INVESTMENT CAPITAL UKRAINE
INVESTMENT BANKING

Focus
Ukraine

Scope
Economics

Quarterly Report

Ukrainian jigsaw puzzle

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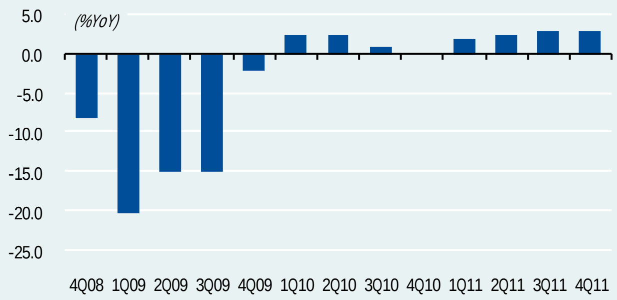
Executive summary

The end of 2009 is set to witness a 13.1% contraction in the economy in real terms, followed by a sluggish recovery in 2010-11. Rising unemployment and general economic weakness are likely to keep domestic demand constrained. With recent gains in the competitiveness of the economy, our base-case scenario forecasts a strengthening in the local currency (towards 7.7/USD as of end-2009).

Ukraine's economy is set to adapt to a new norm of functioning, while the global economy re-balances, via a deep recession that is likely to last till the end of this year. A combination of prolonged weakness of foreign demand for key Ukraine's exports (steel) and dampened local demand due to corporate weakness and stagnation of consumers' income has been sending economic activity in the country to a gradual cooling.

Chart 1. Quarterly real GDP growth forecast 2009-11

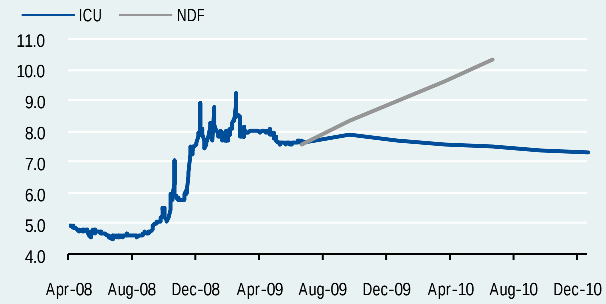
Quarterly change over year ago, since 4Q08



Source: State Statistics Committee of Ukraine.

Chart 2. Exchange rate forecast (UAH per US$)

ICU forecast versus the rates derived from non-deliverable forwards market



Sources: Reuters, Investment Capital Ukraine LLC.

Our base-case scenario assumes an increase in unemployment rate above the 11% level as of end-2009, as the army of unemployed is likely to return to levels seen during the previous episode of recession (in late 1990s). This would lead to real contraction of GDP in the 2Q and 3Q of this year by 15% YoY each quarter, followed by some moderation in real GDP decline in 4Q09, by only 2%, thanks largely to base effect (the economy contracted by 8% YoY in 4Q08).

Faced with the prospects of overcoming the major concern of a shrinking economy in Ukraine hinges on the wiliness and capability of the authorities to maintain monetary stability. Indeed, this presents the biggest uncertainty regarding the future path of the economy. As the country is preparing to enter the election cycle of 2009-10, which is likely to host not only presidential elections (January 2010) but parliamentary ones as well (somewhere in 1Q10 or in early 2Q10), the government is hesitant regarding spending cuts in an unrealistic budget. Though politicians are vocal with populist rhetoric, the central bank, in our view, has a strong desire to maintain economic stability and avoid an increase in inflation. Politicisation of the central bank was averted this winter; instead, the bank confirmed its commitment to greater exchange-rate flexibility and declared that it is heading up an inflation targeting regime. With limited options on sources of financing, the government is left to seek compromise with IMF requirements on prudent policymaking. This appears to be a safeguard of monetary stability, as well, in our view.

Ukraine's external balance is likely to compensate for its previous imbalance (of a sizable C/A deficit), thanks to lower demand for imports (marginal decline spreads into engineering imports and hydrocarbons are consumed in lower tonnage due to weaker economy). Our base-case scenario assumes that the C/A account will return into surplus territory as soon as 2Q09. We expect some deterioration in the trade balance in 4Q09 as imports of hydrocarbons accelerate ahead of the winter season.

The exchange rate of the local currency hryvnia currently is undervalued, in our view, as in real terms, the currency has remained at a bottom, which was reached after a wave of devaluation seen in 4Q08. While monetary stability amid a contracting economy is a key uncertainty factor, we do not rule out that a negative perception of the local currency may push the exchange rate into weaker territory again. However, we expect that the central bank's determination will keep the rate below 8.00/USD. Still, our baseline forecast viewpoint is that the exchange rate should lean towards the 7.00/USD level.

Table 1. Key quarterly macroeconomic forecast for the period of 2009-11 (according to base-case scenario)

	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09E	3Q09F	4Q09F	1Q10F	2Q10F	3Q10F	4Q10F	1Q11F	2Q11F	3Q11F	4Q11F
Real GDP (%YoY)	6.30	6.20	6.40	-8.00	-20.30	-15.00	-15.00	-2.00	2.50	2.50	1.00	0.00	2.00	2.50	3.00	3.00
Unemployment rate (%)	7.08	6.24	5.99	6.36	9.49	9.99	10.45	11.36	10.06	9.60	9.37	9.37	9.20	8.74	8.51	8.28
CPI headline (%YoY, eop)	26.24	29.27	24.61	22.31	18.09	15.00	16.73	16.96	14.91	14.91	13.21	10.46	7.97	6.37	6.37	5.43
Current account balance (% of GDP)	-9.92	-6.88	-3.63	-9.63	-3.62	0.19	4.24	-2.54	-3.03	1.07	2.94	-0.23	1.19	1.26	1.59	0.42
Net FDI (% of GDP)	6.52	6.33	5.66	2.15	4.15	3.38	3.02	2.68	3.48	2.83	2.41	2.18	2.91	2.45	2.13	2.01
FX reserves (% of ann'd GDP, eop)	21.90	21.13	20.07	17.17	15.02	17.93	22.03	22.45	20.49	19.27	18.01	15.46	14.35	13.77	12.43	12.09
UAH/US$ (eop)	4.99	4.53	5.07	7.80	8.00	7.72	7.90	7.70	7.60	7.50	7.40	7.30	7.20	7.20	7.00	7.00
UAH/€ (eop)	7.87	7.14	7.15	10.90	10.60	10.83	10.90	10.63	10.56	10.50	10.36	10.22	10.15	10.15	9.87	9.87

Note: ratio of current account balance to GDP and net FDI to GDP are based on quarterly data.

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

Global economy

"We must set ourselves on a path so that one country, or group of countries, does not consume in excess while another set of countries produces in excess."
Timothy F. Geithner, U.S. Treasury Secretary, in April 2009

While the world has begun seeing the green shoots of recovery from the economic and financial slumps of 2007-08, in the long run, a more profound change is likely to take place in the way the global economy mechanism functions. This is due to the rebalancing of global economies – some are taking measures to increase their reliance on domestic demand and less on foreign, thereby reducing their current account surpluses (most notably China), while others plan to accelerate domestic savings, thereby reducing their current account deficits (most notably the US).

General view

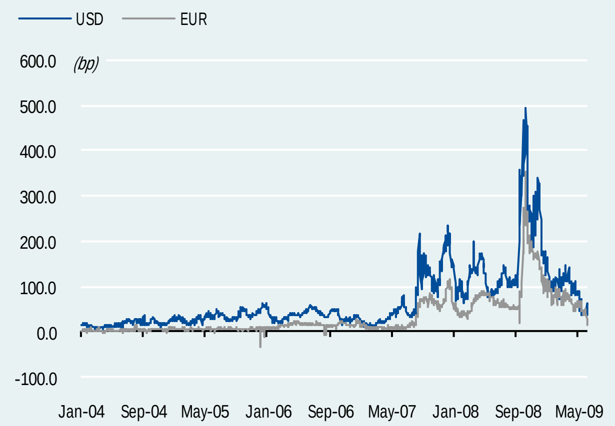
The global economy is set to undergo an adjustment of the global balance of payments

Indeed, there have been a number of indications of green shoots in the financial world lately, as conditions in several global financial markets have stabilised, and some have even begun to see a rally. Furthermore, by some measure, conditions have returned to the levels seen right on the eve of fateful bankruptcy of Lehman Brother in September, 2008.

Thus, conditions on the money markets for the US dollar and the European single currency have improved to levels not seen since August 2007, when the subprime credit crisis began. In all, equity markets both in developed, and more notably, in emerging countries, have been on a measurable rally since March.

Chart 3. Money market conditions have returned back to levels not seen since August 2007

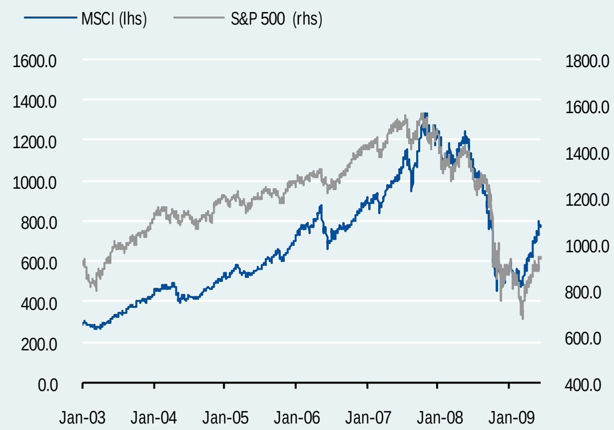
TED Spread for each currency indicates the spread between yield of 3-month government bond and 3-month LIBOR rate



Source: Reuters.

Chart 4. Equity markets have been in a continued rally since early March 2009

S&P 500 index and MSCI EM index

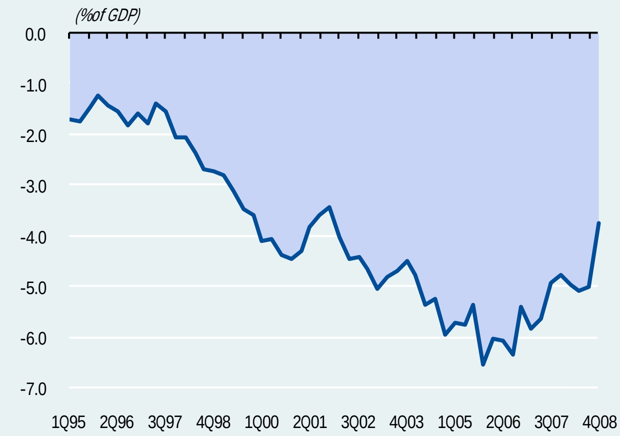


Source: Reuters.

However, while some financial markets indicators have normalised, it is too early to say whether fundamental factors supporting sustainable economic growth in many corners of the globe have also normalised. The rebalancing of the global balance of payments has yet to be addressed, as debtor and creditor nations are caught up in rescue efforts of their economies, struggling to position themselves in the path of sustainable growth.

Chart 5. U.S. current account balance

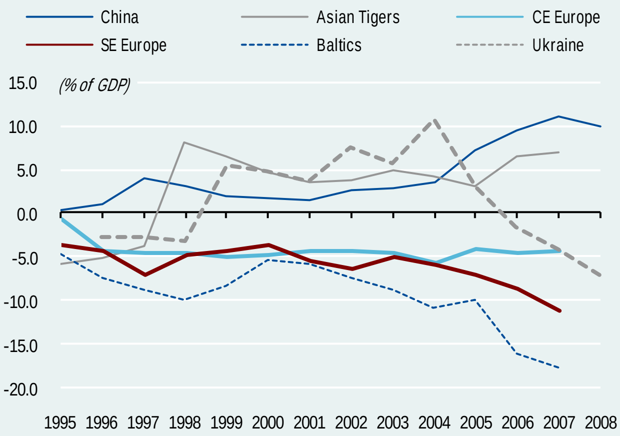
As a percentage of GDP



Source: IMF.

Chart 6. Current account balances for selected EM economies

As a percentage of GDP



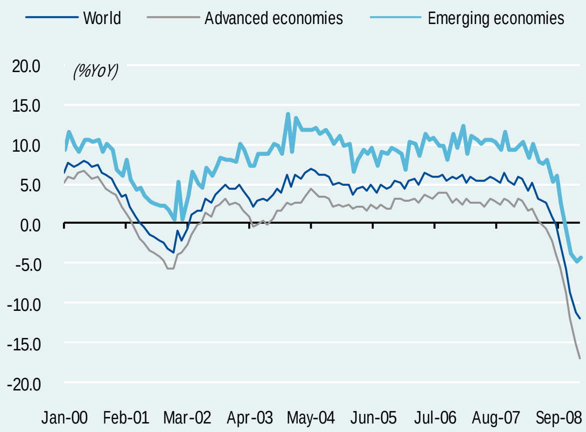
Source: IMF, State Statistics Committee of Ukraine, National Bank of Ukraine, Investment Capital Ukraine LLC.

A starting point for the process of rebalancing is the current state of global industrial production and trade

In this regard, in our view, the recovery of the global economy is likely to be generally slow across certain regions around the globe. Stabilization in the balance of payments of debtor countries (i.e., those with current account deficits), among which are the US and many EM economies, has proven equally trying for creditor countries (i.e., those with current account surpluses). The latter used to rely on debt-fuelled consumer demand from the former for their manufactured exports, explaining why industrial production dropped sharply worldwide, reflecting reduced international demand for goods. As formerly mighty consumers are still repairing their balance sheets, the demand pattern of the past has a low likelihood of re-emerging over the upcoming year, in our view.

Chart 7. Worldwide industrial production plunge in 4Q08,...

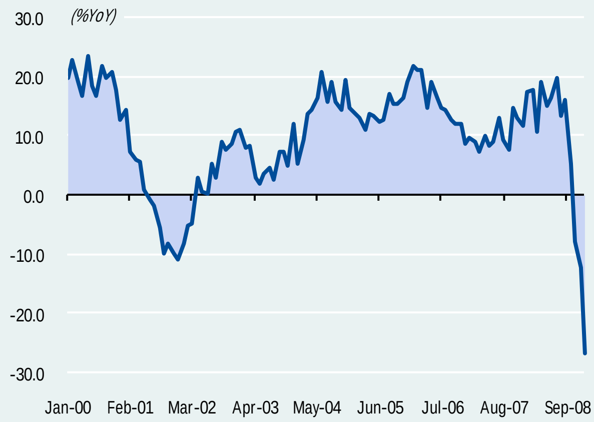
Percentage change over a year ago of industrial production



Source: IMF.

Chart 8. ...reflecting a collapse in world trade

Percentage change over a year ago, in SDR terms



Source: IMF.

Hence, we incorporate into our base-case scenario of Ukraine's 3-year macroeconomic forecast the following factors: 1) global real GDP growth for the period of 2009-11 will be at -1.3%, 1.9%, and 2.5%, respectively, in year-on-year terms; and 2) Ukraine's key trading partner, Russia, is forecast to experience real GDP growth of -6.0%, 0.5%, and 2.5% over the same period of time. The two indicators for 2009 and 2010 are taken from the IMF forecast published in the World Economic Outlook (April 2009).

Commodities vital for Ukraine

Two commodities are vital for Ukraine's forecast – oil and steel

There are two vital commodities whose price performance on the global markets is likely to have an impact on Ukraine's macroeconomic fundamentals, especially on its external balance and industrial production activity.

Oil market

Imports of minerals, where hydrocarbons account for the lion's share of the total, have a 30% share of total merchandise imports (in annualised terms). As the prices of most of the mineral goods are tied to the crude oil price (directly or indirectly), oil market conditions are critical to Ukraine' economy.

Hydrocarbons account for a 30% share of total imported of goods into Ukraine

The WTI crude oil price has risen quite quickly over the course of 2Q09, towards the level of US$70 per barrel, thanks to some recovery in demand, a thaw of global money markets (due to improved liquidity made possible by central banks' interventions), and decreased risk aversion among investors. In terms of the monthly volatility of the average price of crude oil, recent jumps in the price have been the most rapid for nearly the last 10-year period. Such a spike of oil was partly a reflection of US dollar weakness (towards 1.40/EUR), on investor concern regarding the sustainability of US fiscal policy.

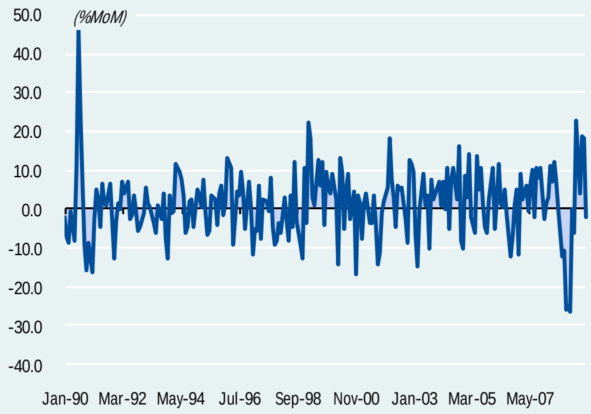
Chart 9. Crude oil price history since 1990

Monthly averages of WTI (West Texas Intermediate) spot price

Source: Reuters, Investment Capital Ukraine LLC.

Chart 10. Volatility of crude oil price

Percentage change of WTI monthly average spot price over a month ago



Source: Reuters, Investment Capital Ukraine LLC..

The futures prices on WTI indicate that the price will end this year at US$65.0 a barrel, and at US$70.0/bbl and US$73.0/bbl as of the end of 2010 and 2011, respectively. This may result in average prices for 2009 of US$59.6/bbl, US$68.0/bbl, and US$71.5/bbl for 2010 and 2011, respectively.

