in 2011. It occupies a sizeable share of Ukraine's GDP. In the structure of last year's GDP, consumer expenses comprised 83.4% (62.6% from individual consumers and 20% from the public sector), gross capital formation 19.4%, and net exports -2.8% (as total imports exceeded total exports in Ukraine in 2010).

It is worth noting that in 2010, domestic demand grew without the support from bank lending, as banks' balances of loans issued to retail clients were diminishing across Ukraine's banking system throughout 2009 (down 14%) and 2010 (down 13.1%). But, banks' lending activity resumed starting in 2011, and will stimulate economic growth during the year (but at the same time, will affect the inflation indicators, pushing prices and imports volume up, thus pressuring the local currency and widening the current account deficit). In a sign of scaled-up consumer demand, likely stimulated by bank lending, January 2011 recorded a phenomenal 50% YoY increase in new car sales, according to data from Autoconsulting.

Chart 26. Retailers' trade turnover

Percentage change to previous year of the 12-month rolling data on retail trade turnover

Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Machine-building, chemicals, light industry, and iron-ore mining became the industrial leaders in 1Q11, in addition to steelmaking …

Strong industrial dynamics continued in 1Q11 (up 9.7% YoY), but slowed down in April. In March 2011, industrial output stayed at a healthy level of 8% YoY, although it has slowed down compared with the 9.7% posted in January and 11.5% in February of this year. The frontrunners in 1Q11 in terms of YoY growth rates were chemicals (up 18%), light industry (up 17.4% YoY), machine-building (26.8%), production of non-metal mineral products other than coke and oil (29.3%), and metallurgy (up 11.7%). Light industry sped up in 2011, and has shown healthy growth rates in 1Q11. This was helped by the steady recovery of domestic demand, which can be measured by retail turnover indicators: it rose 12.3% in 1Q11, whereas in the same period last year, it fell 1.8% YoY. The transport sector's indicators were also on the rise in 1Q11: cargo turnover grew 15.5% YoY (in particular, construction materials were up 51.7%, but grain products were down 24.4%), and passenger transportation rose 3.6% YoY.

… but in April, industrial growth slowed down on falling external demand due to problems in Europe, Asia and North Africa

The 4M11 still saw good dynamics (industrial output up 4.9% YoY), albeit slower than in 1Q11, against last year's high base. But, while most industries posted YoY growth, the MoM data for April showed a considerable slowdown, indicating lower prospective growth rates for 2Q11. Only the food and beverages industry and the production of other non-metal goods saw MoM growth in April (by 2.4% and 14.1%, respectively), while other industries posted declines compared with the previous month, of 17.3% in the sector of electricity, water and gas production and distribution; 8.8% in machine-building; 3.2% in the chemicals industry; 5.9% in the clothing manufacturing industry; 3.8% in the steel sector; and 1.4% in the production of coke and oil products. April's industrial slowdown reflects worsening conditions in the world regions among which are Ukraine's main trading partners–Europe, Asia, and North Africa. That supports our earlier assessment that GDP growth will be lower in 2Q11 and 3Q11, bringing the full-year GDP up 4.5% in real terms.

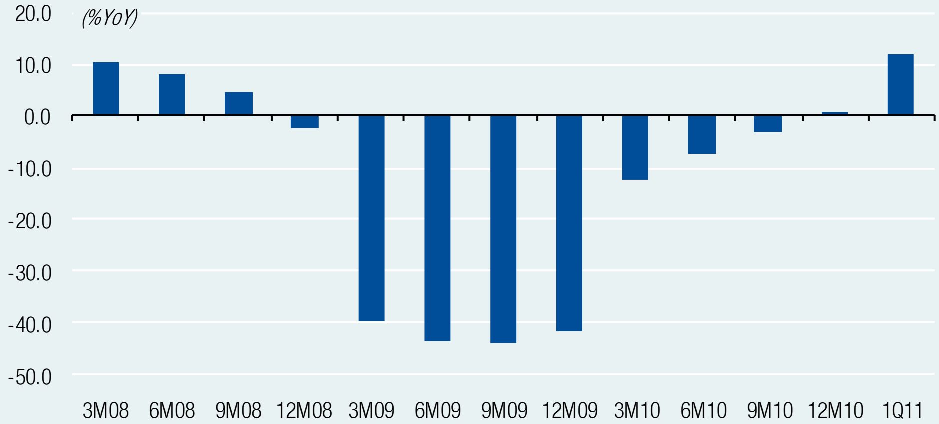
Fixed capital investments will be another important factor driving economic growth in 2011. In 2010, the share of fixed capital investments in GDP at 18.1% was still at the level of the crisis-laden 2009, i.e., still lower than the average in the pre-crisis years of 2004-08, at 24.62%. This gives room for fixed investments to increase their share in GDP, at least to reach the average level seen in the pre-crisis period, stimulated in part by the upcoming Euro-2012 football championship.

Fixed investments are to become an additional growth factor in 2011, as their share of GDP is yet to reach the 26% seen in the pre-crisis years, from the current level of 18%

Fixed investments started demonstrating positive dynamics beginning in 2H10: while in 1Q10, they fell 12.5% YoY, in 2H10 the rate of fall declined to 7.4%, further to 2.9% in 9M10, and to 0.6% YoY in 2010 as a whole. Fixed capital investments started growing due to increased public spending, starting from 3Q10, stimulated by the need to improve the country's infrastructure, i.e., stadiums, roads, airports, etc., ahead of the Euro-2012. The overall fall in fixed capital investments, by merely 0.6% YoY in 2010, was a rather positive indicator after their falling 41.5% YoY in 2009.

Chart 27. Fixed capital investments

Percentage change in real terms, year-to-date data



Source: State Statistics Committee of Ukraine.

The current government's team is generally known for its emphasis on fixed investment, in contrast with the previous Tymoshenko government, known to be more focused on public social spending. As a result, 2H10 brought the revival of the construction industry, after its very deep recession and a 48.2% drop in 2009, in 2010, the industry posted only a 5.4% YoY decline; and in 1Q11, it showed growth of 11.3%. Investment demand, and also retail demand on the part of firms in 2010, was to some extent supported by bank lending, as loans to corporate clients grew 8.4% YoY in 2010. Even though these loans mainly supported firms' working capital, they enabled companies to increase their own fixed capital investments.

The growth of fixed capital investment has continued in 2011: in 1Q11, rising 12% YoY, and the volume of construction works grew 11.6% YoY in 4M11, according to data from the State Statistics Committee, and 20% YoY in April alone. In addition, in 1Q11, the transportation of construction materials grew 1.5x, and the domestic market for rolled steel grew 36% YoY, both of which are indirect evidence of the expansion in construction activity.

Euro-2012 will stimulate enhanced fixed capital investments into infrastructure in 2011, helped by government spending and by resumed bank lending

This trend of growth in fixed capital investment is seen to continue in 2011, on the back of enhanced investments into infrastructure projects prior to the Euro-2012 football championship, to be hosted jointly by Ukraine and Poland. In all regions hosting the Euro-2012 football championship next year, the rate of fixed investments growth was relatively high: up 92.8% in Donetsk; 36.7% in Kharkivska; 23.3% in the Lvivska oblasts; and 26% in the city of Kyiv. At the same time, capital investments growth was also considerable in a number of other Ukraine regions: up 99.2% in Kyrovogradska; 87.7% in Vinnytska; and 55.1% in Ternopilska oblasts. Of the total volume of fixed investments in 1Q11, 40% went to industry; 19.5% to real estate, engineering, and other services to entrepreneurs; 13.9% to transport and communications; 7.9% to agriculture, and only 3.9% to construction, to name the largest destinations for capital investments. These data show that the growth in fixed investments is also stimulated by the country's overall economic recovery and expected resumption of bank lending.

Public spending now comprises only 3.9% of the total capital investment, while 63% is covered by companies' own funds

In 2011, the growth of fixed capital spending will be supported by both the private sector and the government, and likely by bank loans. The government's infrastructure spending in preparation for hosting the Euro-2012 championship initially became the catalyst of this process (back in 2H10), but in 1Q11, the government was the source of only 3.7% of the total capital investments. At the same time, the robust rates of growth of capital investments in the regions, other than those preparing to host the championship, show that the investment dynamics in Ukraine are also heightened by private investments, on the back of overall industrial and economic recovery and improved business expectations. Statistics show that 62.9% of the total capital investments came from the enterprises' own funds and 14.6% from bank loans, meaning that private sources dominate over state funding. In addition, the spectacular 122% growth of capital investments in Crimea in 1Q11, which might be the result of tax benefits introduced by the new Tax Code, could indicate the start of development of the tourism industry in Ukraine, which is a positive trend, as it will capitalise on Ukraine's natural competitive advantage in the region.

As shown above, industrial, transport, and retail trade statistics were all positive in 1Q11, showing healthy growth of Ukraine's economy, supported by both external and internal demand.

Fixed capital investments, external demand, and domestic consumption will be the factors supporting economic growth in 2011

Based on the 1Q11 and 2010 dynamics, we expect that economic growth will be led by the following drivers in 2011:

- **The rise of fixed investments**, in large part due to the government's infrastructure spending prior to Euro-2012, and also due to the expected recovery in bank lending. The statistics on fixed capital investments, domestic sales of rolled steel, on the construction industry, and the transportation of construction materials all indicate the revival of investment demand, deemed to add as a driver of growth to the following two factors, which had already been in place in 2010.
- **External demand** will remain one of the main drivers, but its strength will depend on the situation in the world economy, which currently demonstrates mixed trends.
- **Domestic consumption**, which will be supported by the continuing rise in real salaries, and in addition, by the expected revival of bank consumer lending in 2011.

External demand is rather uncertain, and might slow down in the coming months, as managers' surveys show

The prospects for external demand, however, are yet unclear for 2011. The European Commission's Business Climate Indicator (BCI) for the Euro area fell for the second consecutive month, to 1.28 in April 2011 from 1.43 in March and 1.45 in February. The current level of the indicator, which is close to its historical peaks, suggests that the recovery in industry will continue in the coming months. The drop in the BCI reflects worsening assessments of production trends observed in recent months, and of production expectations which declined sharply. At the same time, there was a slight improvement in the European managers' assessment of overall order books and export order books, but that did not offset the negative developments on the production side. The volume of industrial output in Europe unexpectedly dropped 0.2% MoM in March, whereas a 0.3% growth was anticipated. In emerging markets, growth has steadied in 1Q11, but is expected to be sustained, even though at a slower pace, according to a PMI index constructed by Markit. In view of monetary tightening measures currently being put in place by central banks and governments of almost all countries to cool down inflation in both developed and fast-growing markets, external demand for Ukraine's products might slow down. Ukraine's exports, however, might be helped this year if export quotas for all agricultural commodities are lifted after the harvest season, as expected (so far, the restrictions were removed for corn only).

We expect slower GDP growth in 2Q11 and 3Q11, bringing the real GDP growth for 2011 to 4.5%

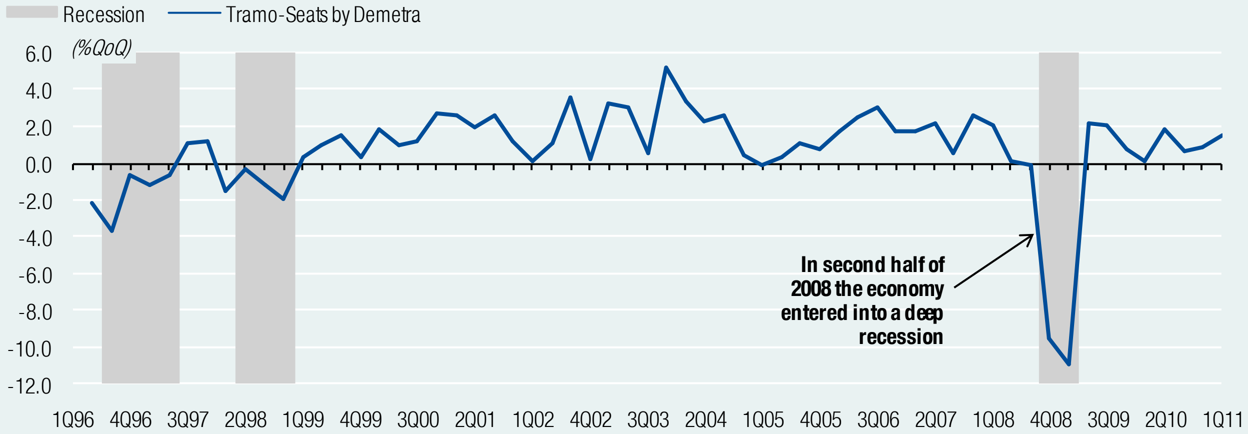
With the volatility of external demand & domestic demand seen in April and May, fixed investment spending has come to the forefront of factors supporting GDP growth in 2011. As we showed above, industries other than metallurgy, Ukraine's traditional growth driver, started gaining momentum, implying a broader basis for economic growth in 2011.

However, the steel industry remains the largest driver of Ukraine's economy so far, and its trends see a slowdown in 2Q11 and 3Q11. The output of Ukraine's steelmaking industry fell in April and the first week of May, and metallurgy enterprises are planning to decrease their output further by 3-5% in June, due to lower demand for their products in the world market, namely, East Asia and North Africa. The output in 4M11 rose only 1% YoY for iron, and 6% for steel and rolled steel. But nevertheless, in May, the Ministry of Industrial Policy upgraded its forecast for the output in metallurgy for 2011, which is now seen to grow at rather optimistic rates, of 12% for rolled steel; 9% for steel; and 6% for iron. We expect slower GDP growth in 2Q11 and 3Q11, so that the resulting industrial growth output will reach 8%, and real GDP growth in Ukraine will stand at 4.5% in 2011, in our view.

In terms of competitiveness, due to the fact that inflation in Ukraine in 1Q11 has been rising more slowly than in most of its trading partners, against a relatively stable exchange rate, this has pushed down the real effective exchange rate (REER) of the Ukrainian hryvnia, thus making Ukraine's exports more competitive. These data correspond with the ICU's TWI (trade weighted index), which we calculate based on data from Ukraine's major trading partners, which also points out the gradual increase in the external competitiveness of Ukraine's goods. In the mid-term, after the ECB's raising its interest rate, but with the Fed retaining its rate at the same level so far, the euro will experience appreciation pressure, making Ukraine's exporters even more competitive.

Chart 28. Narrow approach* on recessions in Ukraine's economy, since 1996 (% change to previous quarter)

Period of recessions are determined by the two consecutive contraction of real GDP to previous quarter in seasonally-adjusted terms

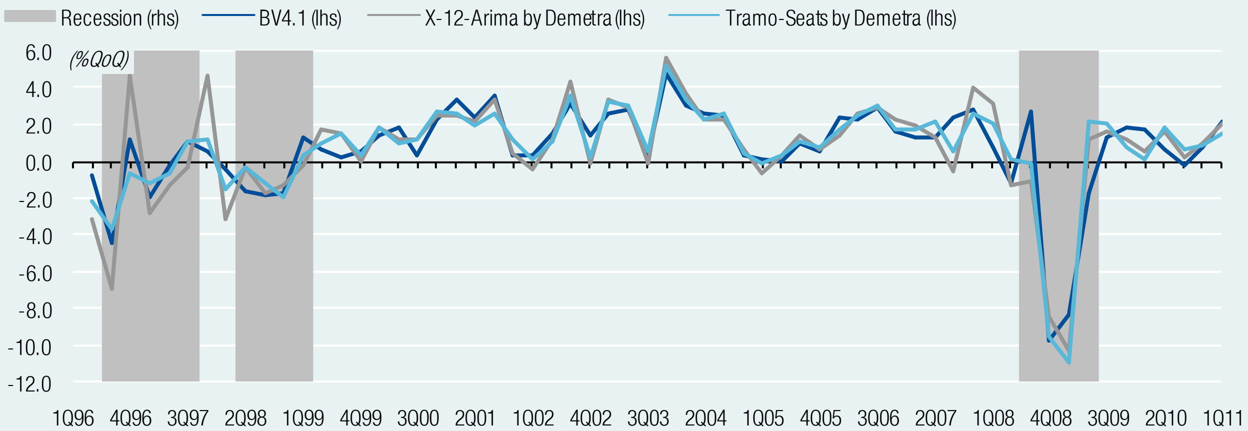


Note: narrow approach is a measurement of quarterly real GDP growth rates in seasonally-adjusted terms by Tramo-Seats model of Demetra.

Sources: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Chart 29. Wide approach to recessions in Ukraine's economy, since 1996 (% change to previous quarter)

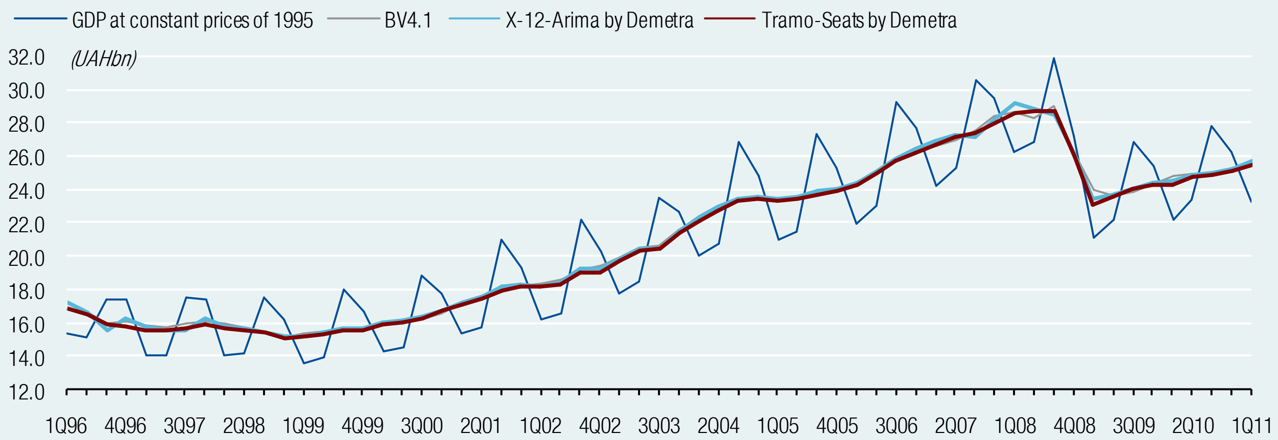
Period of recessions are determined by the two consecutive contraction of real GDP to previous quarter in seasonally-adjusted terms



Note: wide approach is a measurement of quarterly real GDP growth rates in seasonally-adjusted terms by three methods: 1) Tramo-Seats model of Demetra; 2) X-12 Aroma model of Detmetra; and 3) BV4.1.

Sources: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Chart 30. Quarterly GDP volume: Not seasonally-adjusted and seasonally-adjusted* (UAHbn)



Note: seasonally adjusted by three methods, for more details see table below. Sources: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Table 7. Ukraine's quarterly GDP in 1996-2011. Volumes in current and constant prices as well as volumes in seasonally adjusted terms and growth rates calculated by three methods

Period	Reported statistics				ICU calculations						
	GDP at current prices	Real growth (% YoY)	Seasonally-adjusted real growth (% QoQ)	GDP deflator (%YoY)	GDP at constant prices of 1995	Seasonally-adjusted GDP			Seasonally-adjusted real growth (% QoQ)		
						BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra	BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra
1Q96	16,688	-8.1		118.3	15,381	16,838	17,187	16,873			
2Q96	17,867	-9.1		83.9	15,108	16,705	16,659	16,513	-0.8	-3.1	-2.1
3Q96	22,510	-11.6		58.2	17,462	15,963	15,508	15,906	-4.4	-6.9	-3.7
4Q96	24,454	-10.0		40.1	17,404	16,151	16,228	15,799	1.2	4.6	-0.7
1Q97	18,728	-8.3		22.3	14,114	15,833	15,780	15,622	-2.0	-2.8	-1.1
2Q97	20,485	-6.6		22.7	14,117	15,797	15,586	15,520	-0.2	-1.2	-0.7
3Q97	26,076	0.5		15.3	17,544	15,981	15,531	15,699	1.2	-0.4	1.2
4Q97	28,076	0.0		14.8	17,405	16,065	16,258	15,885	0.5	4.7	1.2
1Q98	20,871	-0.3		11.8	14,068	15,996	15,744	15,644	-0.4	-3.2	-1.5
2Q98	23,367	0.5		13.5	14,188	15,742	15,701	15,588	-1.6	-0.3	-0.4
3Q98	28,908	-0.1		10.9	17,538	15,460	15,435	15,403	-1.8	-1.7	-1.2
…	…	…	…	…	…	…	…	…	…	…	…
3Q03	75,812	5.9		10.0	23,539	20,632	20,444	20,409	0.4	0.0	0.6
4Q03	78,151	12.2		4.7	22,727	21,622	21,605	21,478	4.8	5.7	5.2
1Q04	66,981	12.9		12.8	20,030	22,291	22,407	22,201	3.1	3.7	3.4
2Q04	78,607	12.7		14.8	20,773	22,881	22,923	22,712	2.6	2.3	2.3
3Q04	99,405	14.3		14.7	26,909	23,470	23,453	23,313	2.6	2.3	2.6
4Q04	100,120	9.1		17.4	24,800	23,540	23,616	23,415	0.3	0.7	0.4
1Q05	88,104	5.0		25.3	21,027	23,567	23,480	23,384	0.1	-0.6	-0.1
2Q05	101,707	3.5		25.1	21,484	23,572	23,569	23,465	0.0	0.4	0.3
3Q05	122,861	1.5		21.8	27,306	23,797	23,919	23,731	1.0	1.5	1.1
4Q05	128,780	1.9		26.3	25,257	23,930	24,090	23,913	0.6	0.7	0.8
1Q06	106,348	4.3		15.7	21,937	24,499	24,438	24,338	2.4	1.4	1.8
2Q06	126,319	7.2		15.9	23,023	25,074	25,080	24,964	2.3	2.6	2.6
3Q06	152,406	7.3		15.6	29,301	25,827	25,832	25,742	3.0	3.0	3.1
4Q06	159,080	9.6		12.8	27,659	26,256	26,421	26,183	1.7	2.3	1.7
1Q07	139,444	8.9		18.6	24,253	26,614	26,951	26,638	1.4	2.0	1.7
2Q07	166,869	8.6		20.4	25,260	26,962	27,303	27,208	1.3	1.3	2.1
3Q07	199,535	6.2		25.4	30,592	27,619	27,169	27,352	2.4	-0.5	0.5
4Q07	214,883	7.4		26.4	29,558	28,396	28,263	28,057	2.8	4.0	2.6
1Q08	191,459	8.5		26.6	26,303	28,611	29,161	28,635	0.8	3.2	2.1
2Q08	236,033	6.2		33.2	26,824	28,271	28,796	28,685	-1.2	-1.3	0.2
3Q08	276,451	4.3		32.9	31,892	29,036	28,486	28,666	2.7	-1.1	-0.1
4Q08	244,113	-7.8		23.3	27,233	26,216	26,080	25,932	-9.7	-8.4	-9.5
1Q09	189,028	-19.6		22.8	21,148	24,043	23,402	23,083	-8.3	-10.3	-11.0
2Q09	214,103	-17.3		9.7	22,181	23,625	23,693	23,599	-1.7	1.2	2.2
3Q09	250,306	-15.7		7.4	26,886	23,926	24,091	24,099	1.3	1.7	2.1
4Q09	259,908	-6.7		14.1	25,412	24,369	24,385	24,292	1.9	1.2	0.8
1Q10	219,428	4.8	0.7	10.7	22,176	24,792	24,511	24,321	1.7	0.5	0.1
2Q10	260,150	5.5	1.4	15.1	23,415	24,965	24,928	24,789	0.7	1.7	1.9
3Q10	304,709	3.6	0.4	17.5	27,855	24,926	24,993	24,951	-0.2	0.3	0.7
4Q10	310,320	3.3	0.7	15.6	26,247	25,109	25,233	25,176	0.7	1.0	0.9
1Q11	261,199[1]	5.2	2.9	13.2[1]	23,329	25,663	25,768	25,551	2.2	2.1	1.5

Notes: in constant prices means that volumes are deflated by GDP deflator back towards December 1995; [1] figures are calculated by ICU.

