Focus
Ukraine

Scope
Economics

Quarterly Report
Change at the gate

Alexander Valchyshen
Kiev, +38 044 2200120
alexander.valchyshen@icu.ua

March 2010

READ FIRST THE DISCLOSURES SECTION FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

Contents

RESEARCH TEAM
Alexander Valchyshen
Head of research
alexander.valchyshen@icu.ua
Kiev, +38 044 2200120 extn. 205

PUBLICATION DATE
15 March 2010 13:03

Executive summary

The economy is estimated to grow by 2.5% in FY10 in real terms, a lower rate than it would have grown if the domestic banking sector had functioned normally. Fiscal woes will be addressed by the new, technocratic government (the FY10 budget deficit is forecast at 4.2% of GDP). Domestic weakness in demand is helping to further remedy the external trade balance. And finally, inflationary pressure is forecasted to shift the authorities' stance towards allowing a stronger currency, the year-end exchange rate of which is forecast at 7.8/USD.

Key forecasting themes

This research publication provides the following arguments, supporting our three-year, quarterly forecast for 2010-12:

Fixed investments and net exports as key drivers of economic growth in 2010

- This year, the domestic economy will be supported on the demand side by two main components—fixed investments and net exports. Household consumption is likely to be strained by quite weak real disposable income growth (that was negative in 2009) and indebtedness on the part of some consumers who participated in a borrowing spree for property (real estate, land, or personal-use cars). Full-year real GDP growth is forecasted at 2.5% for 2010, and our quarterly forecast on growth is laid out in the table below. More on this appears in the chapter, "*Measuring economic growth in 2010*" on page 23.

Table 1. Key macroeconomic figures of ICU three-year quarterly-detailed forecast for 2010-12
For a more detailed forecast refer to Table 12 on page 46and Table 13 on page 47

	1Q10E	2Q10F	3Q10F	4Q10F	2010F	1Q11F	2Q11F	3Q11F	4Q11F	2011F	1Q12F	2Q12F	3Q12F	4Q12F	2012F
Real GDP (%YoY)	2.0	3.5	2.5	2.0	2.5	3.5	3.5	3.0	3.0	3.2	3.5	3.5	3.5	3.5	3.5
Unemployment rate (%)	8.9	8.7	8.2	8.0	8.0	7.8	7.8	7.6	7.6	7.6	7.4	7.1	7.1	7.1	7.1
CPI headline (%YoY, eop)	11.7	11.7	11.4	12.7	12.7	9.9	9.4	10.1	9.0	9.0	8.3	7.2	6.0	6.6	6.6
Current account balance (% of GDP)	2.7	4.1	0.5	0.1	1.6	1.4	3.5	1.7	1.2	1.9	1.4	2.6	0.4	0.0	1.0
Net FDI (% of GDP)	3.8	3.9	3.1	2.9	3.4	3.5	3.3	2.7	2.6	3.0	3.2	2.9	2.4	2.3	2.6
FX reserves (% of ann'd GDP, eop)	22.4	21.2	19.9	18.6	18.6	17.3	16.3	15.7	14.8	14.8	13.7	13.3	12.4	11.7	11.7
UAH/US$ (eop)	8.0	8.1	8.0	7.8	7.8	7.7	7.5	7.5	7.5	7.5	7.3	7.1	7.0	7.0	7.0
UAH/€ (eop)	10.8	10.9	11.1	11.1	11.1	10.8	10.4	10.4	10.3	10.3	9.9	9.9	9.8	9.8	9.8

Notes: eop – end of period; ann'd – annualized.
Source: Investment Capital Ukraine LLC

Public finance, a prime concern, is likely to be fixed by the technocrat government

- Public finances are still a key area of concern, as 2009 ended with a consolidated budget deficit of 7.4% of GDP, according to our assessment. While we forecast that nominal GDP will show growth of 21.4% this year, somewhat larger budget revenues would translate into a narrower deficit already this year (our forecast is for 4.2% of GDP). While the fiscal stimulus of 2009 was designed to avoid cuts in public sector wages and pensions, and to allow Naftogaz to carry on without a surely unpopular increase of the state-regulated tariff on natural gas, these measures continue to be a priority of the country's prudent fiscal policy of 2010. Hence, the government is likely not to have any room left to extend the fiscal stimulus. For more on this, please read the chapter called "*Fiscal balance: deficit cuts to follow,*" starting on page 27.

The banking sector is too weak to support the economy

- The domestic banking sector is still weak and unable to support the economy with commercial credit until likely the 4Q10, i.e., banks as a whole are not likely to return to sustainable growth of lending activity until late this year, in our view. That is why support for the economy provided by both fiscal and monetary authorities is likely to be weak.

Lower political risks, hence better governance

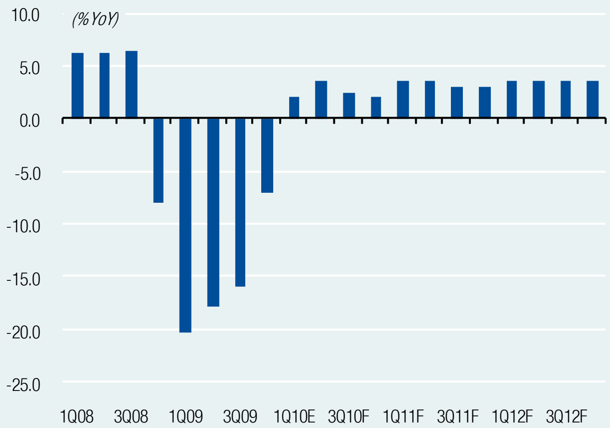
- As the peak of the previous political cycle has passed, i.e., the presidential elections of January 2010 concluded in a largely smooth handover of presidential power to the former opposition leader, reasonable chances exist for the creation of a technocratically focused government that will be able to take care of the economy (more detail on this appears in the chapter "*Ukraine's politics*" on the page 15). This provides assurance that such a technocrat government will take all the needed steps (including a realistic 2010 budget law and unlocking IMF assistance) to borrow from the international capital markets.

Global economy fragility may impact the steel market, and hence Ukraine's economy

- There are some key risks the economy is going to face this year, among them the chance of a marginal slowdown in the global economic recovery, particularly in China. China's authorities' efforts to cool down the current rapid acceleration in the domestic economy in an orderly fashion may fail, and in turn become disruptive to the global steel market with regard to decreasing demand, and hence prices for, iron ore, metallurgic coal, and eventually, steel (see "*Global economy*" on page 10). If this materialises, then the domestic economy would end up in a second wave of economic crisis, as a new recession caused by damage to Ukraine's leading commodity export would likely be as painful as the recent one, i.e., export volume would decrease, leading to a nominal devaluation of the local currency towards the 10-12/USD range. However this risk has just a 25% probability of materialising, in our view.

Chart 1. ICU forecast of quarterly real GDP growth

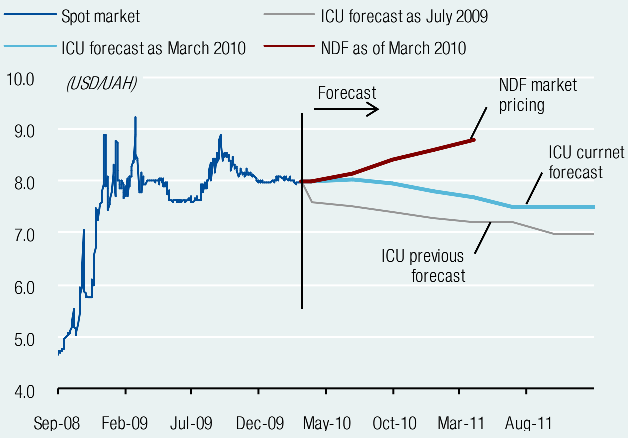
Chang over previous year



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

Chart 2. ICU exchange rate forecast

ICU forecast versus the rates derived from NDF market



Sources: Reuters, Investment Capital Ukraine LLC

A key policymaking choice between inflation and exchange rate may pose risk

- Another reason for concern over the economy is Ukraine's authorities' chronic lack of will to make a proper policymaking choices. A new wave of inflation acceleration has a reasonable chance of materialising (60% probability). In first two months of 2010, monthly headline CPI was accelerating, partially due to the undervalued currency, in our view. The authorities' dilemma will be to make a choice between defending a stable exchange rate of the local currency in nominal terms (allegedly to sweeten voters' sentiment), or defending price stability. While the local currency stays undervalued, according to our assessments, it creates an inflationary potential in the economy, in our view. Arrival of new leaders in power—namely, Ms Irina Akimova, former head of a Kiev-based economic think-tank, to the post of Deputy Head of the presidential administration—provides some confidence that a shift towards price stability, as a goal of monetary and fiscal policies, will be preserved.