These are price levels that we incorporated into our base-case scenario of Ukraine's 3-year macroeconomic forecast of June 2009. For our best-case scenario, we assume lower crude oil prices (with a discount of 10-15%, which evenly progresses from its lower range for the year of 2009 towards a higher range in 2011). The worst-case scenario takes into account more expensive crude oil over 2009-11, i.e., it assumes crude oil prices that have a margin over the prices from the base-case scenario of the 15-25% range.

Steel market

Steel exports account for a 40% share of Ukraine's merchandise exports

Steel market conditions are as vital for Ukraine as crude oil. Steel exports account for a 40% share of total merchandise exports (in annualised terms). In our forecast, we use the price of hot-rolled coil as our benchmark price, as most of the steel exports from Ukraine come in the form of hot-rolled steel products.

Over the course of the last 12-month period, steel prices (see left-handed chart below) have swung from over US$1,000 a tonne sharply lower towards US$360 a tonne.

The upward swings in the steel price seen since the end of 2002 have reflected a prolonged period of industrialisation in many EM economies, especially in those large ones that have benefited from strong demand for manufactured goods and the commodities they produce. However, the current economic crisis has changed fundamentals for many sectors (from civil construction to car-making) that formed most of the demand for steel. From the current point of time – with depressed industrial production worldwide and a likely lengthy standstill in construction, especially in many countries that saw their domestic real estate markets overheating – it is likely that the supply-demand pattern of the global steel market will keep steel prices at at the current low level, allowing only a modest upward trend over the long term.

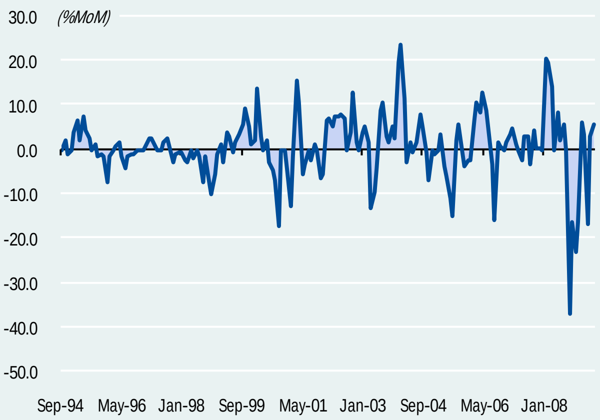
Chart 11. Steel price history since 1994

Monthly averages of HR coil spot price

Source: Bloomberg, Investment Capital Ukraine LLC.

Chart 12. Volatility of the steel price

Percentage change of HR coil monthly average spot price over a month ago



Source: Bloomberg, Investment Capital Ukraine LLC.

Our base-case scenario assumes the steel price for the upcoming 1.5 years to mirror futures prices as determined by the London Metal Exchange (LME). Thus, the average price for steel is forecast at US$370.0 per tonne for 2009, and US$425.0 and US$450.0, respectively, for 2010 and 2011. Our best-case scenario assume steel price level for a 3-year period of 2009-11 has a margin of 10-15% over the base-case scenario, while the worst-case scenario steel prices accompany a discount of 15-25%.

Assumptions on global economy performance

The following table provide details of key macroeconomic assumptions used in our 3-year macroeconomic forecast for Ukraine:

Table 2. Key assumptions for Ukraine's macroeconomic forecast

	2Q09E	3Q09F	4Q09F	2009F	1Q10F	2Q10F	3Q10F	4Q10F	2010F	1Q11F	2Q11F	3Q11F	4Q11F	2011F
World real GDP (%YoY)	-1.8	-1.2	0.3	**-1.3**	2.0	2.2	1.5	1.9	**1.9**	2.5	2.0	3.0	2.5	**2.5**
Russia real GDP (%YoY)	-8.0	-5.0	-1.5	**-6.1**	1.2	0.0	0.5	0.3	**0.5**	3.0	2.5	2.0	2.5	**2.5**
Crude oil price (US$/bbl, average)	68.0	62.0	65.0	**59.6**	66.0	68.0	68.0	70.0	**68.0**	70.0	71.0	72.0	73.0	**71.5**
Steel price (US$/tonne , average)	357.1	360.0	365.0	**370.1**	380.0	420.0	450.0	450.0	**425.0**	450.0	450.0	450.0	450.0	**450.0**

Sources: Investment Capital Ukraine LLC.

Geopolitics

"The current architecture of managing global affairs is broken and needs to be fixed. [...] We live in an interdependent world and the only way to move forward is to cooperate."
Kofi Annan, former U.N. Secretary General, at Davos, Switzerland, in January 2009

It would be right to say that above-mentioned quote precisely captures the current situation of global political affairs. Echoing it, US President Obama started his tenure with sweeping changes in his country's geopolitical stance, aiming to heal relations between the US and the Muslim world, and, among other priorities, guiding the US to "push the reset button" in relations with Russia, the geopolitical heavyweight in the CIS. How do and how will these actions concern Ukraine? We try to address this in our analysis below. In short, however, we conclude that there are risks of political and economic nature which continue to hang over Ukraine, and are likely to mount further as the geopolitical game between the West and Russia over the region of CIS continues. Indeed, Ukraine-Russia relations should follow the approach rightfully outlined by Kofi Annan.

The US and Russia look set to reassert their political and economic clout over Eastern Europe and central Asia, …

In its analysis of US-Russian relations, the *Financial Times* (FT) got to the core of these two countries' involvement in the satellite countries that once were a part of former Soviet Union (FSU), referring to the "Great Game," an analogy to rivalry between two great empires of the 19th century – Great Britain and Russia – over the vast lands and resources of central Asia (see the FT article *"Privileged position,"* dated 3 April, 2009).

Extending the logic of this article, such a game, which has lasted since the time of the peaceful break-up of the former Soviet Union (FSU) in 1991, has been perpetuated. The cycles of the game have ended and recommenced with the consecutive departure and arrival of (or principal change in) a new leadership in the respective offices – The White House and the Kremlin. The Bush-Putin cycle has receded into history, while the new cycle of Obama and his administration's involvement with the Russian duopoly of Medvedev-Putin is set to re-emerge, thanks to the US's proposal to Russia to "push the reset button" on bilateral relations.

… representing a new chapter in the great East-West rivalry

These relations are likely not limited to the issue of the US deploying a missile defence system in Eastern Europe, or to Iran's nuclear programme, or to fighting the Taliban in Afghanistan. There is no doubt that one of the foremost issues to be discussed will be the Kremlin's call to the West that FSU countries represent its "traditional sphere of interests." This belt of countries, which lie West and South of Russia on the map, is quite rich in oil and natural gas reserves (6.4bn tonnes of oil and 8.62trn cubic meters of natural gas, or a 3.8% share of world total of both oil and natural gas as of end of 2007, according to the British Petroleum Statistical Review of World Energy).

In addition, the area already comprises pipeline infrastructure that is capable of channelling these hydrocarbons to markets if proper investments are made to complete pipeline linkage with producing sites. Aside from its importance from an economic point of view, this belt of countries, especially the part in central Asia, became an important chain in the war waged by NATO forces against Taliban forces in Afghanistan.

What does "pushing the reset button" mean to Ukraine?

The US is seeking to strengthen its cooperation with Russia, ...

By itself, the "reset button" proposal by the new US administration appears to be an intention to seek a compromise with Russia on a variety of issues. It would depend, then, on the Obama administration on how far it will be willing to compromise, especially on the issue of what Kremlin calls the "traditional sphere of interests," meaning former republics of the USSR, particularly Ukraine.

In the meantime, the US has the following priorities on its agenda, which in some way or another are interconnected with Ukraine:

... from its current priorities in Iran and Afghanistan

- **The Muslim world is in the White House's spotlight.** The US side, with its new style of leadership – underscoring President Obama's soft approach to international issues – seems preoccupied with repairing its image in the global arena after the Iraqi war, especially in the Muslim world. But here, the US administration faces two key challenges, such as Iran's nuclear enrichment programme and fighting the Taliban in Afghanistan.
- **US-Russia cooperation is likely to extend to Iran and Afghanistan.** On both issues mentioned above, Russia's assistance appears vitally important for the US's success on issues confronting the Obama administration in Iran and Afghanistan. Traditionally, Russia has developed wide diplomatic and economic cooperation with Iran, and its leadership listens to the Kremlin. On the Afghanistan issue, Russia maintains de facto control of military affairs over a handful of central Asian countries, republics of the FSU, which border Afghanistan and serve as entry points to this country. The recent closure of the Manas airbase in Kyrgyzstan, which was used by the US military as transit hub to NATO forces in Afghanistan, is a prime example of this, as the move itself came as a surprise to NATO.

In the Manas case, Russia has demonstrated it has leverage over central Asia

The Manas affair was masterful in terms of showing the newly arrived Obama administration what kind of leverage Russia has over the regions, and in the Great Game. In particular, it was Kyrgyzstan President Kurmanbek Bakiev whose central Asian country with a population of more than 5m and a GDP of US$6bn, who announced on 3 February, 2009 after meeting his Russian counterpart, that his country would close the Manas airbase. Newswires also reported that the same meeting also ended up with a promise from the Russian president to provide a US$2bn rescue package (one-third of the Kyrgyz GDP) for the economy that was significantly impacted by the global economic crisis. While later on, Russian officials dismissed the idea that these two decisions were connected, they pledged to be open to cooperation with the US and NATO for deliveries to Afghanistan via Russian territory.

The US has shelved the Bush administration's previous commitments, which sent jitters across Russia; ...

Nevertheless, aside from the Manas case, the US administration is keen to improve relations with Russia. In doing so, it has not only watered down the commitments made by the previous administration on the deployment of the missile defence system in the two countries of Eastern Europe, namely, Poland and the Czech Republic, but has also extended this stance to the NATO enlargement issue. The bids of two countries from the FSU – Ukraine and Georgia – are now off the agenda. While the popular view in Ukraine is still lacking a majority favouring the move, the opposite is true for Georgia, where the majority of the nation backs the idea. At such, it appears that NATO's stance change was made as a bow to Russian interests, which vocally oppose the NATO enlargement to its borders, and lobbied for such a move by any means possible.

... in particular, Ukraine's bid for NATO membership is off the agenda

Ukraine's bid for NATO membership and the Orange revolution that brought the pro-Western elite to power have acted as a great rift in the relations between US and Russia, as the latter allegedly viewed the US's backing of these developments in Ukraine, and has being sceptical on whether it was an Ukrainian public vote that eventually brought Ukraine's current leaders to the power helm.

The risk for Ukraine is that such a move could be replicated in other areas, …

The risk for Ukraine arising from the so-called Great Game, waged by the US and Russia within the FSU space and further across the Europe, that the recent move (to put Ukraine's NATO bid on the shelf) can be replicated into other less military-sensitive areas such as, for instance, greater cooperation of the EU with Ukraine, or any instance of such would-be cooperation, would have the precondition of Kremlin approval. In an extreme form, this may in turn have an impact on the pattern of direct investment flow into Ukraine. It may also reshape such issues as natural gas deliveries from Russia to the EU across Ukraine.

... having an impact on FDI and natural gas as a final result

Further on, another key area which could be a trade-off between the US and Russia, in an extension of the Britain-Russia Great Game, is the electoral process within the FSU countries. Highly contested elections in these countries, excluding Russia, have always featured a battle of words between organizations that are called on to control the process in terms of legitimacy and fairness. These organisations are the Organizations of Security and Co-operation in Europe and a mission of elections observers of Commonwealth of Independent States (CIS), a loosely Moscow-backed organization of the FSU countries. On a number of occasions, these organizations took different sides while assessing the elections, as CIS mission observers tended to be biased towards a presidential candidate or a party which is viewed as a promoter of Kremlin-friendly policies.

For the 2009-10 election cycle, the balance of the US-Russia Great Game may end up with less of a response from the West

For Ukraine, which is to stage presidential elections soon, most likely in January 2010, events could develop into the following:

- The Kremlin may press its G8 partners to maintain a hands-off policy towards the upcoming elections in Ukraine, during which the incumbent president, whom the Kremlin views on par with the incumbent Georgian president (i.e., highly mistrusting of both), is likely to leave the office to another candidate due to low public approval ratings. This is a win-win strategy for the Kremlin, because it enjoys a wide audience across the CIS, where there is no such issue as a language barrier, and within which the Russian media has a strong presence. This is particularly true in Ukraine's case.
- On their ends, the US and the EU, weary of Ukraine's democracy, which has been viewed as messy and dysfunctional by the Western media and chaotic by the Russian media, may decide to bow to the Russian proposal and wait until this election cycle ends, which, nevertheless, is likely to bring a change of leadership to Ukraine's political helm.

"Piponomics" and "pipopolitics"

The natural gas issue has become a major part of geopolitics in the FSU

The natural gas business, which is being conducted by a handful of state-run companies in the FSU countries, including Russia's national champion Gazprom and Ukraine's national Naftogaz, has its place on the geopolitical chessboard. The two above-named companies make up the cornerstone of the natural gas production and transit to the EU. Largely in government hands, these two companies mishandled the leverage that they have over each other, as evidenced by the January 2009 stand-off.

What was intended to be more or less peaceful negotiations on the natural gas price to be paid by Ukraine's Naftogaz in 2009 and the transport tariff paid by Russia's Gazprom eventually developed into a heated confrontation..

A sequence of events in international relations led to a second natural-gas stand-off between Ukraine and Russia

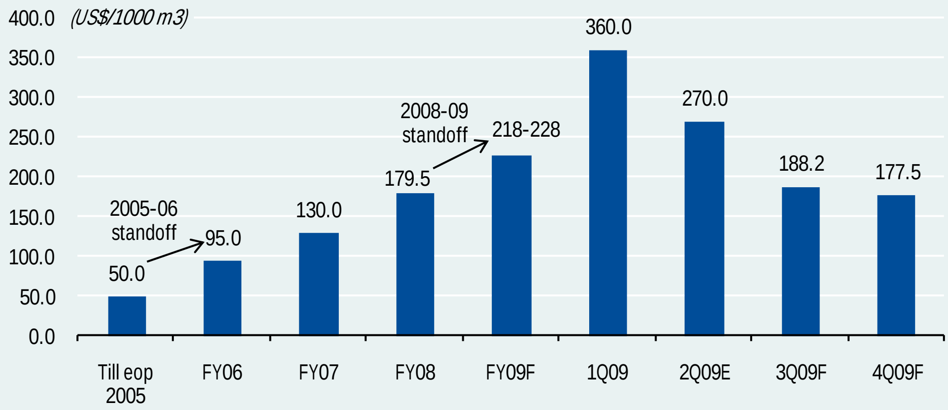
The 2009 stand-off took place a month later, when US and Ukraine foreign ministers signed a protocol that extended these two countries' cooperation in the natural gas sector and showed the US administration's commitment to an open diplomatic council in the city of Simferopol, the capital of the Crimea Republic, a peninsula that is part of Ukraine, but this is hotly contested by a number of Russian political front men. It could be coincidence, but the parallels of squeezing out the opponent in the Great Game from every site of the "traditional sphere of interests" are apparent, in our view.

A previous standoff in the winter of 2005-06 was caused in part by a change of political leadership in Ukraine

In effect, the natural gas affair between Ukraine and Russia, in our view, is an integral part of the geopolitical structure of the region. As Ukraine's leadership under President Viktor Yuschenko has been pushing the country into international organizations since 2005 – such as the WTO (successfully) and the EU and NATO (unsuccessfully), the Kremlin's reaction to this was discontent from the point of view of the zone of "traditional interest," in the WTO case. Talks between certain politicians of the two countries initially focused on synchronising the entry of the two countries into the WTO – for Ukraine, in theory, this would have nevertheless meant delayed entry.

Then, more complicated talks on natural gas deliveries followed. The first stand-off of the 2005-06 period followed the election of the incumbent president (January 2005); the second one of 2008-09 followed a year of 2008, when Ukraine's has had two attempts of joining NATO in April 2008 during Bucharest summit; and lastly in December 2008, during the ministerial meeting in Brussels. In addition to these stand-offs, bilateral negotiations between the sides were relatively calm, as the government, led by then-PM Yanukovych (serving from April 2006 till mid-December of 2007) had put the NATO issue on the shelf and enjoyed relatively smooth negotiations on the natural gas price pick-ups.

Chart 13. Natural gas price levels, negotiated by Naftogaz of Ukraine and Gazprom, since 2005



Note: Quarterly price levels for 2009 are estimated by ICU; price for full-year 2009 is derived upon quarterly prices and quarterly volumes of natural gas contracted for 2009 (http://ua.pravda.com.ua/news_print/2009/1/22/88288.htm), the lower side of the price range assumes that annual natural gas consumption amounts to 33bn, the upper side of the ranges assumes 40bn consumption of natural gas this year.
Source: State Statistics Committee of Ukraine, Reuters, www.pravda.com.ua, Investment Capital Ukraine LLC.

Ownership status of Ukraine's natural gas pipeline system is a cornerstone of Ukraine's policy-Russia disagreements in the sphere

However, there is another geopolitical factor in the standoffs between Ukraine and Russia. Ukraine's natural gas pipeline system, which has the capacity to transport 142bn cubic meters annually, is the prime transportation route for natural gas that Gazprom pumps from its production sites and from Central Asia-producing nations towards the European market. The table on the following page illustrates this affirmation in detail. The key feature of Ukraine's pipeline system is that it is 100%-owned by the state, and Gazprom's desire to invest into the pipeline (in return of a stake in it) remains unsatisfied.