Sources: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Fiscal policy

New Tax Code in force since 2011

The New Tax Code reduces the burden of official taxes for enterprises, but closes many loopholes for tax evasion

The influence of the newly adopted Tax Code on Ukraine's further economic development will be twofold, in our view. On the one hand, it will reduce the tax burden of official taxes on enterprises, but on the other hand, enterprises will lose many opportunities for tax optimisation, because the Code closes many loopholes, and because the state tax administration hiked up its effort to fight tax evasion. Therefore, the overall net effect of the new Tax Code is likely to be a zero to slightly upward change in the size of the overall enterprises' tax bill. However, for certain industries which the government is pushing for development, the tax burden reduces considerably. In terms of public revenue, the stricter controls over tax evasion should enhance revenue collection to the state budget.

Corporate profit tax and VAT rates have been cut

First and foremost, the Tax Code reduces tax rates, and cancels certain minor taxes, thus relieving the tax burden for companies and simplifying the country's tax system. For corporate profit tax, the rate decreases from 25% to 23% in 2011, to 21% in 2012, to 19% in 2013, and down to 16% in 2014. VAT will fall to 17%, starting from 2014, down from its current level of 20%; in addition, the government developed and launched in March a mechanism of automatic refunding of the VAT to enterprises meeting certain criteria. Another tax novelty is that enterprises with sales below UAH3m will be entitled to a 0% income tax.

Tax benefits are given to textile & garment industry, hotels, aircraft and shipbuilding, production of agricultural machinery, and renewable energy

In addition, the Tax Code gives tax privileges, i.e., an income tax-free regime for 10 years, to certain industries including the textile & garment industry, hotels, aircraft, and shipbuilding, production of agricultural machinery, and electricity production from renewable sources; the income tax, released as a result, shall be directed to technological upgrading of the enterprise. The rationale behind this is to give new impetus to the development of industries in which Ukraine has historical and geographical strengths, to build on the country's competitive advantages, and to stimulate import substitution. Also, construction works in the social housing and government-sponsored projects will not be levied with the VAT. The expected result of these measures is that accelerated growth in these industries will contribute to overall GDP growth in the long term.

Also, the Tax Code provides incentives for the development of alternative energy sources by waiving till 1 January, 2019 the VAT on supplies and imports of equipment used for producing or utilising energy from alternative sources, and waiving till 1 January, 2020 income tax for the producers of biofuels and machinery utilising bio-fuels.

The budget revenue is set to rise due to the introduction of progressive personal income tax, and the closing of many tax evasion loopholes

At the same time, the new tax code provides for the increase in the budget tax revenue on a number of positions. First, it introduces a progressive tax for personal income: 15% for incomes below the level equalling 10 minimum salaries (UAH9410, or US$1,184), and 17% for incomes exceeding that amount. Previously, all personal incomes were taxed at a flat 15% rate. Second, it removes from grain exporters the right to claim VAT rebates, starting from June 2011, this way reducing the sum of VAT redemptions paid out from the state budget.

Another major goal of the new Tax Code is to close the loopholes used for tax evasion. For example, the government liquidated many benefits, which had been for a number of years enjoyed by small entrepreneurs under a simplified taxation system. Also, from now on, the costs of goods or services purchased from enterprises registered under simplified tax system cannot be deducted from taxable income. These changes already caused many small businesses to close up. For large and mid-size businesses, these restrictions might result in larger tax obligations in the short run, but that effect will be offset by the reduced taxes in the mid- and long term.

Overall, the new Tax Code will have positive consequences for Ukraine, but more likely in the mid-term

Overall, the adoption of the new tax code will bring more positive consequences to Ukraine's economic development than negative, we believe. However, the positive consequences are seen to manifest themselves only in the mid- and long term, while in the short term, we might see a certain reformatting of the economic landscape, caused by closing down of some enterprises and increased tax burden on the remaining ones. The most important advantage of adoption of the new code is that it puts all tax norms in good order, making Ukraine's intricate tax legislation more comprehensive for an investor.

In the mid-term, Ukraine's economy will benefit from more transparency and reduced energy-consumption, cut its tax burden, and enhance economic activity in the tax-benefit industries. By closing the existing loopholes, the Tax Code will bring a larger share of enterprises' incomes and employees' salaries out from the grey zone, helping to heal the government's finances. However, the structure of Ukraine's economy will need to undergo a certain reformatting in the near term, in terms of increasing the share of mid-sized and large enterprises, closing down some less efficient businesses that are unable to compete under more transparent system, and bringing a larger portion of enterprises' income to light, thus making Ukraine's economy more transparent.

Our view on the 2011 budget deficit reduction prospects

With the new government currently in office, the budget performance improved dramatically

The new government's team, which took office in March 2010, during their first year of tenure, showed improved fiscal discipline, and that they can manage public finances rather well, in contrast with the previous government. The improved management of public finances could be seen from the results of both 2010 and 4M11, so we can expect a rather healthy state of the public budget in 2011, with the deficit going down below the planned 3.1%.

In 2010, the total deficit of the consolidated budget and Naftogaz reached 7.35% of GDP, exceeding the 6.5% ceiling set by the IMF

The government finished the 2010 with a deficit of the state budget reaching UAH64.4bn, which exceeded the year's plan by UAH12bn, or 19%, according to the MoF data. The consolidated budget deficit, which includes the state budget and local budgets, reached UAH64.8bn, bringing the 2010 consolidated budget deficit to the level of 6% of GDP. The deficit of state oil and gas monopolist Naftogaz rose 1.5x, to UAH15bn, compared with the planned UAH10bn. Together with Naftogaz's deficit, the total actual deficit reached 7.35% of GDP in 2010, exceeding the 6.5% ceiling set by the IMF.

Public revenue posted 22.6% YoY growth in 2010, if adjusted for the VAT arrears accumulated in 2008-09 by the previous government

The official figure on the state budget revenue in 2010, as reported by the State Treasury, stands at UAH240.4bn (US$30.2bn), which is up 14.6% YoY over actual state budget revenue in 2009. However, we should note that actual public revenue in 2010 stood at a higher level, UAH257.1bn, but in August, the UAH16.4bn was deducted from the revenue as a result of the conversion of VAT rebate arrears into government bonds. This technically reduced the official figure on public revenue, and made it look as if the state budget was underfulfilled in 2010 by 5.7% compared with the plan (UAH255bn).

At the same time, there are certain reservations to such a conclusion. The VAT arrears, which were converted into VAT bonds in August 2010, were accumulated in the period from 2008 up until April 2010 (i.e., under the tenure of the previous government of Yulia Tymoshenko). So in fact, the public revenue that the government collected in 2010 had to cover part of the public deficit from the previous years. Public finance accounting rules require deducting the VAT arrears (UAH16.4bn) from revenues at the time of the conversion of these VAT arrears into state bonds. Therefore, the officially reported figure on 2010 public revenue in fact understates the government's fiscal performance in 2010 and its ability to raise funds and fulfil the state budget. If we take into account the actual figure of state budget revenue raised by the government in 2010, then it turns out that the actual state budget revenue exceeded the plan by 8.3% and exceeded the actual 2009 revenue by 22.6%. This observation is important in terms of making a forecast for the government's ability to keep to fiscal targets of 2011, when revenue is set to rise 18.5% (to UAH285.1bn) and the deficit to drop 40% (to UAH38.8bn), and be confined to a rather tight limit of 3.1% of GDP (the IMF-set the ceiling for the public deficit in 2011 as 3.5% of GDP).

The government can regulate the size of the public deficit by year-end expenditures, and did so in 2010

State budget revenue for 2011, according to the amended law, is planned at the level of UAH285.1bn (US$35.64bn), up 18.5% over the officially reported 2010 revenue, and up only 10% if compared with actual public revenue collected in 2010, i.e., before deducting the sum of UAH16.4bn that was converted into the government's VAT bonds, which in fact represented a deficit from the previous years. The consolidated budget revenue for 2011 is planned at UAH360bn (US$45.3bn), or 28.7% of estimated GDP. Over the recent years, consolidated budget revenue as a share of GDP has decreased: in 2008, it stood at 31.4% of GDP (UAH948.1bn); in 2009 at 29.8% (UAH914.7bn); and in 2010 at 29.6% (UAH1083bn). Consolidated budget includes state budget and regional budgets.

The state budget plan for 2011 looks quite realistic: revenue is planned at US$35.4bn, up only 10% over the actual 2010 revenue, while public expenditure is up merely 6%

Public expenses in 2011 are planned at the level of UAH325.5bn (US$40.5bn), up 7.2% over last year's. Also important is to note the timing of public expenses. In 2010, the government afforded large-scale expenses not until December (UAH36.9bn, while the average monthly budget expenses equaled UAH25.3bn). Large-scale public expenses at the end of the fiscal year are the usual practice in Ukraine. We consider that the government waits with major expenses until the very last moment to see if it keeps more-or-less in line with the revenue, and if the budget could balance overall. So, only those expenses which would not spoil the government's fiscal position are carried out eventually, and in case of 2010, the IMF's assessment of Ukraine's fiscal discipline. Overall, public expenses equaled UAH303.6bn in 2010, which was 1.3% less than planned (UAH307.75bn).

The state budget deficit is set to drop to UAH38.8bn (US$4.9bn) in 2011, down 40% from UAH64.4bn of the officially reported deficit, and still down 19% from the adjusted level of public deficit (UAH48bn), i.e., the deficit net of the VAT bonds issued, which are in fact the deficit of the previous years.

With or without the VAT bond adjustment, the 2011 state budget plan looks rather feasible for its fulfillment, especially taking into account the dynamics of the budget fulfillment in 4M11. To compare, in 2010, the actual state budget revenue grew 14.7% over 2009, while state budget expenses grew 25.2%.

In 4M11, budget revenues reached US$11.25bn, having grown 21% YoY, and comprised 32% of the year's plan, while the deficit stood at merely US$0.5bn

The government's budget performance in 4M11 turned out quite strong. Despite a poor fiscal performance in January, linked with a long period of holidays, in 4M11, revenues collected into the state budget posted 20.8% YoY growth, reaching UAH89.8bn (US$11.25bn), comprising 31.5% of the full year's plan (UAH285.1bn, or US$35.2bn). In particular, VAT proceeds (UAH40.47bn) exceeded by 9.6% the plan designated for the 4M11 period, and the proceeds from corporate income tax (UAH13.1bn) exceeded the plan by 4.9%. In April alone, state budget revenue grew 7.7% MoM. The results from 4M11 showed that the budget fulfillment is staying at a better-than expected level this year: the state budget revenue has almost reached its planned level, while the deficit of the state budget has stayed as low as UAH3.97bn (US$0.5bn) in 4M11, or merely 10% of the full year's plan (UAH38.8bn, or US$4.85bn). This is despite the fact that overdue taxes, non-received from one of the largest taxpayers, state-owned Naftogaz, grew to UAH3.4bn in 1Q11, and the volume of taxes due which have been postponed rose to UAH13.7bn.

The IMF-sanctioned fiscal target, of the public deficit not exceeding 3.5% of GDP in 2011, will likely be fulfilled...

In 5M11, the state budget revenue grew to UAH119bn (US$14.88bn), which is a 26.8% YoY increase. The average monthly revenue in 5M11, which includes the seasonally low January's proceeds, stood at around UAH23.8bn, which matches the average monthly revenue needed to fulfill the budget plan for 2011 (UAH285.1bn). Therefore, on the basis of the 5M11 fiscal performance, we can conclude that the government is coping with the budget plan for 2011 rather well. In addition, the state budget received sizeable support (a total of UAH10.57b, or US$1.32b) in April and May from the privatisation of state-owned fixed telecommunications monopolist Ukrtelecom. As of 1 June, 2011, the government's cash balance in the consolidated treasury account in the national currency stood at an astonishingly high level, UAH17.6bn (US$2.2bn), plus the government had around US$2.25bn in its accounts in the foreign currency.

… and public debt obligations will be repaid in full, as the government has rather high balances on its accounts, in both the national and foreign currency

Therefore, despite the new norms and tax benefits that took effect from April, according to the new Tax Code, they did not affect the budget revenue; therefore, we see that the government has a high chance of fulfilling the state budget at nearly the planned level by the year end, i.e., with the deficit not exceeding 3.5%, as agreed upon with the IMF. This will enable the government to make timely payments on its debt obligations this year: the total public debt due in 2011 is UAH81.65bn, or US$10.23bn, including UAH59.5bn of principal and UAH2.6bn of interest; of the total, UAH24.35bn, or US$3bn, was already paid in 4M11. The sufficient level of public revenue will also enable the government to finalise the repayment of its VAT debt arrears to enterprises.

The strong fiscal performance in 4M11 shows that the fulfilment of the budget plan will be better than expected in 2011...

The better-than-expected public revenue collection in 4M11 gave the government the reason to announce the plan to increase public expenditures in 2H11, in order to raise salaries to state employees and pensions, in a move to appease the electorate before next year's elections. Several days earlier, Ukraine President Viktor Yanukovich even declared that Ukraine will finish 2011 with a zero deficit of the state budget. As the government is monitoring the situation in the budget performance on a day-to-day basis, their bold statements must have been made taking into account the state budget dynamics for the first two weeks of May as well. Thus, even though one statement contradicts the other, they both show the government's confidence that the public revenue in 2011 will exceed the plan.

Overall, given the 2011 year's economic dynamics and its further prospects, if the 4M11 dynamism of the government's public revenue collection continues into the later months of the year, we forecast that the state budget in 2011 will be fulfilled around the planned level. The increased public revenues imply two alternative outcomes: either a fiscal deficit will be lower than the originally planned 3.1% of GDP by the year-end, or state expenditure will be increased, to utilise the extra revenue collected.

We foresee that the level of public deficit will likely not be reduced, despite extra available revenues: in the year preceding the elections, and amidst halted cooperation with the IMF, the government will be inclined to spend all extra available resources to generate tangible, material benefits, rather than achieving some intangible goals like reducing the state budget deficit.

... but any extra collected revenues will be spent on raising salaries and pensions

The government seems to be coping well with the budget fulfillment this year, and the new Tax Code seems to be having a positive impact on the public revenue collection. On the flip side of this, we should bear in mind that to achieve such results, the state tax service has likely applied administrative pressure to some taxpayers to make them pay taxes in advance of the due date, a practice that was even at one point publicly critcised by the president. In addition, the tax authorities have likely succeeded in their campaign to bring 'grey' salaries out into the official, taxable, zone. Also, the State Audit Commission reported that the VAT arrears have again started building up, reaching UAH1.365bn (US$0.2bn) in

1Q11, whereas it was near zero at the beginning of the year. Finally, the new tax code is extremely disadvantageous to small entrepreneurs, forcing many to close down and causing their public protests in several Ukrainian cities in May.

The government will have resources for enhanced capital spending in 2011, adding impetus to GDP growth

The good level of public revenue collection in 4M11 will provide the necessary funds for enhanced fixed capital spending, particularly for state infrastructure improvement projects for the Euro-2012 football championship to be jointly held by Ukraine and Poland in 2012, i.e. the construction and reconstruction of roads, railways, stadiums, airports, hotels, and electricity networks. The increased fixed capital spending through the ripple effect should add impetus to economic growth this year.

Monetary policy: shift on inflation, at last

Inflation was single-digit (9.1% YoY) in 2010, due to government's administrative measures...

As elsewhere in the world these days, inflation will be a big challenge for Ukraine in 2011. Headline CPI began to rise again in 2011, after it unexpectedly entered a single-digit territory last year (9.1% YoY in 2010) resulting from coordinated anti-inflation actions on the part of the new government and the NBU's cautious monetary policy and mobilization of excessive liquidity from the market, keeping monetary aggregates within IMF-designated limits. Additional factors that prevented prices from rising quickly in the post-crisis year-2010 included both the halt in banks' credit activity and also the uneven recovery in Ukraine's regions, with the periphery lagging behind the capital in its recovery. The government's administrative anti-inflation measures, aimed at holding down prices, however, played a major role in achieving slowing price dynamics in 2010 and will continue to be a major factor in 2011 as well. The anti-inflation measures included putting price caps of certain social goods, limiting retailers' margins, imposing grain export quotas, sending enterprises' management the lists with recommended prices and applying anti-monopoly sanctions against some companies that disobey.

... but is accelerating in 2011: CPI stood at 9.4% YoY in April

However, in 2011, inflation got a new impetus, as world prices for major commodities have continued rising. Although the level of core inflation was still lower in 4M11 (7.2% YoY) versus the same period last year (10.4% in 4M10), on a MoM basis it accelerated to 0.8% in March, before falling to 0.6% in April. The process reflects secondary external inflationary effects, as rising commodity prices had an impact on the prices of processed goods, and has little influence from the NBU's monetary policy. This shows that inflationary risks have scaled up this year, and might include postponed effects from last year's administrative suppression of prices. As a result, the index of consumer prices grew 4.7% in 4M11, and 1.3% MoM in April, whereas in 2010 prices were declining on a MoM basis in each month from March to July. So it will be a big challenge for the government to fulfill its own inflation plan, i.e. to reduce inflation further to 8.9%, as stated in the 2011 budget plan.

Summer 2010 saw a milestone shift in the NBU's priorities from managing the UAH/USD pegged exchange rate to targeting inflation

In the context of accelerating inflation, the shift in the NBU's strategic priorities towards targeting inflation from controlling the hryvnia/USD exchange rate was a milestone, as it shall become a crucial factor helping to cope with inflation in the mid-term. Last summer, a new Law on the National Bank was finally adopted, under IMF guidance, which has put price stability as the major goal of the central monetary regulator. Until now, the NBU was predominantly concentrating on keeping the hryvnia exchange rate within the pre-determined corridor and regularly intervening in the FX market to smooth UAH/USD exchange rate fluctuations; therefore, it had little control over prices. Starting from 2010, the central bank has been working with the government on fighting inflation, unlike in previous years when fiscal policy often went contrary to the low inflation goal. In autumn 2010, the NBU got a new head, Serhiy Arbuzov, who is believed to be loyal to the current president and government, so we can expect continued cooperation of fiscal and monetary authorities to keep prices dynamics under control.

As noted above, Ukraine's central bank legally sealed its shift to inflation targeting policy in the law adopted last summer. The NBU also declared a 5% inflation rate as the target to be reached by 2014. At the same time, there is still a long way to go before the NBU can abandon its de facto fixed currency exchange rate policy in favour of focusing on controlling the stability of prices. In order to fully embark into an inflation targeting regime and allow the currency exchange rate to be fully set by the market, Ukraine needs to create and launch a forward currency market to hedge currency risk. This has officially been planned for June, but until now only a few steps have been made in this direction. One of the most recent was the NBU's decree (which was adopted in May, i.e. even prior to the IMF's deadline, set for the end of September) to liberalize intraday bank currency trading starting from May 20 (allowing banks to sell and buy currency on the same day) and introduce swap instruments from May 30 to help banks better manage liquidity without the central bank's interventions. The market accepted the liberalization quite well, and did not experience a big difference in terms of currency rate volatility after the NBU's decree took effect. Earlier, the NBU cancelled the tax on FX operations. At the same time, a major prerequisite for the successful move away from FX-rate targeting is the introduction of forward markets and the mechanisms of hedging currency risks, which unfortunately still remains unrealized and is hopefully under development by the central bank.

At present, the NBU de facto remains committed to the policy of a managed UAH/USD peg

The NBU keeps reiterating publicly that it will hold to its policy of achieving price stability, and will tighten monetary policy if any liquidity hikes need to be capped. At the same time, the NBU keeps intervening in the FX market, both selling and buying US dollars, to soften the UAH/USD rate fluctuations. At present, the NBU de-facto continues to maintain a fixed exchange rate regime, and it has often reiterated that it will attempt to prevent the hryvnia's exchange rate from severely fluctuating – this is a policy that in fact contradicts the inflation targeting goal.

But the NBU's steps towards inflation targeting are progressing rather slowly

As commodity prices rise amidst excessive liquidity worldwide, and as the NBU continues monetary interventions through the FX channel to stabilise the hryvnia exchange rate, we believe inflation will reach 11.3% in 2011. Although the IMF expects the central bank to move to a fully flexible currency exchange rate regime by the end of September, we see this timeline as rather unlikely, because there is a significant jump from the NBU's current verbal interventions to taking real steps to move away from the UAH/USD peg toward price control as the major monetary policy goal.

The banking sector

Prior to the Lehman collapse in September 2008, this sector that grew at an explosive rate in real terms (as an example, the foreign currency loan book growth peaked at 96% in April 2007) is still undergoing the rebalancing, and, in some parts of the sector, loan book contraction. Russian state banks are driving growth and lending now.

The rebalancing sector

The sector rebalances away from a loan-to-deposit ratio of 1.6x seen in August 2008 toward a more prudent level…

Since the deep recession of 2008-09, on the eve of which bank lending had accelerated its pace of loan extension to nearly 100%, the local banking sector in the country has been rebuilding their balance sheets to restore its funding base, being focused on deposits and working on the quality, rather than the size, of its loan portfolio. As the following charts depict (see Chart 33 and Chart 34 on page 44) the local banks as a whole have seen much faster growth of customers' deposits in real terms[7] than growth of the loan portfolio.

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[7]By saying in real terms we mean the growth rate of loans and deposits that are adjusted to inflation in Ukraine (concerns the local currency loans and deposits) and in the US (concerns the foreign currency loans and deposits as

The banking sector had been exposed to sizable foreign currency operations on both sides of the balance sheet, i.e. in both lending and deposits. As of 1 April 2011, the banking sector's loan book composition between the local-currency loans and the foreign-currency ones was 53.8% and 46.2%[8], respectively. While corporate clients tend to rely on local-currency lending more than households do – corporate clients have loans owed to banks in the currency composition of 61.7% local versus 38.3% foreign currency, while households have 32.3% versus 67.7%.

The government ban on foreign-currency lending in 2009-10 as a result of the crisis, and banks' self-restraint over lending to the unhedged borrowers (largely, these are households and businesses with no export sales) in foreign currencies, have contributed to the trend of falling stock of foreign-currency loans on the banks' balance sheets (see the left-handed part of Chart 33, page 43).

…relatively high nominal interest rates and positive real rates on UAH deposits aid to this rebalancing

Another trend, starkly visible in the sector, is that banks have been attracting customer deposits with much more vigour than in the pre-crisis period, when the predominant strategy was to borrow from the wholesale debt markets, i.e. the Eurobond and syndicated loan markets, and in turn lend that money to the customers. Currently, such a trend has a two-fold explanation: (1) the banking sector as a whole is trying to shift its structure of liabilities to rely more on core liabilities like customer deposits and less on wholesale borrowings; and (2) the macroeconomic environment has provided fertile soil for customers to increase their savings into bank accounts (see charts next page).

Thus, from August 2009 through April 2011, for which NBU statistics on customer deposits are available, the real rate of one-year deposits for households has been positive (see Chart 31 below), averaging 2.8%. This, in our view, is one of the reasons for an increase of monthly inflows of household deposits into the banks' balance sheets. In total, the banking sector attracted UAH132.9bn as household deposits maturing 6-12 months or UAH6.3bn per month on average. In the previous period, when the real rate on 1-year household deposits was negative, according to our calculations, the monthly inflow of household savings into bank deposits was UAH2.1bn a month on average.