The natural gas price is another risk factor

- Natural gas price payments are once again a special area of concern and risk to the economy. Our assessment of the crude oil price and prices of petroleum products, which take part in the price formula on natural gas in the Naftogaz-Gazprom agreement, leads us to the conclusion that a further increase in price will take place in 2010 (due to an upward trend in commodities markets that has taken hold since early 2009), if the price formula is not renegotiated. Indeed, the average price for 2010 may rise by 58.8%, to US$330.55 from US$208.14, the factual average price paid in 2009. See “*External balance: focus on minerals trade*” on page 34.

Despite the myriad of risks, the currency forecast is for the hryvnia to trend into stronger territory

- Regarding the local currency, the hryvnia, we view it as undervalued as of now: its real TWI is at 49 points, according to our calculations, well below its long-term average of 72 points. Such an undervalued currency is one of the key contributors to the inflationary pressures that unfold in 1H10. Authorities are likely to balance greater flexibility of the exchange rate (to allow appreciation, albeit marginal) with occasional support of the nominal exchange rate stability, both verbally (by government officials) and via market intervention (by the central bank) to preserve external competitiveness for the sake of the country’s export-oriented industrial sectors. That is why we forecast the hryvnia’s exchange rate versus the US dollar at 7.8/USD as of year-end 2010.

Investment implications

Ukraine’s risk premium derived from the debt market is still relatively high,…

In our view, the recent rally of Ukraine’s sovereign debt price in the Eurobond market is much less an overreaction to the smooth outcome of the presidential elections and likely instalment of a technocrat government into the office, but rather a movement towards a new norm for Ukraine’s sovereign risk premium—the spread of Ukraine’s sovereign Eurobond over the respective US Treasury bond—which will probably stay above its pre-crisis level, which was hovering around the 30ppt level. Currently at 564bp, it is still well above the pre-crisis level (see Chart 3 below).

Risk of sovereign default measured by credit default swaps in Ukraine is broader compared with other major sovereigns of the CIS regions such as Russia and Kazakhstan (see Chart 6 below); Ukraine’s CDS spread is in the 790s, while Russia’s is at 141bp, and Kazakhstan’s at 171bp as of 9 March 2010.

Hence, the difference in the sovereign default risk measures (by 5-year CDS) between Ukraine and these two sovereigns is above 5ppt, or nearly double the prevailing level of 1.5-3.0ppt in the pre-crisis period (see Chart 6 below).

...despite the recent rally in Ukraine’s sovereign debt price;…

Apparently, such a gap seems rational, given the different fiscal positions of these sovereigns. However, another measure implies a further, albeit small, contraction of Ukraine’s risk premium. This other measure is the difference between the risk premiums of Ukraine’s bond yield due in 2017 and a Greek 2017 bond yield over benchmarks (see Chart 4 on page 7). This difference now stands at 244bp, or 6bp higher than the pre-crisis historical low of 238bp seen in April 2008. Times have changed since then—both Greece and Ukraine are vying for financing from foreign capital markets, with the markets now seeing borrowing costs heightened—but there are some major differences between these two economies.

Chart 3. Ukraine versus Greece: sovereign credit risk compared (in percentage points)

Spread of Ukraine sovereign USD Eurobond due in 2017 over US Treasuries and spread of Greece sovereign EUR Eurobond due in 2017 over German government bonds

Source: Reuters

Chart 4. Market perception of sovereign risk of Ukraine over Greece (in percentage points)

Difference between the two countries' spreads of their Eurobonds due in 2017 over the benchmarks

Sources: Reuters, Investment Capital Ukraine LLC

…we see further scope in Ukraine's sovereign risk premium reduction

Firstly, Greece, as a euro-zone member, does not have the possibility of devaluing its currency and hence gaining external competitiveness, while Ukraine, having its own, and quite weak, currency is likely paving its way to recovery via export- and investment-led growth. Secondly, real and nominal GDP growth rates are different in both countries—Greece's GDP is expected by the IMF to contract by 0.1% in real terms and to stay intact, at best, in nominal terms, while we forecast Ukraine's economy to rise 2.5% in real terms and more than 20% in nominal terms due to inflation—this is likely to play in favour of Ukraine's debt sustainability measures improving, albeit slightly. Thirdly, the indebtedness ratios of these two countries are strikingly different, again, in favour of Ukraine (see the section "Comparing Ukraine's debt sustainability with other countries" on page 32).

These are the factors that, in our view, are likely to translate into an even tighter spread between Ukraine and Greece risk premiums over the benchmarks, implying a further contraction of Ukraine's benchmark spreads, by a range of some 100-200bp.

Chart 5. Risk of sovereign default: Ukraine versus other CIS major sovereigns of Russia and Kazakhstan

Measured by five-year credit default swaps, in percentage points

Source: Bloomberg

Chart 6. Difference of measures of risk of sovereign default

Measured by five-year credit default swaps, in percentage points

Source: Bloomberg, Investment Capital Ukraine LLC

The non-government debt universe looks adequately priced by the market,…

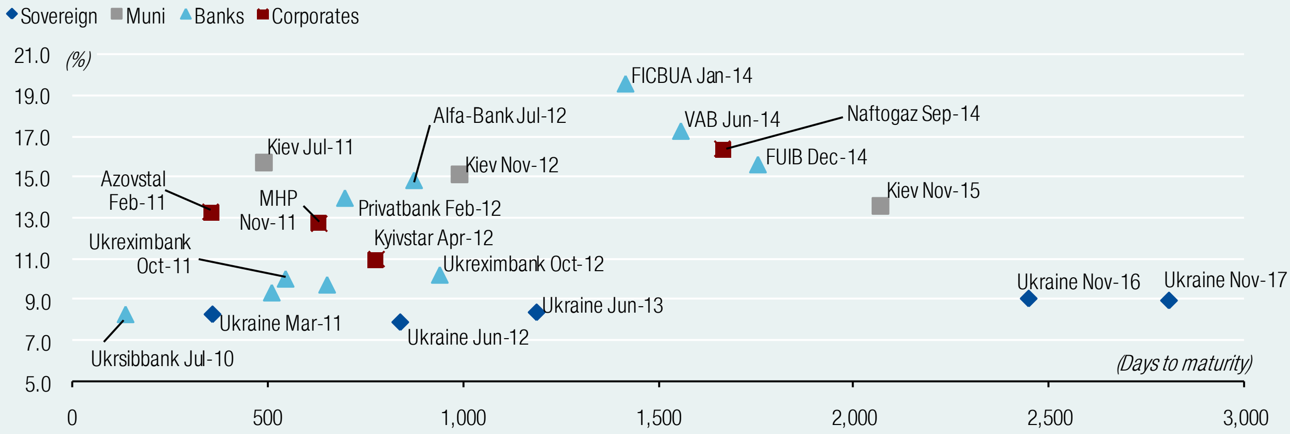
Across the universe of US-dollar tradable debt issued by Ukrainian borrowers (see Chart 7), we do not see the possibility of marginal spread tightening in the corporate names over the sovereign yield curve in the short term (over the next six months). However, some shifts in the spreads is possible, in our view, in such names as VAB Bank, given two factors that could materialise during this period of time—firstly, the note holders agree on the restructuring terms on extending the maturity to 2014; and secondly, controlling shareholder Kardan N.V. increases its stake to 98%—bringing its note to trade at par with FUIB's note due in 2014. This is because these two banks have quite similar operations in terms of asset breakdown, limited exposure to related parties, and shareholders' commitments to recapitalise.

…but corporate issues like VAB, and later on, FICBUA, may tighten

In our view, the prospects for spread tightening over the sovereign yield curve are more remote for FICBUA's note because the bank is believed to have larger exposure to related ownership parties than at VAB and FUIB, and lags behind these two in terms of loan-loss provisioning. But, the fortunes of FICBUA's main shareholder Konstantin Zhevago, a Ukrainian businessman whose main industrial asset is one of Ukraine's largest iron ore mining enterprises, are likely to improve along with the global economy recovery. This is likely to provide support to prices on the debt of Zhevago's bank, resulting in its yield tightening closer to that of VAB and FUIB.

Chart 7. Term structure of yields of US-dollar tradable securities at the Eurobond market, which are issued by Ukraine's borrowers

Prices are as of 9 March 2010



Sources: Reuters, Investment Capital Ukraine LLC.