Table 3. Natural gas pipeline systems linking Russia with European countries

Pipelines	Capacity* (bn m3)	Status	Description
Ukraine's pipeline system	188	Existing	The pipe system consists of 8 routes linking Russia with Europeans and CIS countries. Export capacity is 126bn cubic meters. Pipeline is state-owned.
Belarus' pipeline system	33	Existing	The pipe is the Belarus part of the Yamal-Europe pipeline, linking Russia with Poland and then with European countries. Gazprom is in agreement to acquire 50% stake in Beltransgaz.
Blue Stream	16	Existing	The pipe links Russia and Turkey through the Black Sea bed. Joint venture of Gazprom and Italian ENI.
Nord Stream	55	Planned. 1st branch in 2010, 2nd branch in 2012	The pipeline is to link Russia and Germany under the Baltic Sea. Joint venture with E.ON Ruhrgas & Wintershall, in which Gazprom holds a 51% stake.
South Stream	30 (60)	Planned, under feasibility study	The pipeline is to link Russia and Bulgaria under the Black Sea. Joint venture of Gazprom and Italian ENI.

Note: * annual volume of transported natural gas. According to Gazprom, Nord Stream pipeline's first branch is to be commissioned in 2010 and the second one in 2012; South Stream pipeline capacity was renegotiated in May 2009 and it was doubled from 30bn cubic metres to 60bn.
Sources: Naftogaz of Ukraine, Gazprom.

Ukraine's political system shields the pipeline under state control

Ukrainian politicians and lawmakers, especially those who do not consider themselves as pro-Russian politicians, are vigilant about not allowing a foreign firm to participate in the privatisation of the system, which would risk letting it fall into the hands of a company run by a foreign government (above all, the Russian government). This is because consumption of natural gas in Ukraine has been historically large (i.e., inefficient) and subsidised (via different means; for instance, via special arrangements with Russian government till the end of 2005). Hence, it is considered inappropriate to cede control over the pipeline, especially when it is feared that such control may produce political pressure. That is why Ukraine's political leadership extended to the EU a proposal of cooperation in the natural gas transit sphere and adopted a joint declaration signed on 23 March, 2009; the move quickly caused discontent in the Kremlin.

In 2005-09, Ukraine-Russia disagreements were over price levels; ...

The Russian government (Gazprom) had been exerting pressure on its Ukraine's partner (Naftogaz of Ukraine) about agreeing on increases of the price paid for natural gas to be used by the Ukrainian economy (businesses and households) since late 2005 to the market-based level. And eventually, the sides agreed to adopt a market formula that has brought the price level to a market-determined one beginning in 2009.

... after 2009, the nature of the disagreements is likely to shift into new territory

However, room for new possible disagreements over the natural gas business between the two sides – the Ukraine and Russian governments (Naftogaz of Ukraine and Gazprom of Russia) – was not eliminated, in our view. The reading of the 10-year agreement signed by both sides on 19 January, 2009 on the "pay or take" principle leads us to conclude that it incorporates features under the rubric of sizable, and also inefficient, natural gas consumption by Ukraine's economy, which could cause new standoffs, and the possibility of such stand-offs having the same magnitude of those seen in previous cases (2005-06 or 2008-09) is rather considerable. This means that the core point of the disagreements may shift from the past issue of raising the level of natural gas price towards the more relevant issue of underconsumption of those volumes of natural gas that were agreed upon by the two sides.

The last Ukraine-Russia 10-year agreement is vulnerable to a new kind of strain, ...

While the agreement allows annual negations of the two sides on their key positions, its prime clauses constitute the following: that Naftogaz will buy 40bn cubic meters of natural gas in 2009, and 52bn cubic meters during 2010-19. Already in 2009, due to economic recession, the country consumed natural gas to the tune of 2.5bn cubic meters instead of the 5bn prescribed for consumption in 1Q09. Moreover, recent assessments by the Ukraine government of natural gas consumption in 2009 estimate that it would decline, to the extent that import requirements of natural gas would decline from 40bn, the level that was estimated before the signing of the agreement with Gazprom in January 2009, to 33bn.

... that of a penalty for lower-than-contracted consumption volume, for whatever reason

In the wake of the 1Q09 results, Gazprom has been mulling the possibility of putting into effect the clause of the agreement that allows it to penalize Naftogaz. According to Interfax-Ukraine, the volume of possible 1Q09 penalty sanctions was US$1.188bn; however, this news seems to have been watered down by Ukraine's authorities. Nevertheless, more news on this issue may resurface throughout this year and during the traditional season of heated disagreements in December 2009-January 2010 if "unfriendly moves" by Ukrainian authorities are spotted by the Kremlin.

Rescue funds: IMF and VEB

The IMF's initial agenda was to assist Ukraine, but its programme then stalled; …

The quick response by the IMF to Ukraine's request for financial assistance in October 2008, when just few countries were mulling such a possibility, is telling – thanks to its geopolitical standing, especially in the light of the Bush-Putin cycle of the Great Game that lasted till end of 2008, the country accessed the IMF lending programme quite smoothly.

While currently, the programme has stalled, as Ukraine's authorities were not able to bring the state budget deficit in line with expected economic performance due to political disagreements, the IMF still shows a full understanding of the situation and is patiently awaiting resolution of the disagreements and fulfilment of previous commitments made by the authorities. Given Ukraine's messy democracy and the election cycle that has already begun, the IMF appears highly committed to successful fulfilment of the programme in Ukraine. This is because it strives to raise its international legacy, which means successful cooperation with emerging markets that require financial assistance.

On the other hand, local politicians are not ready to trim a budget that would meet the IMF's requirement for it to be realistic, i.e., in line with the expected performance of the economy. This stalls the realisation of the programme.

… meanwhile, the VEB is active in lending to the FSU sovereigns, with slightly different requirements

Geopolitical rivalry has put its mark as well on the issue of rescuing troubled economies in the FSU. The Russian government extended the lending mission of the state-run bank VEB (Vnesheconombank) towards lending a hand to the governments in the CIS countries. Examples of this include: the US$3bn credit line for up to 10 years to the Kazakhstan state welfare fund Samruk-Kazyna; and negotiations on cooperation held between VEB and the Belarus government.

In 1Q09, Ukraine's government – under the weight of an unrealistic state budget (and no political will to trim the spending side of the state budget) and a stalemated IMF programme – did mean, in our view, a Kremlin-run VEB as a provider of a credit line to fund the fiscal deficit when it was revealed to the media that the government was talking to several countries on the issue. As most of the developed countries that asked for such help by Ukraine's government are themselves under fiscal strain and had enlisted the aid of a number of international financial institutions (the IMF, in particular) to help do the job, only the Russian government has been lending directly to the countries in need (largely in the FSU area, and with other sorts of requirements demanded on the part of the borrowing country).

One of VEB's requirements -- privatization by Russian companies -- is not feasible in Ukraine within the short term

The strings that are likely to be attached to a VEB lending agreement with a CIS sovereign could be similar to the key point of cooperation between VEB and the Belarus government[1] – privatization of local assets by Russian companies, the process whose financing will be consulted and organized by VEB. In Ukraine's case, such a credit line would face resistance from the political system (which incorporates rivalry between key decisionmakers – the president and PM); in fact, it did face resistance, and the government that mulled the idea of the Russian credit line eventually shelved it and instead concentrated on unlocking the lending programme with the IMF.

It should be noted that VEB itself, seeing how the political system works (which includes inside rivalry and resistance against the spread of Russia's business interests), decided to finance the private sector of Ukraine's economy, and in December 2008 acquired a 75% stake in Prominvestbank, which was the first bank put under central bank receivership when the current economic recession began in Ukraine. Effectively, VEB opened a US$1bn, 3-year credit line to Prominvestbank, which was put off from the central bank's receivership in 1Q09 and started to lend to businesses.

We argue that Ukraine's authority will be pressured to deal with the IMF

Given the difference between requirements imposed by the IMF and VEB – the former's are about policymaking, while the latter's are about Russian business interests in the economy and state guarantees – Ukraine's governments will likely be forced to find some common ground with the IMF rather than with VEB because of the following considerations:

- Firstly, VEB requirements are about a state guarantee that privatization of Ukrainian state-owned enterprises would not be questioned by the current political system and by new leadership (when the 2009-10 election cycle ends). Due to this fact, VEB may not be willing to be readily available to local authorities, knowing that the risk is high and that the state guarantee could be withdrawn.
- Secondly, IMF requirements appear a bit softer in terms of geopolitical willingness by the IMF to be readily available when Ukraine's authorities adjust policymaking, regardless of the fact they are entering the 2009-10 election cycle. Recent developments (the IMF announced on 17 April, 2009 that it would resume disbursement of the next tranche of the credit agreement) confirmed this.

Conclusion

From a geopolitical point of view, Ukraine will not drop out of favour of the Great Game participants in the foreseeable future. However, its intentions to somewhat rewrite the rules of the game could emerge as early as this year. This is because, in our view, the US administration will likely try to replicate its stance of having an "engagement, based upon mutual interests and mutual respect" with affairs of the Muslim world in its dealings with Russia.

The former has already been softening its stance on the issues (concerning Ukraine) that caused discontent in the Kremlin (for instance, US officials said on 2 June, 2009 that they put into a standstill the decision to open a representative office in the Crimea Republic). The latter, however, does and likely will further toughen its grip on a range of affairs with regard to Ukraine, primarily on the issue of natural gas transportation across Ukraine, by threatening with other stand-offs, the true aim of which are to acquire a controlling stake in the Ukraine's natural-gas pipeline system, either solely or via its European partners (German or/and Italian).

[1] See http://www.veb.ru/ru/about/press/news/index.php?from33=7&id32=4925 (in Russian).

Rephrasing the quote of Kofi Annan at the beginning of this section, Ukraine-Russia relations are broken and need to be fixed, and the best way to do this is through cooperation. The leadership in both countries is in dire need of this kind of vision; however, their current stances, which are formed on certain ideology priorities and territorial views of the interconnected history of both nations, leaves doubt that these relations can be quickly or easily healed.

Ukraine's politics and economy are and will be subject to its interconnectivity with Russia, which remains one of its key trading partners and retains political clout over Russia-leaning voters. In this regard, some extremes in the political and economic trends in Ukraine are still likely to be seen.

Ukraine's politics

"Ukraine is a real democracy"

William Taylor, former U.S. ambassador to Ukraine 2007-09, in May 2009

The political system in the country proved to be a true democracy, albeit quite a messy one, over the last four years. Along the way, it has developed an internal ability to generate some turnover among the political heavyweights – a development that is likely to come to the forefront in the 2009-10 election cycle. The current political system, with its power-sharing framework, i.e., counterbalances, appears to be local currency-positive, as it puts additional limits on the government alongside the recession in the attempt to fund a pre-election increase in social standards.

The 2009-10 election cycle

Ukraine's political system has become highly competitive, as well as tiresome, for voters

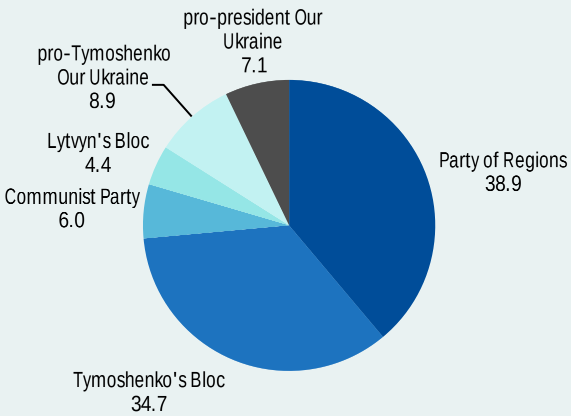
Ukraine's political system is organised in such a way that it evokes parallels with disorganized democracies, where competition with not only opposition parties but inside the power bodies (between key incumbent figures -- in Ukraine's case, the president and prime minister) themselves is so fierce that frequent elections are becoming cumbersome.

The system is built on competition, albeit one that is based on democratic principles, of such a fierce nature that the temptation to undermine the rival is so high that it goes against the logic of agreements reached by the same politicians on previous occasions. As a result, a spiralling-down effect has been observed in the relations between the competing sides.

The government is backed by a thin coalition, the formation of which is questioned by a legal case in the constitutional court

At the moment, competition is concentrated between key political parties, represented in the Parliament by the following:

Chart 14. Breakdown of Ukraine Parliament by political factions (% of total seats, 450)



Source: Parliament of Ukraine.

The president's low popularity saw his Our Ukraine party's faction in the parliament split between his devoted backers and those who shifted towards PM Tymoshenko's faction. The former part of the faction accounts for 32 MPs, or about 7% of total MPs, exactly the number of MPs who supported the formation of the ruling coalition on 9 December, 2008.

The ruling coalition, which was reshuffled after the departure of the Our Ukraine faction in

December 2008, currently consists of Yulia Tymoshenko's Bloc faction (156 MPs), the leader of which heads the government, and MPs from few smaller factions, namely, the pro-Tymoshenko part of the Our Ukraine faction (40 MPs); the Lytvyn Bloc (20 MPs); and the Communist Party faction (27 MPs). While the coalition consists of 243 MPs, representing a (rather slim) majority of 18 MPs -- more than half of the total MPs -- it nevertheless does not pass law on a number of sensitive issues such as, for instance, the Communist Party abstaining from voting for IMF-required laws. Hence, on a number of issues, the government was seeking wider support.

Opposition is currently represented by the Party of Regions (175 MPs); however, there are two MPs in the faction who explicitly support certain decisions of the coalition.

Presidential elections will be held in January 2010, …

Constitutional norms say that next elections in the country will be presidential, to be held in January 2010. However, such factors such as economic recession and natural changes in the public approval ratings of key politicians (see more details on this see below) have pushed some politicians to redraw the rules of political games. Thus, the leaders of two largest factions in the parliament – namely, PM Yulia Tymsohenko and Party of Regions leader Victor Yanukovych – had held confidential talks on behalf of both parties, which eventually resulted early this June in a broad decision programme.

… but the two largest factions aim to rewrite the constitution and stage presidential elections in the legislature

The key guidelines of the programme include the following:

- The parties are to form a coalition in the parliament (together, the largest factions have 331 MPs, enough not only to adopt laws, but sufficient to overcome presidential vetoes and to rewrite the constitution).
- The agreement aims to rewrite the constitution, the new version of which will describe more precisely the powers of the president, Parliament and Cabinet of Ministers. The new constitution envisages that the president is elected by Parliament, while the next parliamentary elections are to be held in 2014.
- The deal envisages that sides are to cooperate till 2024, including forming a single bloc to run for the next parliamentary elections (which will be held in 2014, according to the new reading of the constitution).

The controversy of this programme is that it, firstly, runs against the political preferences of voters of each of the party; and secondly, aims to change the constitution according to the needs of those who authored it.

The only faction that has stood up to oppose this programme was the pro-Yushchenko part of Our Ukraine, a tiny faction with 32 MPs, or just 7.1% of the total voting body. Its leader allegedly stated that the true aim of Tymsohenko-Yanukovych duopoly is to safeguard positions in the power and avoid elections, which may appear stressful for a number of politicians. The allegation provides the following logic of the broad programme of the two largest factions in the parliament:

1. The new constitution abandons elections of president by popular vote and introduces new political feature of presidential elections in the legislature; and

2. The new constitution also prolongs the terms of acting MPs towards 2014, meaning that the same MPs that have seats in the legislature now elect the president.

Summing up both allegations, it appears that a coalition of factions of the Tymsohenko-Yanukovych team may effectively elect the president from the ranks of the coalition (allegedly, Yanukovych takes this prize), and government posts are evenly shared between coalition members (allegedly, Tymoshenko preserves the PM post).

Held in secrecy from the public, the programme explicitly indicates its authors' reluctance to participate in the elections and compete with politicians whose popularity proved rising. In our view, despite the fact that these initiatives are being pushed by two largest factions in the parliament and backed with proper assistance of PR and media resources, their fate is not looking bright, because public opinion is against shifting the popular vote to the legislature, and opposing politicians will attack this theme. Mechanisms that try to precede these initiatives will eventually result in failure and be abandoned as those whose popularity will be undermined among voters.

Heavyweights to experience turnover

Voters tend to see new politicians at the helm; …

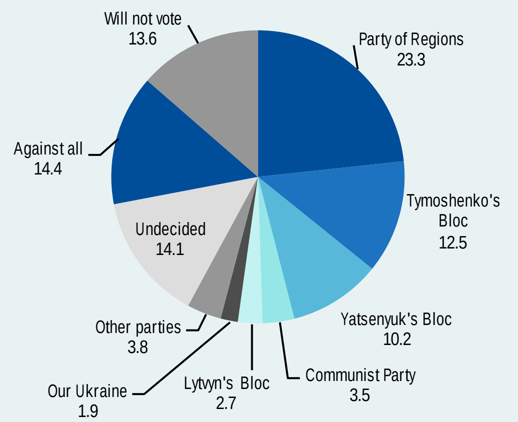
As we noted above, the very fact that for the last four years (starting from early 2005), the country has witnessed constant political rivalry with a high degree of noise and twisty manoeuvring has caused the public to grow tired and wary of the leaders who were called upon to realise the policies they previously voted for. The current economic recession just adds more negative sentiment to these views.