In our view, real rates are to remain positive in 2011 to allow banks to build up core liabilities of their balance sheets

As inflationary pressures are expected to intensify later this year—due to administrative measures on increasing state-regulated tariffs on household utilities and to higher energy costs on the back of higher crude oil prices—the real rate is likely to alter its latest value of 0.2% as of April[9], but it will not turn into the red, in our view, as banks' determination to build up their funding base from customer deposits is to lure customers with rates that will likely cause a bit of inflation in 2011. Hence, real rates that banks pay for their key types of core liabilities (the benchmark, one-year household deposit) should be positive, i.e. within a 2-5% per annum.

Another cornerstone issue of liquid assets that are a key component of the banks' balance sheet nowadays (see Chart 32 below) is that over the several past years bank lending has barely increased. On one hand, banks have been raising their capitalization, as exemplified by the equity-to-assets ratio that rose above 14.3% for the whole banking system as of April 2011, up from pre-crisis level of 12.4% in August 2008, primarily though capital injections from state and private shareholders who largely invested their spare liquidity into the least

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we assume that most of the foreign currency loans and deposits are denominated in the US dollar). We consider the banking sector volume of loans and deposits at constant prices as of December 1996.

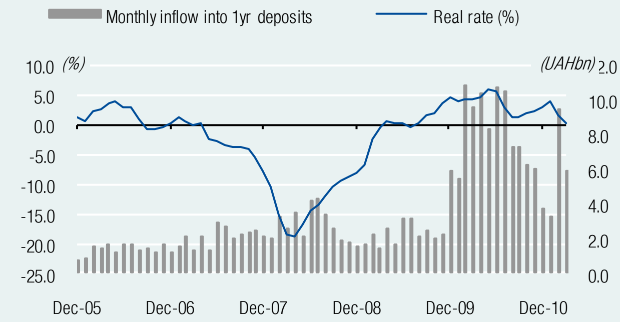
[8]It should be noted that since 1999, such a proportion in rough terms has been common for the domestic banking sector as share of foreign-currency loans have never dropped below the 40% threshold.

[9] This real rate is derived as difference between nominal rate on household deposits with maturity of 6 months to one-year, 9.6%, and yearly CPI of 9.4%.

risky assets, i.e. local-currency state bonds. The share of state bonds in banks' assets rose from less than 1% in August 2008 to 7% as of April 2011.

Chart 31. One-year real deposit rate and monthly deposits inflow

History since December 2005 till April 2011

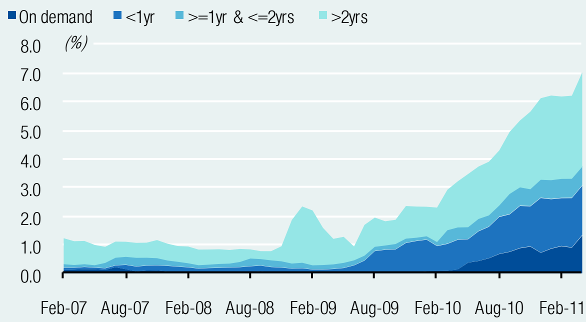


Notes: real rate is a nominal rate on household deposits with maturity between 6 months and 1 year; monthly inflow is a volume of funds the households put into the deposits with maturity range from 6 months to 1 year.

Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 32. Banks' investments into UAH state bonds (% of assets)

Breakdown by maturity of the securities



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

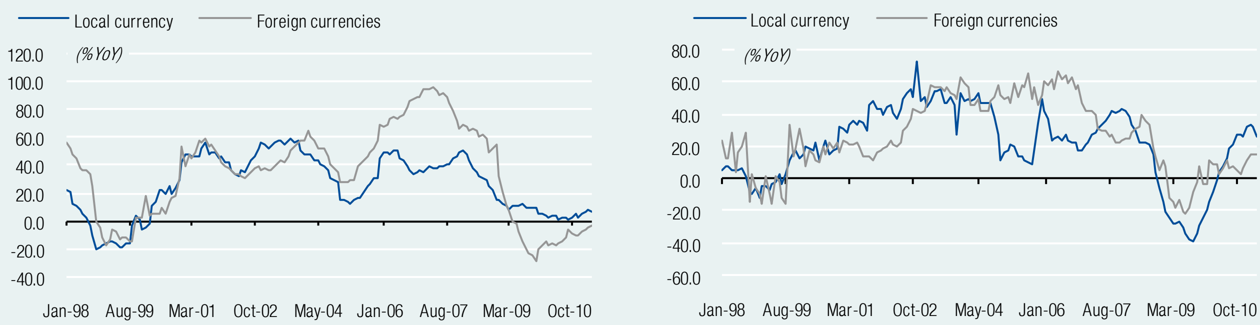
The most active banks in terms of lending are Russia's owned banks and local state-owned banks

While Ukraine's fiscal and monetary authorities were content with the government's ability to tap the local bond market to finance its deficit and rollover local debt during 2009-10, the authorities have been more vocal on pushing the banks to lend to businesses to stimulate domestic economic activity. In our view, the banking system's reaction to this call from the authorities will largely be muted as most of the banking system is still cautious to accept additional credit risk into its loan portfolio (read the next section called "Tri-speed sector: Who is in the lead?" on page 46). It appears that banks owned ultimately by Russian government and the local state-owned banks which are instrumental in the state hands to lend to Ukrainian government controlled enterprises and projects are the two groups of banks that have been most active in 2010. The local banking sector's developments in 1Q11 did not change this notion much, in our view, and in the rest of 2011 their dominance will prevail in the lending business.

Chart 33. Real growth[1] of banking sector's loans (left chart) and deposits (right chart): breakdown by local and foreign currencies

History since January 1998 till April 2011, data adjusted for inflation and exchange rate movement of the local currency hryvnia

Loans[2] *Deposits[2]*

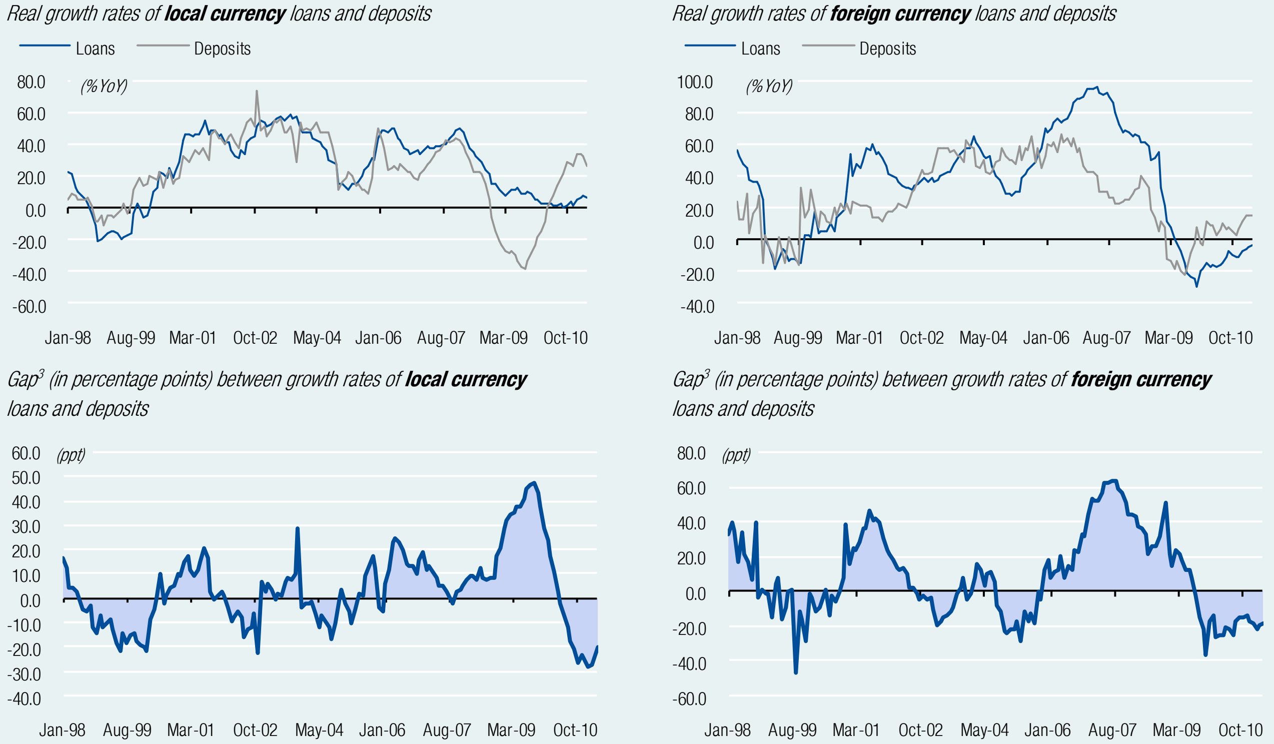


Notes: [1] real growth means that growth rate is measured as a percentage change in year-on-year terms between volumes of loans and deposits at constant prices of January 1997, loans and deposits in local currency hryvnia are adjusted by headline CPI in Ukraine, foreign currency loans and deposits are assumed to be in US dollar, they derived from reported volumes in UAH by diving a monthly volume of loans and deposits by average exchange rate of UAH/USD for the respective month, then these US-dollar volumes of loans and deposits are adjusted by headline inflation in USA; [2] loans and deposits are break downed into two groups: local- and foreign-currency loans and deposits.

Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 34. Real growth[1] of loans[2] versus deposits[2] of the banking sector: in the local currency hryvnia (left chart) and foreign currencies (right chart)

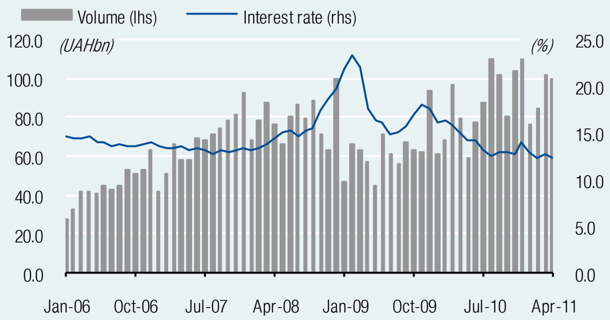
History since January 1998 till April 2011, data adjusted for inflation and exchange rate movement of the local currency hryvnia



Notes: [1] real growth means that growth rate is measured as a percentage change in year-on-year terms between volumes of loans and deposits at constant prices of January 1997, loans and deposits in local currency hryvnia are adjusted by headline CPI in Ukraine, foreign currency loans and deposits are assumed to be in US dollar, they derived from reported volumes in UAH by diving a monthly volume of loans and deposits by average exchange rate of UAH/USD for the respective month, then these US-dollar volumes of loans and deposits are adjusted by headline inflation in USA; [2] loans and deposits are break downed into two groups: local- and foreign-currency loans and deposits;
[3] gap, or spread, between loans growth rate over the deposits growth rate.

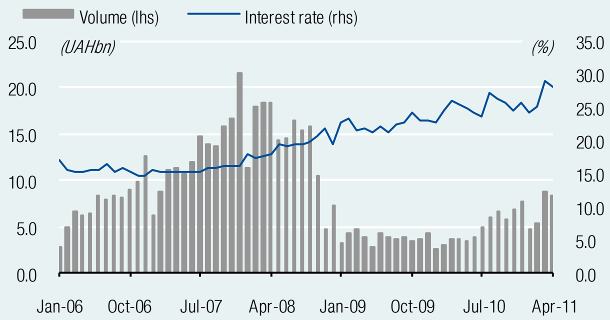
Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 35. Monthly volume of loans extended by banks to customers (non-financial corporations)



Source: National Bank of Ukraine.

Chart 36. Monthly volume of loans extended by banks to households

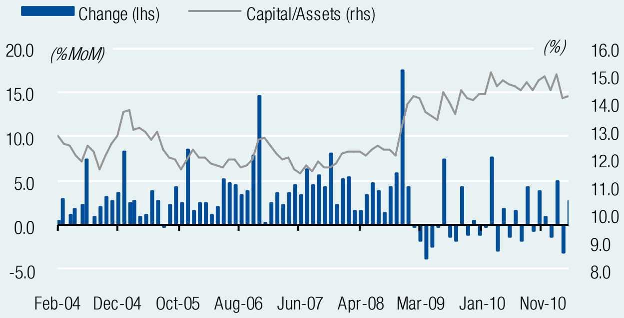


Source: National Bank of Ukraine.

What has changed? 1Q11 has not shown us material changes in the structure of bank loan portfolios. As can be seen in further charts, despite the continuing decrease in foreign currency household loans, the total amount still shows a decreasing trend, although local currency household loans from December 2010 have risen slightly over three consecutive three months. As charts above show, while Ukrainian banks are still searching for good household customers, but pay more attention to business customers.

Chart 37. Banking sector capital: relative size and monthly growth

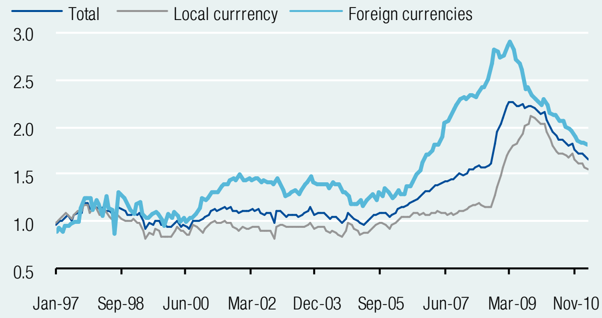
History since February 2004 till April 2011



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 38. Loans-to-deposits ratio (x)

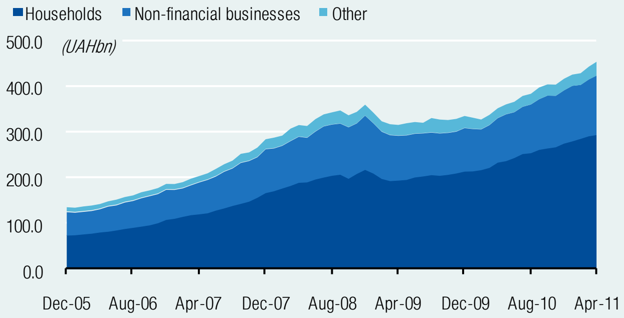
History since January 1997 till April 2011



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

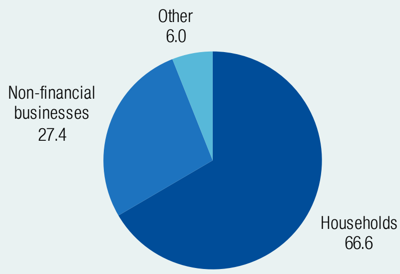
Chart 39. Nominal volume of customer deposits in the Ukraine's banking sector: historical evolution and breakdown by customer

History since December 2005 till April 2011



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

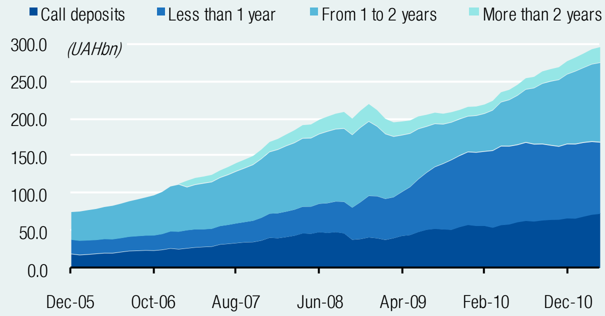
Breakdown as of end-April 2011; 100% = UAH454.8bn



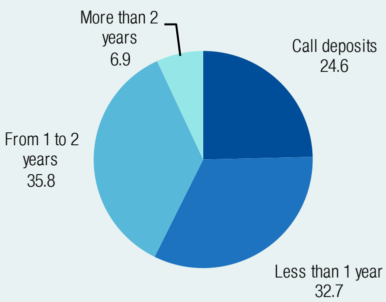
Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 40. Household deposits in the Ukraine banking sector: historical evolution, term and currency structure

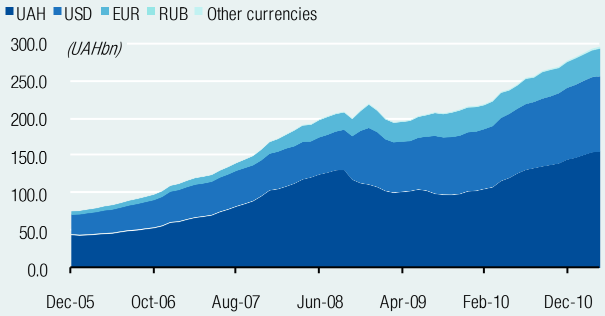
Term structure breakdown; history since December 2005 till April 2011



Breakdown of household deposits by term, as of end April 2011; 100% = UAH280bn

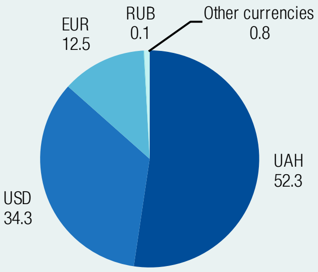


Currency structure breakdown; history since December 2005 till April 2011



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Breakdown of household deposits by currency, as of end April 2011



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

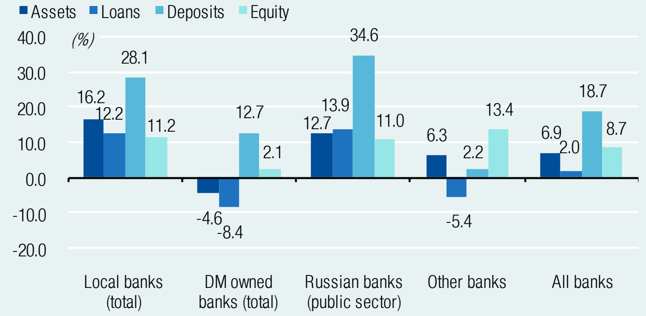
Tri-speed sector: Who is in the lead?

The banking sector as whole was stagnating in 2008-10, while EU banks were deflating their books, Russian banks were expanding

According to our data on Ukraine's banking sector performance in 2008-10 (see charts and the table below as well as tables on pages 6-10), Ukraine' banking sector could be divided into three groups differentiated from each other by ownership and attitude to balance sheet growth. As the data below show, the driving force of the sector in terms of growth is the group of banks owned ultimately by the Russian government: its share by assets as of April 2011 was just 8.1% of total assets in the sector, but the group has had 12.7% 2008-10 CAGR of asset growth. This was well ahead of local state-owned banks, which lend a hand to government goals.

Chart 41. Breakdown of Ukraine's banking sector* growth of key balance sheet figures by key groups of banks

By compound annual growth rate in 1Q08-1Q11

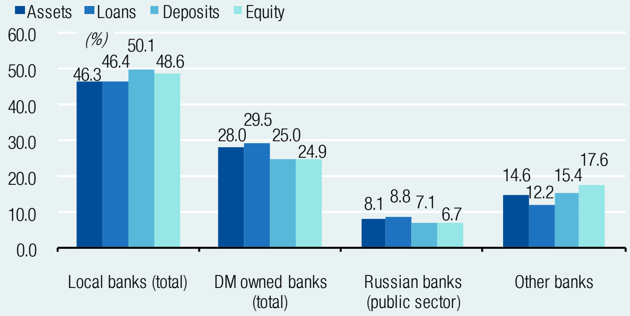


Notes: [*] the banks that were considered into the breakdown are top 42 banks by assets as of 1 January 2011; Russia owned banks are those that are owned by public sector Russian banks (read, controlled by the Russian government).

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 42. Breakdown of Ukraine's banking sector* by key groups of banks

Share of total as of April 2011



Notes: [*] the banks that were considered into the breakdown are top 42 banks by assets as of 1 January 2011; Russia owned banks are those that are owned by public sector Russian banks (read, controlled by the Russian government).

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Table 8. Ukraine's banking system of 1 April 2010: grouped by banks attitude to growth

	CAGR 1Q08-1Q11 (%)				Share of total banking system (%)			
	Assets	Loans	Deposits	Equity	Assets	Loans	Deposits	Equity
Group No.1 – Local banks, which are less aggressive and tolerate local risk								
Local banks (private sector)	17.63	14.63	26.23	4.84	29.48	31.59	34.42	21.75
Local banks (public sector)	13.89	7.54	32.59	17.23	16.86	14.84	15.68	26.82
Local banks (total)	**16.23**	**12.21**	**28.12**	**11.16**	**46.34**	**46.43**	**50.10**	**48.57**
Group No.2 – Developed markets banks, which are much less aggressive and quite cautious to local risk								
DM owned banks (Austria)	-3.17	-9.84	6.39	-3.07	6.55	6.38	6.28	5.65
DM owned banks (France)	-2.62	-7.01	21.08	9.26	6.38	6.64	6.16	5.13
DM owned banks (Italy)	-5.36	-7.85	7.99	6.54	5.70	6.31	4.28	6.03
DM owned banks (Other)	-6.25	-8.83	14.97	-1.02	9.39	10.14	8.34	8.07
DM owned banks (total)	**-4.56**	**-8.45**	**12.71**	**2.11**	**28.02**	**29.47**	**25.05**	**24.89**
Group No.3– Russian owned banks, which are aggressive and tolerate local risk								
Russian banks (public sector)	**12.65**	**13.90**	**34.56**	**11.00**	**8.14**	**8.82**	**7.10**	**6.70**
Russian banks (private sector)	-3.20	-7.78	5.38	-0.56	2.86	3.11	2.33	2.26
Russian banks (total)	7.80	6.82	25.17	7.70	11.00	11.92	9.42	8.97
Other banks	6.25	-5.36	2.20	13.38	14.64	12.18	15.43	17.57
All banks	**6.91**	**2.02**	**18.66**	**8.74**	**100.00**	**100.00**	**100.00**	**100.00**

Notes: DM – developed countries.

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Balance of payments conditions

BoP was positive in 2010, with a surplus of US$5bn, despite the current account deficit of US$2.88bn

Ukraine finished 2010 with the overall balance of payments surplus of US$5bn. However, it generated a deficit of US$2.88bn on its current account in 2010, mainly due to high volume of natural gas imports from Russia. At the same time, inflows on the capital and financial account reached US$7.9bn, so they covered the current account deficit last year and allowed to balance the FX market and build up central bank's international reserves.

In 1H10, the country's current account was still helped by the effect of the 60% hryvnia devaluation that occurred in October 2008 and stimulated export, so that export grew faster than import. However, starting from 2H10, the effect of hryvnia devaluation seems to have waded, as import growth accelerated, and outpaced export growth. In 2010, imports grew 36.2% YoY, while exports grew only 29.2%. That happened also on the back of overall economic recovery and expanding economic activity (hence increased demand for imported fuels), the revived consumer demand (mainly for imported goods) due to growing purchasing power of the population and some first signs of resumption of corporate lending.

Imports started growing faster than exports in 2H10, fuelled by quickly rising price for natural gas, which comprises a quarter of the country's total imports

At the same time, a key factor of fast growth of Ukraine's imports is the growing costs of natural gas imported from Russia. The gas contract price rises quarterly, according to the formula linked with the world oil price, which has been rising since the beginning of 2009. Fuels imports comprised 40% of the country's total imports in 1Q11; in the total fuels imports, natural gas comprised 64%, showing that the influence of natural gas price and volume on Ukraine's imports is dramatic. The analysis of natural gas imports as a factor affecting Ukraine's current account will be given below.

Ex-minerals trade balance, however, stays positive.

At the same time, if cleaned of minerals trade deficit, Ukraine's ex-mineral external trade has remained in surplus since the start of 2009 (see chart below). This means that Ukraine's merchandise exports remain competitive in the world market, and exceed its merchandise imports by quite a sizeable amount; however, due to extreme inefficiency of the Ukraine's economy in terms of energy-consumption, the country needs sizeable fuel imports, which grow very fast with the world oil prices. That pushes the country's balance of trade further into deficit.