Among the local currency debt, mid-term 20% coupon bonds due in 2011 appear to be the right investment

Among the local currency assets, there is decent value, in our view, in the tradable government debt, especially in the securities with the highest coupon rate available (at 20% paid quarterly) and which fall due in 2011-13 (see Table 2 below). The primary bond market saw a 20% coupon bond due in November 2011 sold at a 23.2% YTM, a 2.3ppt yield tightening over the span of two weeks (23 February-9 March 2010). Given our expectation of the local currency's slow appreciation on the back of current undervaluation and a possible shift by the authorities toward greater FX flexibility to contain inflationary pressures over the course of 2010, local currency government debt may bring decent returns to investors.

Table 2. Local currency bonds that are placed by MoF at primary market and pay 20% coupon rate

ISIN	Outstanding volume (UAHm)	Maturity
UA4000054456	429.30	27-Apr-11
UA4000062012	1,390.80	23-Nov-11
UA4000063564	2,202.17	12-Sep-12
UA4000060883	730.50	26-Sep-12
UA4000061451	1,415.07	31-Oct-12
UA4000064018	351.00	20-Feb-13
Total	**6,518.84**	
Total (US$m)	**817.92**	

Notes: these are bullet bonds paying coupons on semi-annual basis.
Sources: Ministry of Finance, Investment Capital Ukraine LLC

Global economy

"The surplus countries […] show little or no interest in making the needed policy changes."

Martin Wolf, chief economics commentator at the FT, December 2009

In our view, the global economy's recent emergence from the 'Great Recession' is still rather fragile and continues to pose risks to Ukraine's economy. While currently, the pace of global economic growth has stabilised in many countries, it has taken place partially thanks to China's further drive for industrialisation and infrastructure investments. This has in turn supported global commodities markets, particularly steelmaking, which has been showing some signs of a binge market, as raw materials costs are rising more rapidly than during the pre-crisis period, i.e., in 2008. For the meantime, the key risk to Ukraine's economy stemming from abroad will be the Chinese putting the breaks on its country's investments spree, which may slow demand, and hence lower the price for steel.

Recovery without sufficient rebalancing

Global recovery has begun taking place on thin ice, in our view,…

The global economy has been recovering from the great recession of 2008-09, but at a slow pace, as economic growth across the globe has been supported by various governments' stimuli packages aimed at keeping the *status quo* in the economic policymaking of major sovereigns.

In particular, countries that enjoyed surpluses in their external trade in the pre-crisis period have preserved their stance on supporting export-led growth of their economies (the BRICs are a major example, followed by oil-exporting countries, and Germany and Japan out of the developed economies).

…as a rebalancing of the major economies has not yet happened

At the same time, those countries that used to run their economies with external deficits financed by private-sector borrowings are pulling their economies out of deep recessions, with government borrowings that have substituted for private-sector borrowings, i.e., in sum, their external deficits have remained in place, albeit of a narrower size than in the pre-crisis periods (the US and UK are major examples of this, and peripheral counties of the EU add to the spectrum).

China's economic performance in 2009 is remarkable in this regard;…

In this regard, China's economy is of significant importance to the global economic recovery, and to the Ukraine's economic prospects in particular. Firstly, why is China important to Ukraine? The answer is: the global steel market. The fact of the matter is that the Chinese government has provided a great deal in terms of stimulus to its economy, helping prevent it from a sharp slowdown. It has not only supported its ailing export-oriented manufactured goods from a slump in global demand by keeping the exchange rate of China's local currency, the renminbi (RMB), stable in nominal terms, but it has pushed local banks since early 2009 to extended lending to the economy, especially to its industrial sector.

…its banks poured new loans worth 32% of GDP into the economy in 2009,…

Thus, during the entire year 2009, new loans extended to the Chinese economy amassed to RMB10.6trn, or 31.5% of China's FY09 nominal GDP, which was reported at RMB33trn, about USD4.9trn. Over the course of 2009, Chinese banks' loan portfolios grew by 33%, from RMB32.0trn as of year-end of 2008 to RMB42.6trn as of 31 December, 2009. As the followings charts show, such a grand lending extension in the aftermath of global recession (of late 2008 and early 2009) and the subsequent demand for Chinese exports (which followed immediately after) provided impetus to wide sectors of the economy.

In particular, investments in fixed assets grew by 30.1% YoY, amounting to RMB22.5trn in FY09, or a 67% share of nominal GDP. Out of the country's total investments, for instance, fixed investments in railway transportation grew by 67.5% YoY, and investments into the sector of ore mining, and processing of non-metallic minerals and its products, rose by 43.8% YoY.

…spurring industrial growth

Subsequently, such a pace of further industrialisation in China included its steelmaking sector, whose output of crude steel increased by 13.5% YoY, to 567.8 million tonnes. The correlation between industrial production growth and crude steel output growth (both are depicted on separate charts below) is obviously positive. The very fact that China's industrial growth took off sharply in mid-2009 has helped global steel prices to recover and spur output in the steelmaking sector in the rest of the world, as global monthly crude steel output rose by 30.2% YoY in December 2009 versus 26.6% YoY in China. Currently, China's crude steel output in monthly terms reached 44.8% as of December 2009, up from a pre-crisis level of 37.7% in March 2008.

At the same time, household consumption has remained tame

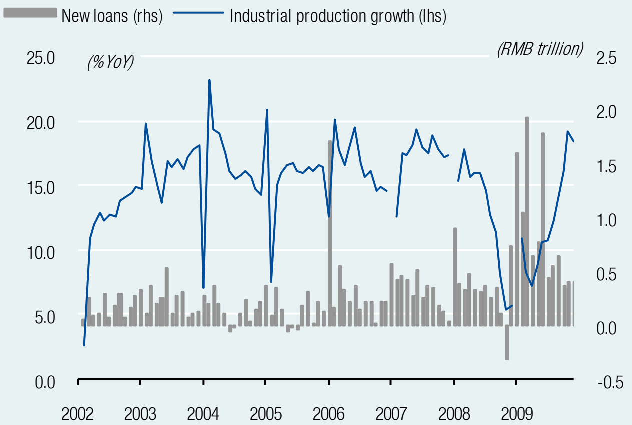
While China's economy has shown spectacular industrial-led growth (with spectacular GDP growth of 8.7% in 2009), its consumers have continued to stay on the outskirts of economic growth and the wealth accumulation it provides: total retail sales of consumer goods rose by only 15.5% YoY in FY09, amounting to RMB12.5trn, or 37.4% of nominal GDP.

To underline China's reliance on fixed investments, this country's breakdown of nominal GDP by an expenditure approach shows that gross capital formation currently amounts to 42.3%, according to the most recent data for FY07 on this statistical series, while final consumption expenditures, which include consumption by households and government, amounts to 48.8% (by some independent estimates such as Nikolas R. Lardy in "China: Rebalancing Economic Growth," published in May 2007, the share of household consumption in China's GDP dipped below 40% in the second half of the 2000s).

As early as in 2000, such a proportion was in favour of increased consumption, as a 62.3% share of GDP represented final consumption expenditures and a 35.3% share for gross capital formation (of investments into fixed assets). Hence, China's GDP in 2009 has been derived largely from investments into fixed assets, leaving household consumption a negligible share, which is less in relative terms than in the other BRIC countries (for instance, Russia's household consumption share in FY09 GDP was 53.8%).

Chart 8. China's recovery since early 2009 has been taking place thanks industrial growth aided by massive credit extension

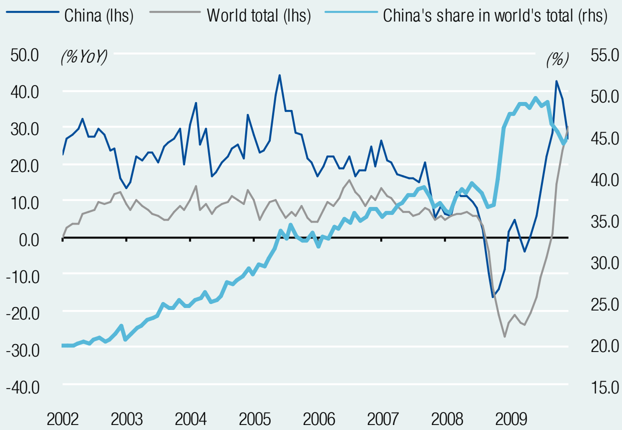
Monthly industrial production growth over a previous year versus monthly volume of new loans extended by the banking sector (in RMB trillion), 2002-09



Source: Reuters

Chart 9. Crude steel production: China versus entire world, 2002-09 history

Percentage change of monthly volume of production over a previous year (left axis); China's share of crude steel production in the global total (right axis)



Source: World Steel Association

Hence, the above-mentioned depiction of how Chinese economic growth is biased toward investments into fixed assets points to the fact that global recovery is taking place amid a still-unbalanced global economy. China leads the global economy's growth statistics, and will serve to pull the regional Asian economy out of recession, but such unbalanced growth in China, led by a spark of industrial growth aided by government stimulus, provides risks, especially for those economies—Ukraine's in particular—that rely on the recovery in markets of certain commodities.