…however, incumbents like Yanukovych and Tyomshenko will likely remain in the arena

At the moment, opinion polls show that the previous troika of leaders in the opinion polls – namely, President Viktor Yuschenko, PM Yulia Tymoshenko, and the leader of the Party of Regions, Viktor Yanukovych – have experienced a decline in opinion of the incumbent president, whose public approval ratings tumbled towards the low single-digit territory (hovering around 2% as of now), and a rise in popularity of former Parliament Chairman and Foreign Minister Arseniy Yatsenyuk.

Chart 15. Percentage chance to be elected into parliament

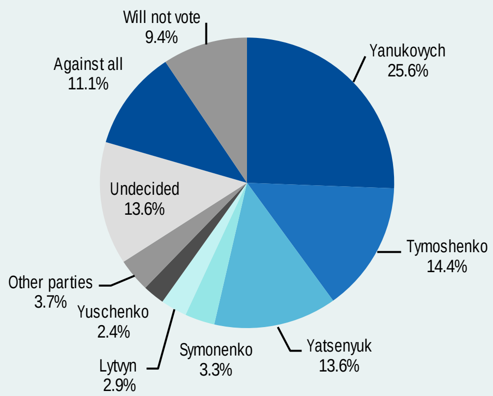
Opinion poll as of 17 April 2009 – what if parliamentary elections held next Sunday



Source: Interfax-Ukraine, Kiev International Institute of Sociology.

Chart 16. Percentage chance to be elected president

Opinion poll as of 17 April 2009 – what if presidential elections held next Sunday



Source: Interfax-Ukraine, Kiev International Institute of Sociology.

Thus, one of the many of recent opinion polls shows that if presidential elections are held next Sunday, then the leading candidates for the post would be Viktor Yanukovych (25.6% of those polled), Yulia Tymoshenko (14.4%), and Arseniy Yatsenyuk (13.6%). The rest of the candidates would not gain more than 3.5%. Such a tendency, with a rise of Yatsenyuk popularity towards the double-digit area, was seen since early this year as a mixture of experience and youth played in his favour.

The youthful and experienced Yatsenyuk could garner leadership by gaining ground after the 2009-10 election cycle

While Yanukovych and Tymoshenko have regarded their base of supporters as relatively firm – a decline in relatively passive behaviour on the part of the opposition by the former, and populist rhetoric as well as the friendship with the Kremlin by the latter – Yatsenyuk's rise has arrived as a surprising factor. However, the tiresome politics of the last four years (at least) could explain the recent rise in popularity of the newer figures.

At the moment, it is difficult to say whether Yatesnyuk may succeed in terms of beating his opponents, but it is evident to us that his political weight will grow at the end of the 2009-10 election cycle. His experience in serving as an official in the government bodies of Ukraine's south oblasts, like Odessa and Crimea Republic, though not very lengthy (610 days, or 1.7 years in total, according to our calculations), should work in his favour during his future campaign trips in these regions.

The fact that a MP leaked to the media information that certain MPs are discussing raising the age barrier for a presidential candidate from the current 35-year-old threshold to a 40-year-old one indicates how worrisome to incumbent political heavyweights the rivalry is with a politician whose chances appear more promising. This move would add to the popularity of Yatsenyuk if it is realised by the current establishment in the parliament, the public approval rating of which as a whole is at the same low single-digit level as that of the incumbent president.

Table 4. Key contenders for the leadership in the 2009-10 election cycle in Ukraine

	Yanukovych	Tymoshenko	Yatsenyuk
Year of birth	1950	1960	1974
Age	59	48	35
Professional background	Executive positions in transport state-owned enterprises	Executive positions in energy business (including hydrocarbons)	Executive positions in legal and banking businesses
Senior government positions	Prime Minister (November 2002-January 2005; August 2005 - December 2007), Donetsk oblast governor (1997-2002)	Prime Minister (December 2007 till present; February-September 2005), first deputy prime-minister (December 1999-January 2001)	Parliament Speaker (December 2007-November 2008), minister of foreign affairs (March 2007 - December 2007), first deputy of head of presidential administration (September 2006 - March 2007), minister of economy (September 2005 - August 2006), first deputy of Odessa oblast governor (March 2005 - September 2005), first deputy governor of central bank (January 2003 - February 2005), minister of economy of Crimea Rep. (November 2001 - January 2003)
Political leadership, since	2003	2002	2009
Political party	Party of Regions (172 MPs)	Tymoshenko's Bloc (156 MPs)	Movement "Front of Changes", party yet to be formed. No sizable voice in the parliament.
Native oblast	Donetsk (eastern Ukraine)	Dnipropetrovsk (central Ukraine)	Chernivtsy (Western Ukraine)
Electoral map	Targets pan-Ukrainian audience of voters, succeeds largely in the eastern and southern oblasts	Targets pan-Ukrainian audience of voters, succeeds largely in the western and central oblasts	Will target pan-Ukrainian audience of voters, his success yet to be tested

Sources: Cabinet of Ministers of Ukraine, parliament of Ukraine, movement "Front of Changes".

Ukraine's political triangle is likely to survive the cycle, but it will likely be reshaped

In effect, Ukraine's politics will remain divided among three competing camps, the policies of which will concentrate on the following:

- **Party of Regions:** pro-Kremlin policies on defence, trade, and energy issues; controversy in granting official status to the Russian language and membership in Kremlin-sponsored international organizations;
- **Tymoshenko's Bloc:** implicitly neutral polices in international affairs; concentration on bilateral relations with Western countries as well as with Russia; and
- **Yatsenyuk's Bloc:** balanced approach to international relations with a stance of integration into Western organizations, along with the desire for fruitful cooperation with Russia. It is expected that pro-Western policies will dominate, as NATO membership talks have the propensity to be watered down alongside the new cycle of US-Russia

relations.

Power-sharing: Hryvnia positive for now

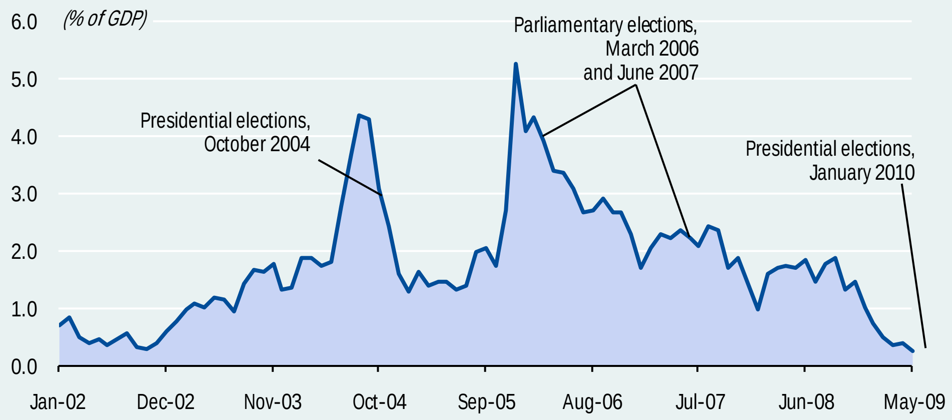
Ukraine's political system puts limits on the government's finances …

Ukraine has seen its constitution amended in December 2004, resulting in a structure of power-sharing that engenders steep rivalry between the branches of power (namely, the president and cabinet of ministers). Over the last six-month period, which spans the economic recession felt in Ukraine, the structure proved resistant towards the explicit requirement mandated by the government for the central bank to fund its local currency borrowings. Such a requirement was written in the 2009 state budget law; however, recently, it was eliminated by the Parliament under the weight of growing opposition among lawmakers to grant this tool to the government and abide to requirements by the IMF.

… to raise social standards on the eve of elections, …

According to the general rule of thumb, authorities tend to maintain a looser fiscal policy on the eve of decisive elections. In Ukraine's case, the most recent example of such a stance was evident in autumn of 2004, right on the eve of presidential elections, which the ruling party eventually lost to opposition. At that time, the government enjoyed quite a strong fiscal position – its total volume of funds in treasury increased to UAH13.9bn, or 4.3% of GDP in September 2004, but it then declined to UAH8.3bn (2.4% of GDP) in November of the same year, and then to UAH4.5bn (1.3%) in January 2005, due to additional commitments of the government to increase pensions and salaries to public sector employees. This served as an impetus for a spike in CPI, which accelerated from 9.9% YoY in August 2004 to 12.6% YoY in January 2005.

Chart 17. Government funds at the Treasury account (as percentage of annualised GDP)



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

… especially via the central bank's assistance

At the moment, the government appears to be cash-strapped, as the treasury account had UAH4.8bn (0.5% of GDP) as of the end of February, a much weaker position by the government on the eve of the 2009-10 election cycle, let alone the mention that its borrowing capabilities from private investors and from other sovereigns and international financial institutions are very limited.

Another important fact is that such an option of funding the fiscal deficit via local currency bonds, which ultimately end up on the central bank's balance sheet, is not open to the government, as the central bank's governor promotes independency from the government's financing needs. In fact, the incumbent president, who is critical of the government and constitution, and has a final say over the central bank's governor (i.e., whether to dismiss him and to propose a new candidacy), will tend to disassociate the central bank from the government's needs. Hence, the possibility of inflationary public finances throughout 2009 is a non-issue.

Conclusion

Currently, this represents another chapter in Ukraine's modern history, as the political scene weathers something of a turnaround point, about whether the country will undergo a process of political renewal, which is in our view demanded by the society by means of elections by popular vote, or appear hostage to local political heavyweights that fear elections.

Opinion polls suggest that there are more young politicians who are capable of catching the public's attention and attract voters' support. In our view, Ukraine's democracy will eventually choose the second option, i.e., the election cycle of 2009-10 will be carried out and result in the rise of politicians who will topple the current dominance of incumbent political heavyweights.

Briefing on Ukraine's economy

The economy has been hit hard by a twin slump in foreign demand for its key exports, and in domestic demand due to the impact of heavy lending in the economy. With an expected sharp decline of real GDP in 1Q09 by 18-20% YoY after an official decline of 8% YoY in 4Q08 (our own estimation of real GDP change produced a larger decline for this period of 12% YoY), the economy is yet to experience declines in year-on-year terms for the rest of 2009. A cleaning-up of the banking sector and sluggish foreign demand for steel would translate into modestly slow growth in 2010, followed by a partial recovery in 2011, in our view.

Demand factors within the economy

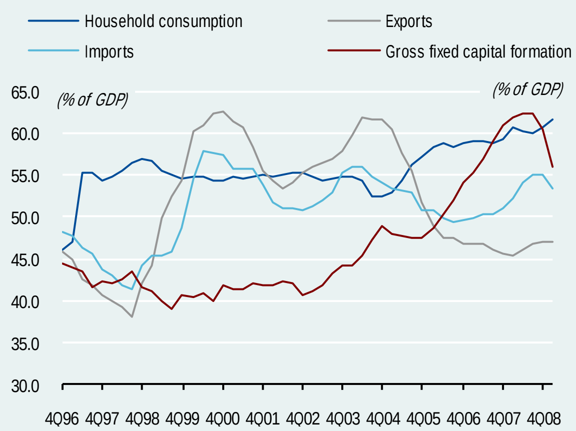
Two key drivers of economic growth in 2005-1H08 were household consumption and foreign demand

During the period of the last four years (from early 2005 till the end of 2008), the economy had been driven by a pattern of demand that featured strong household consumption, which amounted to 61% as of the end of 4Q08, up by 9ppt from 52% back in 4Q04, and foreign demand for Ukrainian goods and services. The latter was met with exports that varied in volume terms from a 55% share down to a 47% share of GDP during the above-mentioned period of time. Imports volume had risen over the period by 1ppt, and reached a 55% share of GDP as of the end of 4Q08.

That period also featured a strengthening of the exchange rate of the local currency against the US dollar, which reinforced the tendency in household consumption to rely more on imports. The linkage between the two components of GDP is seen from the data on change in growth rates of retail turnover and merchandise imports (see Chart 19), which is reasonably strong, in our view (0.7 correlation is calculated from the growth rate in monthly volume of retail turnover and the growth rate in annualised merchandise trade).

Chart 18. Historical breakdown of GDP by expenditure approach (1996-1Q2009)

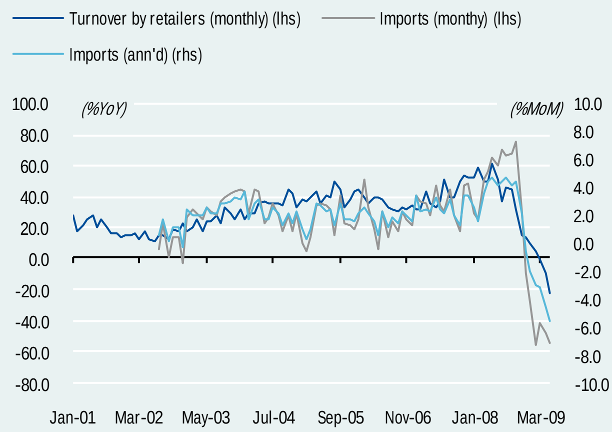
Annualised data, as a percentage share of nominal GDP



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

Chart 19. Consumers' bias towards imported goods, from January 2001 to May 2009

Percentage change over a year ago (for monthly data on retail turnover and merchandise imports) and over a month ago (for annualised merchandise imports)



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

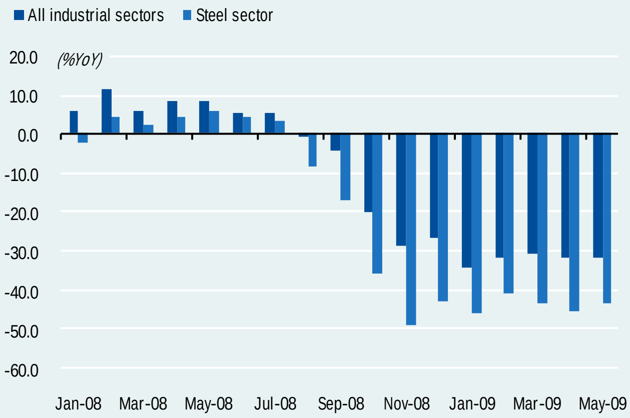
On the other hand, the industrial sector of the economy is largely export-oriented, and a 64% share of sales of the produce by the industrial sector is classified by the domestic statisticians as raw materials, i.e., goods with low added value that are consumed by other industrial customers, largely abroad, for further processing (see Chart 21). That is why a steep slump in global trade has had a severe impact on the local economy, the industrial sector of which shed one-third of its production compared to the previous year (see Chart 20).

Collapse in foreign demand eat down industrial production by a third

The sharp contraction of the economy in 4Q08 has broadened during 1Q09, epitomised by changes in industrial production during 2008-09 seen in the chart below. In 1Q09, industrial production declined by 31.9% YoY, and its key sector of steelmaking, whose products account for a 40% share of total merchandise exports from the country, dropped by 43.3% YoY, reflecting both a reduced foreign demand for steel products globally and a steel price correction from recent highs.

Chart 20. Monthly statistics on industrial production growth (2008-09)

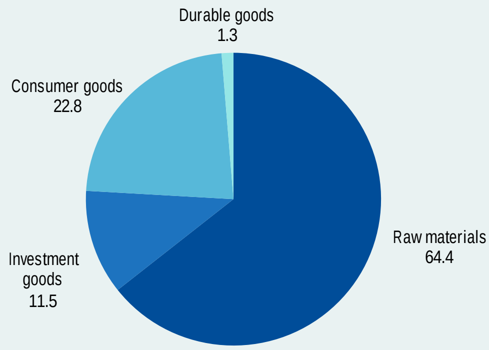
Percentage change over a year ago



Source: State Statistics Committee of Ukraine.

Chart 21. Breakdown of goods of industrial produce, for the period of January-April 2009

In percentage shares



Source: State Statistics Committee of Ukraine.

The flow of demand and supply between local households and businesses and their foreign counterparts used to leave just a faction of such a flow locked within the local economy, i.e., when demand formed by local businesses and households was met by supply (of goods and services) from other Ukrainian firms. This is especially true in tradable goods. While it is rather a lengthy routine to quantify such a proportion on how local demand had been locked on foreign supply, it is quite clear that such a bond was reasonably strong.

Rebalancing of demand in the economy is likely to be a lengthy process

That is why, in our view, the domestic economy appeared trapped after a sudden halt in liquidity into its banking sector, which supported the economy with a tide of credit over the period, and a steep drop in prices for key exports, largely for steel, on the global marketplace. A rebalancing of the economy from such a demand structure towards one that enjoys demand meeting supply within the domestic economy did not spring up readily; in fact, such a process could be quite lengthy, as the government cannot substitute those recent providers of liquidly to the local borrowers and those buyers of local goods.

Inevitably, such a process will begin, but it is going to be slow, as the government appears limited in its capacity to create stimulus, especially stimulus that would re-channel domestic industrial production from exports towards the local market. Revival of the industrial sector could materialise, given that there is some pick-up in demand from abroad on Ukrainian exports and some government stimulus aimed at infrastructure projects.