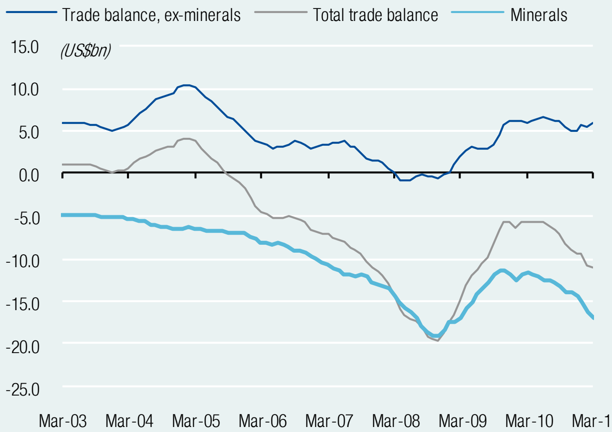
Chart 43. Ukraine's trade balance excluding minerals

12-month rolling data

Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 44. Ukraine's trade balance (US$bn)

12-month rolling data



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

In April, 12-month current account deficit stood at 3.2% of GDP...

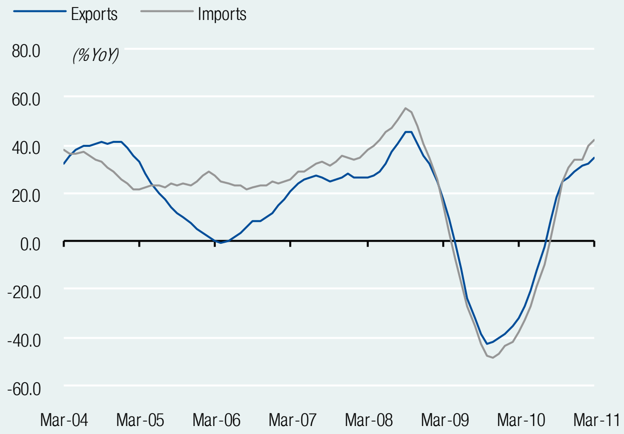
In 4M11, deficit of the current account grew to US$1.6bn (whereas in the same period last year, there was a surplus of US$172m), and the rolling 12-month current account deficit reached US$4.7bn, or 3.2% of GDP. In April alone, the current account deficit fell to US$293m (from US$381m in March). However, In 4M11, the rates of growth of both the export and import of goods and services fell compared with 1Q11 (36.7% in 4M11, down from 40.4% in 3M11 for export, and 47.3%, down from 52.9% for import). Thus, imports growth declined faster than export, as can be seen from the data, but still, the rate of imports growth remained higher than that of exports. Imports growth was mainly due to the energy component (gas imports from Russia), and imports of vehicles, for both investment and consumer purposes.

... but was covered by the surplus on capital and financial account

The capital and financial account generated a surplus of US$3.75bn in 4M11, including US$1.3bn in April alone. By comparison, in 4M10, the surplus equaled only US$442m. The strong capital inflows in 4M11 were due to the placing of government Eurobonds worth US$1.6bn altogether in January and February, and the privatisation payment for Ukrtelecom (US$0.53b) in April. It is also worth noting that in 4M11, the sum of loan redemptions exceeded the sum of new loans by US$115m, , whereas in 4M10, it was to the contrary: loans received exceeded the amount of loans redeemed by US$238m; this shows that the pace of borrowing slowed, and that deleveraging is taking place in the Ukraine's economy.

Chart 45. Ukraine's exports and import growth rates

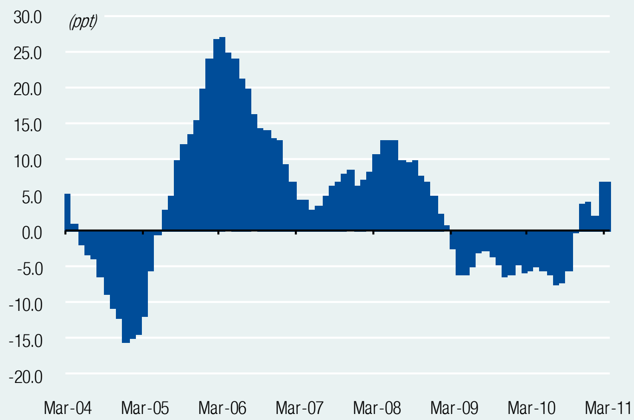
12-month rolling growth



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 46. Difference between export and import growth rates

Based on 12-month rolling growth, in percentage points



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

NBU's international reserves reached a record-high level of US$39bn by mid-May

Overall, the BoP deficit stayed positive in April (US$1bn) and in 4M11 (US$2.143bn), meaning that capital inflows covered the deficit of the current account. This holds true even if we deduct the major, one-off component of the capital inflows, i.e., privatisation proceeds, from the total. Such a favourable situation in capital inflows resulted in the accumulation of international reserves by the NBU, to the historical maximum of US$38.4bn as of end-April, according to the NBU's official report. Moreover, by mid-May, the NBU's international reserves exceeded US$39bn, as follows from the verbal statement by the head of the NBU's Board, Petro Poroshenko.

The problem of growing current account remains Ukraine's main risk, and can be cured in the mid-term through improving energy efficiency and finding new sources of gas supplies…

The solution to the problem of Ukraine's expanding current account deficit can lie in improving the energy efficiency of its economy and decreasing its dependence on the Russian gas imports. In particular, the new Tax Code stimulates a wider usage of alternative fuels. Also, the government has launched a project on building a liquefied gas terminal on the Black Sea, enabling to import a much cheaper gas from Arabic countries. Another project is the exploration of shale gas fields, reportedly available in Ukraine. However, all these measures can bring effect only in the mid-to long term. In the short term, Ukraine is doomed to suffer from the risks of growing current account deficit.

… and in the short term – if Russian gas contract price falls, world oil prices drop or Ukraine's exports grow (e.g. agricultural, on cancelled quotas)

In the short term, the current account will be helped by the lifting of grain export quotas starting this summer, which will allow an increase in the volume of agricultural exports. Additional aid could come from the reduction of the price Ukraine pays for Russian gas, if the bilateral negotiations that are being currently held result in Russia's agreeing to change the gas price formula to a more favourable one for Ukraine. Also, even if the gas formula stays unchanged, gas prices could fall due to the expected slowdown of global oil price growth. And the volume of gas imports will be lower in 2-4Q11 than in 1Q11 due to the reasoning explained below.

New capital inflows will continue covering the current account deficit, which can reach 4% of GDP in 2011

Overall, the 2010 and 4M11 data showed a healthy state of the BoP, so that capital account inflows covered the current account deficit with a surplus. In the later months of the year, the announced privatisation of GenCos (to take place in the autumn), the new government's Eurobond issue and corporate IPO and bond placements, and possibly the IMF's delayed tranches that will be finally received, will generate new capital inflows, which will continue covering the growing current account deficit, in our view. We forecast the current account deficit will reach 4.0% in 2011.

Natural gas calculus in Ukraine's current account deficit

Price for natural gas imported from Russia has been growing each quarter, thus gas imports now weigh heavily on Ukraine's current account

A considerable factor pushing up Ukraine's imports is the price for Russian natural gas. The notorious gas contract, signed in January 2009 by then Prime-Minister Yulia Tymoshenko, under pressure from the Russian side, sets the gas price count according to the formula, linked with the oil price in the world market. Given that the crude oil price grew more than 3.5x from its low in December 2008 to its high in April 2011, Ukraine's gas imports bill grew accordingly and started weighing heavily on the country's current account in 2011. Also, Ukraine had to give back to a gas distributor RosUrkEnergo the US$12.1bn cubic meters of natural gas, which, as the Stockholm arbitrage court ruling showed, were unlawfully appropriated from the company by Ukraine under the government of Yulia Tymoshenko in 2009. Those gas redemptions, which started from October 2010, according to our observations, added in parts to Ukraine's monthly gas bills, contributed to increasing the country's minerals trade deficit 70%, from an average of US$1bn in 9M10 to an average of US$1.7bn in the period October 2010-March 2011. As a result, Ukraine's overall current account deficit soared to US$2.335bn in 4M11, compared with just US$177m in 4M10.

After their peaks in 1Q11, when the gas debt to RosUkrEnergo was paid out, Ukraine's gas bills are likely to lower down in 2-4Q11, despite price growth to US$370-380 in 4Q11, according to our calculations.

By now, Ukraine has presumably already finished returning its gas debt to RosUkrEnergo, according to an Interfax-Ukraine report citing informed sources. The 12.1bn cubic meters of gas had to be returned through purchasing them from Russia's Gazprom, as it was laid out in the memorandum with the IMF. This total volume of gas was likely spread evenly over about two quarters (4Q10 and 1Q11), so we believe it was mainly these extra costs that inflated the Naftogaz' monthly gas bills in that period. From April 2011 Naftogaz's gas payments fell noticeably, to US$948m in both April and May, down from US$1.25bn in March, US$1.6bn in February and US$1.4bn in January. The analysis of physical volume of gas imported by Naftogaz also shows that in 1Q11 the average imported monthly volume stood at 5.9bn cubic meters, or 44% higher than the 3.3bn cubic meters of projected monthly imports in 2Q11, as it follows from the figures reported by Naftogaz' Head of the

Board, Yevgen Bakulin. Therefore, the payments for gas imports in 2Q11 and in 2H11 will likely be lower than in 1Q11, even despite the growth of price from US$264 for 1,000bn cubic meters in 1Q11 to US$298 in 2Q11, and their expected further growth to US$350-360 in 3Q11 and to US$370-380bn in 4Q11, according to our calculations.

View on the local currency: cheap, but plagued with inflation and USD-peg

"…to my knowledge, no model projecting directional movements in exchange rates is significantly superior to tossing a coin."

Alan Greenspan, Fed chairman (1987-2006), speaking at European Banking Congress in November 2004

Below are our updates of the in-house methods (namely, TWIs and PPP, or trade-weighted indices and purchasing power parity) evaluating the current value of the local currency hryvnia (UAH). The methods are updated with available data up to May 2011. The conclusions that arise from our observations are following, but firstly we review the currency through the prism of general macroeconomic conditions in the country.

Through the prism of general macro conditions

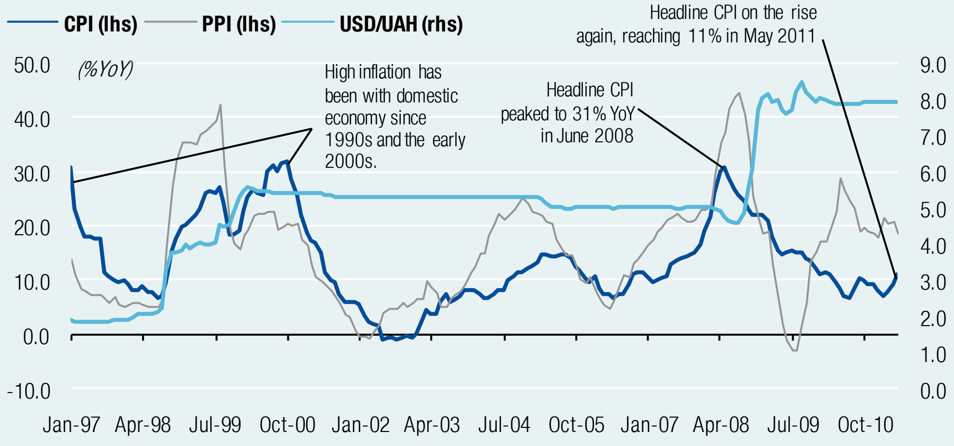
Already more than two years have passed since the last sizable devaluation of the local currency (see chart below). Since then, particularly in the last 18 months, the central bank has been managing the currency within a tight band of 7.98-8.00UAH/USD.

High inflation is a plague to the local currency…

The last devaluation in 2008, as well as the previous ones in late 1990s, has a bouquet of factors that forced the market to debase the local currency. Aside from BoP factors like the trade deficit and capital inflows, there is an issue of high inflationary environment that plague the purchasing power of the currency, which eventually causes public mistrust in the currency's stability expressed in the hard currency, predominantly through the USD peg which currently hovers at 8/USD.

Chart 47. Headline inflation (CPI and PPI) versus UAH nominal FX rate (January 1997 till May 2011)

Annual inflation as percentage change to previous year and monthly average of exchange rate of UAH per USD



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

…FX policy on maintaining a USD-peg is losing credibility, in our view

The situation becomes complicated when borrowing is preferred in foreign currency at lower interest rates over the local currency at higher rates, thus creating a foreign currency overhang in the economy. Since the last crisis, the central bank banned foreign-currency lending not only to businesses without foreign-currency revenues but also to households. Nevertheless, we have evidence now from the banking sector that corporate clients prefer foreign currency loans due to the lower cost, which is an upfront cost that is taken by the borrower at face value without thorough consideration of operational risk or exchange rate risk.

The former risk is neglected because businesses do not tend to rely on conservative assumptions of future earnings, especially those derived from overseas sales. The latter risk is neglected because businesses and households in the heady days of the economy became comfortable with authorities' verbal assurance that they were capable of maintaining the currency's stability in nominal terms. The notion of ongoing reliance on foreign-currency loans also has statistical support, as NBU data for April 2011 shows that the entire banking system portfolio of foreign-currency loans to businesses (non-financial corporations) continued to increase, and grew 12.4% YoY in nominal terms[10].

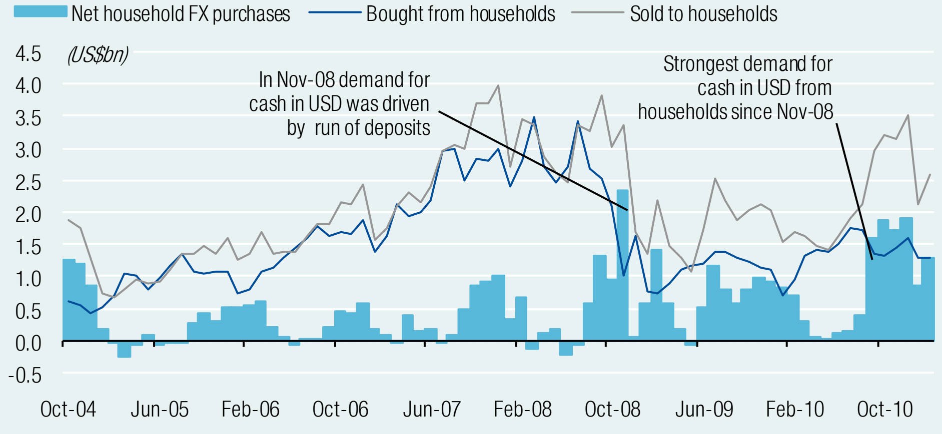
The longer FX policy stays intact, the stronger will be new misalignment of the exchange rate due to shocks

All in all, the above mentioned considerations lead us to conclude that the longer the NBU adheres to its *de-facto* USD-peg FX policy, the less credible will this policy be in the eyes of local economic agents. Even worse, a new overshoot of the currency's exchange rate will be even more severe when some external or internal event shocks the local financial market, causing a run on both local banks and the currency, similar to what was observed in late 2008, which was just cooled down with a re-basement of the currency, and in late 2004, which was tamed by the central bank.

If the NBU is serious about its intention to shift its monetary policy focus from exchange rate into targeting inflation—so far this has amounted to mostly verbal interventions on this front by the new governor of the central bank and to certain preparation steps—then we would lower own notion regarding the institutional risk surrounding the local currency.

Chart 48. Net purchases of foreign currencies by Ukrainian households (October 2004 to April 2011)

Monthly volumes of foreign currencies exchanges operations by banks with their retail clients



Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

[10] This growth represents an increase of loan portfolio, which is reported in the local currency hryvnia (UAH). Total foreign currency loan portfolio to non-financial corporations amounted to UAH205.9bn as of April 2011. Meanwhile, growth of local-currency loan portfolio to non-financial corporations rose by 18.0% YoY in April 2011 and amounted to UAH324.8bn as of end of the month.

Trust in local currency for transactions and cash holdings is not rising…

The above-mentioned chart on the monthly net volume of FX purchases by Ukrainian households depicts how the economy is adept at foreign-currency operations and savings. Previous occasions (the last one was in 2008) of heightened increase in the volume reflected true strong demand for the currency from the households, which is effectively a run on the banks and the currency.

…and this is a risk to the local currency

Since late 2008, the sizable and persistent growth of monthly net volume of foreign currency purchases, while banks do not experience lengthy queues of people buying hard currency, is widely associated with the so-called shadow economy.

This development may signal that the economy (and its shadow part) is indeed recovering, but it also reflects an increased risk of further reliance of the economy on foreign currency for transactions and savings. In our view, such a development increases the institutional risk to the UAH, as described above.

Through the prism of ICU's trade-weighted indices

Currently, ICU's monthly TWIs of hryvnia are lower than their long-term average…

Since early 2011, the UAH has been devaluing in trade-weighted terms. The real trade-weighted index of the currency slid 3.4% in January-May 2011 from 54.76 as of year-end 2010 to 52.87 at the end of May. In nominal terms, it contracted 4.9% from 53.28 to 50.69.

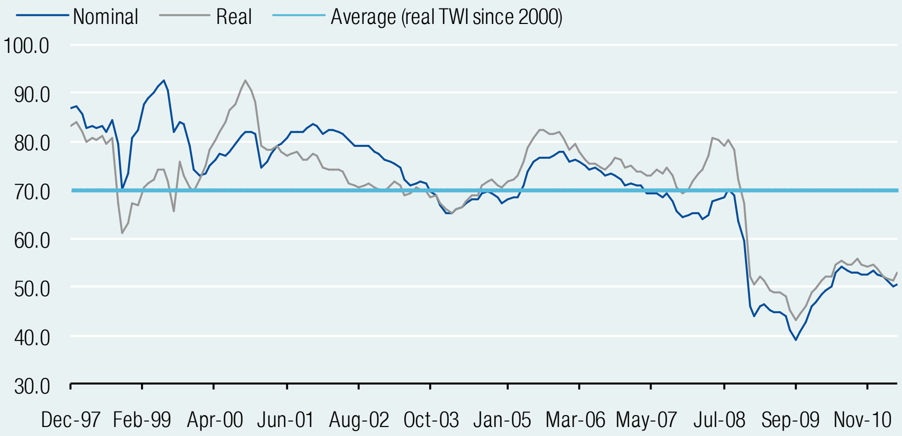
There were a number of reasons that shaped this trend (described in more detail on the next page). In total, it provided Ukraine's economy with greater external competitiveness, which was largely intact in 2010 and was lost in 2H09, when the hryvnia appreciated noticeably in trade-weighted terms.

…underlying the economy's external competitiveness gained in late 2008 still persists

The long-term average of the real TWI is still well above the current level of the index (see chart below), indicating that there is still a sizable room for competitiveness to be eroded via a combination of internal real appreciation and external real devaluation. We expect the combination of these two factors, over time, will gradually result in the convergence of the real TWI with its long-term average.

Chart 49. ICU monthly TWIs of the local currency hryvnia (December 1997 to May 2011)

Calculation is based on monthly data of merchandise trade, consumer price inflation indices and average exchange rates of 26 countries that account for a 75% share of Ukraine's annualised merchandise trade turnover (exports and imports)



Source: Investment Capital Ukraine.

To enhance our currency view, we launched a daily observation of UAH TWIs

Further developing our view of the currency through monthly TWIs, we enhanced this approach with daily TWIs (see more details on this in the section "Methodology: UAH trade-weighted index (update)" on page 61). The above chart with monthly trade-weighted indices appears in a livelier version on the chart below. It allows us to observe on a daily basis how the local currency moves in trade-weighted terms as well as in nominal and real terms.

Chart 50. ICU daily TWIs of the local currency hryvnia (December 1997 to May 2011)

Calculation is based on monthly data of merchandise trade, consumer price inflation indices and daily exchange rates of 26 countries that account for a 75% share of Ukraine's annualised merchandise trade turnover (exports and imports)

Source: Investment Capital Ukraine.

In 2011 YTD, Fed's QE2, ECB tightening and Belarus BoP crisis shaped UAH TWIs movement…

During 2010-2011 YTD (see the chart below), ICU's trade-weighted indices of the hryvnia (UAH) moved sideways to a broad extent. In light of recent developments this year, there were two major factors that determined the trend of TWIs: (1) the widespread weakness of the USD versus major developed and emerging nations' currencies caused by the Fed's QE2 programme; and (2) the ECB's more hawkish stance on the macroeconomic situation in the Eurozone, particularly its prime focus of monetary policy on price stability, and not on economic activity, despite the sizable debt problems in periphery countries that now lack the economic growth that would save them.

…nominal and real TWIs lost 2.9% and 1.5%, respectively

More precisely, EUR and RUB strengthening over the first four months of 2011 caused UAH to devalue in trade weighted terms. The balance-of-payment crisis in Belarus in May caused a massive debasement of its local currency rouble (BYR). With a sizable share in merchandise trade with Ukraine (4.0% in last 12-month period to March 2011, which is on par with Poland's 4.1% and Turkey's 3.9% but less than China's 5.4%), Belarus is a significant trade partner for Ukraine's competitiveness. The upward movement of the TWIs in most of May was due to not only the BYR devaluation, but also the temporary risk-aversion among investors due to the Greek debt crisis that boosted the US dollar for a while. Since June, as expectations of the Greek debt crisis eased, the UAH TWI's trended again lower.

Chart 51. ICU daily TWIs in 2010-11 depicted versus key news stories that shaped the trends

History since 1 January 2010 till 6 June 2011

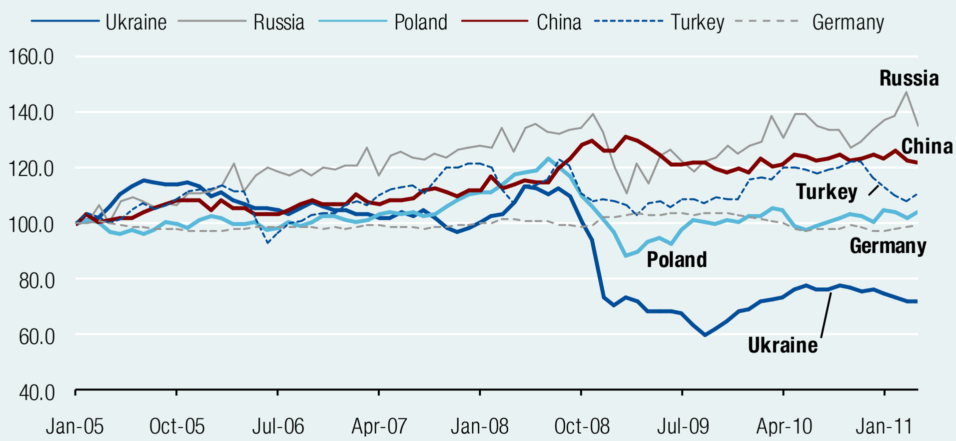
Source: Investment Capital Ukraine.

Relative international comparison of real TWIs confirm UAH weakness

An international comparison of the UAH with currencies of selected economies, particularly the main trading partners of Ukraine (see chart below), via indices of currencies in real trade-weighted terms, shows the following: (1) Ukraine's currency is the weakest one among the selected countries; (2) during late 2010 and 2011, significant developments caused a reversal of the UAH's previous convergence with other currencies, i.e. UAH appreciation in real trade-weighted terms plateaued in mid-2010 and then began to depreciate. This chart reinforces our belief that a mid-term path for the UAH real trade-weighted index is toward growth, i.e. back to convergence with other currencies' indices. This must be realized by the developments in the economy and financial markets, which could mean higher inflation and nominal appreciation in the domestic economy as lower inflation and currency nominal devaluation occur in trade partners' countries.

Chart 52. Ukraine versus its main trading partners by real TWI (January 2005 to April 2011)

Real trade weighted indices of local currencies are rebased as 100 as of January 2005



Sources: Bank for International Settlements, Investment Capital Ukraine.