Ukraine's fortunes from global affairs

Ukraine's economic risks lie largely in the hands of Russia and China

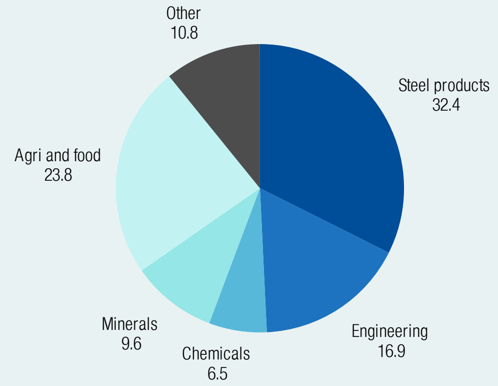
For Ukraine's economy, a significant importance in the framework of global economic conditions lies in the group of countries that are at the core of the global rebalancing theme–namely, from such BRIC countries as Russia and China (see Chart 11).

Russia's economy, which takes a 21.2% share of Ukraine's total merchandise exports in a variety of goods, relies on commodities markets, particularly the crude oil market, for its wherewithal. Hence, the Russian economy's demand for Ukraine's exports may be at risk once the crude oil price settles down or even goes below the US$40/bbl level, a kind of threshold above which the Russian fiscal balance and trade balance need to stay in order to remain in surplus. For the time being, such a scenario looks quite distant, and hence the inherent risk is reasonably insignificant.

Economic performance in China, which accounts for a 3.5% share of Ukraine's merchandise exports, is not only important due to the fact that the country takes a sizable share of Ukrainian produce of tradable goods, but also due to the fact that the global steel market tends to illustrate the rise of industrial production, i.e., the pace of industrialisation, in this country. Ukraine's risks with regard to China lie in the following: if China's industrialisation slows (for instance, due to the government's withdrawal of stimulus on the back of inflation fears or other factors that may push steel demand down), then along with steel-market declines, Ukraine's economy could suffer a loss in its exports revenues, as more than a 32% share of its merchandise exports are in steel products.

Chart 10. Ukraine's key merchandise exports: breakdown by type of goods (%)

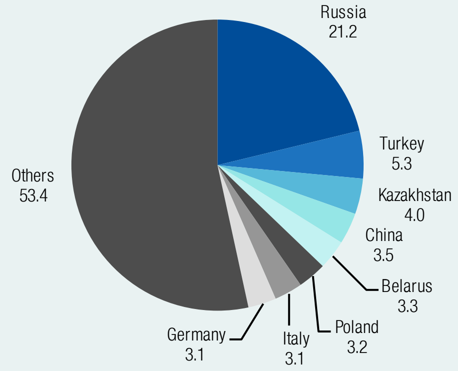
100% = US$39.6bn, for the 12-m0nth period to November 2009



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine

Chart 11. Ukraine's key trade-partners in merchandise exports: breakdown by country (%)

100% = US$39.6bn, for the 12-m0nth period to November 2009



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine

Our base-case scenario assumes a smooth recovery of the global economy

Our base-case scenario for upcoming global economic performance is that authorities in major economies are likely to manage their stimulus packages in such way that avoids a second phase of recession, i.e., preventing a W-shaped performance. On the extreme side, however, an overheating of China's economy resulting in an abrupt cut in lending (due to accelerating inflation and rising NPLs in commercial banks portfolios, for instance) may bring about an impasse to the global recovery, sending Ukraine in particular into another phase of deep recession due to the affected steel market.

Commodities vital to the livelihood of Ukraine's economy

A mix of factors, like government stimuli packages adopted by the majority of global economies in response to the economic recession, and a resulting weak US dollar, has aided the recovery of prices for a number of commodities, particularly for crude oil and steel, both of which are vital for Ukraine's economy.

Crude oil market

The fragile recovery of the global economy has put limits on a further increase in the crude oil price

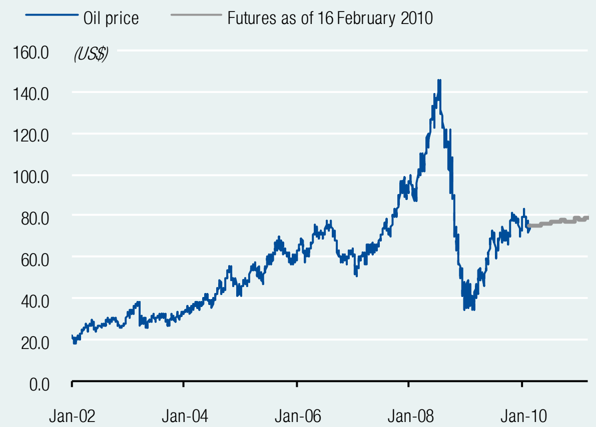
The US crude oil price was at US$77.86 a barrel as of 19 February, 2010. As the global economy has been relying on a mix of monetary and fiscal stimuli across key developed and emerging economies, strains have developed on the future recovery of the global economy and, hence, on global demand for crude oil.

These strains stem from the notion that government stimulus packages are likely to be withdrawn sooner or later—however, policymakers tend to want to preserve the stimuli, fearing a second wave of global recession—having a negative impact on overall demand for crude oil, as the private sector, especially in the key developed economies, is still weak.

That is why, in our view, the crude oil price is likely to stay at a level close to US$80/bbl. The base-case scenario for our 3-year forecast on Ukraine's economy incorporates the price on crude oil derived from the futures market (see Table 3 on page 14).

Chart 12. Crude oil price and futures

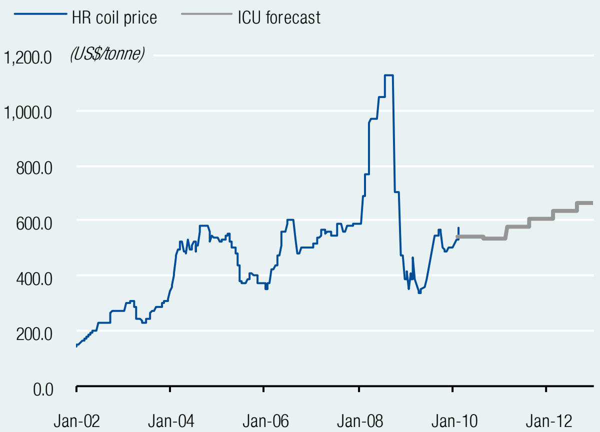
US$ per barrel



Source: Bloomberg, Investment Capital Ukraine

Chart 13. Steel price and forecast

US$ per tonne



Source: Bloomberg, Investment Capital Ukraine

Steel market

The steel sector has been recovering slowly,…

As we pointed out above, the industrialisation and infrastructure binge that has been taking place in China since 2009, directed by the government, has aided in the partial return of global steel demand to some normality, as the steel sector has left behind the 2008 drop in output, one of the deepest contractions in its history.

…but raw material supplies have become tighter,…

As media reports point out, miners of iron ore and metallurgical coal are showing strong commitment to pushing the steelmakers to accept higher prices for their product for the 2010-11 season. For instance, iron ore mining global majors are seeking to install a price of US$90 a tonne for this season, a 50% increase over the previous season of 2009-10, and a level that was last seen in the pre-crisis season of 2008-09. The rationale of the proposed price increase lies in the spot market, where the price for iron ore rose to US$120, double the long-term contract price of US$60 in fact, due to tight supply.

…leading to likely additional costs to steelmakers in the 2010-11 season

All this suggests that there are market conditions at the moment that will force the steelmakers to pass through higher raw materials costs to their customers. Hence, a further pick-up in steel prices is likely, in our view, but due to the fact that capacity utilisation in the steel sector is about 70%—if one considers the world's largest steelmaker, Arcelor Mittal, as a bellwether of the entire sector—which is not an indication of tight conditions in steel supply. Hence, the global steel price is likely to be strained by this fact as well. Our base-case scenario incorporates a 3-year forecast of steel price, as shown in the table below.

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

	4Q09E	1Q10F	2Q10F	3Q10F	4Q10F	1Q11F	2Q11F	3Q11F	4Q11F	1Q12F	2Q12F	3Q12F	4Q12F
World real GDP (%YoY)	-0.4	4.5	3.8	3.8	3.5	3.0	4.8	4.8	4.8	3.3	3.3	3.3	3.3
Russia real GDP (%YoY)	-1.5	4.3	3.6	3.3	3.3	3.0	3.5	3.8	3.3	3.0	3.0	2.5	3.3
Crude oil price (US$/bbl, average)	76.13	78.20	74.36	78.00	79.39	78.96	80.00	80.00	80.00	85.00	85.00	85.00	85.00
Steel price (US$/tonne , average)	506.67	532.14	538.47	533.47	533.47	573.47	573.47	603.47	603.47	633.47	633.47	663.47	663.47

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

Ukraine's politics

"Ukraine is a real democracy."