Rising unemployment would dampen household consumption

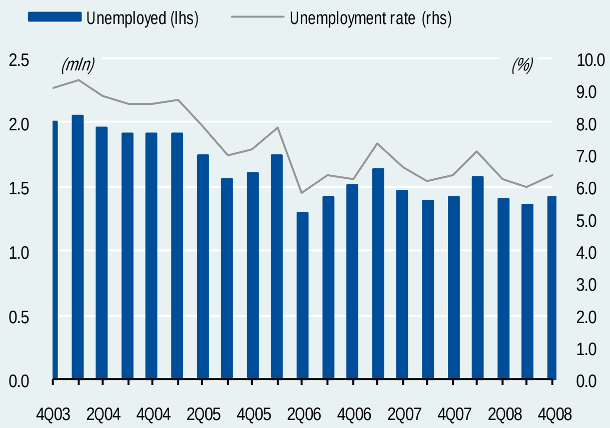
Along this trend, however, unemployment is likely to rise from the latest official data of 6.4% as of the end of 2008 towards a more realistic figure of, say, 8-10% as of the end of this year. The local statistical office, which publishes unemployment data on a quarterly basis, has the latest data on the subject as of 4Q08, which is a 6.4%. This implies no increase in the unemployment rate (it was at 6.4% in 4Q07 as well), dramatically opposite what had happened in many other economies affected by the same global crisis; for instance, Spain's rise in unemployment rate was reported at more than 8 percentage points last year, according to *The Economist* magazine, while Russia's economy had experienced a 4.2 percentage-point rise in the unemployment rate.

In fact, unemployment rate is set to rise to 8-10% from 6.4% as of end-4Q08

While local statisticians remain calm regarding the unemployment rate for 1Q09, there are other statistics that gauge the employment trend -- monthly data on wages that tracks not only wage volumes but also the official number of the employed within the entire economy and across all the sectors of the economy. In fact, the data shows (see Chart 23) that starting from November 2008, official number of the employed recorded a noticeable reduction in workforce by 1.3% over the month earlier, or 148,000 employees; in absolute terms, it was the first occurrence of such a magnitude since November 2006, when we began recorded this statistical data.

Chart 22. Unemployment, 2003-08

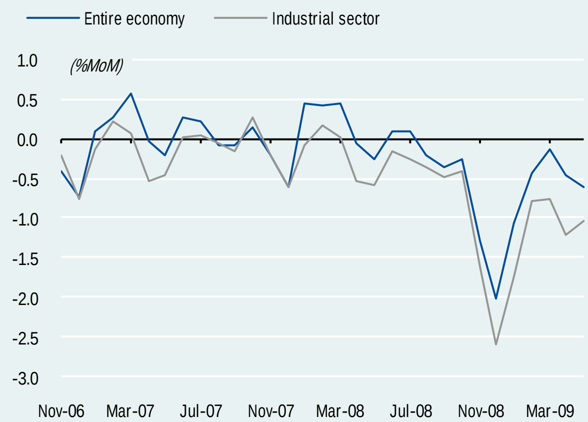
Official quarterly statistical data, as of end of period



Source: State Statistics Committee of Ukraine

Chart 23. Monthly change in the employed

Statistical data from November 2006 till May 2009, percentage change over a month ago



Source: State Statistics Committee of Ukraine

Some statistic data show that number of employed contracted by 0.7m since November 2008

Then, in December 2008, a 2.0% MoM, or 228,000 reduction in the official number of the employed followed. This January saw some slowdown in the reduction pace, as 119,000 were removed from the statistics on the employed; this was a 1.8% MoM cut. While a further slowdown in the reduction of the employed had been observed in February and March this year (declines were 0.4% and 0.1% on the previous month, respectively), the process started to accelerate in April, when the number of employed in the entire economy contracted by 51,000, or 0.5% MoM. In May, this figure slid further, by 66,000, or 0.6% MoM, to 10.9m.

With such employment statistics, it is likely that the number of unemployed, which was reported at 1.4m as of end of 2008, will return towards the level of 1.8-2.0m, level seen as early as in 4Q03, or just before the period of strong economic growth in the country, fuelled by waves of favourable external factors (not least strong rises in the global price for steel).

Hence, household consumption in the economy is set to experience a period of stagnation as current deep recession is likely to weigh on incomes on a broad spectrum of wage-earners, would subsequently enlarge the army of unemployed.

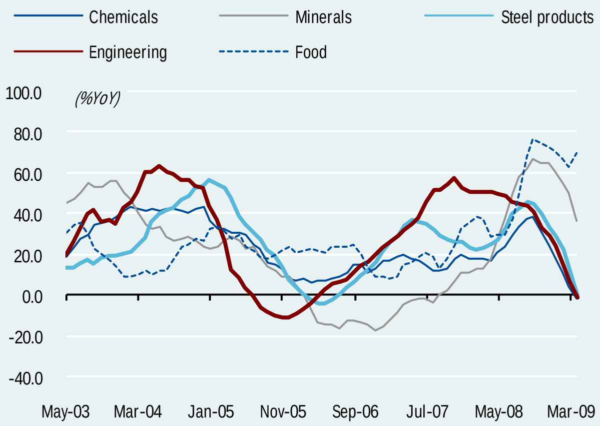
External trade: falling demand to fix balance

Economy's external trade balance still depends on crude oil and steel prices

We already noted above that external factors have had great impact on the economic growth in the country. Taking a brief look at the two pairs of charts, which depict breakdown of the most recent volumes of merchandise trade and growth dynamics of trade in key goods for the last 6-year period, proves that economy is subject to dependence on two commodities. Its imports bill depends on the level of price of crude oil as a nearly 31% share of merchandise imports are hydrocarbons (crude oil, oil products and natural gas), the value of which either is directly or indirectly tied to the crude oil price. On the other hand, exports proceeds are even more dependent on global steel market conditions, as up to a 40% share of merchandise exports consist of this type of industrial goods.

Chart 24. Exports growth of key merchandise items, 2003-09

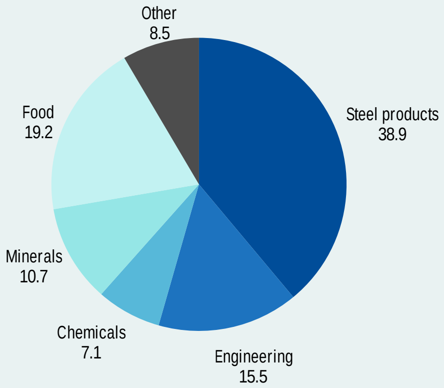
Percentage change of annualised USD-based volume of trade over a year ago



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

Chart 25. Breakdown of merchandise exports as of April 2009

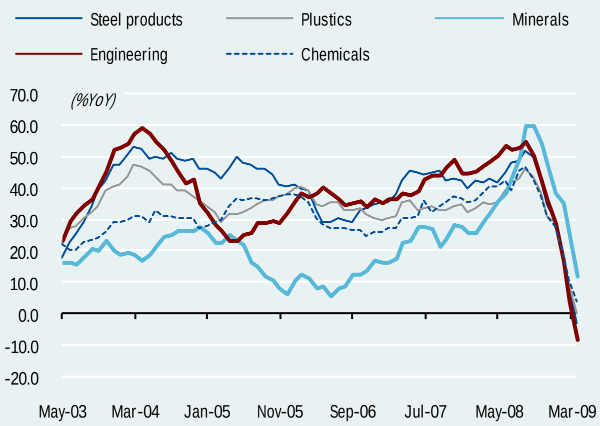
Annualised data as of end of April 2009, 100% = US$59.1bn



Source: State Statistics Committee of Ukraine

Chart 26. Imports growth of key merchandise items, 2003-09

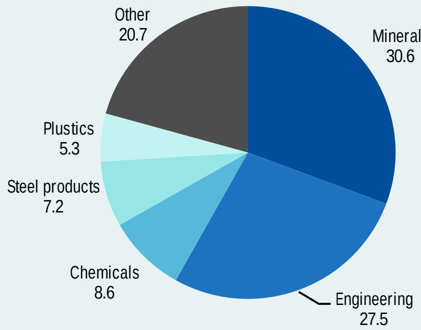
Percentage change of annualised USD-based volume of trade over a year ago



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

Chart 27. Breakdown of merchandise imports as of April 2009

Annualised data as of end of April 2009, 100% = US$72.2bn



Source: State Statistics Committee of Ukraine

The current recession of the global economy, particularly among key trading partners, means that exports of such products as manufactured goods of steel and engineering sectors are likely to stagnate along the way. A deep recession of the domestic economy is likely to extend weakness of local demand for a broad range of imports – from hydrocarbons to engineering sector products. Weakness on the global steel market has sent exports volume contracting.

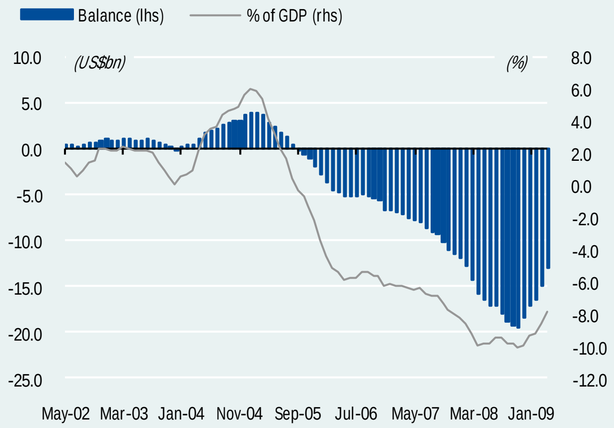
The merchandise trade deficit is contracting, …

Developments in 4Q08 and 1H09 showed that the merchandise trade deficit started to contract from its peak of US$19.5bn in annualized terms as of end of November 2008 to US$13.1bn as of the end of April 2009, according to the latest available trade statistics. In relative terms, the trade deficit narrowed from 10.1% of GDP to 7.8% of GDP over the same period. This is taking place thanks to weakened demand, as the annualized volume of imports is decreasing on a monthly basis at a faster pace than the annualized volume of exports.

Thus, imports for the last 12-month period ending in November 2008 contracted by 0.6%, compared to annualized imports to October 2008, so faster acceleration has been observed in every following month, and the latest trade statistics for April 2009 showed a 5.7% decline in annualized imports. At the same time, annualized volume of exports experienced slower declines – a 4.0% decrease was reported in April 2009.

Chart 28. Merchandise trade balance

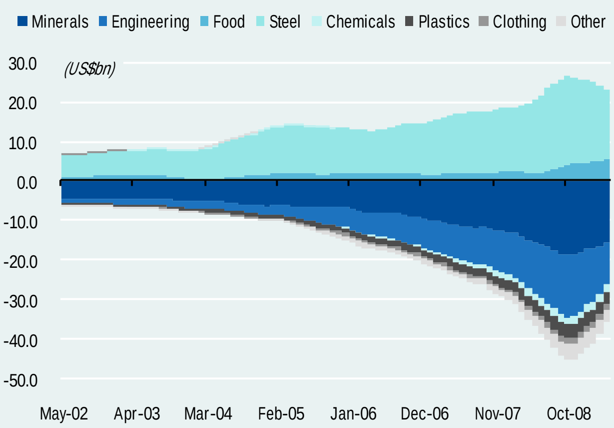
Annualised data, since May 2002 till April 2009



Source: State Statistics Committee of Ukraine

Chart 29. Trade balances in certain goods

Annualised data, since May 2002 till April 2009



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

Markedly, the trade deficit is in decline despite negative developments in terms of trade – steel price went lower this year compared to 2008, while the natural gas price, one of Ukraine's key imports, will rise – proving that deep recession cut the demand for a broad range of imported goods.

… thanks to weaker domestic demand

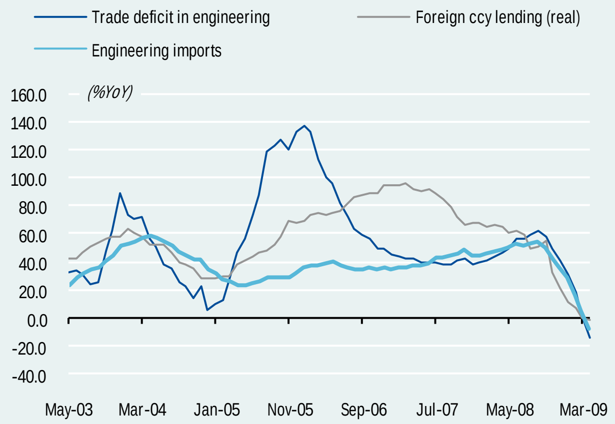
Thus, engineering imports (which include imports of passenger cars, in the recent binge of consumerism in the country, as well as a wide range of capital goods of engineering products, like engines and turbines) contracted in annualised terms very sharply, declining by 8.3% YoY in April 2008. Compared to other imports, engineering saw the largest drop in demand (see Chart 26).

Indeed, the credit boom of 2005-08 helped to stimulate economic growth, as businesses invested in engineering products and consumers were on a buying spree of imported cars. As the banking sector cut its lending programmes for consumers, and the weaker economy does not encourage consumer spending and business investments, imports of engineering products indeed collapsed (see Chart 30), and are yet to experience further decline over the course of this year.

This trend, alongside weaker demand for other imported goods, is likely to make foreign trade more balanced, i.e., causing a slimmer trade deficit. Foreign trade excluding minerals (the trade item that in this sector in Ukraine is mostly comprised of hydrocarbons -- a 94% share, to be precise) has already returned into surplus, which amounted to US$2.7bn in annualised terms, or 1.6% of GDP (see Chart 31).

Chart 30. Engineering trade and foreign currency lending

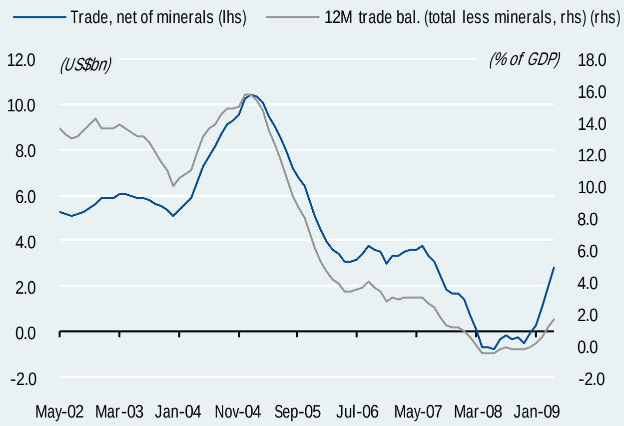
Percentage change of annualised volume of trade over a month a ago, foreign currency lending growth is adjusted for CPI in USD



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

Chart 31. Ex-minerals merchandise trade balance

Trade volumes exclude trade in minerals (oil, oil products and natural gas)



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

Banking sector: lengthy repair

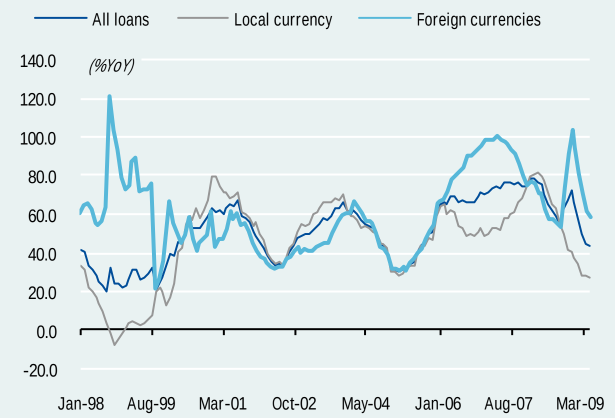
The banking sector appears to need repair after a lengthy period of buoyancy, …

A cascade of events in the fall of 2008 plunged the banking sector, which had experienced a period of booming growth of 2005-08, into a situation where banks' depositors were reassessing their trust in the banks and the system as a whole, banks' wholesale lenders were seeking out redemptions of their funds in due terms, and borrowers struggling to meet their obligations to the banks.

Indeed, the credit boom of 2005-08 featured hyper growth rates of bank lending, as the loan portfolio of the banking sector rose 70% YoY (see Chart 32) in nominal terms. However, much more revealing was the real growth of lending in the country (see Chart 34) in the local and foreign currency (which is mostly the US dollar). Thus, growth of lending in the local currency, hryvnia, adjusted for inflation of consumer prices, hovered around 40% YoY during the period, while lending in foreign currency grew by more than 80% YoY in real terms.

Chart 32. Nominal growth of banking sector's loan portfolio, breakdown by currency

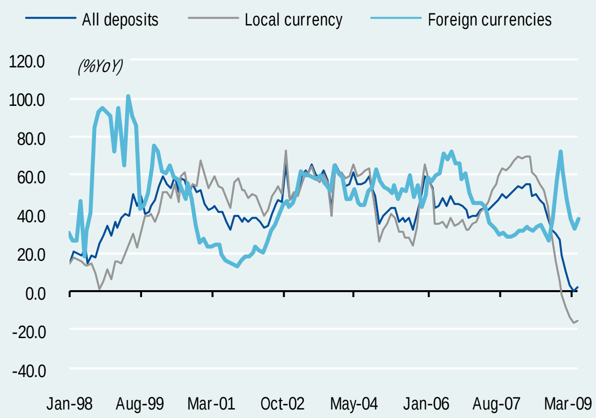
Percentage change over a year ago adjusted for CPI indices in UAH and USD



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

Chart 33. Nominal growth of banking sector's deposit base, breakdown by currency

Percentage change over a year ago adjusted for CPI indices in UAH and USD



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

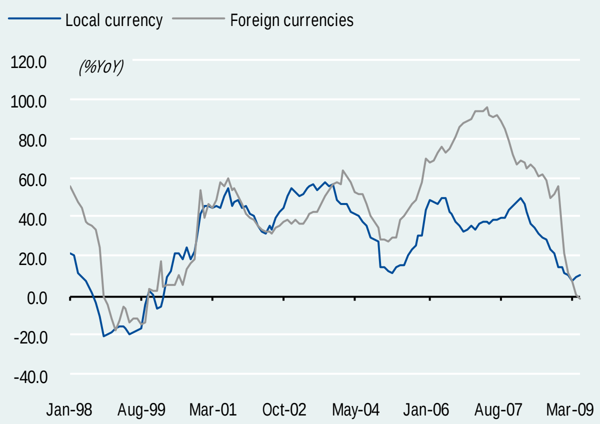
Much of bankers' devotion to the lending process was turned to lending to households (consumer lending, mortgage lending, and lending for light vehicle purchases, mostly of foreign produce) and to non-manufacturing businesses (in total, three such sectors, retail trade, construction and real estate operations, accounted for a 60.6% share of total lending to non-financial corporations). As for the household lending, bankers' attention was grabbed by the booming real estate market as they increased the volume of loans extended massively to households for the purpose of home buying (mortgage lending) and real estate renovation and construction – for instance, there was a rise in total volume of loans of this type from UAH5.6bn as of February 2006 to UAH231.8bn as of December 2008.