Through the prism of ICU PPP observations

ICU's PPP shows that the standardized basket of goods remains depressed in value terms in Kiev versus NYC and Moscow

Our final approach on assessing the UAH is a rough measurement of relative prices via an ICU basket of goods and services (see Table 9, page 55). According to our observations made at the end of May, the standardised basket of goods and services for three cities – namely Kiev, New York, and Moscow - showed US dollar values of US$35.44, US$55.88, and US$52.90, respectively. When compared with our *Quarterly Report* publication date July 2010, the basket experienced inflation in every place of 7.5%, 4.2%, and 27.4%, respectively. Judging from stronger basket inflation in Moscow, Kiev's basket appeared to lag. Of the three cities, Kiev is the lowest—and has remained so for all of our monthly observations since the ICU PPP inception in February 2010—underscoring the old story that the UAH remains undervalued, and, in the long run, the baskets should converge in value via inflation or changes in exchange rates.

Table 9. ICU PPP observation in 2Q10: Ukraine's local currency hryvnia versus US dollar (USD) and Russian rouble (RUB)

Item of the basket	Description	Kiev, central district 25-May-11 Price (UAH)	New York, metropolitan area 26-May-11 Price (US$)	Moscow, central district 25-May-11 Price (RUR)
Consumer goods				
Coca-Cola (0.5 liter, plastic bottle)	Non-alcohol beverages	4.36	0.68	37.90
Beer Stella Artois (0.33 litre, glass bottle)	Alcohol beverages	5.92	1.67	52.90
Bunch of fresh bananas (1 kg)	From Ecuador	13.48	1.74	39.90
Pack of milk (1 liter)	Locally produced, soft package, i.e. not glass bottle	6.42	1.35	53.90
Chicken meat (1 kg pack)	Locally produced and branded package, boneless breast	38.94	9.44	159.00
Canned pineapple (0.85 kg, can)	Pineapple circles, Dole brand	21.71	2.70	129.00
Pasta (0.5 kg)	Soft package, produced in Italy	13.27	1.94	68.90
Sugar (1 kg)		12.39	3.17	33.90
Package of table salt (0.5 kg)		5.36	0.53	12.90
Chicken eggs (10 units pack)	White eggs, standard size	9.81	2.20	42.00
Chocolate (100 g)	Made by Craft Foods Corp, Milka brand	9.96	2.99	55.90
Toothpaste (100ml package)	Colgate	18.82	1.69	91.90
Shampoo (200ml package)	Head & Shoulders brand, for normal hair	25.83	2.23	139.00
Toilet paper (4 rolls package)	Kleenex Cottonelle brand, white paper, Regular toilet tissue	17.54	3.92	68.90
Magazine	Men's Health, local edition, A4 format (standard one, not a pocket book format)	21.50	4.99	109.00
Gasoline (1 liter)	Lukiol, regular	10.49	1.14	27.87
Services				
Underground commuite ticket	Within the central part of the city	2.00	2.50	28.00
Cinema ticket	Thursday's night price for the seat with good location, Hollywood film	45.00	11.00	350.00
Total basket value (in local currency)		**282.80**	**55.88**	**1,500.87**
Exchange rate versus US dollar at spot market as of date of observation		7.980	1.000	28.370
Total basket value (in US$)		**35.44**	**55.88**	**52.90**
Overvalued "+" / undervalued "-" (%)				
UAH vs USD		**-36.58**		
UAH vs RUR		**-33.01**		
Fair value in the long-run as of observation date				
UAH per USD		**5.061**		
UAH per RUR		**0.188**		

Note: Prices are recorded at supermarkets.

Source: Investment Capital Ukraine.

Three-year forecast viewpoints

Our base-case scenario stipulates a 4.5% YoY real GDP growth rate this year, rising to 5.2% YoY in 2012 due to the Euro-2012 impetus. The price of crude oil price is a key factor now that will shape the C/A deficit (expected to be 4.0% of GDP in full-year 2011), but we expect the price of crude oil to recede, thus stabilising energy imports for the economy over the next few years. Inflation induced by higher prices for imported energy pushes Ukraine's monetary authorities onto the bandwagon along with nearly every other EM central bank, most of whom much earlier began to worry about mounting inflation. This creates a signal to international investors that local rates may become more interesting. The UAH FX rate is expected to be 7.9/USD at year-end 2011, and averaging to 8/USD in 2012, as 2012 debt repayments are much heavier than in 2011.

Key forecasting viewpoints in detail

Internal and external demand factors within the economy

The domestic economy is entering a slowing phase

As in 2010, Ukraine's economy is set to experience a slowdown in 2H after strong growth in the first six months. This is due to softening external demand as many economies of Ukraine's trade partners tighten their fiscal and monetary conditions.

Ukraine's own economic policies also are not expansionary, as fiscal policy is on the path to gradually reduce its budget deficit, and the monetary stance just recently became tighter as annual inflation rose from 9.4% YoY in April to 11% YoY in May.

Domestic demand is still too soft to be a source of concern about BoP

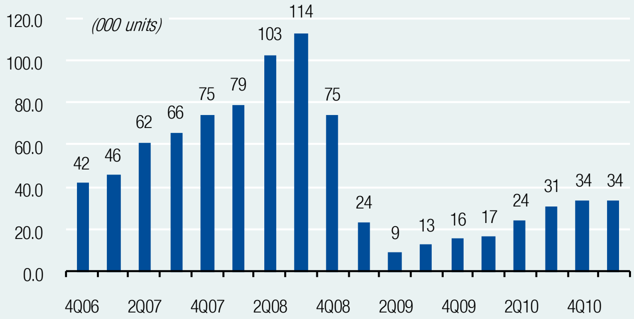
In our view, domestic demand has not yet recovered sufficiently to fear a growing trade deficit as a kind of a channel that may bring FX market adjustments. In Chart 53 below, the quarterly imports of cars—a key item of middle class affluent consumption—reached 34,000 units over the last two quarters.

Although this is a significant jump from the lows of 2009 (in 2Q09, 9,000 cars were imported), it is still far short of the 42,000 cars imported in 4Q06, when the banking sector was just beginning its surge of consumer lending. But even more notable, it is only one third of the quarterly volume of the heady days of 2008, when the summer season heated consumer demand to 114,000 units in 3Q08 after 103,000 units in 2Q08.

Based on our belief of a gradual economic slowdown in 2H11, we do not believe that banks or consumers will significantly inflate the future numbers for this chart in the upcoming 12-month or 18-month period.

Chart 53. Car imports as a gauge of domestic demand

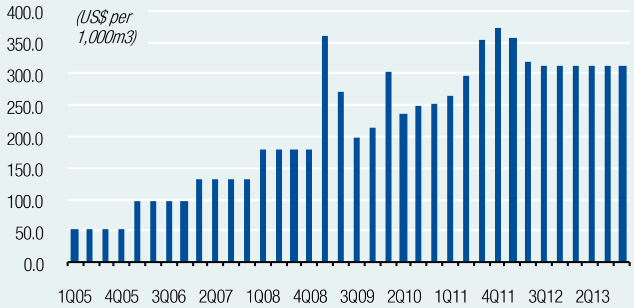
Quarterly imports in thousand units.
History from 4Q06 till 1Q11



Sources: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Chart 54. Natural gas price: history and forecast

Quarterly price in US dollars per 1,000 m3
Forecast is made for 2011



Sources: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Energy prices are a key concern for BoP…

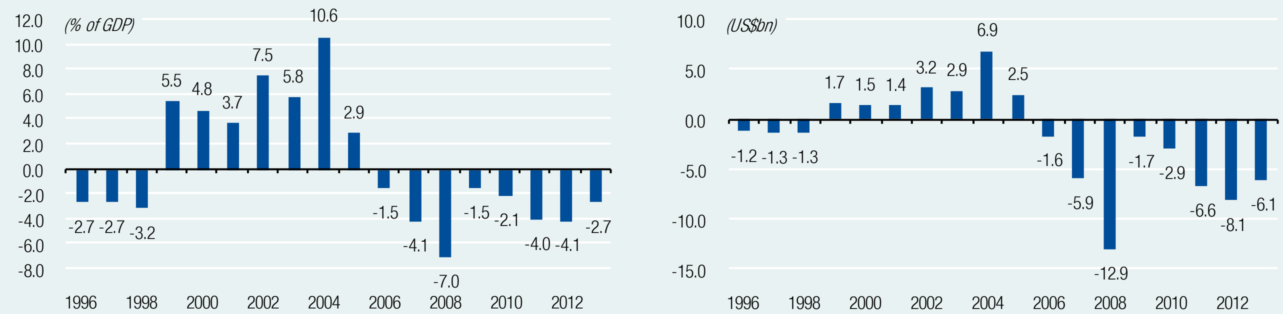
The key reason for concern indeed from the BoP point of view is imports of hydrocarbons, natural gas in particular. This is due to an expected 24% price increase of natural gas from its 2010 average of US$260 per 1,000 m3 to its 2011 average of US$323. For 2012-13, we forecast average natural gas prices of US$326 at the start, falling to US$313 at the end. This is based on our projections of crude oil prices, which ripple into oil products (fuel oil and gasoil) which are key components in the price formula used in the agreement between Naftogaz of Ukraine and Gazprom of Russia. Our projections assume that natural gas consumption will be a bit more efficient due to the gradual increase of the natural gas tariff paid by households and the steady improvement in energy efficiency by businesses. Hence, we project total volumes of imported natural gas for 2011-13 of 40.0bn, 39.5bn, and 38.5bn cubic metres, respectively.

…as the C/A deficit is expected to approach 4.0% of GDP

This leaves us with a 4.0% current account deficit for 2011, nearly doubling from that of 2010, primarily as a result of the crude oil price surge. In 2012-13, we believe that a gradual economic recovery will strengthen domestic demand, which will add pressure on the external balance, widening it towards 4.1% of GDP. In 2013, we expect the external deficit to decrease as the global economy to enter a growth cycle that will produce increased foreign demand for Ukraine's exports.

Chart 55. Current account balance: 1998-2010 yearly historical figures and 2011-13 projections

As percentage of GDP *In billions of US dollars*



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Prices, interest rates, and the exchange rate

Inflation is a key concern that will push rates up

In our view, the inflation rise this quarter is not a base-effect play, but rather the result of a monetary policy that pegs the UAH to a weak US dollar, hence inflation blossomed in Ukraine when global prices on commodities and other tradable goods (priced in US dollars) increased dramatically, particularly for crude oil and oil products. Also, earlier weakness of the UAH in trade-weighted terms (created in 4Q08 and 1H09) never fully recovered as NBU interventions prevented the currency from rising despite significant inflows of private capital into the country.

The corrective moves in domestic policymaking, including a genuine shift to inflation targeting (albeit at an early stage), prescribed by the IMF, will gradually be realized, despite a number of political factors. Hence, we factor in a gradual tightening of monetary conditions by the NBU hiking its key rate by 50-100bp in 3Q11 (we are leaning more toward a 100bp hike to 8.75%) and then to 9.50% at the end of 2011.

The NBU is to allow wider fluctuations of the currency, with a 7.8-8.0/USD range expected

As for the exchange rate, we believe that the NBU will, in light of above mentioned notion, allow “2 percentage point fluctuations” - as stated by the NBU head recently - and the hryvnia will begin to fluctuate within a 7.84-8.16/USD range[11] or within a more approximate range of 7.8-8.0/USD. This fluctuation will allow movements toward both sides and the FX market will first test precisely the weaker end of the range, but the NBU will likely stabilize any sizable weakness of the currency via interventions. Then, interest rate policy will likely encourage inflows of capital, causing the FX rate to strengthen if the NBU does not object.

[11] Calculated as ±2% difference from 8/USD rate.

Quarterly forecast

Table 10. Forecast of key macroeconomic indicators for 2011-13 (quarterly)

	4Q10	1Q11	2Q11E	3Q11F	4Q11F	1Q12F	2Q12F	3Q12F	4Q12F	1Q13F	2Q13F	3Q13F	4Q13F
Activity													
Real GDP (%YoY)	3.3	5.2	5.0	4.0	3.7	6.0	6.8	4.0	4.2	4.5	4.0	5.0	5.0
Nominal GDP (UAHbn, qtly)	310.3	261.2	313.0	367.0	372.4	315.0	367.4	418.1	424.3	360.0	417.9	479.9	485.3
Nominal GDP (US$bn, qtly)	39.0	32.9	39.3	45.3	46.5	39.9	44.8	52.3	53.0	45.6	52.9	61.5	62.2
GDP per capita (US$, ann)	3,007	3,129	3,273	3,425	3,593	3,750	3,873	4,029	4,175	4,301	4,481	4,686	4,890
Unemployment rate (%)	8.1	8.0	7.9	7.8	7.8	7.8	7.5	7.5	7.5	7.6	7.6	7.6	7.6
Prices													
CPI headline (%YoY, eop)	9.1	7.7	11.4	8.8	10.3	8.9	7.8	6.7	7.2	6.9	6.9	6.9	5.4
CPI headline (%YoY, average)	9.5	7.7	10.6	10.4	9.9	9.7	7.9	7.2	6.9	6.9	6.9	6.9	6.1
PPI (%YoY, eop)	18.8	20.4	20.6	23.3	23.3	17.2	12.7	12.7	12.7	12.7	12.7	12.7	12.7
PPI (%YoY, average)	19.2	20.0	20.1	22.5	22.7	19.5	13.3	12.7	12.7	12.7	12.7	12.7	12.7
Fiscal balance													
Cons'd budget balance (UAHbn)	-16.2	-2.3	-9.5	-1.9	-29.8	-0.1	-10.9	-5.6	-38.3	-0.1	-13.1	-5.9	-43.7
Cons'd budget balance (% of GDP)	-5.2	-0.9	-3.0	-0.5	-8.0	0.0	-3.0	-1.3	-9.0	0.0	-3.1	-1.2	-9.0
Budget balance (UAHbn)	-10.5	-2.4	-8.0	-2.3	-23.6	-0.7	-9.1	-5.2	-30.2	-0.9	-10.9	-5.5	-34.5
Budget balance (% of GDP)	-3.4	-0.9	-2.5	-0.6	-6.3	-0.2	-2.5	-1.2	-7.1	-0.2	-2.6	-1.2	-7.1
External balance													
Exports (US$bn)	19.8	19.5	19.0	19.5	21.7	20.9	20.7	21.2	22.7	22.6	22.1	22.7	24.3
Imports (US$bn)	22.4	21.3	21.4	22.2	23.1	23.4	23.4	23.7	24.8	24.2	24.5	25.2	25.7
Trade balance (US$bn)	-2.6	-1.8	-2.4	-2.7	-1.5	-2.5	-2.8	-2.4	-2.1	-1.6	-2.4	-2.6	-1.4
Trade balance (% of GDP)	-6.7	-5.6	-6.1	-5.9	-3.2	-6.4	-6.2	-4.6	-4.0	-3.5	-4.4	-4.2	-2.3
Current account balance (US$bn)	-2.3	-1.1	-2.2	-2.3	-1.1	-1.9	-2.5	-2.0	-1.7	-1.0	-2.0	-2.1	-1.0
Current account balance (% of GDP)	-6.0	-3.3	-5.5	-5.0	-2.4	-4.8	-5.5	-3.8	-3.2	-2.2	-3.7	-3.4	-1.6
Net FDI (US$bn)	2.2	0.8	1.5	1.4	1.9	1.3	1.7	1.6	1.9	1.7	1.9	1.8	2.0
Net FDI (% of GDP)	5.6	2.3	3.7	3.1	4.2	3.4	3.9	3.0	3.6	3.7	3.6	2.9	3.3
C/A bal. + net FDI (% of GDP)	-0.5	-0.9	-1.8	-1.9	1.7	-1.4	-1.6	-0.8	0.4	1.4	-0.1	-0.5	1.7
External debt (US$bn, eop)	108.5	108.9	110.5	113.3	116.4	118.6	122.0	123.6	129.5	127.6	131.7	136.8	146.1
External debt (% of ann'd GDP, eop)	78.7	76.0	73.8	72.4	71.0	69.3	69.1	67.4	68.1	65.2	64.6	64.2	65.7
FX reserves (US$bn, eop)	34.6	36.4	36.9	38.1	41.1	42.2	44.1	44.8	49.7	53.3	56.4	60.2	68.8
FX reserves (% of ann'd GDP, eop)	25.1	25.4	24.6	24.3	25.1	24.7	25.0	24.4	26.1	27.2	27.7	28.3	31.0
External debt / FX reserves (x, eop)	3.1	3.0	3.0	3.0	2.8	2.8	2.8	2.8	2.6	2.4	2.3	2.3	2.1
FX reserves imports cov. (months)	6.8	6.5	6.1	6.2	6.6	6.7	6.9	6.9	7.5	8.0	8.4	8.9	10.1
Interest rates													
Central bank key rate (%, eop)	7.75	7.75	7.75	8.75	9.50	9.00	9.00	8.00	8.00	7.00	7.00	7.00	7.00
3-month rate (%, average)	6.12	5.39	5.12	5.12	7.00	8.00	8.00	7.00	7.00	6.00	6.00	6.00	6.00
Exchange rates													
UAH trade-weighted index (nominal)	53.28	51.26	51.21	50.89	52.06	52.64	50.78	52.23	52.27	52.95	52.92	52.92	52.92
UAH trade-weighted index (real)	54.76	51.77	53.49	53.36	54.36	54.63	52.37	53.52	53.22	53.98	54.01	54.07	54.13
UAH/US$ (eop)	7.97	7.95	7.95	8.10	8.00	7.90	8.20	8.00	8.00	7.90	7.90	7.80	7.80
UAH/US$ (average)	7.95	7.95	7.97	8.10	8.00	7.90	8.20	8.00	8.00	7.90	7.90	7.80	7.80
UAH/€ (eop)	10.66	11.25	11.64	11.50	11.20	11.22	11.64	11.36	11.36	11.22	11.22	11.08	11.08
UAH/€ (average)	10.80	10.88	11.49	11.50	11.20	11.22	11.64	11.36	11.36	11.22	11.22	11.08	11.08
US$/€ (eop)	1.30	1.30	1.45	1.42	1.40	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42
US$/€ (average)	1.36	1.37	1.45	1.42	1.40	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42
Population													
Population (million, eop)	45.8	45.7	45.7	45.6	45.6	45.6	45.5	45.5	45.4	45.5	45.5	45.4	45.4
Population (%YoY)	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.1	-0.1	-0.1	-0.1

Notes: eop – end of period; cov. – coverage; con'd – consolidated; ann – annualized.

Source: Investment Capital Ukraine LLC

Annual forecast

Table 11. Forecast of key macroeconomic indicators for 2011-13 (annual)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Activity													
Real GDP (%YoY)	9.2	5.2	9.6	12.1	2.7	7.3	7.9	2.3	-14.8	4.2	4.5	5.2	4.6
Nominal GDP (UAHbn)	204	226	267	345	441	544	721	948	913	1,095	1,314	1,525	1,743
Nominal GDP (US$bn)	38	42	50	65	87	108	143	184	114	138	164	190	222
GDP per capita (US$, ann)	779	874	1,044	1,371	1,850	2,319	3,091	3,982	2,474	3,010	3,598	4,180	4,896
Unemployment rate (%)	10.9	9.6	9.1	8.6	7.2	6.2	6.4	6.4	8.8	8.1	7.8	7.5	7.6
Prices													
CPI headline (%YoY, eop)	6.1	-0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	10.3	7.2	5.4
CPI headline (%YoY, average)	12.3	0.8	5.2	9.0	13.6	9.1	12.8	25.3	16.0	9.4	9.7	7.9	6.7
PPI (%YoY, eop)	0.9	5.8	11.2	24.3	9.6	15.4	23.2	21.1	15.3	18.8	23.3	12.7	12.7
PPI (%YoY, average)	8.9	3.1	7.8	20.3	17.0	9.6	20.5	33.6	7.4	21.4	21.3	14.5	12.7
Fiscal balance													
Cons'd budget balance (UAHbn)	-1.3	1.7	-0.5	-11.8	-7.7	-3.7	-7.7	-24.9	-67.5	-63.3	-43.6	-54.9	-62.8
Cons'd budget balance (% of GDP)	-0.6	0.8	-0.2	-3.4	-1.7	-0.7	-1.1	-2.6	-7.4	-5.8	-3.3	-3.6	-3.6
Budget balance (UAHbn)	-1.3	1.2	-1.0	-10.2	-7.9	-3.8	-9.8	-12.5	-32.7	-63.0	-36.1	-45.3	-51.8
Budget balance (% of GDP)	-0.6	0.5	-0.4	-3.0	-1.8	-0.7	-1.4	-1.3	-3.6	-5.8	-2.8	-3.0	-3.0
External balance													
Exports (US$bn)	21.1	23.4	29.0	41.3	44.4	50.2	64.0	85.6	54.3	69.3	79.7	85.5	91.7
Imports (US$bn)	20.5	21.5	27.7	36.3	43.7	53.3	71.9	100.1	56.2	73.1	88.1	95.4	99.7
Trade balance (US$bn)	0.6	1.9	1.3	5.0	0.7	-3.1	-7.9	-14.5	-2.0	-3.9	-8.4	-9.9	-8.0
Trade balance (% of GDP)	1.6	4.4	2.6	7.7	0.8	-2.8	-5.5	-7.9	-1.7	-2.8	-5.1	-5.2	-3.6
Current account balance (US$bn)	1.4	3.2	2.9	6.9	2.5	-1.6	-5.9	-12.9	-1.7	-2.9	-6.6	-8.1	-6.1
Current account balance (% of GDP)	3.7	7.5	5.8	10.6	2.9	-1.5	-4.1	-7.0	-1.5	-2.1	-4.1	-4.3	-2.7
Net FDI (US$bn)	0.8	0.7	1.4	1.7	7.5	5.7	9.2	9.7	4.7	5.8	5.6	6.6	7.4
Net FDI (% of GDP)	2.0	1.6	2.8	2.6	8.7	5.3	6.4	5.3	4.1	4.2	3.4	3.5	3.3
C/A bal. + net FDI (% of GDP)	3.4	4.8	5.7	9.5	11.2	3.7	0.5	-7.7	2.4	1.3	-3.3	-4.6	-2.7
External debt (US$bn, eop)	N/A	N/A	23.8	30.6	39.6	54.5	80.0	101.7	101.4	108.5	116.4	129.5	146.1
External debt (% of ann'd GDP, eop)	N/A	N/A	47.5	47.2	45.6	50.4	55.8	55.3	89.2	78.7	71.0	68.1	65.7
FX reserves (US$bn, eop)	3.0	4.2	6.9	9.5	19.4	22.3	32.5	31.5	26.5	34.6	41.1	49.7	68.8
FX reserves (% of ann'd GDP, eop)	7.8	10.0	13.8	14.7	22.3	20.6	22.6	17.2	23.3	25.1	25.1	26.1	31.0
External debt / FX reserves (x, eop)	N/A	N/A	3.4	3.2	2.0	2.4	2.5	3.2	3.8	3.1	2.8	2.6	2.1
FX reserves imports cov. (months)	2.1	2.8	3.6	3.8	6.4	6.1	6.4	4.5	7.1	6.8	6.6	7.5	10.1
Interest rates													
Central bank key rate (%, eop)	12.5	7.0	7.0	9.0	9.5	8.5	8.0	12.0	10.3	7.8	9.5	8.0	7.0
3-month rate (%, eop 4Q)	N/A	N/A	17.9	15.0	11.5	9.9	7.6	21.6	17.6	6.1	7.0	7.0	7.0
Exchange rates													
UAH trade-weighted index (nominal)	83.45	77.64	66.81	67.19	77.84	70.90	64.93	45.89	46.09	53.28	52.06	52.27	52.92
UAH trade-weighted index (real)	77.13	70.35	67.18	70.41	80.93	74.89	70.20	52.40	49.02	54.76	54.36	53.22	54.13
UAH/US$ (eop)	5.34	5.33	5.33	5.31	5.05	5.05	5.05	7.80	8.00	8.00	8.00	8.00	7.80
UAH/US$ (average)	5.37	5.33	5.33	5.32	5.10	5.03	5.03	5.25	8.03	7.95	8.00	8.03	7.85
UAH/€ (eop)	5.12	4.75	5.60	6.71	7.20	5.97	6.66	7.36	10.90	11.45	11.20	11.36	11.08
UAH/€ (average)	4.81	5.04	6.04	6.62	6.35	6.32	6.89	7.67	11.19	10.54	11.35	11.40	11.15
US$/€ (eop)	0.89	1.05	1.26	1.36	1.18	1.32	1.46	1.40	1.43	1.30	1.40	1.42	1.42
US$/€ (average)	0.90	0.95	1.13	1.24	1.24	1.26	1.37	1.47	1.39	1.33	1.42	1.42	1.42
Population													
Population (million, eop)	48.9	48.5	48.0	47.3	47.0	46.6	46.4	46.1	46.0	45.8	45.6	45.4	45.4
Population (%YoY)	-1.0	-1.0	-0.9	-1.4	-0.8	-0.7	-0.6	-0.5	-0.4	-0.4	-0.4	-0.3	-0.1

Notes: eop – end of period; cov. – coverage; con'd – consolidated; ann – annualised.