William Taylor, former US ambassador to Ukraine, May 2009

Our base-case scenario for future developments in Ukraine's political scene during 1H10 assumes that newly elected president Viktor Yanukovych, via his Party of Regions' large faction in the Parliament (with more than a 38% share of the total seats) will renegotiate its coalition with minority factions, avoiding snap re-elections in the legislature. We also provide arguments that the next parliamentary elections will bring more stability to the country's politics.

Start of Yanukovych's presidency, at a glance

Yanukovych has a good chance of renegotiating his coalition with minority factions and setting the stage for a co-operative government

Despite the fact that Yanukovych won the presidential race of 17 January-7 February 2010 with a slim majority (of a some 3.5ppts lead over incumbent Prime Minister Yulia Tymoshenko), he has a fairly good chance not only to stage his inauguration for the post this March, but to renegotiate his coalition in the parliament with other factions and install a loyal technocrat in the post of prime minister at the same time.

In our *Economic Insight* reports entitled, "Ukraine under a Yanukovych presidency," published on 9 February, 2010, we provided arguments that snap parliamentary elections became less likely as post-election momentum yielded the winner, and its political force, the Party of Regions, with a chance to consolidate with minority factions in the parliament to form a new and stronger coalition.

His former ties with Tymoshenko were cut

Early in 2009, Yanukovych and Tymoshenko did willingly stage a series of secret talks to negotiate the establishment of a new, larger coalition that would secure their presence in power for a lengthy period, providing that the former takes the presidency and the latter stays in charge of the Cabinet of Ministers. However, these negotiations collapsed on a lack of trust between the sides, and eventually, Yanukovych withdrew from the talks first. And now, shortly after the 2010 presidential elections campaign, which saw myriads of accusations pouring in on vote-rigging and duplicity in the voting supervision, there is a very small chance that these sides may return to the negotiation table in a time span of, say, at least the next six months, or even a year. Hence, Yanukovych will strive to install a friendly and cooperative government in sync with his official entry into the presidential post.

Our view regarding Yanukovych's future steps—particularly on his rejection of early elections as a quite lengthy and equally unreliable way of shaping a new coalition in the parliament—is based on the following:

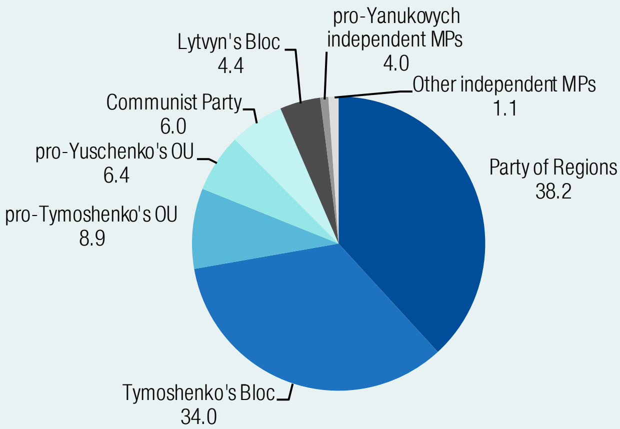
Pros and cons of snap parliamentary elections in 1H10

- President Yanukovych has two options in dealing with shaping his new coalition: firstly, to renegotiate the status of his current coalition with minority factions in the parliament, leaving Tymoshenko's Bloc on the sidelines; and secondly, to engineer snap elections into the parliament, in hopes that the party and other friendly blocs will get into the new parliament and then form the coalition. Naturally, the second option would be lengthier, and is not likely to improve the standing of the Party of Regions in the legislative body in a decisive manner.
- To better illustrate the notion that second option is not viable at this particular moment, we constructed a would-be shape of the new parliament if snap elections are held in 1H10, and if results of these elections are exactly the same as in the first round

of presidential elections on 17 January, 2010 (see Chart 14 and Table 4 on page 17). Ultimately, it appears that the Party of Regions would add just five seats to its faction (from 172 MPs now to 178 MPs after snap parliamentary elections), which is not an impressive result, and moreover does not move the party closer to having a sole majority.

Chart 14. Breakdown of parliament's seats by factions and groups, which may determine the shape of the future coalition (%)

100% = 450 seats



Source: Ukraine's parliament, Investment Capital Ukraine LLC

- True, Tymoshenko's Bloc is likely to see the heaviest casualties of these elections, as it is going to lose about 67 of its loyal MPs—from 193 MPs currently, including a quite loyal number of 40 MPs from the Our Ukraine faction, to 126 MPs after the snap elections. But, such a reduction may not outweigh another consideration against snap elections, the point being that if Tymoshenko steps down from premiership, she would be left with just the post of leader of her political bloc, without having access to the parliament tribune (as she is not an MP currently). For Tymoshenko, this means a sizable setback, as she will be incapable of capturing the possibility to lead and inspire her faction for aggressive opposition activities against ruling factions.

Snap elections will increase the number of factions,…

- As a result of snap parliamentary elections, the number of factions which play their own game will increase, and this would create an unneeded burden for the Party of Regions to have to negotiate with a larger number of leaders than in the current parliament. Thus, such young leaders who do not have factions in the current parliament and who succeeded in the first round of elections by arriving in third and fourth place after the front-runners—namely Tigipko and Yatseniuk—are likely to get the factions with 66 and 35 MPs, respectively. Their recent success and youth (albeit in relative terms) will drive their appetites, forcing the Party of Regions to make larger concessions.

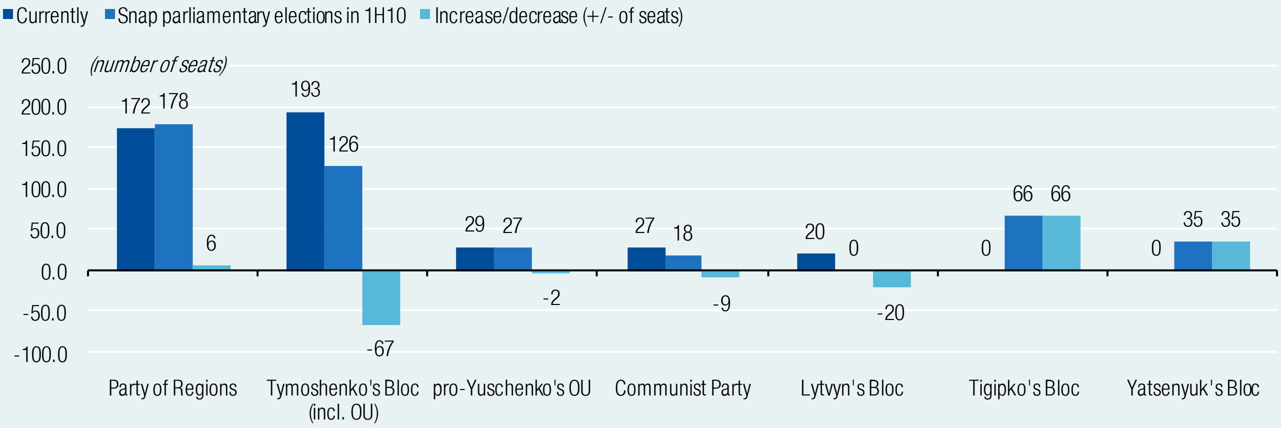
…while the current smaller factions will shrink in size or disappear

- The Party of Regions is likely to make progress in renegotiating its coalition with such minority factions as the Communist Party and Lytvyn's Bloc, because they stand to lose sizably if snap elections take place, hence their participation during the talks will be important. Thus, Lytvyn's Bloc will disappear altogether in the legislature, and Communist faction will shrink in size by one-third, or by 9 MPs, to 18 MPs.
- The pro-Yuschenko part of the Our Ukraine faction will only lose 2 MPs, to 27 MPs after snap parliamentary elections, and hence may not be hugely fearful of re-elections. Nevertheless, Yanukovych has room to manoeuvre and align with this faction. He may try to soften his differences on certain policymaking issues (e.g., official language, relations with Russia).

In the end, the probability of a coalition renegotiation by the Party of Regions through end-1Q10 is 60%. Other scenarios, like a failure of coalition renegotiation by the Party of Regions, followed by early parliamentary elections, has a 20% probability, and a lengthy deadlock between President Yanukovych and Prime Minister Tymoshenko has the same 20% probability, in our view.