… especially in household lending and real estate lending

According to our calculations derived from the monthly banking sector lending statistics published by the central bank, the banking sector's exposure to the real estate market via household and corporate lending appeared to be quite a significant one – its share in the total volume of the loan portfolio of the banking sector (in local currency equivalent) amounted to 46.5% as of May 2009, while being as high as 48.1% in February 2009, due to exchange-rate volatility that extended the volume of the hryvna equivalent of foreign currency loans. Complicating the situation with borrowers' servicing of such loans, the majority of these loans (or a 78.5% share in May 2009) was in foreign currencies (the US dollar accounts for 82.3% of loans to households and a 50.5% share of loans to non-financial corporations). The devaluation of the local currency and cooling of the real-estate markets makes these loans a subject of heightened concern from the standpoint of banks' assets quality.

Chart 34. Real growth of banking sector's loan portfolio, breakdown by currency

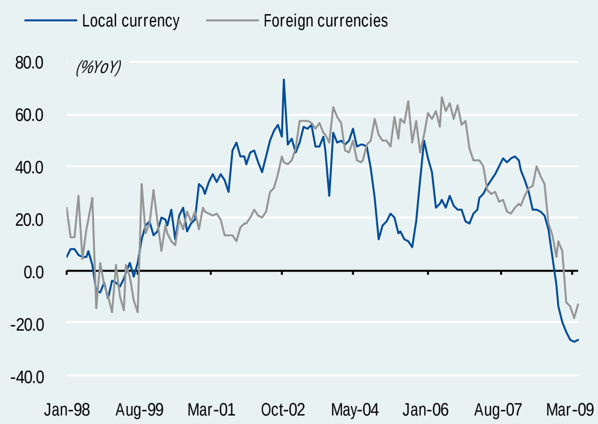
Percentage change over a year ago adjusted for CPI indices in UAH and USD



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

Chart 35. Real growth of banking sector's deposit base, breakdown by currency

Percentage change over a year ago adjusted for CPI indices in UAH and USD



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

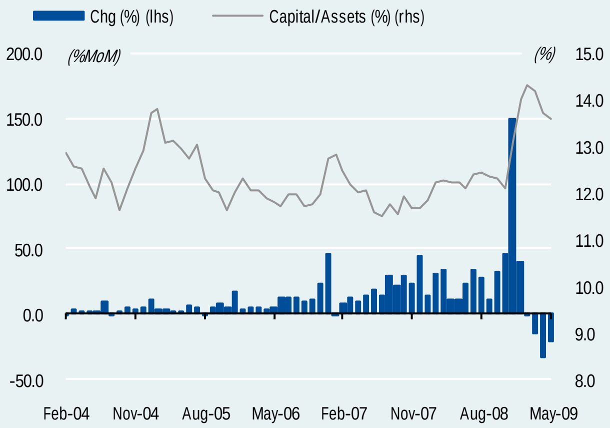
Currency and maturity mismatches have dogged the banks

Accumulated mismatches on the solvency of one bank in October 2008 (Prominvestbank received bad publicity as a small number of depositors rushed to bank offices to withdraw their funds, with some TV channels providing a coverage of this event) ignited a spiralling chain of events that eventually caused the souring trust among banks on the money market. Redemptions of wholesale debt that fell due in 4Q08 clouded the situation even more as the foreign-exchange market reacted with a higher demand for the US dollar, hence weakening the exchange rate of the local currency and straining balance sheets of unhedged foreign currency borrowers.

Since 4Q08, the number of commercial banks put into receivership grew to 15 as of the end of 2Q09. Under the oversight of the central bank and as a requirement of the IMF, commercial banks underwent stress tests. While two state-owned banks had been recapitalised by the government, and foreign banks assured support of their local subsidiaries, only three banks (middle-ranked by size of assets) that were privately held by local owners were recapitalised by the government (effectively, this was nationalisation, as the government seized full control over their operations). However, there are still some banks among the top 30 owned by locals that will need additional capital to be brought into their balance sheets, because of the nature of the problems of the banking business is the same for every bank. Hence, the banking sector would need several waves of recapitalisation, as the number of non-performing loans and their total volume should rise this year and next, in our view.

Chart 36. Banking sector's own capital

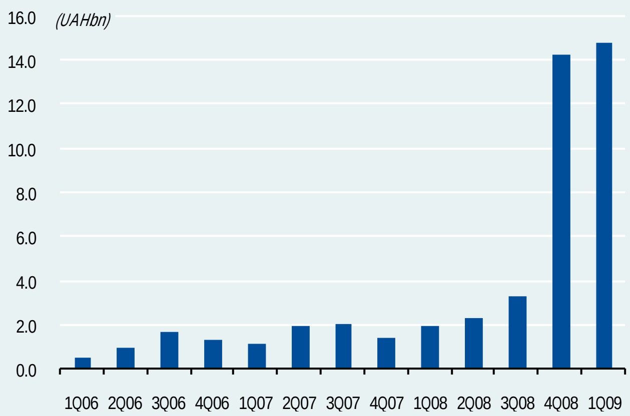
Percentage change over a month ago (left axis) and banks' own capital as a share of net assets (right axis)



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

Chart 37. Quarterly volumes of loan loss provisions

By the banking sector as a whole, available history since 1Q of 2006



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

The more complex loan portfolio of the sector suggests repair is to be lengthier than during the previous clean-up

During the previous financial crisis of 1998, which sent most of local banks at that time into trouble, as the number of borrowers who missed their due payments on loans went nearly to majority, the banking sector saw lending growing in real terms after nearly a 1.5-year period (see Chart 34). At that time, the loan portfolio of the banking sector consisted vastly of corporate loans; nowadays, it is a nearly even mix of corporate and household loans.

Banks will not stimulate demand as they used to in 2005-08

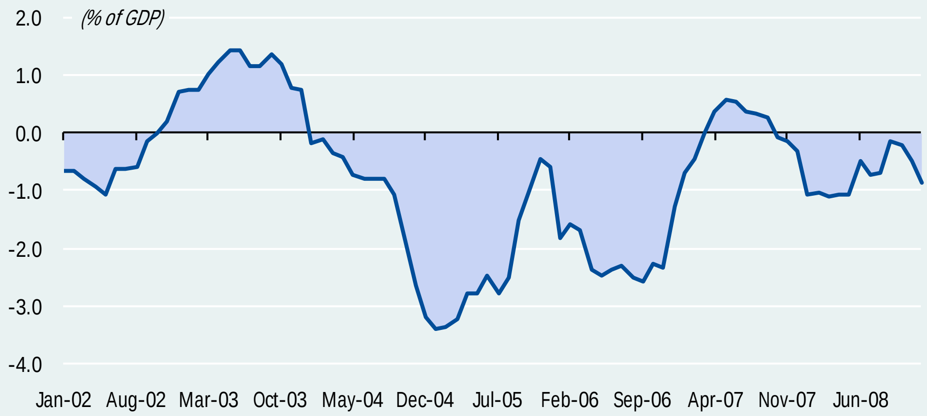
We mentioned above that with such a large ratio of foreign-currency borrowers, strains on their balance sheets are very serious (not saying severe). In our view, the banking sector will undergo a process of trimming its operations in terms of costs (optimising them by effectively minimising them) and in terms of asset quality by making heavy provisions (as it did in 4Q08 and 1Q09). Such a process, coupled by the fact that the NPL ratio will rise in its true size, is likely to last at least well into next year, in our view. In terms of the banking sector's contribution to economic growth, our expectation is that it is going to be close to nil during this period of time. Hence, domestic demand would not enjoy the same support in the form of car payment lending and mortgage lending of the magnitude seen in 2005-08.

Policymaking: still populist but tamed by IMF

Government is strained by economic contraction as available options of funding have caveats, …

The government's policymaking in the fiscal sphere resembles dancing while the music has stopped, i.e., it has only been fulfilling its obligations in terms of fiscal expenditures under the weight of a severe contraction of the revenues base. Given the similarly severe contraction of the economy, it appears that the government is extremely strained in meeting its liabilities. While the government has not provided full disclosure on its state budget since January 2008, a 20.3% YoY decline in real GDP in 1Q09 and expected contraction of 2Q09 real GDP by 15.0% YoY makes the fiscal position of the government indeed dire. No access to a capital market with a long-term borrowing structure complicates the situation further. Among available sources of funding, the government has just few options: firstly, cooperating with the IMF, which imposes restrictive (though it loosened them in 1H09) rules of the game (i.e., policymaking); secondly, borrowing in local currency mostly short-term funds from the local capital markets (where only commercial banks that apparently have excess liquidity are buyers but are fearful of lending to businesses and households due to higher risks); and thirdly, effectively encouraging the central bank to print money for funding of the government's recapitalisations of banks, which in turn fund national corporate champion Naftogaz of Ukraine to meet its obligation on natural gas imports from Russia.

Chart 38. Consolidated state budget balance (annualised data)



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

… which dampen populist influences in policymaking

All the available options of funding, in our view, are not likely to stimulation consumer price hikes. The IMF, as a provider of the largest pool of funds to the government, indeed imposes strict requirements (even after its April concession allowing a 4% budget deficit after previously demanding a zero-budget deficit). The central bank appears as the key promoter of IMF requirements, as it (slowly, without much ado and despite harsh criticism from politicians for its alleged lacklustre handling of the monetary policy and banks' oversight) paves the way for an inflationary targeting regime.

The second source of funding (local currency for short-term borrowing) is more or less a factor of crowding out private borrowers from the local credit market, as banks, which participate in auctions of 3-month and 6-month bonds at yields ranging from 18-20% a year, prefer to place their funds in this low-risk asset class rather than high-risk lending to private businesses and households.

The third option of funding so far has been used in the funding of monthly payments on natural gas imports. The scheme locked the funds disbursed by the central bank into the balance sheets of state-owned corporate entities (Naftogaz of Ukraine and two banks, Oschadbank and Ukreximbank), and eventually, the funds ended up in the bank accounts of Russia's Gazprom, the natural gas supplier. This source of funding represents a medium-term threat, if Naftogaz operations are not rectified via an increase of the natural gas tariff to local consumers (a political issue), because the balance sheets of two-state banks would appear to have accumulated a sizable portfolio of loans to Naftogaz, which should be classified as non-performing, undermining state-owned banks' credibility among depositors and private wholesale lenders. Hence, any prudent realisation of government-sponsored programmes would not be feasible, as these banks would not enjoy a low-cost funding base.

External indebtedness of the economy: largely manageable deleveraging

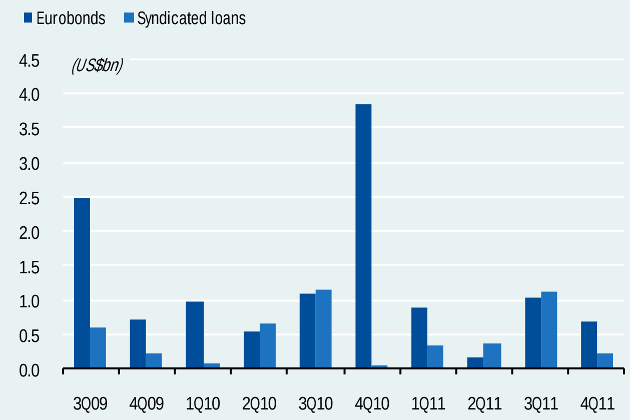
One of the key concerns regarding Ukraine's economy has been the question of whether local borrowers (from sovereign to quasi-sovereign and from banks to non-financial corporates) are capable of managing the deleveraging process in the tough conditions of the global capital markets, access to which has been restrictively costly to many emerging-markets issuers. Indeed, the private sector (especially a number of banks and a real estate developer) had allowed technical defaults, as their shareholders (mostly locals, with the exception of Alfa-Bank Ukraine) then decided to talk to investors on restructuring.

Our analysis of external debt indicates that sovereign and quasi-sovereign issuers dominate the redemption schedule

Below, we provide a detailed breakdown of upcoming redemptions of external debt of Ukraine's borrowers, as originally prescribed by borrowing documentations (prospectuses, etc). The data is divided into quarterly time frames and four types of issuers: sovereign; quasi-sovereign (Naftogaz of Ukraine, Ukreximbank, Ukrtelecom, and the like); foreign-owned entities (for instance, Forum Bank owned by Commerzbank; Alfa-Bank Ukraine; which is a banking arm of Russian Alfa Group; and Raiffeisen Bank Aval owned by Austria's Raiffeisen International); and other borrowers, which cannot be classified as part of the previous three groups.

Chart 39. Quarterly volumes of external debt redemptions

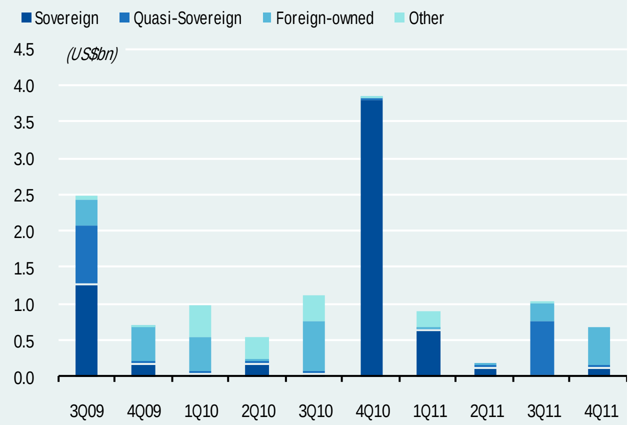
Schedule from 3Q of 2009 to 4Q of 2011. Eurobond and syndicated loan market; Eurobond data includes principal and interest payments



Notes: data does not include restructuring agreements, such debts are included at their initial maturity profile. Source: Reuters, Cbonds.Info, Investment Capital Ukraine LLC.

Chart 40. Quarterly volume of Eurobond redemptions

Schedule from 3Q of 2009 to 4Q of 2011. Breakdown by type of issuers, data includes principal and interest payments



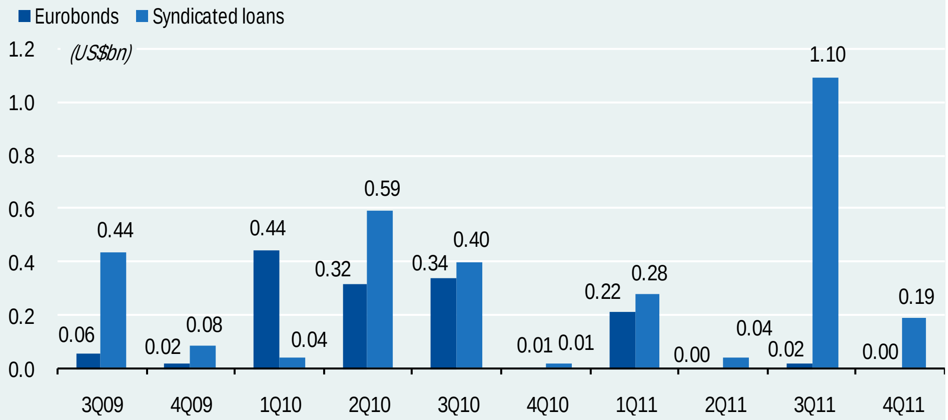
Notes: data does not include restructuring agreements, such debts are included at their initial maturity profile. Source: Reuters, Cbonds.Info, Investment Capital Ukraine LLC.

In 3Q09 and 4Q09, shares of sovereign, quasi-sovereign and foreign owned external debt payers accounted for a 97% share in each quarter

This data shows that 3Q09 is heavy in scheduled redemptions: US$3.0bn in total, according to our calculations (see Table 5 on page 33), of which Eurobond redemptions account for US$2.5bn, and syndicated loan redemptions for US$0.6bn. Taking a more detailed look at Eurobond redemptions in 3Q09, it appears that sovereign and quasi-sovereign redemptions dominate in this quarter, accounting for US$1.3bn and US$0.8bn, respectively. Foreign-owned borrowers have to redeem US$0.3bn in this quarter. Together, these three types of borrowers account for a 97.8% share of redemptions in 3Q09, nearly the same share as 4Q09's estimated 97.2%, albeit the total volume is much lower, at US$0.7bn.

With our expectations that local authorities are capable and willing of paying back their external debts in due course, their support for quasi-sovereign borrowers like Naftogaz of Ukraine and Ukreximbank is also very strong, affirming that these kind of debts are likely to be repaid. Another important issue worth mentioning is that authorities have tested and apparently adopted the scheme of meeting external liabilities of quasi-sovereign entities (when they are strapped for foreign currency cash) with the full assistance of the authorities, when the central bank sells foreign currency to these entities off the foreign-exchange market. This means that there is high likelihood that exchange-rate movements during the peaks of external debt redemptions are going to stay broadly calm. Foreign-owned entities (mostly banks owned by banks from the EU) also provide support to their subsidiaries in meeting their redemption liabilities. The remaining borrowers are likely to be a concern of restructuring negotiations, and their impact on the local foreign-exchange market is likely to be more profound, as their efforts to accumulate foreign currency before a payday would weaken the local currency.