Source: Investment Capital Ukraine LLC

Methodology: UAH trade-weighted index (update)

ICU's UAH TWIs are trade-weighted indices (these are two indices the nominal one and the real one) of the local currency hryvnia. Nominal trade-weighted index, or nominal TWI, is a measurement of the hryvnia's exchange rate developments trade weighted against Ukraine's trade partner countries. Real trade-weighted index, or real TWI, is the nominal TWI that is adjusted for differentials in inflation between Ukraine and its main trade partners. These indices are also referred as nominal and real effective exchange rates. Our calculation of the indices is being made a monthly and daily basis. So, we arrive to observe the UAH performance being tracked by four indices monthly nominal and real TWIs and daily nominal and real TWIs.

Our in-house method of calculating the trade-weighted indices of Ukraine's currency hryvnia (UAH) takes into account the following inputs. First of all, this is merchandise trade statistics published by State Statistics Committee of Ukraine on a monthly basis that is used to determine a basket of key trade partners of Ukraine. Secondly, it is foreign exchange market data on movements of the national currencies of those key trade partners of Ukraine against the US dollar, the key anchor currency in the global FX market. And thirdly, it is data on consumer price indices (CPIs), which are the monthly CPIs presented as percentage change of inflation to the same month of previous year, in those trade partners.

The *monthly* TWIs are calculated upon the monthly data: aside from trade and inflation data, which are reported on monthly bases, the exchange rates are monthly averages.

The *daily* TWIs are calculated upon the monthly data on trade and inflation (these are the same data series as in monthly TWIs calculation), while the exchange rates are the daily FX market closing.

Trade partners

The calculation is based on the basket of 26 countries, which are Ukraine key trade partners and in total account for an 81.4% share of total merchandise trade turnover (exports and imports) for the last 12-month period to March 2011 (see Table 12 and Chart 56, page 62).

The trade weights are calculated upon the following formula:

$$w_i = \frac{X_i + M_i}{\sum_{i=1}^{n} X_i + \sum_{i=1}^{n} M_i} \qquad \sum_{i=1}^{n} w_i = 1,$$

where X_i and M_i are annualised volume of exports and imports respectively of i country and n=26.

There are following aspects regarding the available data on foreign merchandise trade and its usage in these calculations. Firstly, State Statistics Committee reports merchandise trade data on a monthly data since year of 2001, to be more precise from May 2001. This allows us to operate with 12-month rolling data on foreign trade starting from May 2002. Secondly, there is available statistics on merchandise trade of earlier period, which is for 1995-2000. Due to lack of monthly trade data for this period our method of TWI calculations factors in the monthly average data for each year out of this period.

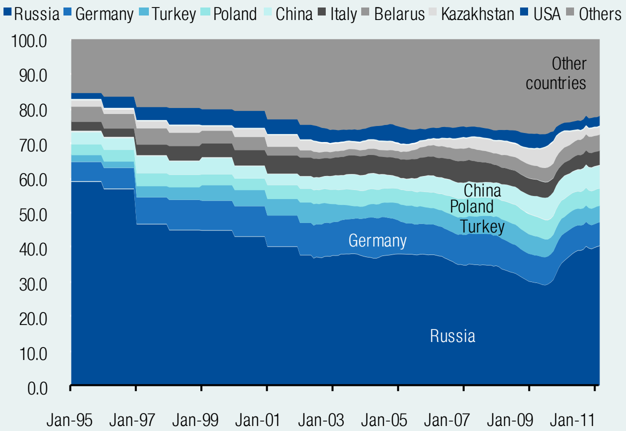
Table 12. Ukraine's key partners in merchandise trade and their weights in UAH real TWI, as of March 2011

Country	As of March 2011			Average weight,	Average weight,
	Trade turnover* (US$bn)	Share of total turnover (%)	Weight (%)	May 2002 till March 2011	1995-2001 (%)
Russia	40,811.06	32.9	40.4	36.0	47.9
Germany	6,800.57	5.5	6.7	8.8	7.6
China	6,680.17	5.4	6.6	4.8	3.9
Poland	5,074.59	4.1	5.0	4.9	3.5
Belarus	4,961.58	4.0	4.9	3.4	4.1
Turkey	4,782.20	3.9	4.7	5.0	3.7
Italy	4,183.90	3.4	4.1	5.1	3.9
United States	2,906.47	2.3	2.9	3.5	4.0
Hungary	2,289.68	1.8	2.3	2.6	2.3
India	2,277.13	1.8	2.3	1.7	1.1
Kazakhstan	2,250.02	1.8	2.2	3.0	2.0
France	1,816.94	1.5	1.8	1.9	1.6
Romania	1,598.48	1.3	1.6	1.5	1.0
Czech Republic	1,577.87	1.3	1.6	1.7	1.5
Netherlands	1,574.82	1.3	1.6	2.0	1.3
United Kingdom	1,430.26	1.2	1.4	2.0	1.6
Korea, South	1,429.85	1.2	1.4	1.6	0.9
Egypt	1,336.13	1.1	1.3	1.3	0.8
Austria	1,250.70	1.0	1.2	1.5	1.4
Slovakia	1,152.21	0.9	1.1	1.4	1.7
Spain	1,042.69	0.8	1.0	1.4	0.9
Japan	968.12	0.8	1.0	1.4	0.8
Sweden	895.76	0.7	0.9	0.9	0.6
Brazil	822.49	0.7	0.8	0.9	0.6
Moldova	819.13	0.7	0.8	1.3	1.1
Singapore	189.15	0.2	0.2	0.6	0.2
Others	23,015.23	18.6	x	x	x
Total	**123,937.19**	**100.0**	**100.0**	**100.0**	**100.0**

Notes: * total turnover is sum of annualised exports and imports as of April 2009.
Sources: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

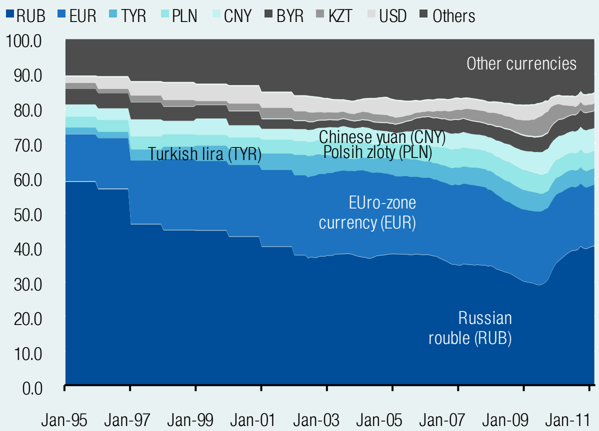
Chart 56. Historical breakdown of the ICU trade basket – history from January 1995 till March 2011 (% of total)

Breakdown by countries



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Breakdown by currencies



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Taking account that monthly merchandise trade statistics is available since May 2001, hence annualised volume of trade is available since May 2002. As of previous periods, there is just yearly merchandise trade statistics for the period of 1995-2001. Then, monthly weights of 26 countries in merchandise trade with Ukraine for the period of 1995-2001 are derived from annual figures, for the period of January 2002 till April 2002 the weights are assume equal to the weights derived from annualised trade statistics as of May 2002.

Exchange rates

History of exchange rates (national currency against the US dollar) is sourced from Bloomberg. Then, the data on exchange rates is used to construct a chain of cross-rates (via US dollar) of national currencies of key trade partners against the Ukrainian hryvnia (UAH).

The obtained cross-rates are used to calculate the exchange rate index:

$$I_i = \frac{R_i^t}{R_i^b},$$

where I_i – nominal exchange rate index of the currency of *i* country against the Ukrainian hryvnia; R_i^t – exchange rate of the currency of *i* country against the Ukrainian hryvnia at t period; R_i^b – exchange rate of the currency of *i* country against the Ukrainian hryvnia at base period (January 1995).

Monthly averages of exchange rates are used for monthly TWIs, while daily market closing data for respective exchange rates is used for daily TWIs calculation.

Inflation

CPI monthly history (in year-on-year terms) is maintained since January 1995 for the range of countries, mentioned in the above table, and for Ukraine. Upon the available data on CPI the following index is calculated:

$$P_i = \frac{CPI_i}{CPI_{ukr}},$$

where P_i – relative inflation level in *i* country against versus Ukraine; CPI_i – consumer price index of *i* country; CPI_{ukr} – consumer price index in Ukraine.

Nominal trade-weighted index

Nominal trade-weighted index of the Ukrainian hryvnia is calculated upon the following formula:

$$nTWI = \prod_{i=1}^{n} (I_i)^{w_i}$$

Real trade-weighted index

Real trade-weighted index of the Ukrainian hryvnia is calculated upon the following formula:

$$rTWI = \prod_{i=1}^{n} \left(\frac{I_i}{P_i}\right)^{w_i}$$

Results

The following tables and charts provide the results of calculations of the trade-weighted indices of the local currency hryvnia in nominal and real terms.

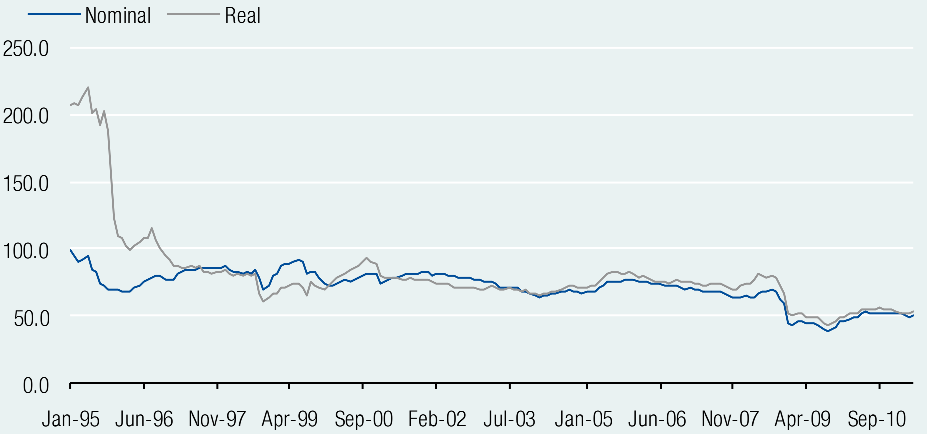
Table 13. Highlights of ICU monthly TWIs

	Jan-95	Jan-00	Jan-05	Jan-06	Jan-07	Jan-08	Jan-09	Jan.10	Mar.11	Apr.11	May.11
Nominal	100.00	73.03	68.16	75.90	71.30	65.16	44.02	47.03	51.26	50.25	50.69
Real	207.52	72.15	71.66	78.49	74.99	71.84	50.38	49.57	51.77	51.59	52.87

Sources: State Statistics Committee of Ukraine, Reuters, Investment Capital Ukraine LLC.

Chart 57. ICU monthly TWIs

All-time history from January 1995 to May 2011



Sources: State Statistics Committee of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

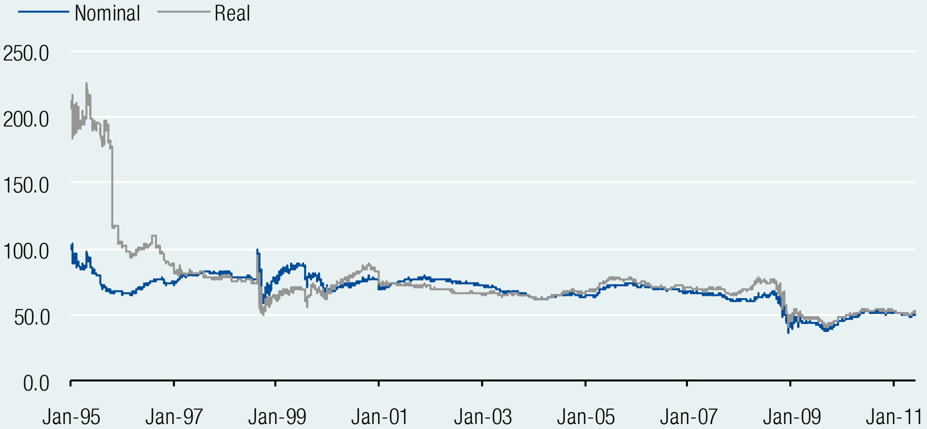
Table 14. Highlights of ICU daily TWIs

	2-Jan-95	…	31-Dec-07	31-Dec-08	31-Dec-09	31-Dec-10	…	31-May-11	1-Jun-11	2-Jun-11	3-Jun-11	6-Jun-11	7-Jun-11	8-Jun-11
Nominal	100.00	…	61.47	43.36	45.42	52.03	…	50.61	50.71	50.45	50.23	50.50	50.28	50.23
Real	207.53	…	66.46	49.51	48.31	53.48	…	52.78	52.89	52.62	52.39	52.67	52.44	52.39

Sources: State Statistics Committee of Ukraine, Reuters, Investment Capital Ukraine LLC.

Chart 58. ICU daily TWIs

All-time history from January 1995 to June 2011



Sources: State Statistics Committee of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Appendix

5yr sovereign external debt payback

Table 15. Foreign-currency debt* (Eurobonds and loans) repayments for the upcoming 5-year period, as of 10 June 2011

	Repayments, hryvnia equivalent (UAHm)						Repayments, US dollar equivalent (US$m)					
	Interest		Principal		Total		Interest		Principal		Total	
Period	Eurobond	Loan	Eurobond	Loan	Interest	Principal	Eurobond	Loan	Eurobond	Loan	Interest	Principal
BY QUARTERS												
2Q11	592.5	29.7	0.0	0.0	622.3	0.0	74.3	3.7	0.0	0.0	78.0	0.0
3Q11	1,075.9	200.0	0.0	0.0	1,275.9	0.0	134.9	25.1	0.0	0.0	160.0	0.0
4Q11	933.7	734.2	4,784.1	15,947.0	1,667.9	20,731.1	117.1	92.1	600.0	2,000.0	209.2	2,600.0
1Q12	1,075.9	200.0	0.0	0.0	1,275.9	0.0	134.9	25.1	0.0	0.0	160.0	0.0
2Q12	773.4	200.0	3,986.8	0.0	973.4	3,986.8	97.0	25.1	500.0	0.0	122.1	500.0
3Q12	1,075.9	230.7	0.0	1,439.9	1,306.6	1,439.9	134.9	28.9	0.0	180.6	163.9	180.6
4Q12	646.1	194.6	0.0	4,653.2	840.7	4,653.2	81.0	24.4	0.0	583.6	105.4	583.6
1Q13	1,075.9	177.2	0.0	4,653.2	1,253.1	4,653.2	134.9	22.2	0.0	583.6	157.2	583.6
2Q13	646.1	159.7	7,973.5	4,653.2	805.8	12,626.7	81.0	20.0	1,000.0	583.6	101.1	1,583.6
3Q13	1,075.9	142.3	0.0	5,676.3	1,218.2	5,676.3	134.9	17.8	0.0	711.9	152.8	711.9
4Q13	341.1	121.0	0.0	5,676.3	462.1	5,676.3	42.8	15.2	0.0	711.9	58.0	711.9
1Q14	1,075.9	99.7	0.0	6,667.0	1,175.6	6,667.0	134.9	12.5	0.0	836.1	147.4	836.1
2Q14	341.1	74.7	0.0	6,667.0	415.8	6,667.0	42.8	9.4	0.0	836.1	52.1	836.1
3Q14	1,075.9	49.7	0.0	5,227.1	1,125.6	5,227.1	134.9	6.2	0.0	655.6	141.2	655.6
4Q14	341.1	30.1	0.0	2,013.8	371.2	2,013.8	42.8	3.8	0.0	252.6	46.6	252.6
1Q15	1,075.9	22.5	0.0	2,013.8	1,098.5	2,013.8	134.9	2.8	0.0	252.6	137.8	252.6
2Q15	341.1	15.0	0.0	2,013.8	356.1	2,013.8	42.8	1.9	0.0	252.6	44.7	252.6
3Q15	1,075.9	7.4	3,986.8	990.7	1,083.4	4,977.4	134.9	0.9	500.0	124.2	135.9	624.2
4Q15	341.1	3.7	6,161.2	990.7	344.8	7,151.8	42.8	0.5	772.7	124.2	43.2	897.0
BY YEARS												
2011	2,602.1	964.0	4,784.1	15,947.0	3,566.1	20,731.1	326.3	120.9	600.0	2,000.0	447.2	2,600.0
2012	3,571.3	825.3	3,986.8	6,093.1	4,396.7	10,079.9	447.9	103.5	500.0	764.2	551.4	1,264.2
2013	3,139.1	600.1	7,973.5	20,659.1	3,739.2	28,632.6	393.7	75.3	1,000.0	2,591.0	469.0	3,591.0
2014	2,834.1	254.1	0.0	20,574.9	3,088.2	20,574.9	355.4	31.9	0.0	2,580.4	387.3	2,580.4
2015	2,834.1	48.7	10,147.9	6,009.0	2,882.8	16,156.9	355.4	6.1	1,272.7	753.6	361.5	2,026.3

Notes: [*] debt redemptions include also interest payments; debt comprises Eurobonds, IMF and VTB loans; IMF loan is meant all tranches received in 2008-10; [1] redemption of US$2bn loan to VTB is a worst-case scenario within this loan agreement, it may be prolonged 2 times and this in effect may shift the redemption to 4Q11 or 2Q12.

Sources: Ministry of Finance, IMF, Bloomberg, Reuters, Investment Capital Ukraine LLC.

Ukraine's top 42 banks' key financial figures 2010 and 1Q11

The following pages contain five tables with 42 top banks by assets. Each table depicts quarterly performance of a financial indicator of a bank (assets, loans, deposits, capital, and loan loss reserves) in the quarterly perspective from 1Q10 till 1Q11.

Table 16. Assets growth in the Ukraine's banking sector (details on top 42 banks by size of assets as of 1 April 2011)