Chart 15. Modelling the new shape of the parliament

If snap parliamentary elections mirror the results of first round of presidential elections



Notes: 1) Data for snap parliamentary elections in 1H10 is obtained from the results obtained by the leaders of these political parties in the first round of presidential elections on 17 January 2010; 2) Tymoshenko's Bloc includes the MPs from pro-Tymoshenko's wing of the fractious Our Ukraine faction.
Source: Investment Capital Ukraine LLC

Table 4. Modelling the shape of the parliament, if snap parliamentary elections mirror the results of first round of presidential elections

Political parties and blocs	Currently (number of MPs)	Snap parliamentary election in 1H10[1] (number of MPs)	Increase/decrease (+/- of seats)
Party of Regions	172	178	6
Tymoshenko's Bloc (incl. Pro-Tymoshenko's OU[2])	193	126	-67
pro-Yuschenko's OU	29	27	-2
Communist Party	27	18	-9
Lytvyn's Bloc	20	0	-20
Tigipko's Bloc	0	66	66
Yatseniuk's Bloc	0	35	35
Independent MPs	9	0	-9
Total	**450**	**450**	**0**

Notes: 1) number of seats derived from the results obtained by the leaders of these political parties in the first round of presidential elections on 17 January 2010; 2) Tymoshenko's Bloc includes the MPs from pro-Tymoshenko's wing of the fractious Our Ukraine faction.
Sources: Investment Capital Ukraine LLC

Depending on how the coalition's renegotiating talks proceed, and what kind of concessions the Party of Regions will be forced to make, there are several candidates for the post of prime minister in the next government. Our guessing game produced the following names, listed in descending order by probability of their nomination as candidate for the post:

Azarov, as a close ally to Yanukovych, has a good chance of being appointed as the next PM

- **Mykola Azarov (30% probability).** This 63-year-old technocrat is considered as one of the founding fathers of the Party of Regions. Thanks to his long experience in public service—as head of the state tax administration under Leonid Kuchma's presidency in the 1990s and then minister of finance and first deputy prime minister under Yanukovych's two premierships in 2002-05 and 2006-07—he is considered as a first choice for Yanukovych. We also noticed that Azarov has been not only a close ally to Yanukovych since his early days in the government, but has been also like a mentor to Yanukovych on economic policymaking (albeit, Azarov-type policymaking). Thus, some foreign banks have named Azarov as chief economic advisor to Yanukovych. This fact is very revealing, suggesting that the bond between Yanukovych and Azarov is quite strong. The Party of Regions itself has become quite a complex, but strongly united structure, with certain camps inside it. Azarov as party's founder represents a so-called orthodox wing, which is viewed as circle of persons who had been in top management positions at industrial enterprises in eastern Ukraine, and then became owners of these enterprises, thanks to the wave of privatization in the 1990s (they are also referred as 'red directors'). The other wing, or the so-called liberal wing, is viewed as a circle of younger-generation persons, who owns businesses that are more diversified than those of red directors.' The boldest of these is Rinat Akhmetov, dubbed by the media as the wealthiest Ukrainian businessman, who funds a Kiev-based think tank on economic issues, and who pushed Iryna Akimova, former head of this think tank, into the ranks of the Party of Regions in the parliament, and then into the post of minister of economy in the Yanukovych's opposition's shadow Cabinet of Ministers. But in the end, it appears that Yanukovych will keep Akimova's economic advising power at bay and take advice from Azarov instead. Hence, Azarov's premiership is more likely than the others' candidacies, and in any scenario, Azarov is likely to be in the government, at the post of the finance ministry, at least.

Sergiy Tigipko's candidacy could stir up controversy inside the Party of Regions

- **Sergiy Tigipko (20% probability).** Thanks to his strong showing in the first round of presidential elections, where he gained a 13.5% share of votes, arriving in third place after Yanukovych and Tymoshenko, 50-year-old Tigipko has strengthened his political clout, forcing other politicians to consider him seriously. By asking Tigipko to run the Cabinet of Ministers, Yanukovych may try to appeal to and address the voters who sought leadership roles other than Yanukovych and Tymoshenko. But in all practicality, the Cabinet of Ministers will be packed with a number of Party of Regions representatives in key posts, limiting Tigipko's freedom in realising his policies. Moreover, Tigipko previously had poor relations with the Party of Regions, when he left the post of head of the Yanukovych presidential campaign in late 2004 right after a court ruling setting a re-run of the second round of the presidential elections due to massive vote violations, a soundly defeating moment for Yanukovych and his party. That moment likely left a mark in the memory of key figures of Party of Regions, and likely Yanukovych's as well, which is why Tigipko is not a totally ideal partner for Yanukovych this time.

Yatseniuk's candidacy could be a bow to liberals

- **Arseniy Yatseniuk (20% probability).** As a 36-year-old politician, who swiftly climbed the ladder in politics from a minister of economy of Crimea in the early 2000s to a presidential candidate, with 7% support, in January 2010, Yatseniuk strives to engineer a bolder political carrier going forward. Together with Tigipko, the pair proved that a critical mass of voters is forming to demand true change among the political heavyweights. Yatseniuk's candidacy for the premiership may appear to be a compromise between the Party of Regions (especially its liberal wing) and the pro-Yuschenko Our Ukraine faction in forming a new coalition in the parliament without staging a snap re-election of lawmakers. In our view, this candidacy could be the most capital markets-friendly of all mentioned in this analysis.

Borys Kolesnikov has a limited chance of obtaining the post, in our view

- **Borys Kolesnikov (15% probability).** Having run Yanukoych's parliamentary elections campaign during snap elections in 2007, this 48-year-old MP from the Party of Regions is a close ally to Rinat Akhmetov and has been active in terms of forming the party's modern look. Over the last few weeks, he has been one of the most active public speakers from the Party of Regions (alongside Azarov) on the issue of pushing Tymoshenko and her faction to accept the 2010 presidential elections results and step down from premiership. Such an activity could be a sign of the larger clout of the liberal wing of the Party of Regions, which has faded a bit over last couple of years, when Azarov took over heading Yanukoych's election campaign to becoming president in 2010.

Yekhanurov may resurface as the next PM candidate, but still has a low chance of doing so

- **Yuriy Yekhanurov (15% probability).** Yekhanurov is a 62-year-old, experienced technocrat who has closely cooperated with president Yuschenko and who led the pro-Yuschenko Our Ukraine bloc during the 2006 parliamentary elections. He did not give up on Yuschenko when many MPs in the Our Ukraine bloc dropped out in favor of Tymoshenko. He is viewed as having established contacts with the Party of Regions during his premiership in 2005-06. There is some possibility that the pro-Yuschenko Our Ukraine faction may propose his candidacy while renegotiating the parliamentary coalition.

In the end, the Party of Regions has to shape a kind of coalition government in order TO provide president-elect Yanukovych with the support of a functioning coalition in the parliament, and hence a cooperative Cabinet of Ministers.

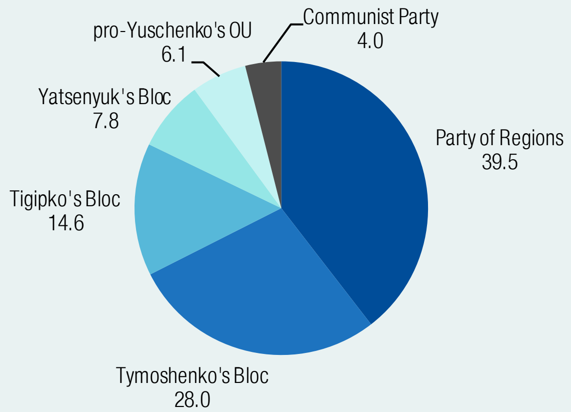
Next parliament elections likely to bring more political stability

More political stability is likely after parliamentary elections,…

While snap parliamentary elections do not have a high chance of materialising this year, given the current political landscape that appeared after the popular vote in the second round of elections, our general view is that the next parliamentary elections, if held according to schedule (in September 2012), will bring more political stability to the government.

Chart 16. Breakdown of parliament's seats by factions and groups, if parliamentary elections mirror the results of first round of presidential elections (%)

100% = 450 seats



Source: Investment Capital Ukraine

…thanks to the arrival of political moderates like Tigipko and Yatseniuk into the legislature

We base our view on the following assumptions:

- The critical mass of local voters who demand leadership other than Yanukovych and Tymoshenko's dual rivalry, has grown; these are the ones who cast their votes in support of Tigipko and Yatseniuk. Both are moderates, reasonably liberal, and most importantly, are generally frank in saying that the country needs reforms.