Chart 41. Quarterly volume of redemptions by "other" borrowers at Eurobond and syndicated loan markets



Notes: data does not include restructuring agreements, such debts are included at their initial maturity profile.
Source: Reuters, Cbonds.Info, Investment Capital Ukraine LLC.

With this idea in mind, and taking into account the portrayal of scheduled redemptions of external debt by "other" borrowers (private businesses owned by local investors) in Chart 41, it is believed that 2009 will not be a headache regarding the exchange rate of the local currency, as US$500m is required to be paid off by these types of borrowers in 3Q09, and US$100m in 4Q09. More worrisome will be 2010, starting from the second quarter and followed by the third quarter, when US$910m and US$740m, respectively, will be paid back.

Table 5. Breakdown of redemptions of external debt by Ukrainian issuers (US$m)

Period	Eurobond market						Syndicated loan market						
	Total	Sovereign	Quasi-Sovereign	Foreign-owned	Other	Other (% of total)	Total	Quasi-Sovereign	Foreign owned	Other	Other (% of total)	Total*	Total** (Other)
3Q09	2,457.74	1,256.23	811.74	334.50	55.27	2.25	582.00	0.00	146.50	435.50	74.83	**3,039.74**	490.77
4Q09	698.15	156.75	28.81	492.98	19.61	2.81	198.97	0.00	116.47	82.50	41.46	**897.12**	102.11
1Q10	951.51	20.63	31.74	455.75	443.39	46.60	47.00	0.00	12.00	35.00	74.47	**998.51**	478.39
2Q10	531.33	156.75	28.81	26.16	319.61	60.15	623.50	0.00	31.00	592.50	95.03	**1,154.83**	912.11
3Q10	1,083.97	20.63	31.74	689.75	341.86	31.54	1,117.50	550.00	167.50	400.00	35.79	**2,201.47**	741.86
4Q10	3,840.80	3,780.64	28.81	26.16	5.19	0.14	23.34	9.25	0.00	14.10	60.38	**3,864.14**	19.28
1Q11	880.04	620.63	31.74	11.56	216.11	24.56	302.00	0.00	27.00	275.00	91.06	**1,182.04**	491.11
2Q11	153.74	98.77	28.81	26.16	0.00	0.00	330.47	0.00	291.00	39.47	11.94	**484.21**	39.47
3Q11	1,013.30	0.00	731.74	261.56	20.00	1.97	1,095.00	0.00	0.00	1,095.00	100.00	**2,108.30**	1,115.00
4Q11	653.74	98.77	28.81	526.16	0.00	0.00	187.00	0.00	0.00	187.00	100.00	**840.74**	187.00

Notes: * total of Eurobond and syndicated loan markets; ** total of Eurobond and syndicated loan markets for just those issuers that are classified as 'Other'; data does not include restructuring agreements, such debts are included at their initial maturity profile.
Sources: Reuters, Cbonds.Info, Investment Capital Ukraine LLC.

Forecast viewpoints

In short, our 3-year forecast is based on assumptions that a subdued global steel market, sluggish global demand as key trading partners slowly recover from recession, and domestic demand, is likely undergo restructuring from consumer-led growth to more of an investment-led one.

Key viewpoints detailed

Foreign demand

In our view, the global economy is set to restructure its accumulated imbalances with developing Asian economies, seen as likely engines of the new global economic recovery, and restructuring from export-led growth models to more inward looking economies (albeit exporting sector remaining vast), where household consumption of consumer and durable goods intensify and previous industrialisation aimed at exports recedes. This is going to be a process with no immediate effect, but rather a lengthy one, in order to engender, for example, a consumer appetite in Asia that is similar to that of the US consumer base. Hence, Ukraine's vital export item, steel products, will not enjoy a marginal rebound in price on the global market place (in fact, our base-case forecast scenario assumes US$360-365 a tonne in 2H09 and US$380-450 a tonne in 2010 and US$450). In terms of export volumes (in tonnes), our expectation is that in 2009-11 volumes will be lower than those seen in 2007-08, reflecting weaker demand. In total, 2009 is likely, in our view, to see 26.0m tonnes in steel exports, followed by 27.0m next year and 28.9m in 2011. Food exports will gain significance during the forecasted period, as the government is likely to leave grain exports free of quotas – our forecast assumes that food exports revenues would average US$2.0bn a quarter during the period. Engineering exports, which in our view follow CIS economic growth, are to experience some slump this year, recovering in US dollar terms in 2011.

Domestic demand

Several engines of internal growth of 2005-08 (construction, banking sector) will experience a rather lengthy decline in activity. A slowing in the real estate market and bundling of banking services to the wider public will both dampen growth for a while, which is likely to extend well into 2010 (however, we do not rule out that even 2011 will see such an extension). Demand for imported goods is going to stagnate, as fewer buyers will form slimmer ranks of owners of goods from imported light vehicles and labelled clothing; the same logic applies to businesses, as their recent cut in investments will not reverse overnight soon, especially when politics complicate economically prudent policymaking.

A combination of weaker foreign and domestic demand extending into most of this year is likely to force the economy to consume a lower volume of inputs than during the period of buoyancy (2005-08). Thus, imports of hydrocarbons in volume terms is going to be lower as the economy becomes not only less hungry for growth catalysts (due to recession), but also a bit more efficient. Our base-case scenario assumes that imports of natural gas will be lower than in 2008 (when 53bn cubic metres of natural gas were imported): 36.7bn in 2009, followed by 37.1bn and 39.0bn in 2010 and 2011, respectively. The price for imported natural gas paid by Ukraine was set at US$198.0 per 1,000 cubic metre in 3Q09, and likely to be at US$180.0 per 1,000 cubic metres in 4Q09. In 2010 and 2011, the average quarterly price is likely to be at US$190.0 and US$202.3, respectively. Imports of oil (crude oil and oil products) will likely be lower as well (in tonnes) during the forecasted period than in 2007 and 2008 (amounting to 10.8m and 10.7m in crude oil equivalent), at 8.4m, 8.7m and 9.1m in 2009, 2010 and 2011, respectively. Imports of engineering goods (from light vehicles to investment goods) in our view will decline quite dramatically in US dollar terms, from US$25.5bn in year of 2008 to US$7.3bn in 2009, followed by just a modest pick-up in 2010 and 2011, to US$7.6bn and US$8.7bn, respectively. Poor labour conditions, which are likely to see the army of unemployed rising further during the year of 2009, sending the unemployment rate above the 11% level of last December, would pave the way for sluggish demand. In 2010 and 2011, labour market conditions may become tighter (in terms of demand for labour), resulting in some reduction of unemployment, to 9.4% as of the end of 2010, and 8.3% as of end of 2011, according to our expectations.

Investments

The inflow of foreign direct investments (FDI) in net terms, in our view, is likely to drop this year by nearly 50%, from US$9.7bn in 2008 to US$3.9bn in 2009. During the following two years of 2010-11, it is expected that end of the election cycle will coincide with the appearance of some signs that the economy has adapted to the new norm of a functioning global economy, and net FDI is likely to rise to US$4-5bn a year.

Prices

The trend in consumer prices is likely to be shaky as double-digit inflation of consumer prices takes hold in the country. Still, the central bank’s determination to introduce inflation targeting alongside with greater exchange-rate flexibility should eventually bear fruit, as the CPI is likely to moderate towards the single-digit zone as early as in late 2011.

Interest rates

Generally, the central bank’s interest rate policy should not see another pick-up in the key rate during the forecasted period, as in our view, the worse of the current banking crisis will have been averted. And, by the recent 1ppt cut (unexpected for us, as the bank, in our view, was more in a position to fix the banking sector balance sheets by reinforcing its deposit base with higher interest rates) to 11%, the bank appears to have sent a signal that it will gradually lower the rate in order to stimulate growth once banks renew active lending. After raising its key rate in 2008 to 12% and holding it there in 1Q09, the bank has apparently achieved stabilisation of the deposit base of commercial banks. According to our expectations of interest-rate movements, the key central bank rate should end 2009 at the same level that is in effect now, of 11% ,and likely at 9.5% and 8% at year-end of 2010 and 2011, respectively. This will reflect the central bank monetary policy shift towards the stance of stimulating activity via a lower policy rate.

Bond yields, however, are likely to be elevated for some time, especially in 2H09, as the risk profile of the government (which faces a problem of declining revenues) remains sour, and a wide consensus of local economists is expecting another period of weaker currency in this period. The yields on the primary market recently of short-dated bonds (of up 1 year) of 18-20% is likely to dominate throughout 3Q of this year and probably rise to the range of 20-22% in the fourth quarter of this year as budgetary expenses reach their peak during this time. However, in 2010, we expect moderation of interest rates and the local currency yield curve moving slightly down across available maturities, thanks to the improved risk profile of the economy, which will test the new norm in terms of performance, to the new government’s bid to improve policymaking, and not least to the improved perception on local currency exchange rate (being undervalued in over view).

Exchange rate

In our view, the local currency hryvnia is undervalued. Our calculation of the real trade-weighted index (for more details on this, see “Methodology of UAH real TWI” on page 39) of the currency show that it continues to stay in devalued territory – the index (in real terms) has hovered around 50 points since January 2009, or well below a recent peak of 80 points after appreciation in 1H of 2008. Even the recent appreciation of the local currency, by nearly 4% from 8/USD as of the end of April 2009 to 7.7/USD as early July 2009, did not affect the currency in real terms, as relative changes in exchange rates and inflation rates in Ukraine versus its key trading partners resulted in still no marginal appreciation of the currency in real terms.

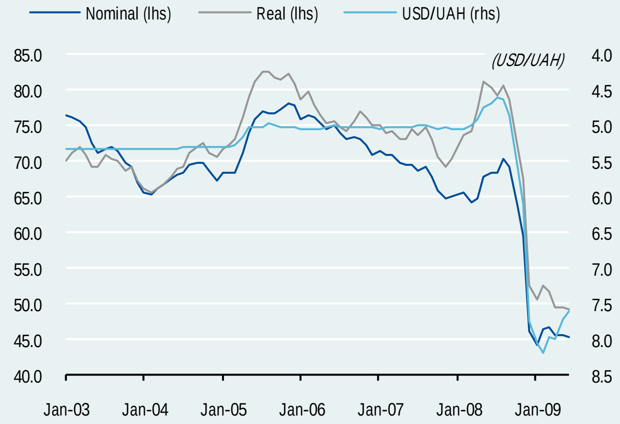
Chart 42. Real trade-weighted index of UAH

History since December 1995 to June 2009

Source: Investment Capital Ukraine LLC.

Chart 43. Hryvnia: exchange rate (reverse scale) and trade-weight indices (nominal and real)

History since January 2003 to June 2009

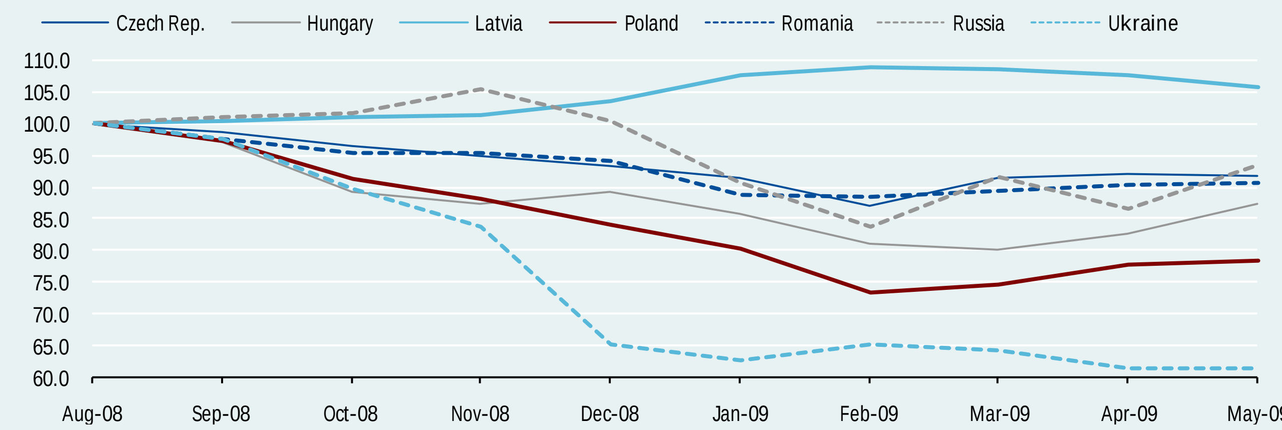


Source: Reuters, Investment Capital Ukraine LLC.

In real terms, the Ukrainian hryvnia remains one of the most weakened currencies in the region in the aftermath of the financial and economic crisis that started with a severe contraction of vital economic activities in September 2008. Chart 44 below clearly shows this. Notably, a number of key trading partners of Ukraine saw their currency appreciating in real terms as well as in nominal terms against the US dollar. In our view, Ukraine's economy's competitiveness, which gained ground via currency devaluation, remains an advantage, despite the recent nominal appreciation of the currency. That is why, in our view, the exchange rate is likely to heading towards the level of 7/USD in the forecasted period.

Chart 44. Real indices of local currencies of selected countries of emerging Europe

Rebased as 100 points as of August 2008



Source: Bank for International Settlements, Investment Capital Ukraine LLC.

Quarterly forecast

Table 6. Key macroeconomic forecast (quarterly)