Bank	Ownership	Assets (UAHbn, eop)					Assets (%YoY)					CAGR 2Y (%)	Share (%)
		1Q10	2Q10	3Q10	4Q10	1Q11	1Q10	2Q10	3Q10	4Q10	1Q11		
Privatbank	Local banks (private sector)	91.98	97.47	104.40	113.44	128.36	23.68	22.59	28.08	31.80	39.55	31.38	13.63
Ukreximbank	Local banks (public sector)	62.65	66.06	68.98	73.17	76.26	22.68	16.44	25.08	27.93	21.71	22.19	8.09
Oschadbank	Local banks (public sector)	57.63	58.75	59.51	59.02	68.08	5.16	9.72	-2.00	-1.51	18.14	11.46	7.23
Raiffeisen Bank Aval	DM owned banks (Austria)	54.03	53.98	55.93	55.10	54.89	-9.66	-5.66	-7.15	1.95	1.59	-4.20	5.83
Ukrsibbank	DM owned banks (France)	45.79	44.75	43.30	46.13	46.87	-12.56	-12.20	-10.63	-0.47	2.35	-5.40	4.97
Ukrsotsbank	DM owned banks (Italy)	42.21	42.67	42.95	41.60	41.75	-9.56	-5.12	-2.99	-4.70	-1.10	-5.43	4.43
Prominvestbank	Russian banks (public sector)	29.96	28.65	28.91	34.61	34.95	-8.26	2.81	-6.13	13.72	16.64	3.44	3.71
VTB Bank	Russian banks (public sector)	28.00	29.85	30.83	33.14	33.59	5.57	9.39	9.09	15.17	19.97	12.54	3.57
Alfa Bank	Russian banks (private sector)	27.29	27.17	27.14	26.59	28.47	-10.20	-16.11	-20.08	-7.31	4.34	-3.20	3.02
OTP Bank	DM owned banks (Other)	28.11	26.79	26.20	24.68	24.63	-9.28	-9.90	-12.46	-16.03	-12.37	-10.84	2.61
Nadra Bank	Local banks (private sector)	25.08	22.85	23.09	22.91	22.45	-10.66	-13.09	-10.81	-7.80	-10.49	-10.58	2.38
Finance and Credit Bank	Local banks (private sector)	20.45	22.20	21.71	22.37	23.18	11.68	26.22	17.66	14.96	13.30	12.49	2.46
First Ukrainian Int'l Bank	Local banks (private sector)	20.18	17.04	18.74	18.10	20.00	8.77	-4.02	4.91	4.02	-0.88	3.84	2.12
Brokbiznesbank	Local banks (private sector)	14.53	15.56	15.24	15.83	16.59	7.90	8.72	7.67	-2.09	14.17	10.99	1.76
Creditprombank	Local banks (private sector)	13.07	13.82	13.85	14.23	14.59	-3.54	5.08	-0.49	4.84	11.63	3.76	1.55
Bank Forum	DM owned banks (Other)	17.14	17.10	15.52	14.02	13.71	-11.61	-10.59	-16.74	-27.92	-20.01	-15.91	1.45
Ukrgazbank	Local banks (public sector)	14.17	14.00	14.50	13.84	13.49	13.41	15.29	12.03	14.45	-4.80	3.91	1.43
Delta Bank	Local banks (private sector)	6.51	8.15	13.07	13.80	15.33	22.49	47.72	113.76	63.01	135.45	69.82	1.63
Swedbank	DM owned banks (Other)	12.85	12.35	12.33	12.25	11.29	-15.10	-10.78	-10.27	-11.57	-12.17	-13.65	1.20
Rodovid Bank	Local banks (public sector)	12.80	11.17	10.56	10.48	9.94	16.45	27.98	16.05	-38.18	-22.33	-4.90	1.05
Pivdenny	Local banks (private sector)	10.45	10.47	10.86	10.28	10.38	-1.96	-0.12	2.08	-3.99	-0.63	-1.30	1.10
Dongorbank	Local banks (private sector)	8.07	8.80	9.87	10.14	9.31	17.06	22.01	32.06	42.87	15.34	16.20	0.99
Sberbank of Russia	Russian banks (public sector)	8.26	7.10	8.39	9.92	12.48	77.46	40.98	52.61	60.13	51.08	63.74	1.32
Erste Bank	DM owned banks (Austria)	12.93	10.00	10.81	9.83	10.26	33.57	-1.95	-3.77	15.84	-20.65	2.95	1.09
ING Bank Ukraine	DM owned banks (Other)	8.14	9.07	8.90	9.63	9.35	-8.29	9.82	-7.06	-0.69	14.90	2.65	0.99
Universal Bank	DM owned banks (Other)	8.66	9.29	9.47	8.58	8.22	14.39	20.25	11.03	-5.76	-5.15	4.16	0.87
Unicredit Bank	DM owned banks (Italy)	8.45	8.75	8.68	8.49	8.69	-11.67	-2.89	-6.10	-2.29	2.89	-4.67	0.92
Kreschatyk Bank	Local banks (private sector)	6.01	6.45	6.96	7.07	7.21	23.40	18.96	15.76	9.96	20.00	21.69	0.77
VAB Bank	DM owned banks (Other)	7.01	7.12	6.79	6.66	7.29	-1.36	2.94	-8.84	-8.21	4.09	1.33	0.77
Finance Initiative	Local banks (private sector)	6.07	5.71	5.90	6.50	6.74	19.82	8.13	9.06	21.29	11.10	15.38	0.72
Imexbank	DM owned banks (France)	5.44	6.03	6.03	6.28	6.45	12.32	22.32	21.83	10.88	18.51	15.37	0.68
Bank Credit Dnipro	Local banks (private sector)	4.49	4.57	5.17	6.04	5.72	28.14	7.00	11.71	24.87	27.41	27.77	0.61
Citibank	DM owned banks (Other)	4.83	4.83	5.41	5.77	6.04	10.88	35.27	31.91	38.48	25.06	17.76	0.64
Pravex-Bank	DM owned banks (Italy)	7.37	6.71	5.89	5.66	6.26	4.39	-7.13	-15.72	-25.01	-15.08	-5.85	0.66
Index-Bank	DM owned banks (France)	5.26	4.94	5.05	5.33	5.31	-7.45	-33.81	-17.53	-5.41	0.89	-3.37	0.56
KyivskaRus	Local banks (private sector)	4.32	4.30	4.66	4.95	5.56	20.35	14.81	25.08	32.21	28.85	24.53	0.59
Credobank	DM owned banks (Other)	5.48	5.01	4.81	4.45	4.29	-12.53	-12.62	-13.04	-18.73	-21.77	-17.28	0.46
Credit Agricole	DM owned banks (France)	4.22	3.99	4.09	4.38	4.86	4.16	-8.38	-8.82	-2.77	15.23	9.55	0.52
BTA Bank	Local banks (private sector)	3.66	3.45	3.76	3.83	4.42	33.68	67.07	52.24	19.74	20.87	27.12	0.47
Marfin Bank	DM owned banks (Other)	4.79	5.01	4.37	4.13	4.24	26.70	17.99	-15.42	-18.94	-11.52	5.88	0.45
Pireus Bank	DM owned banks (Other)	3.10	3.54	3.48	3.59	4.40	8.58	19.67	18.62	12.83	41.73	24.05	0.47
Megabank	Local banks (private sector)	3.37	3.30	3.52	3.51	3.49	11.14	11.97	18.85	10.63	3.71	7.36	0.37
Other banks		**110.18**	**116.43**	**127.83**	**131.74**	**145.68**	**-14.61**	**-8.29**	**-2.18**	**18.26**	**32.21**	**6.25**	**15.46**
Total		**874.96**	**885.26**	**917.50**	**942.08**	**995.03**	**0.50**	**2.38**	**3.09**	**7.86**	**13.72**	**6.91**	**100.00**
	Local banks (private sector)	238.23	244.16	260.83	272.98	293.33	12.38	13.26	17.89	18.42	23.13	17.63	29.48
	Local banks (public sector)	147.24	149.97	153.54	156.51	167.77	13.83	14.36	11.33	7.08	13.94	13.89	16.86
	Local banks (total)	**385.47**	**394.13**	**414.37**	**429.49**	**461.10**	**12.93**	**13.68**	**15.37**	**14.02**	**19.62**	**16.23**	**46.34**
	DM owned banks (Austria)	66.96	63.98	66.75	64.93	65.15	-3.64	-5.10	-6.62	3.83	-2.71	-3.17	6.55
	DM owned banks (France)	60.72	59.71	58.48	62.12	63.49	-9.31	-11.83	-8.66	-0.05	4.56	-2.62	6.38
	DM owned banks (Italy)	58.03	58.14	57.52	55.75	56.69	-8.33	-5.03	-4.94	-6.91	-2.30	-5.36	5.70
	DM owned banks (Other)	100.10	100.11	97.29	93.77	93.45	-5.84	-1.96	-7.88	-12.11	-6.65	-6.25	9.39
	DM owned banks (total)	**285.80**	**281.94**	**280.02**	**276.57**	**278.77**	**-6.61**	**-5.54**	**-7.15**	**-5.04**	**-2.46**	**-4.56**	**28.02**
	Russian banks (public sector)	66.22	65.59	68.13	77.68	81.01	3.73	8.99	5.53	18.75	22.34	12.65	8.14
	Russian banks (private sector)	27.29	27.17	27.14	26.59	28.47	-10.20	-16.11	-20.08	-7.31	4.34	-3.20	2.86
	Russian banks (total)	93.51	92.76	95.28	104.28	109.49	-0.76	0.21	-3.30	10.80	17.09	7.80	11.00
	Other banks	110.18	116.43	127.83	131.74	145.68	-14.61	-8.29	-2.18	18.26	32.21	6.25	14.64
	All banks	**874.96**	**885.26**	**917.50**	**942.08**	**995.03**	**0.50**	**2.38**	**3.09**	**7.86**	**13.72**	**6.91**	**100.00**

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Table 5. Loans growth in the Ukraine's banking sector (details on top 42 banks by size of assets as of 1 April 2011)

Bank	Ownership	Loans (UAHbn, eop)					Loans (%YoY)					CAGR 2Y (%)	Share (%)
		1Q10	2Q10	3Q10	4Q10	1Q11	1Q10	2Q10	3Q10	4Q10	1Q11		
Privatbank	Local banks (private sector)	81.18	85.44	90.98	101.86	111.47	13.76	21.41	23.73	35.82	37.31	24.98	14.51
Ukreximbank	Local banks (public sector)	48.83	48.27	51.96	52.09	52.36	13.71	8.78	10.98	7.84	7.21	10.41	6.82
Oschadbank	Local banks (public sector)	43.86	44.10	45.05	44.78	45.04	18.04	5.08	3.21	0.40	2.69	10.10	5.86
Raiffeisen Bank Aval	DM owned banks (Austria)	47.02	46.27	44.91	43.85	43.75	-12.57	-9.35	-11.67	-10.00	-6.96	-9.81	5.70
Ukrsibbank	DM owned banks (France)	43.36	41.41	40.98	38.70	36.93	-10.92	-11.59	-12.45	-14.52	-14.83	-12.89	4.81
Ukrsotsbank	DM owned banks (Italy)	39.08	38.47	38.05	37.47	37.17	-8.45	-6.45	-8.28	-7.60	-4.91	-6.70	4.84
Prominvestbank	Russian banks (public sector)	25.24	24.96	27.15	25.71	27.38	7.63	5.23	10.43	5.11	8.47	8.05	3.56
VTB Bank	Russian banks (public sector)	26.41	26.16	26.21	30.52	30.58	6.28	3.46	-1.14	16.40	15.78	10.93	3.98
Alfa Bank	Russian banks (private sector)	25.76	23.84	24.94	22.91	23.88	-8.26	-21.51	-6.83	-9.51	-7.29	-7.78	3.11
OTP Bank	DM owned banks (Other)	27.42	23.75	23.88	21.48	20.58	-9.34	-19.79	-21.92	-26.07	-24.94	-17.51	2.68
Nadra Bank	Local banks (private sector)	24.18	23.69	24.09	24.55	24.99	-3.65	-4.60	-4.89	-0.99	3.33	-0.22	3.25
Finance and Credit Bank	Local banks (private sector)	17.20	18.03	18.88	18.85	19.37	8.30	16.34	18.42	13.15	12.63	10.45	2.52
First Ukrainian Int'l Bank	Local banks (private sector)	13.32	12.92	13.24	13.62	14.10	-8.09	-7.86	-5.04	0.44	5.85	-1.37	1.84
Brokbiznesbank	Local banks (private sector)	11.93	12.48	12.00	12.48	12.41	12.38	17.31	7.18	9.58	3.95	8.08	1.62
Creditprombank	Local banks (private sector)	11.79	11.76	11.89	11.07	11.25	0.83	1.61	-0.33	-6.02	-4.51	-1.88	1.47
Bank Forum	DM owned banks (Other)	15.46	15.31	15.07	14.12	14.07	-8.35	-7.46	-12.60	-16.95	-9.01	-8.68	1.83
Ukrgazbank	Local banks (public sector)	9.82	10.14	11.83	10.54	12.17	6.46	11.89	27.48	8.20	23.89	14.85	1.58
Delta Bank	Local banks (private sector)	4.04	4.84	10.60	12.31	11.42	4.82	22.51	154.79	193.19	182.93	72.21	1.49
Swedbank	DM owned banks (Other)	17.74	17.29	16.67	15.43	13.02	26.80	32.06	25.92	-14.85	-26.60	-3.53	1.70
Rodovid Bank	Local banks (public sector)	5.38	5.23	4.98	4.45	4.42	-41.64	-40.72	-41.87	-17.00	-17.91	-30.78	0.58
Pivdenny	Local banks (private sector)	7.97	8.17	8.47	8.42	8.27	-11.05	-5.98	-1.90	0.88	3.70	-3.96	1.08
Dongorbank	Local banks (private sector)	5.09	4.78	4.51	4.27	4.11	0.91	-4.96	-7.97	-14.02	-19.29	-9.75	0.54
Sberbank of Russia	Russian banks (public sector)	5.44	5.98	7.50	8.97	9.75	39.99	39.68	58.03	85.28	79.20	58.38	1.27
Erste Bank	DM owned banks (Austria)	5.87	5.65	5.55	5.38	5.27	-9.91	-8.87	-11.38	-11.26	-10.29	-10.10	0.69
ING Bank Ukraine	DM owned banks (Other)	6.95	6.57	6.35	6.55	6.52	3.68	5.52	-13.03	-6.11	-6.28	-1.42	0.85
Universal Bank	DM owned banks (Other)	6.77	6.51	6.66	5.25	5.39	2.90	-0.13	-3.05	-24.84	-20.42	-9.51	0.70
Unicredit Bank	DM owned banks (Italy)	7.49	6.72	6.72	6.82	6.45	-10.55	-16.94	-19.52	-14.62	-13.81	-12.20	0.84
Kreschatyk Bank	Local banks (private sector)	3.97	4.12	4.14	4.31	4.25	17.15	5.92	7.71	5.63	7.22	12.08	0.55
VAB Bank	DM owned banks (Other)	6.09	5.91	5.92	5.47	6.12	1.57	-0.76	-6.80	-11.13	0.50	1.03	0.80
Finance Initiative	Local banks (private sector)	5.73	5.77	5.96	6.36	7.05	25.60	26.84	29.34	27.21	23.02	24.30	0.92
Imexbank	DM owned banks (France)	4.57	5.06	5.22	5.45	5.90	26.32	42.66	43.54	39.79	28.98	27.64	0.77
Bank Credit Dnipro	Local banks (private sector)	3.06	3.31	3.66	4.16	4.41	4.24	3.71	7.20	30.11	44.27	22.63	0.57
Citibank	DM owned banks (Other)	2.13	2.36	1.99	2.29	2.18	-11.56	17.21	-8.02	-4.82	2.12	-4.97	0.28
Pravex-Bank	DM owned banks (Italy)	5.33	5.37	5.44	5.05	4.82	-10.92	-5.89	-3.08	-11.40	-9.47	-10.20	0.63
Index-Bank	DM owned banks (France)	3.47	3.93	4.29	4.37	4.69	-6.95	9.80	24.60	29.71	35.21	12.17	0.61
KyivskaRus	Local banks (private sector)	3.26	3.52	3.83	3.93	4.44	8.20	15.90	26.30	26.81	36.16	21.37	0.58
Credobank	DM owned banks (Other)	4.67	4.47	4.40	4.10	3.98	-9.79	-12.91	-15.58	-15.27	-14.87	-12.37	0.52
Credit Agricole	DM owned banks (France)	3.19	3.17	3.33	3.35	3.50	7.09	2.29	-4.50	1.38	9.53	8.31	0.46
BTA Bank	Local banks (private sector)	1.60	1.52	1.83	2.17	2.30	18.42	-6.37	8.51	32.37	43.96	30.57	0.30
Marfin Bank	DM owned banks (Other)	2.97	2.94	2.89	2.95	3.09	-10.30	-7.60	-9.99	-2.41	4.09	-3.37	0.40
Pireus Bank	DM owned banks (Other)	2.69	2.72	2.70	2.77	2.92	12.58	12.65	3.88	4.16	8.72	10.63	0.38
Megabank	Local banks (private sector)	2.50	2.67	2.76	2.73	2.77	4.43	12.49	15.93	13.04	10.95	7.64	0.36
Other banks		81.10	83.96	86.62	88.59	93.54	-22.35	-19.27	-16.41	3.98	15.35	-5.36	12.18
Total		720.95	719.57	744.08	750.54	768.07	-2.30	-2.11	-0.49	3.34	6.54	2.02	100.00
	Local banks (private sector)	196.82	203.04	216.81	231.10	242.62	6.59	10.77	15.02	21.55	23.27	14.63	31.59
	Local banks (public sector)	107.89	107.74	113.83	111.86	113.98	9.48	3.37	5.08	3.57	5.64	7.54	14.84
	Local banks (total)	**304.71**	**310.78**	**330.64**	**342.96**	**356.59**	**7.60**	**8.09**	**11.39**	**15.03**	**17.03**	**12.21**	**46.43**
	DM owned banks (Austria)	52.90	51.91	50.46	49.24	49.02	-12.28	-9.30	-11.64	-10.14	-7.33	-9.84	6.38
	DM owned banks (France)	54.60	53.56	53.82	51.87	51.02	-7.47	-6.12	-6.20	-7.12	-6.56	-7.01	6.64
	DM owned banks (Italy)	51.90	50.56	50.21	49.34	48.44	-9.02	-7.93	-9.45	-9.03	-6.66	-7.85	6.31
	DM owned banks (Other)	92.90	87.84	86.53	80.42	77.87	-0.83	-3.15	-8.70	-17.29	-16.18	-8.83	10.14
	DM owned banks (total)	**252.29**	**243.88**	**241.02**	**230.87**	**226.34**	**-6.57**	**-6.17**	**-8.95**	**-11.92**	**-10.28**	**-8.45**	**29.47**
	Russian banks (public sector)	57.09	57.10	60.86	65.20	67.71	9.40	7.16	8.98	17.43	18.59	13.90	8.82
	Russian banks (private sector)	25.76	23.84	24.94	22.91	23.88	-8.26	-21.51	-6.83	-9.51	-7.29	-7.78	3.11
	Russian banks (total)	**82.85**	**80.94**	**85.80**	**88.11**	**91.59**	**3.22**	**-3.25**	**3.86**	**9.00**	**10.55**	**6.82**	**11.92**
	Other banks	81.10	83.96	86.62	88.59	93.54	-22.35	-19.27	-16.41	3.98	15.35	-5.36	12.18
	All banks	**720.95**	**719.57**	**744.08**	**750.54**	**768.07**	**-2.30**	**-2.11**	**-0.49**	**3.34**	**6.54**	**2.02**	**100.00**

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Table 6. Deposits growth in the Ukraine's banking sector (details on top 42 banks by size of assets as of 1 April 2011)

Bank	Ownership	Deposits (UAHbn, eop)					Deposits (%YoY)					CAGR 2Y (%)	Share (%)
		1Q10	2Q10	3Q10	4Q10	1Q11	1Q10	2Q10	3Q10	4Q10	1Q11		
Privatbank	Local banks (private sector)	55.25	61.88	67.75	75.18	81.53	25.46	31.71	42.15	50.86	47.56	36.06	17.23
Ukreximbank	Local banks (public sector)	20.70	21.43	24.87	27.33	31.46	41.89	15.26	40.45	40.71	51.99	46.85	6.65
Oschadbank	Local banks (public sector)	19.52	22.27	22.76	24.42	33.13	16.17	19.60	-8.49	-0.42	69.71	40.41	7.00
Raiffeisen Bank Aval	DM owned banks (Austria)	27.46	26.93	28.48	28.34	28.15	7.31	1.65	1.95	2.44	2.50	4.87	5.95
Ukrsibbank	DM owned banks (France)	15.25	17.29	18.00	17.87	20.63	22.81	27.60	33.35	26.28	35.25	28.88	4.36
Ukrsotsbank	DM owned banks (Italy)	12.46	14.05	14.73	15.34	14.91	1.37	15.35	27.18	24.29	19.70	10.16	3.15
Prominvestbank	Russian banks (public sector)	14.83	15.54	16.98	19.48	18.75	21.68	19.80	23.46	33.50	26.43	24.03	3.96
VTB Bank	Russian banks (public sector)	7.04	9.12	9.52	8.09	8.98	60.30	109.21	90.96	56.39	27.63	43.03	1.90
Alfa Bank	Russian banks (private sector)	7.25	8.49	9.23	9.65	11.00	-26.86	-21.72	-20.12	30.08	51.81	5.38	2.33
OTP Bank	DM owned banks (Other)	6.96	7.04	7.20	7.79	7.46	25.59	16.10	7.95	9.37	7.27	16.07	1.58
Nadra Bank	Local banks (private sector)	8.87	7.74	7.47	7.78	7.01	-16.25	-24.43	-22.21	-8.66	-20.94	-18.63	1.48
Finance and Credit Bank	Local banks (private sector)	7.04	8.01	8.78	10.12	10.01	-8.12	23.72	47.20	44.93	42.12	14.28	2.12
First Ukrainian Int'l Bank	Local banks (private sector)	6.43	6.64	8.27	8.00	8.11	30.89	35.54	59.96	38.82	26.29	28.57	1.71
Brokbiznesbank	Local banks (private sector)	8.02	8.62	8.97	9.17	10.10	9.23	26.40	23.51	21.04	25.90	17.27	2.13
Creditprombank	Local banks (private sector)	4.29	4.79	5.93	6.61	7.19	2.27	22.06	47.05	69.02	67.41	30.85	1.52
Bank Forum	DM owned banks (Other)	7.51	8.13	8.00	7.56	8.04	29.03	21.74	9.95	2.33	7.00	17.50	1.70
Ukrgazbank	Local banks (public sector)	4.46	4.92	5.72	5.24	5.43	-29.64	-11.51	36.26	29.58	21.53	-7.53	1.15
Delta Bank	Local banks (private sector)	4.07	4.99	5.63	6.73	7.83	25.03	59.81	56.55	57.31	92.24	55.04	1.65
Swedbank	DM owned banks (Other)	2.69	2.74	2.59	2.40	2.04	-14.16	1.67	-7.90	-25.00	-24.25	-19.36	0.43
Rodovid Bank	Local banks (public sector)	5.34	4.70	4.38	4.25	4.19	19.41	15.85	69.56	-46.84	-21.54	-3.21	0.89
Pivdenny	Local banks (private sector)	6.17	6.43	7.54	7.32	7.27	13.46	16.35	28.98	28.82	17.88	15.65	1.54
Dongorbank	Local banks (private sector)	5.73	5.47	6.39	7.44	7.31	26.23	18.55	26.51	48.38	27.58	26.90	1.55
Sberbank of Russia	Russian banks (public sector)	2.29	3.16	4.18	4.28	5.85	16.48	63.03	96.34	141.29	155.02	72.35	1.24
Erste Bank	DM owned banks (Austria)	1.11	1.14	1.32	1.43	1.55	72.66	43.93	37.31	46.89	39.44	55.16	0.33
ING Bank Ukraine	DM owned banks (Other)	1.92	2.43	3.08	2.39	2.89	-13.65	17.00	58.36	20.34	50.34	13.94	0.61
Universal Bank	DM owned banks (Other)	3.23	3.41	3.24	3.19	3.21	50.54	39.68	10.92	-1.67	-0.59	22.33	0.68
Unicredit Bank	DM owned banks (Italy)	1.46	2.05	2.16	2.03	2.22	1.11	66.53	62.05	40.04	52.31	24.10	0.47
Kreschatyk Bank	Local banks (private sector)	3.45	4.05	4.33	4.56	4.78	25.82	50.26	42.12	36.51	38.44	31.98	1.01
VAB Bank	DM owned banks (Other)	3.13	3.54	3.83	4.36	4.61	6.36	29.70	34.84	48.67	47.44	25.23	0.97
Finance Initiative	Local banks (private sector)	1.28	1.00	1.02	0.86	1.67	8.47	5.55	2.93	-15.36	30.45	18.95	0.35
Imexbank	DM owned banks (France)	1.58	1.80	1.82	2.22	2.29	-44.78	-18.31	-3.77	32.19	45.19	-10.46	0.48
Bank Credit Dnipro	Local banks (private sector)	2.31	2.37	2.90	3.64	3.59	10.57	12.09	21.69	50.60	55.64	31.18	0.76
Citibank	DM owned banks (Other)	3.54	3.40	4.04	4.20	4.53	9.92	32.80	30.12	37.12	27.84	18.55	0.96
Pravex-Bank	DM owned banks (Italy)	4.48	3.88	3.47	2.83	3.12	23.27	-3.96	-15.20	-35.24	-30.35	-7.34	0.66
Index-Bank	DM owned banks (France)	2.17	2.40	2.76	2.92	2.93	6.56	10.35	32.76	39.96	35.33	20.09	0.62
KyivskaRus	Local banks (private sector)	2.65	2.62	3.12	3.50	3.74	16.99	16.24	45.15	59.86	41.13	28.50	0.79
Credobank	DM owned banks (Other)	3.46	3.35	3.30	2.97	2.88	15.43	3.05	-4.62	-17.58	-16.79	-1.99	0.61
Credit Agricole	DM owned banks (France)	2.07	2.66	2.39	3.12	3.28	-19.19	9.18	-6.27	19.93	58.52	13.18	0.69
BTA Bank	Local banks (private sector)	0.65	0.65	0.82	0.83	0.91	68.94	100.88	144.67	43.01	39.83	53.70	0.19
Marfin Bank	DM owned banks (Other)	1.76	1.72	2.18	2.25	2.38	28.32	26.67	39.23	34.23	35.04	31.64	0.50
Pireus Bank	DM owned banks (Other)	0.75	1.04	1.25	1.31	1.44	60.50	97.00	97.97	82.13	91.66	75.39	0.30
Megabank	Local banks (private sector)	1.46	1.47	1.74	1.81	1.82	-7.51	4.63	19.87	29.94	25.33	7.66	0.39
Other banks		**52.89**	**58.12**	**64.56**	**26.79**	**73.04**	**-24.37**	**-12.50**	**-0.40**	**-50.35**	**38.11**	**2.20**	**15.43**
Total		**354.98**	**383.48**	**416.68**	**397.58**	**473.26**	**5.60**	**12.39**	**18.96**	**13.71**	**33.32**	**18.66**	**100.00**
	Local banks (private sector)	117.68	126.74	140.65	153.54	162.89	15.12	23.83	34.55	41.53	38.41	26.23	34.42
	Local banks (public sector)	50.02	53.32	57.72	61.24	74.20	18.51	13.86	16.96	9.39	48.34	32.59	15.68
	Local banks (total)	**167.70**	**180.06**	**198.37**	**214.77**	**237.09**	**16.11**	**20.70**	**28.91**	**30.59**	**41.37**	**28.12**	**50.10**
	DM owned banks (Austria)	28.58	28.07	29.80	29.77	29.70	8.91	2.88	3.12	3.95	3.93	6.39	6.28
	DM owned banks (France)	21.07	24.15	24.97	26.13	29.13	6.02	18.58	24.73	27.35	38.29	21.08	6.16
	DM owned banks (Italy)	18.39	19.98	20.36	20.20	20.24	5.93	14.48	19.73	11.20	10.10	7.99	4.28
	DM owned banks (Other)	34.95	36.80	38.71	38.41	39.47	17.03	21.13	16.50	9.98	12.95	14.97	8.34
	DM owned banks (total)	**102.98**	**108.99**	**113.84**	**114.51**	**118.55**	**10.34**	**14.16**	**14.82**	**11.99**	**15.12**	**12.71**	**25.05**
	Russian banks (public sector)	24.16	27.82	30.68	31.85	33.58	30.27	44.37	47.01	47.87	38.99	34.56	7.10
	Russian banks (private sector)	7.25	8.49	9.23	9.65	11.00	-26.86	-21.72	-20.12	30.08	51.81	5.38	2.33
	Russian banks (total)	31.41	36.31	39.91	41.50	44.59	10.38	20.58	23.08	43.31	41.95	25.17	9.42
	Other banks	52.89	58.12	64.56	26.79	73.04	-24.37	-12.50	-0.40	-50.35	38.11	2.20	15.43
	All banks	**354.98**	**383.48**	**416.68**	**397.58**	**473.26**	**5.60**	**12.39**	**18.96**	**13.71**	**33.32**	**18.66**	**100.00**