- If the next parliamentary elections take place reflecting the popular vote that was recorded during the first round of presidential elections, than we will have seen the following structure (see chart below). The above-mentioned two moderate politicians—Tigipko and Yatseniuk—would this have gained together 101 seats in the legislature (66 and 35, respectively), making them more powerful politicians, with a sizable faction capable of deciding the fate of coalition talks with the two large factions of the Party of Regions and Tymoshenko's Bloc.

- True, Tymoshenko, being in opposition during Yanukovych's rule, will continue to be a firebrand politician in her attempt to be a deal-breaker, and will use every occasion to stir up political noise by staging blockades on the legislature's floor, as she was want to do during her last position in the opposition camp . But in general, the public view on this kind of activity is changing, and Tymoshenko's prospects to add new public support onto her side have faded, as the first round of elections have shown (a second round of voting is not relevant in this regard, in our view, as it was a narrower range of options for voters in which to decide for whom to vote). In our view, especially those political forces that present a new leadership (a kind of Tigipko and Yatseniuk) will have better prospects in terms of adding supporters.

Key policymaking themes under Yanukovych

We underline key themes of Yanukovych's likely policymaking efforts,…

The main viewpoints of Mr. Yanukovych's Party of Regions–a major faction that will negotiate a new coalition in Parliament and hence direct the governing bodies–on economic policymaking has been quite sound and also partially contradictory. The points itemized by Yanukovych during the election campaign and quite recently, right after the second round of elections, could be summarized into the following.

…primarily, establishing "order" in public finances,…

Firstly, regarding fiscal policy, Yanukovych is intent on establishing "order" in state finances, as Finance Minister Mykola Azarov stated in a newspaper article published on 13 February, 2010, by adopting a state budget law in March and local budgets (for municipalities and oblasts) in the next month. Under Yanukovych, it is generally expected that budget expenses are still to rise, albeit at a slower pace than under the previous government, but structurally, a shift to government-financed capital investments will be introduced. To finance the budget deficit, Yanukovych and his coalition government will work with the IMF on restoring its lending programme, and then tap international capital markets with a Eurobond issue, if market conditions will allow. This is being generally welcomed as capital market-friendly development.

…and the stabilisation of the local currency's exchange rate

Secondly, on monetary policy, Yanukovych's Party of Regions is viewed as a political union, the key financial backers of which, as owners of larges and diversified business groups (for instance, steelmaking and machinery building), derive a major share of their revenues from markets abroad. Moreover, Azarov, who is considered among the front-runners for the post of prime minister in the new government, has long argued that economic growth has to be accompanied or achieved though a surplus in foreign trade.

All of the above points hint that a weak local currency in nominal terms—to support the external competitiveness of Ukraine's industrial sector—could be a key theme of economic policymaking, particularly of the central bank. However, Azarov named stabilisation of the national currency,(meaning the exchange rate stabilization) among his other priorities in the same newspaper article mentioned above.

There is some controversy in terms of economic targets

Such a statement from a leading representative of an export-minded political camp, which may have otherwise lobbied for a weaker currency, suggests that the 4Q08 devaluation of the local currency has helped the industrial sector to revive foreign demand for its export products. And therefore, the Party of Regions is not likely to push the central bank on further devaluation. Another programme statement from the party indicates that they are going to modernise the fixed assets of industrial sector, which is deemed to rely in many cases on outdated technologies and equipment. This is contradictory, in our view, to the call for archiving any surplus in the foreign trade balance, as a modernisation of the industrial base has to increase imports of capital goods, which may result in some degree of deficit in the country's foreign trade.

Yanukovych lacks a strong candidate for central bank governor;…

Despite such programme statements from the Party of Regions that relate to monetary policy issues, its capacity to reshuffle the central bank's executive body (the governor and governor's deputies) is rather limited, though not because of a lack of power. Rather, Yanukovych, as president, will have the ability to name the new candidate to the post of central bank governor and push it through the parliament, which has to approve the candidacy.

…hence, this means the MoF's current monetary policy is likely to be preserved

In fact, Party of Regions lacks a proper candidate for the post. To date, there are two individuals in the party who previously expressed an interest in developing their public careers as the NBU's governor, namely, Sergiy Lyovochkin and Vasyl Gorbal. Both are under 40 years old and MPs from the Party of Regions. But, taking into account that Yanukovych has to align the new coalition with the pro-Yuschenko faction, the most likely candidate will emerge from the central bank ranks, as outgoing president Yuschenko is expected to both accommodate as well as guarantee changes in the central bank's management structure.

In our view, the following candidates are the most prominent ones in terms of presiding as the NBU's governor under the Yanukovych's presidency:

Shapovalov, a deputy to the incumbent governor, is the most likely candidate for NBU governor;…

- **Anatoly Shapovalov** (45% probability) is a 58-year-old, experienced banker, who currently holds the position of first deputy of incumbent NBU governor Volodymyr Stelmakh, and is considered as his right hand. Shapovalov has long experience in Ukraine's banking sector, as he climbed the ladder from a middle-management position at the State Bank of USSR (the so-called Gosbank) in the 1970s to deputy chairman of Prominvestmbank in the late 1990s, one of the largest commercial banks that appeared in country once Ukraine gained independence and former state-owned business entities were privatised. Since 2000, Shapalov moved to the public sector and became deputy to NBU governor Stelmakh. During Stelmakh's brief departure from the post of NBU governor in 2002-04, Shapovalov served as deputy to minister of finance during 2003-05 in the Yanukovych-led Cabinet of Ministers. It is worthwhile to note that Azarov was minister of finance at that time. Hence, Shapovalov can easily find common ground with the Party of Regions. If Shapovalov is appointed as the next central bank governor, then the backbone of the central bank's management will be preserved, as well as a continuing of the same policymaking targets it has maintained. Under such leadership, the central bank will continue to cooperate with the IMF within the framework of monetary policy evolution—from a pegged currency towards inflation targeting. Working against Shapovalov's candidacy may be the factor of his direct involvement in a spate of refinancing to commercial banks in 4Q08, which was deemed as highly non-transparent and allegedly seen by a number of prominent politicians as the equivalent of corruption. Hence, the Party of Regions may retain its political controversy by appointing Shapovalov, as he could be an easy target for the opposition led by Tymoshenko, who has long blamed top NBU's officials for misdeeds in monetary policy.

…however, Stelmakh may stay for a while,…

- **Volodymyr Stelmakh** (25% probability), an incumbent NBU's governor, at the age of 71 years, is required by law to step down from public service due to age threshold. However, his candidacy may be still on the short list for the post, as he is the most accommodative to central bank of all. But still, against him will play a number of considerations: first of all, his age; secondly, his battered reputation as central bank governor under whom the local currency devalued sizably in 4Q08; thirdly, opaque procedures on commercial banks' refinancing; and fourth, a lack of desire on the part of the Party of Regions to maintain the status quo regarding the central bank's management structure.

…while Poroshenko, a Yuschenko ally, could assume the post under certain conditions

- **Petro Poroshenko** (15% probability) is the 45-year-old an incumbent minister on foreign affairs and head of central bank council, an advisory body that determines the framework of the monetary policy to be adopted for the next year and makes its recommendation to the central bank's board. He is considered as a close ally to outgoing president Yuschenko, who may consider Poroshenko as the candidate that fits his vision of accommodating changes at the central bank. Poroshenko has established contacts with Party of Regions, which may help his bidding for the post. But, his main disadvantage is that he may be rejected by those hard-line members in the Party of Regions who view Poroshenko's relations with Tymoshenko (Poroshenko's TV channel has been running implicit supportive coverage of Tymoshenko's campaign and her post-elections statement on vote violations) as unacceptable.

Lyovochkin's chances for the post are fairly small due to lack of experience

- **Sergiy Lyovochkin** (10% probability) is a 38-year-old activist and power broker within the Party of Regions with apparently strong aspirations to lead the central bank. However, against him may play the fact that he does not have banking experience, let alone central banking experience. However, local media outlets allege that he cooperates widely with local wealthy businessman Dmytro Firtash, who amassed wealth in natural gas dealmaking, and retains influence inside Party of Regions. Firtash may therefore help push Lyovochkin into the management of NBU (for instance, for the position of governor deputy) to guarantee him eventual control over commercial bank Nadra, which has been under receivership since the local banking crisis of 4Q08.