	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09E	3Q09F	4Q09F	1Q10F	2Q10F	3Q10F	4Q10F	1Q11F	2Q11F	3Q11F	4Q11F
Activity																
Real GDP (%YoY)	6.3	6.2	6.4	-8.0	-20.3	-15.0	-15.0	-2.0	2.5	2.5	1.0	0.0	2.0	2.5	3.0	3.0
Nominal GDP (UAHbn)	187.7	233.7	275.8	252.7	183.2	225.7	261.7	287.5	221.8	278.5	317.3	341.8	261.9	321.5	365.6	390.9
Nominal GDP (US$bn)	37.3	48.8	58.7	38.9	22.7	29.6	33.1	37.3	29.2	37.1	42.9	46.8	36.4	44.7	52.2	55.8
GDP per capita (US$, ann)				3,975	3,662	3,251	2,701	2,671	2,818	2,987	3,205	3,418	3,582	3,753	3,965	4,170
Unemployment rate (%)	7.1	6.2	6.0	6.4	9.5	10.0	10.4	11.4	10.1	9.6	9.4	9.4	9.2	8.7	8.5	8.3
Prices																
CPI headline (%YoY, eop)	26.2	29.3	24.6	22.3	18.1	15.0	16.7	17.0	14.9	14.9	13.2	10.5	8.0	6.4	6.4	5.4
CPI headline (%YoY, average)	22.5	30.2	25.8	22.6	20.4	15.1	16.4	17.0	15.2	15.2	14.0	11.4	8.7	6.9	6.4	5.7
PPI (%YoY, eop)	29.8	41.6	40.5	21.1	12.9	-1.0	-0.2	13.6	16.9	21.6	20.1	20.1	16.3	12.3	12.3	10.7
PPI (%YoY, average)	25.6	38.2	43.1	27.4	16.8	2.4	-2.3	8.8	16.2	20.8	20.8	20.7	17.7	13.3	12.3	11.2
Fiscal balance																
Consol'd budget balance (UAHbn)	5.7	0.8	5.2	-25.9	-8.6	-13.7	-12.2	-30.9	2.9	2.0	4.4	-14.6	5.0	2.3	4.8	-18.1
Consol'd budget balance (% of GDP)	3.0	0.3	1.9	-10.3	-4.7	-6.1	-4.7	-10.7	1.3	0.7	1.4	-4.3	1.9	0.7	1.3	-4.6
Budget balance (UAHbn)	1.2	0.7	1.0	-15.4	-7.2	-11.2	-10.2	-24.6	1.5	0.6	2.3	-12.3	3.0	0.7	2.5	-15.1
Budget balance (% of GDP)	0.6	0.3	0.4	-6.1	-3.9	-5.0	-3.9	-8.5	0.7	0.2	0.7	-3.6	1.1	0.2	0.7	-3.9
External balance																
Exports (US$bn)	17.5	23.5	27.3	17.3	11.3	12.6	13.5	13.0	12.7	13.9	14.5	14.5	15.0	15.5	16.0	16.4
Imports (US$bn)	22.0	27.4	29.8	20.9	12.2	12.9	12.5	14.0	13.8	13.8	13.5	14.8	14.8	15.2	15.5	16.4
Trade balance (US$bn)	-4.5	-3.9	-2.6	-3.6	-0.9	-0.4	1.0	-1.0	-1.0	0.0	0.9	-0.3	0.2	0.2	0.5	0.0
Trade balance (% of GDP)	-11.9	-8.0	-4.4	-9.2	-3.9	-1.2	3.1	-2.6	-3.5	0.1	2.2	-0.5	0.6	0.5	1.0	0.0
Current account balance (US$bn)	-3.7	-3.4	-2.1	-3.7	-0.8	0.1	1.4	-0.9	-0.9	0.4	1.3	-0.1	0.4	0.6	0.8	0.2
Current account balance (% of GDP)	-9.9	-6.9	-3.6	-9.6	-3.6	0.2	4.2	-2.5	-3.0	1.1	2.9	-0.2	1.2	1.3	1.6	0.4
Net FDI (US$bn)	2.4	3.1	3.3	0.8	0.9	1.0	1.0	1.0	1.0	1.1	1.0	1.0	1.1	1.1	1.1	1.1
Net FDI (% of GDP)	6.5	6.3	5.7	2.2	4.2	3.4	3.0	2.7	3.5	2.8	2.4	2.2	2.9	2.4	2.1	2.0
C/A bal. + net FDI (% of GDP)	-3.4	-0.5	2.0	-7.5	0.5	3.6	7.3	0.1	0.4	3.9	5.4	1.9	4.1	3.7	3.7	2.4
External debt (US$bn, eop)	92.2	100.0	105.4	103.2	103.2	105.3	105.2	107.4	107.2	106.8	105.4	103.0	101.9	101.4	99.3	99.5
External debt (% of ann'd GDP, eop)	60.7	59.7	56.4	56.2	61.1	70.5	84.3	87.2	82.6	77.4	71.9	66.0	62.4	59.4	55.1	52.6
FX reserves (US$bn, eop)	33.2	35.4	37.5	31.5	25.4	26.8	27.5	27.7	26.6	26.6	26.4	24.1	23.4	23.5	22.4	22.9
FX reserves (% of ann'd GDP, eop)	21.9	21.1	20.1	17.2	15.0	17.9	22.0	22.4	20.5	19.3	18.0	15.5	14.4	13.8	12.4	12.1
External debt / FX reserves (x, eop)	2.8	2.8	2.8	3.3	4.1	3.9	3.8	3.9	4.0	4.0	4.0	4.3	4.3	4.3	4.4	4.4
FX reserves imports cov (months)	6.0	5.6	5.3	4.5	4.0	5.2	7.1	8.4	7.8	7.6	7.4	6.6	6.3	6.2	5.6	5.6
Interest rates																
Central bank key rate (%, eop)	10.0	12.0	12.0	12.0	12.0	11.0	11.0	11.0	11.0	11.0	11.0	10.5	10.0	8.0	8.0	8.0
3-month rate (%, average)	9.1	15.7	13.2	21.6	28.3	13.4	15.0	15.0	13.0	12.0	12.0	11.5	10.0	7.5	7.5	7.5
Exchange rates																
UAH trade-weighted index (nominal)	63.99	68.26	68.97	45.89	46.55	45.08	44.28	45.96	46.61	47.74	48.48	49.58	50.20	50.52	51.96	51.96
UAH trade-weighted index (real)	74.23	80.35	78.49	52.41	51.56	49.16	48.70	51.13	51.22	51.81	51.96	52.45	52.46	52.15	52.98	52.32
UAH/US$ (eop)	4.99	4.53	5.07	7.80	8.00	7.72	7.90	7.70	7.60	7.50	7.40	7.30	7.20	7.20	7.00	7.00
UAH/US$ (average)	5.03	4.79	4.70	6.49	8.09	7.63	7.90	7.70	7.60	7.50	7.40	7.30	7.20	7.20	7.00	7.00
UAH/€ (eop)	7.87	7.14	7.15	10.90	10.60	10.83	10.90	10.63	10.56	10.50	10.36	10.22	10.15	10.15	9.87	9.87
UAH/€ (average)	7.55	7.48	7.07	8.58	10.56	10.67	10.90	10.63	10.56	10.50	10.36	10.22	10.15	10.15	9.87	9.87
US$/€ (eop)	1.58	1.58	1.41	1.40	1.33	1.36	1.38	1.38	1.39	1.40	1.40	1.40	1.41	1.41	1.41	1.41
US$/€ (average)	1.50	1.56	1.50	1.32	1.31	1.36	1.38	1.38	1.39	1.40	1.40	1.40	1.41	1.41	1.41	1.41
Population																
Population (million, eop)	46.3	46.2	46.2	46.1	46.1	45.9	45.9	45.8	45.8	45.6	45.6	45.6	45.5	45.3	45.3	45.3
Population (%YoY)					-0.4	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.

Note: eop – end of period; consol'd – consolidated; 3-month rate is average KIEV-PRIME 3-month rate. Source: Investment Capital Ukraine LLC.

Annual forecast

Table 7. Key macroeconomic forecast (annual)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009F	2010F	2011F
Activity																
Real GDP (%YoY)	-10.0	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	2.6	7.1	7.6	2.1	-13.1	1.5	2.6
Nominal GDP (UAHbn)	82	93	103	131	170	204	226	267	345	441	544	713	950	958	1,159	1,340
Nominal GDP (US$bn)	45	50	41	30	31	38	42	50	65	87	108	142	184	120	148	181
GDP per capita (US$, ann)	868	985	816	606	629	779	874	1,044	1,371	1,850	2,319	3,058	3,981	2,619	3,243	4,004
Unemployment rate (%)	7.6	8.9	11.3	11.6	11.6	10.9	9.6	9.1	8.6	7.2	6.2	6.4	6.4	11.4	9.4	8.3
Prices																
CPI headline (%YoY, eop)	40.1	10.1	20.0	19.2	25.8	6.1	-0.6	8.2	12.3	10.3	11.6	16.6	22.3	17.0	10.5	5.4
CPI headline (%YoY, average)	88.5	16.5	10.5	22.8	28.2	12.3	0.8	5.2	9.0	13.6	9.1	12.8	25.3	17.2	13.9	6.9
PPI (%YoY, eop)	17.3	5.0	35.4	15.7	20.6	0.9	5.8	11.2	24.3	9.6	15.4	23.2	21.1	13.6	20.1	10.7
PPI (%YoY, average)	59.3	7.8	13.1	32.1	20.9	8.9	3.1	7.8	20.3	17.0	9.6	20.5	33.6	6.4	19.6	13.6
Fiscal balance																
Consol'd budget balance (UAHbn)	-4.0	-6.2	-2.3	-1.9	1.0	-1.3	1.7	-0.5	-11.8	-7.7	-3.7	-7.7	-14.2	-65.3	-5.2	-6.1
Consol'd budget balance (% of GDP)	-4.9	-6.6	-2.2	-1.4	0.6	-0.6	0.8	-0.2	-3.4	-1.7	-0.7	-1.1	-1.5	-6.8	-0.5	-0.5
Budget balance (UAHbn)	N/A	N/A	N/A	N/A	N/A	-1.3	1.2	-1.0	-10.2	-7.9	-3.8	-9.8	-12.5	-53.1	-7.8	-9.0
Budget balance (% of GDP)	N/A	N/A	N/A	N/A	N/A	-0.6	0.5	-0.4	-3.0	-1.8	-0.7	-1.4	-1.3	-5.5	-0.7	-0.7
External balance																
Exports (US$bn)	20.3	20.4	17.6	17.1	19.5	21.1	23.4	29.0	41.3	44.4	50.2	64.0	85.6	50.5	55.6	62.8
Imports (US$bn)	21.5	21.9	18.8	15.2	17.9	20.5	21.5	27.7	36.3	43.7	53.3	71.9	100.1	51.6	55.9	61.9
Trade balance (US$bn)	-1.1	-1.5	-1.2	1.8	1.6	0.6	1.9	1.3	5.0	0.7	-3.1	-7.9	-14.5	-1.2	-0.3	1.0
Trade balance (% of GDP)	-2.5	-3.1	-2.9	6.0	5.1	1.6	4.4	2.6	7.7	0.8	-2.8	-5.6	-7.9	-1.0	-0.2	0.5
Current account balance (US$bn)	-1.2	-1.3	-1.3	1.7	1.5	1.4	3.2	2.9	6.9	2.5	-1.6	-5.9	-12.9	-0.3	0.7	2.1
Current account balance (% of GDP)	-2.7	-2.7	-3.2	5.5	4.8	3.7	7.5	5.8	10.6	2.9	-1.5	-4.2	-7.0	-0.3	0.5	1.1
Net FDI (US$bn)	0.5	0.6	0.7	0.5	0.6	0.8	0.7	1.4	1.7	7.5	5.7	9.2	9.7	3.9	4.1	4.4
Net FDI (% of GDP)	1.2	1.2	1.8	1.6	1.9	2.0	1.6	2.8	2.6	8.7	5.3	6.5	5.3	3.3	2.8	2.4
C/A bal. + net FDI (% of GDP)	0.0	-0.2	0.5	3.3	3.4	3.4	4.8	5.7	9.5	11.2	3.7	0.6	-7.7	3.0	3.5	4.5
External debt (US$bn, eop)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	23.8	30.6	40.7	54.5	84.3	103.2	107.4	103.0	99.5
External debt (% of ann'd GDP, eop)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	47.5	47.2	46.9	50.4	59.5	56.2	87.2	66.0	52.6
FX reserves (US$bn, eop)	N/A	2.3	0.8	1.0	1.4	3.0	4.2	6.9	9.5	19.4	22.3	32.5	31.5	27.7	24.1	22.9
FX reserves (% of ann'd GDP, eop)	N/A	4.7	1.9	3.5	4.3	7.8	10.0	13.8	14.7	22.3	20.6	22.9	17.2	22.4	15.5	12.1
External debt / FX reserves (x, eop)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	3.4	3.2	2.1	2.5	2.6	3.3	3.9	4.3	4.4
FX reserves imports cov (months)	N/A	1.4	0.6	1.0	1.1	2.1	2.8	3.6	3.8	6.4	6.1	6.4	4.5	8.4	6.6	5.6
Interest rates																
Central bank key rate (%, eop)	40.0	35.0	60.0	45.0	27.0	12.5	7.0	7.0	9.0	9.5	8.5	8.0	12.0	11.0	10.5	8.0
3-month rate (%, eop 4Q)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	17.9	15.0	11.5	9.9	7.6	21.6	15.0	12.0	10.0
Exchange rates																
UAH trade-weighted index (nominal)	78.17	86.78	80.70	74.08	81.57	83.45	77.64	66.81	67.19	77.84	70.90	64.93	45.89	45.96	49.58	51.96
UAH trade-weighted index (real)	92.24	83.34	67.28	69.61	88.20	77.13	70.35	67.18	70.41	80.93	74.89	70.19	52.41	51.13	52.45	52.32
UAH/US$ (eop)	1.89	1.90	3.98	5.20	5.43	5.34	5.33	5.33	5.31	5.05	5.05	5.05	7.80	7.70	7.30	7.00
UAH/US$ (average)	1.83	1.86	2.59	4.31	5.48	5.37	5.33	5.33	5.32	5.10	5.03	5.03	5.25	7.85	7.45	7.10
UAH/€ (eop)	2.30	2.37	2.09	4.66	5.24	5.12	4.75	5.60	6.71	7.20	5.97	6.66	7.36	10.63	10.22	9.87
UAH/€ (average)	2.30	2.11	2.93	4.59	5.06	4.81	5.04	6.04	6.62	6.35	6.32	6.89	7.67	10.66	10.41	10.01
US$/€ (eop)	1.25	1.10	1.17	1.01	0.94	0.89	1.05	1.26	1.36	1.18	1.32	1.46	1.40	1.38	1.40	1.41
US$/€ (average)	1.25	1.13	1.12	1.07	0.92	0.90	0.95	1.13	1.24	1.24	1.26	1.37	1.47	1.36	1.40	1.41
Population																
Population (million, eop)	51.3	50.8	50.4	49.9	49.4	48.9	48.5	48.0	47.3	47.0	46.6	46.4	46.1	45.8	45.6	45.3
Population (%YoY)		-0.9	-0.9	-0.9	-1.0	-1.0	-1.0	-0.9	-1.4	-0.8	-0.7	-0.6	-0.5	-0.6	-0.6	-0.6

Note: eop – end of period; consol'd – consolidated; 3-month rate is average KIEV-PRIME 3-month rate. Source: Investment Capital Ukraine LLC.

Methodology of UAH real TWI

RTWI is abbreviation of real trade-weighted index of the local currency hryvnia. The index is a measurement of the hryvnia's exchange rate developments in real terms, trade weighted against Ukraine's trade partner countries and adjusted for inflation differentials. Such an index is also referred as real effective exchange rate. Our calculation of the index is being made a monthly basis.

Our real TWI calculation is CPI-based and takes into account the following inputs. First of all, this is merchandise trade statistics published by State Statistics Committee of Ukraine on monthly basis that is used to determine a basket of key trade partners. Secondly, it is foreign exchange market data on movements of the national currencies against the US dollar, the key anchor currency in the global FX market. And thirdly, it is data on consumer price indices in those trade partners.

Trade partners

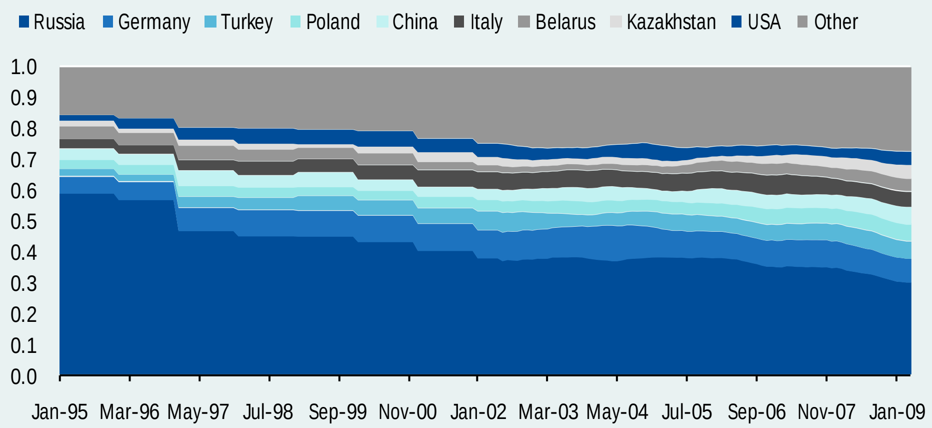
The calculation is based on the basket of countries, which are Ukraine key trade partners and in total account for at least 74% of total merchandise trade turnover (exports and imports). This basket consists of 26 countries (see Table 8). The trade weight is calculated upon the following formula:

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

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

Chart 45. Weights of key trading partners of Ukraine

History since January 1995 to April 2009



Sources: 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.

Table 8. Ukraine's key partners in merchandise trade and their weights in UAH real TWI, as of April 2009

#	Country	Trade turnover (US$bn)	Share of total turnover* (%)	Weight (%)	Average weight, May 2002 till April 2009 (%)	Average weight, 1995-2001 (%)
1	Russia	30.66	22.21	29.87	36.14	47.94
2	Germany	8.02	5.81	7.81	9.20	7.64
3	Poland	5.92	4.29	5.77	4.79	3.50
4	China	5.83	4.22	5.67	4.27	3.88
5	Turkey	5.67	4.11	5.52	5.00	3.65
6	Italy	4.87	3.53	4.74	5.36	3.88
7	Kazakhstan	4.87	3.53	4.74	2.69	1.98
8	United States	4.37	3.17	4.26	3.66	4.00
9	Belarus	4.28	3.10	4.17	3.02	4.08
10	Japan	2.54	1.84	2.47	1.45	0.84
11	Korea, South	2.26	1.64	2.20	1.59	0.87
12	Hungary	2.26	1.63	2.20	2.73	2.25
13	Netherlands	2.18	1.58	2.12	2.00	1.28
14	France	2.00	1.45	1.95	1.94	1.58
15	United Kingdom	1.86	1.35	1.81	2.06	1.56
16	Czech Republic	1.81	1.31	1.77	1.69	1.55
17	India	1.74	1.26	1.70	1.45	1.09
18	Egypt	1.62	1.17	1.58	1.18	0.78
19	Romania	1.57	1.14	1.53	1.57	1.02
20	Spain	1.49	1.08	1.45	1.37	0.91
21	Austria	1.46	1.06	1.42	1.49	1.43
22	Slovakia	1.46	1.06	1.42	1.46	1.73
23	Sweden	1.39	1.01	1.36	0.95	0.57
24	Moldova	1.27	0.92	1.24	1.38	1.13
25	Brazil	0.96	0.70	0.94	0.90	0.63
26	Singapore	0.29	0.21	0.28	0.64	0.24
	Total	**102.66**	**74.36**	**100.00**	**100.00**	**100.00**

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

Exchange rates

History of exchange rates (national currency against the US dollar) is taken from Reuters and then monthly averages of exchange rates are calculated since January 1995. Then monthly data of average exchange rates is issued to construct a chain of cross-rates (via US dollar) of national currencies against the Ukrainian hryvnia. 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).

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 table and chart provide the results of calculations of the trade-weighted index of the local currency hryvnia in nominal and real terms.

Table 9. Trade-weighted indices of Ukrainian hryvnia

	Jan-95	Jan-00	Jan-05	Jan-06	Jan-07	Jan-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09
Nominal	100.00	73.03	68.16	75.90	71.30	65.16	44.02	46.20	46.55	45.20	45.27
Real	207.52	72.15	71.66	78.49	74.99	71.84	50.38	52.30	51.56	49.18	49.14

Notes: May 2009 results are estimates while merchandise trade statistics for this period were not available as of date of publication.
Sources: State Statistics Committee of Ukraine, Reuters, Investment Capital Ukraine LLC.

Chart 46. Trade-weighted indices of Ukrainian hryvnia

History from January 1995

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

Disclosures

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This research publication has been prepared by the analyst(s), whose name(s) appear on the front page of this publication. The analyst(s) hereby certifies that the views expressed within this publication accurately reflect her/his own views about the subject financial instruments or issuers and no part of her/his compensation was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views within this research publication.

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