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Table 7. Capital growth in the Ukraine's banking sector (details on top 42 banks by size of assets as of 1 April 2011)

		Capital (UAHbn, eop)					Capital (%YoY)					CAGR 2Y	Share
Bank	**Ownership**	**1Q10**	**2Q10**	**3Q10**	**4Q10**	**1Q11**	**1Q10**	**2Q10**	**3Q10**	**4Q10**	**1Q11**	**(%)**	**(%)**
Privatbank	Local banks (private sector)	10.49	10.89	11.50	11.88	12.33	23.25	27.03	32.37	15.67	17.56	20.37	8.90
Ukreximbank	Local banks (public sector)	17.28	17.29	17.44	17.45	17.60	110.97	113.28	89.18	60.58	1.81	46.56	12.71
Oschadbank	Local banks (public sector)	16.58	16.54	16.62	16.63	16.84	2.77	0.73	-1.35	1.46	1.58	2.17	12.16
Raiffeisen Bank Aval	DM owned banks (Austria)	5.45	6.43	6.42	6.44	6.45	-23.36	-0.40	7.83	21.24	18.45	-4.72	4.66
Ukrsibbank	DM owned banks (France)	4.25	3.71	3.06	4.86	4.87	5.65	-29.67	-39.10	-0.94	14.59	10.03	3.52
Ukrsotsbank	DM owned banks (Italy)	6.04	6.06	6.07	6.57	6.59	15.11	15.67	5.20	9.00	9.05	12.04	4.76
Prominvestbank	Russian banks (public sector)	5.46	4.99	4.85	4.59	4.54	32.24	52.65	108.68	-18.18	-16.88	4.84	3.28
VTB Bank	Russian banks (public sector)	2.32	2.33	2.18	4.34	3.60	-6.20	-5.46	-11.46	33.72	55.36	20.72	2.60
Alfa Bank	Russian banks (private sector)	2.29	3.13	3.10	3.12	3.14	-27.69	-0.38	1.66	8.45	36.76	-0.56	2.26
OTP Bank	DM owned banks (Other)	2.90	3.05	3.05	3.44	3.67	27.32	57.67	29.51	21.02	26.41	26.86	2.65
Nadra Bank	Local banks (private sector)	0.48	0.48	0.48	0.48	0.48	-62.60	-39.91	-4.24	1.00	0.11	-38.81	0.35
Finance and Credit Bank	Local banks (private sector)	2.00	1.97	1.97	1.86	1.92	-19.08	-13.82	-12.64	-8.36	-4.07	-11.89	1.39
First Ukrainian Int'l Bank	Local banks (private sector)	2.62	2.62	2.65	2.85	2.88	-22.22	-8.71	-8.97	8.50	10.15	-7.44	2.08
Brokbiznesbank	Local banks (private sector)	2.33	2.35	2.36	2.37	2.38	0.71	1.16	1.62	2.34	2.03	1.37	1.72
Creditprombank	Local banks (private sector)	1.77	1.85	1.82	1.86	1.83	10.80	29.94	23.10	51.91	3.23	6.95	1.32
Bank Forum	DM owned banks (Other)	1.59	0.38	1.96	0.76	0.47	-34.74	-82.93	-6.77	-59.03	-70.63	-56.22	0.34
Ukrgazbank	Local banks (public sector)	1.81	1.94	1.80	1.99	1.93	24.42	41.61	-35.15	1986.72	6.62	15.18	1.40
Delta Bank	Local banks (private sector)	0.59	0.59	0.60	0.61	0.62	1.70	1.82	1.65	3.05	4.79	3.23	0.45
Swedbank	DM owned banks (Other)	-1.88	-1.84	1.45	1.48	1.49	-187.19	-199.68	7.65	-180.78	-179.19	-16.91	1.07
Rodovid Bank	Local banks (public sector)	2.04	1.67	1.19	1.15	0.76	65.06	-890.70	-25.29	-73.39	-62.80	-21.64	0.55
Pivdenny	Local banks (private sector)	1.47	1.48	1.50	1.50	1.52	3.29	2.17	2.76	3.28	3.49	3.39	1.10
Dongorbank	Local banks (private sector)	0.63	0.64	0.64	0.68	0.66	-40.36	-33.92	-18.65	7.86	4.55	-21.03	0.47
Sberbank of Russia	Russian banks (public sector)	1.10	1.09	1.05	1.11	1.14	17.74	31.62	61.93	4.13	4.01	10.66	0.82
Erste Bank	DM owned banks (Austria)	0.96	0.87	1.41	1.38	1.37	-21.41	-14.55	45.27	36.06	43.10	6.05	0.99
ING Bank Ukraine	DM owned banks (Other)	1.52	1.45	1.50	1.53	1.61	82.66	7.19	15.28	9.40	5.55	38.85	1.16
Universal Bank	DM owned banks (Other)	0.83	0.96	0.90	0.55	0.87	-0.62	25.63	29.68	-34.68	5.45	2.37	0.63
Unicredit Bank	DM owned banks (Italy)	0.83	0.85	0.86	0.87	0.88	1.72	9.69	8.64	5.10	5.61	3.65	0.64
Kreschatyk Bank	Local banks (private sector)	0.64	0.67	0.67	0.57	0.58	-15.30	-11.52	-8.29	-13.30	-9.61	-12.50	0.42
VAB Bank	DM owned banks (Other)	0.63	0.54	0.60	0.28	0.75	-29.58	-35.42	-20.51	-58.38	18.51	-8.64	0.54
Finance Initiative	Local banks (private sector)	1.61	1.61	1.61	1.91	1.91	27.95	27.97	27.99	18.78	18.76	23.27	1.38
Imexbank	DM owned banks (France)	0.83	0.94	0.96	0.96	0.97	4.72	1.29	7.43	14.59	15.98	10.20	0.70
Bank Credit Dnipro	Local banks (private sector)	0.57	0.57	0.57	0.58	0.58	2.67	9.48	2.59	1.48	1.49	2.08	0.42
Citibank	DM owned banks (Other)	0.96	0.98	1.05	0.71	0.83	6.14	25.51	48.09	-13.29	-13.64	-4.26	0.60
Pravex-Bank	DM owned banks (Italy)	0.96	0.93	0.93	0.89	0.88	-25.90	-18.46	11.48	-25.28	-7.63	-17.27	0.64
Index-Bank	DM owned banks (France)	0.47	0.48	0.51	0.72	0.73	18.88	-12.58	39.23	192.91	54.17	35.38	0.53
KyivskaRus	Local banks (private sector)	0.28	0.28	0.28	0.28	0.28	-24.67	-22.42	-21.50	-1.49	1.41	-12.60	0.20
Credobank	DM owned banks (Other)	0.44	0.26	0.55	0.62	0.60	497.23	-74.10	-22.62	5.63	35.65	184.63	0.43
Credit Agricole	DM owned banks (France)	0.58	0.61	0.57	0.51	0.54	-20.82	-4.23	-15.62	-26.78	-7.46	-14.40	0.39
BTA Bank	Local banks (private sector)	1.54	1.54	1.52	1.54	1.52	0.30	1.79	1.02	0.01	-1.20	-0.45	1.10
Marfin Bank	DM owned banks (Other)	0.51	0.52	0.51	0.51	0.51	-1.38	-0.74	-1.69	-0.38	0.26	-0.56	0.37
Pireus Bank	DM owned banks (Other)	0.31	0.29	0.42	0.29	0.38	-34.05	-38.18	19.34	-0.01	23.68	-9.69	0.28
Megabank	Local banks (private sector)	0.63	0.64	0.64	0.64	0.64	90.07	32.11	31.37	0.42	0.48	38.19	0.46
Other banks		**22.00**	**22.55**	**22.99**	**24.37**	**24.32**	**16.29**	**30.34**	**9.21**	**23.33**	**10.55**	**13.38**	**17.57**
Total		**126.72**	**127.16**	**132.80**	**137.73**	**138.43**	**8.23**	**12.94**	**12.57**	**14.57**	**9.24**	**8.74**	**100.00**
	Local banks (private sector)	27.64	28.17	28.81	29.60	30.12	0.88	7.70	11.29	10.01	8.95	4.84	21.75
	Local banks (public sector)	37.71	37.45	37.04	37.23	37.13	39.61	45.78	21.74	17.48	-1.56	17.23	26.82
	Local banks (total)	**65.36**	**65.62**	**65.84**	**66.82**	**67.24**	**20.10**	**26.57**	**16.94**	**14.05**	**2.89**	**11.16**	**48.57**
	DM owned banks (Austria)	6.41	7.30	7.84	7.83	7.83	-23.08	-2.34	13.09	23.62	22.14	-3.07	5.65
	DM owned banks (France)	6.14	5.74	5.10	7.05	7.10	3.14	-22.34	-26.69	5.46	15.75	9.26	5.13
	DM owned banks (Italy)	7.83	7.84	7.86	8.33	8.35	6.43	9.59	6.27	3.52	6.65	6.54	6.03
	DM owned banks (Other)	7.82	6.58	11.99	10.17	11.17	-31.43	-43.93	10.55	27.15	42.88	-1.02	8.07
	DM owned banks (total)	**28.20**	**27.46**	**32.78**	**33.38**	**34.46**	**-14.67**	**-18.65**	**2.05**	**14.85**	**22.20**	**2.11**	**24.89**
	Russian banks (public sector)	8.87	8.40	8.09	10.04	9.28	17.84	28.18	48.67	1.20	4.56	11.00	6.70
	Russian banks (private sector)	2.29	3.13	3.10	3.12	3.14	-27.69	-0.38	1.66	8.45	36.76	-0.56	2.26
	Russian banks (total)	**11.16**	**11.53**	**11.19**	**13.16**	**12.41**	**4.35**	**18.93**	**31.78**	**2.83**	**11.17**	**7.70**	**8.97**
	Other banks	22.00	22.55	22.99	24.37	24.32	16.29	30.34	9.21	23.33	10.55	13.38	17.57
	All banks	**126.72**	**127.16**	**132.80**	**137.73**	**138.43**	**8.23**	**12.94**	**12.57**	**14.57**	**9.24**	**8.74**	**100.00**

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Table 17. Loan loss reserves growth in the Ukraine's banking sector (details on top 42 banks by size of assets as of 1 January 2011)

Bank	Ownership	LLR (UAHm, eop)					LLR/Gross loans (%)					LLR (%YoY)					CAGR 2Y (%)	Share (%)
		1Q10	2Q10	3Q10	4Q10	1Q11	1Q10	2Q10	3Q10	4Q10	1Q11	1Q10	2Q10	3Q10	4Q10	1Q11		
Privatbank	Local banks (private sector)	14.70	15.00	15.33	16.47	17.28	18.11	17.56	16.85	16.17	15.50	40.91	37.30	30.13	23.12	17.54	28.70	11.83
Ukreximbank	Local banks (public sector)	4.86	5.68	6.61	7.39	8.27	9.96	11.77	12.71	14.19	15.80	127.34	99.83	87.79	72.82	70.10	96.65	5.66
Oschadbank	Local banks (public sector)	3.70	4.22	4.86	5.57	6.15	8.45	9.57	10.79	12.45	13.66	262.32	230.65	224.66	94.37	66.11	145.32	4.21
Raiffeisen Bank Aval	DM owned banks (Austria)	10.17	10.77	11.46	12.08	12.60	21.63	23.28	25.51	27.55	28.79	103.69	69.97	40.64	25.90	23.85	58.83	8.62
Ukrsibbank	DM owned banks (France)	7.64	8.74	10.46	10.44	10.78	17.61	21.11	25.52	26.97	29.18	71.37	71.27	69.11	55.95	41.11	55.50	7.38
Ukrsotsbank	DM owned banks (Italy)	5.04	5.57	6.20	6.58	6.98	12.88	14.48	16.30	17.55	18.78	112.40	88.71	68.82	45.97	38.61	71.58	4.78
Prominvestbank	Russian banks (public sector)	5.02	5.56	5.95	2.09	2.47	19.88	22.28	21.94	8.13	9.03	84.75	87.14	40.27	-57.43	-50.69	-4.56	1.69
VTB Bank	Russian banks (public sector)	3.74	3.97	4.31	4.68	5.70	14.17	15.17	16.45	15.35	18.64	250.88	189.92	136.63	110.94	52.36	131.21	3.90
Alfa Bank	Russian banks (private sector)	5.36	5.67	6.03	6.04	6.31	20.83	23.80	24.17	26.36	26.41	83.42	64.83	87.79	40.57	17.59	46.86	4.32
OTP Bank	DM owned banks (Other)	3.82	3.12	3.44	3.35	3.15	13.92	13.12	14.41	15.62	15.29	44.42	-9.63	-22.78	-8.28	-17.56	9.12	2.15
Nadra Bank	Local banks (private sector)	3.26	4.39	4.58	5.19	5.81	13.49	18.54	19.01	21.14	23.26	75.35	81.85	50.63	67.85	78.25	76.80	3.98
Finance and Credit Bank	Local banks (private sector)	1.32	1.35	1.37	1.53	1.50	7.66	7.48	7.25	8.11	7.72	79.03	32.30	20.59	19.41	13.47	42.53	1.02
First Ukrainian Int'l Bank	Local banks (private sector)	2.75	2.85	2.94	3.01	3.17	20.64	22.09	22.18	22.10	22.46	111.42	46.67	24.52	17.37	15.19	56.06	2.17
Brokbiznesbank	Local banks (private sector)	0.72	0.79	0.85	0.87	0.88	6.04	6.34	7.06	6.94	7.12	44.31	45.52	33.87	25.29	22.52	32.97	0.60
Creditprombank	Local banks (private sector)	1.41	1.48	1.57	1.60	1.65	12.00	12.62	13.23	14.48	14.66	71.15	35.96	33.30	14.68	16.66	41.30	1.13
Bank Forum	DM owned banks (Other)	1.82	2.73	3.31	4.31	4.62	11.78	17.80	21.99	30.51	32.81	94.73	127.65	130.63	156.69	153.29	122.09	3.16
Ukrgazbank	Local banks (public sector)	4.63	4.81	4.93	4.92	5.02	47.16	47.42	41.70	46.68	41.23	916.73	863.73	156.93	10.01	8.31	231.85	3.43
Delta Bank	Local banks (private sector)	0.25	0.27	2.67	3.34	2.71	6.15	5.58	25.15	27.14	23.71	7.30	2.35	919.77	1209.1	990.66	242.10	1.85
Swedbank	DM owned banks (Other)	7.19	7.44	7.62	7.27	5.89	40.52	43.02	45.70	47.13	45.20	446.36	307.22	200.62	4.41	-18.12	111.51	4.03
Rodovid Bank	Local banks (public sector)	3.04	3.31	3.57	3.13	3.36	56.58	63.26	71.65	70.32	75.95	920.51	100.91	64.75	29.76	10.20	235.35	2.30
Pivdenny	Local banks (private sector)	0.54	0.56	0.59	0.62	0.65	6.83	6.79	7.02	7.38	7.82	23.91	18.61	11.42	15.67	18.81	21.33	0.44
Dongorbank	Local banks (private sector)	1.00	1.02	1.07	1.11	1.17	19.69	21.35	23.76	25.96	28.48	157.14	86.31	29.73	19.36	16.74	73.26	0.80
Sberbank of Russia	Russian banks (public sector)	0.54	2.12	2.30	2.45	2.50	9.86	35.40	30.62	27.34	25.63	13.53	193.21	127.87	388.23	365.49	129.88	1.71
Erste Bank	DM owned banks (Austria)	1.23	1.36	1.39	1.40	1.42	20.91	24.10	25.10	25.99	26.99	96.12	63.16	43.81	26.54	15.82	50.72	0.97
ING Bank Ukraine	DM owned banks (Other)	0.11	0.12	0.12	0.15	0.15	1.60	1.80	1.86	2.26	2.37	42.34	33.50	7.18	42.35	38.67	40.50	0.11
Universal Bank	DM owned banks (Other)	0.96	1.09	1.26	1.21	1.29	14.19	16.69	18.94	22.94	23.92	124.57	94.25	64.48	35.70	34.19	73.59	0.88
Unicredit Bank	DM owned banks (Italy)	0.63	0.65	0.72	0.76	0.83	8.39	9.62	10.76	11.20	12.80	80.87	32.38	23.38	18.93	31.52	54.23	0.57
Kreschatyk Bank	Local banks (private sector)	0.17	0.18	0.18	0.39	0.37	4.34	4.28	4.34	8.97	8.75	257.89	185.99	139.75	124.64	116.00	178.04	0.25
VAB Bank	DM owned banks (Other)	0.83	0.90	1.07	1.23	1.30	13.66	15.19	18.10	22.39	21.23	132.73	107.62	108.65	63.01	56.21	90.67	0.89
Finance Initiative	Local banks (private sector)	0.61	0.66	0.78	0.81	0.99	10.59	11.45	13.12	12.70	14.08	38.61	50.01	59.44	45.56	63.50	50.54	0.68
Imexbank	DM owned banks (France)	0.29	0.33	0.38	0.45	0.53	6.36	6.47	7.33	8.22	8.93	180.53	132.38	85.85	72.81	81.02	125.35	0.36
Bank Credit Dnipro	Local banks (private sector)	0.37	0.38	0.41	0.42	0.44	11.94	11.48	11.20	10.02	9.86	14.13	3.00	14.52	16.81	19.14	16.61	0.30
Citibank	DM owned banks (Other)	0.09	0.14	0.14	0.14	0.10	4.03	6.04	6.87	5.96	4.60	93.40	74.47	51.79	59.92	16.49	50.10	0.07
Pravex-Bank	DM owned banks (Italy)	1.47	1.49	1.56	1.06	0.91	27.51	27.81	28.74	21.05	18.84	184.35	120.89	47.93	-13.42	-37.99	32.79	0.62
Index-Bank	DM owned banks (France)	0.71	0.71	0.69	0.60	0.59	20.45	17.94	16.17	13.71	12.52	14.87	-4.69	-2.60	-9.51	-17.25	-2.50	0.40
KyivskaRus	Local banks (private sector)	0.22	0.22	0.22	0.22	0.23	6.67	6.18	5.69	5.68	5.11	68.53	70.23	66.44	12.14	4.32	32.60	0.16
Credobank	DM owned banks (Other)	1.34	1.51	1.55	1.38	1.39	28.68	33.75	35.22	33.58	34.87	64.44	56.55	18.71	13.38	3.49	30.45	0.95
Credit Agricole	DM owned banks (France)	0.05	0.08	0.18	0.27	0.28	1.62	2.64	5.49	8.11	8.10	47.50	103.55	119.36	69.26	449.10	184.59	0.19
BTA Bank	Local banks (private sector)	0.29	0.29	0.31	0.25	0.30	18.15	19.24	16.82	11.39	13.23	68.48	34.06	15.71	-6.92	4.93	32.96	0.21
Marfin Bank	DM owned banks (Other)	0.52	0.56	0.59	0.58	0.60	17.39	19.08	20.32	19.76	19.50	33.16	34.64	22.63	18.85	16.75	24.68	0.41
Pireus Bank	DM owned banks (Other)	0.44	0.45	0.54	0.64	0.64	16.53	16.55	20.07	23.06	21.87	498.54	388.34	131.71	55.98	43.88	193.46	0.44
Megabank	Local banks (private sector)	0.10	0.11	0.12	0.13	0.15	4.03	4.01	4.28	4.83	5.33	30.55	26.77	29.81	37.89	46.83	38.45	0.10
Other banks		**12.28**	**13.23**	**13.84**	**13.50**	**14.96**	**15.14**	**15.75**	**15.97**	**15.23**	**16.00**	**1.11**	**-11.07**	**-16.62**	**-6.01**	**21.86**	**11.00**	**10.25**
Total		**115.23**	**125.87**	**138.08**	**139.63**	**146.06**	**15.98**	**17.49**	**18.56**	**18.60**	**19.02**	**85.01**	**64.34**	**48.98**	**30.26**	**26.75**	**53.14**	**100.00**
	Local banks (private sector)	27.71	29.56	32.98	35.96	37.29	14.08	14.56	15.21	15.56	15.37	54.82	43.99	42.42	39.52	34.57	44.34	25.53
	Local banks (public sector)	16.24	18.02	19.97	21.01	22.79	15.05	16.73	17.55	18.79	20.00	314.88	187.58	119.41	49.81	40.34	141.30	15.61
	Local banks (total)	**43.95**	**47.58**	**52.95**	**56.97**	**60.08**	**14.42**	**15.31**	**16.02**	**16.61**	**16.85**	**101.49**	**77.57**	**64.14**	**43.15**	**36.70**	**65.97**	**41.14**
	DM owned banks (Austria)	11.40	12.13	12.85	13.48	14.02	21.55	23.37	25.47	27.38	28.60	102.84	69.18	40.98	25.97	22.99	57.95	9.60
	DM owned banks (France)	8.69	9.86	11.72	11.76	12.17	15.92	18.40	21.77	22.67	23.86	66.69	63.60	63.07	51.22	40.11	52.82	8.34
	DM owned banks (Italy)	7.13	7.71	8.49	8.40	8.71	13.74	15.25	16.90	17.03	17.99	120.48	87.31	59.66	31.82	22.24	64.17	5.97
	DM owned banks (Other)	17.12	18.04	19.64	20.25	19.12	18.43	20.54	22.70	25.18	24.56	141.83	98.17	64.69	24.64	11.69	64.35	13.09
	DM owned banks (total)	**44.34**	**47.74**	**52.69**	**53.89**	**54.03**	**17.57**	**19.58**	**21.86**	**23.34**	**23.87**	**109.68**	**80.72**	**57.10**	**31.13**	**21.86**	**59.85**	**36.99**
	Russian banks (public sector)	9.30	11.65	12.56	9.23	10.67	16.28	20.40	20.64	14.15	15.76	118.48	130.06	77.57	20.88	14.81	58.38	7.31
	Russian banks (private sector)	5.36	5.67	6.03	6.04	6.31	20.83	23.80	24.17	26.36	26.41	83.42	64.83	87.79	40.57	17.59	46.86	4.32
	Russian banks (total)	**14.66**	**17.32**	**18.59**	**15.27**	**16.98**	**17.69**	**21.40**	**21.67**	**17.33**	**18.54**	**104.20**	**103.66**	**80.76**	**27.97**	**15.83**	**53.79**	**11.63**
	Other banks	12.28	13.23	13.84	13.50	14.96	15.14	15.75	15.97	15.23	16.00	1.11	-11.07	-16.62	-6.01	21.86	11.00	10.25
	Allbanks	**115.23**	**125.87**	**138.08**	**139.63**	**146.06**	**15.98**	**17.49**	**18.56**	**18.60**	**19.02**	**85.01**	**64.34**	**48.98**	**30.26**	**26.75**	**53.14**	**100.00**

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

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