Gorbal is essentially a lame duck within the Party of Regions

- **Vasyl Gorbal** (5% probability) is a 39-year-old MP and Party of Regions' activist in the city of Kiev, where the party has had traditionally weak public support. The Party of Regions relied on Gorbal's business clout in Kiev for running its election campaigns in the city during the 2004 presidential elections and the 2006 and 2007 parliamentary elections. He once won the nomination from his party to become a candidate for Kiev's mayor, but lost the race to the incumbent mayor. Recently, his clout in the party has faded somewhat due to his lack of progress in electoral races, as Kiev's voters have not naturally migrated to the camp of the Party of Regions because Kiev's residents have historically been very skeptical about the credentials of Party of Regions leader Viktor Yanukovych (who has been embroiled in legal difficulties in the past, including allegedly being sentenced twice during his youth, though legal evidence on this has disappeared). And so to run the 2010 presidential campaign in Kiev, the Party of Regions handed over the responsibility of running the campaign in the country capital to another influential figure within the Kiev business circles, Vyasheskav Suprunenko, son-in-law of incumbent Kiev Mayor, Leonid Chernovetsky. Gorbal's strong selling point for the post of central bank governor includes his lengthy experience as chairman of commercial bank Ukrgazbank. However, Gorbal's banking experience has been tattered by the demise of Ukrgazbank, which that collapsed during the 4Q08 banking crisis, likely under the weight of bad loans in its portfolio. He later surrendered ownership of the bank to the state, as the government recapitalised it with taxpayers' funds. The most prominent post in the banking sector Gorbal has preserved to date is his membership in the central bank council.

Briefing on Ukraine's economy

In our view, the domestic economy is undergoing a slow shift within the driving forces of growth, i.e., away from consumption driven in 2005-07 towards net exports and especially fixed assets investments. Along the way, we think that economy's woes of 2009—the fiscal deficit of 7.4% of GDP—will be reduced in 2010 by a new economic stance by the government, and partially aided by inflation. As usual, natural gas imports are a source of risk to the economy due to higher price of the fuel, but this risk may be sidelined if the authorities find common ground with Gazprom. At the end of this section, we provide our arguments to the view why local currency hryvnia (UAH) is undervalued.

Measuring economic growth in 2010

In our view, a FY10 rebound of the economy will not be significant…

In our view, the prospects for a timely renewal of Ukraine's economic performance in the current year will be fragile, despite the fact that the low base effect seems to be providing a sort of rebound from the previous year's sizable contraction of GDP, of 15.4% in real terms. We base our view on the following considerations.

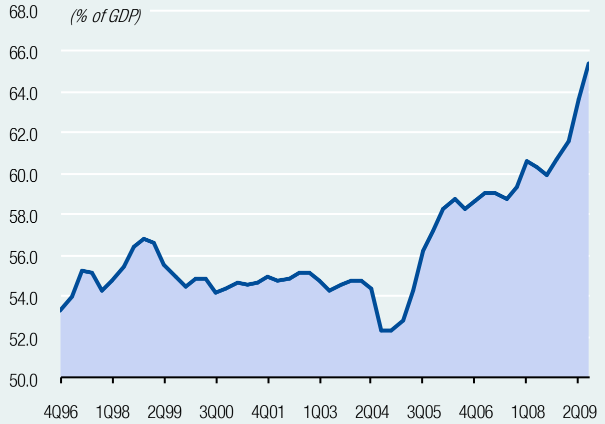
Built-in obstacles to a strong rebound

…due to fundamental obstacles to a fast recovery

In the pre-crisis period of FY05-1H08, economic growth was driven by two components of GDP from the expenditures side: household consumption expenditures, and gross capital formation expenditures. A credit boom in the economy over the same period has been supportive to this kind of economic model. As a result, the share of household consumption in nominal GDP moved beyond the 60% threshold in early 2008 (see Chart 17), while investments into fixed assets peaked at 27.9% as of end-2Q08 (see Chart 18).

Chart 17. Household consumption as a share of GDP

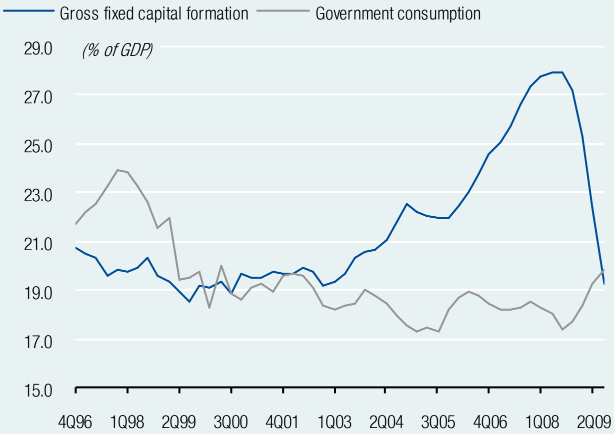
History from 4Q096 to 3Q09, 12-month rolling data at current prices



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

Chart 18. Government consumption and investments

History from 4Q096 to 3Q09, 12-month rolling data at current prices



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

Since early 2005, economic growth has been primarily consumer-driven;…

At the same time, other components of nominal GDP, if it is considered from the expenditure side point of view, provide missing elements to the macro picture of GDP composition: government consumption, as another important component of total consumption, declined towards the level of 17.4%, a historical low for the period from when the statistical office started to provide quarterly data on nominal GDP, in 1995, until early 2008, and the share of next exports in GDP moved deeply into the red towards 8.2% in the 3Q08.

…but as of late, household consumption has emerged as the least affected component of demand in the economy

Such a structure of the economy was slammed into reverse by the global recession and the domestic banking sector crunch. As a result of these two factors, fixed-investments contracted sharply to 19.3% in 3Q09, a level last time seen at the end of 1990s, in the aftermath of the Asian crisis that reached the CIS countries at that time, when net exports returned to nearly zero as a percentage of GDP.

Importantly, household consumption-to nominal GDP in 2009 actually grew, as local consumers were supported by a mix of factors such as:

Household consumption as a share of GDP reached a historic high of 65.4% in 3Q09

- a wider budget deficit, which supported public sector employees; and
- devaluation of the local currency, which supported private sector employers—especially in export-oriented industrial sectors—in maintaining their workforce relatively stable in terms of headcount and nominal wages.

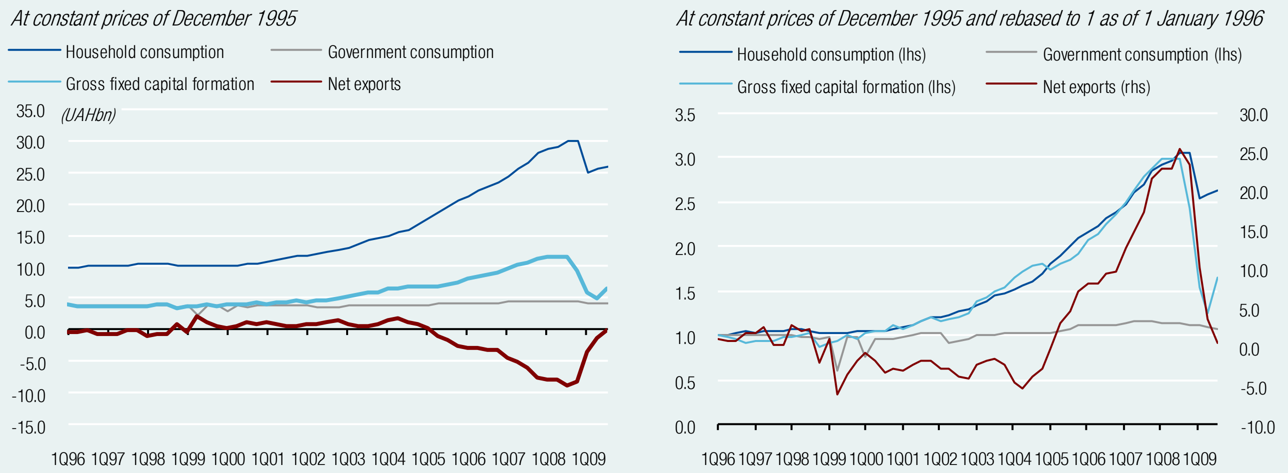
As a result, household consumption expenditures as a share of GDP rose to a historical high of 65.4% as of 3Q09.

The weight of the next model of economic growth is likely to shift towards net exports and investments

Likely, the pattern of economic growth in 2010 will shift…

Going forward, we believe it is worthwhile to underline that given the fact that the previous structure of economic growth—which had been in play from early 2005 till 1H08—is not relevant to today's reality, and therefore, the economic growth pattern is likely to transform into fixed assets that are driven more by net exports and investments, rather than by domestic growth.

Chart 19. Consumption (household and government), investments and net exports as components of quarterly GDP at constant prices of December 1995 and seasonally adjusted, history from 1Q96 till 3Q09



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

…towards export- and investments-driven growth

This is because, as noted above, household consumption, previously fuelled by a generally supportive macro backdrop and the banking sector's lending spree, these very two supportive factors have been lacking since 2009. Firstly, the macro backdrop became worse, as the unemployment rate rose from 6% in mid-2008 to 8.5%, as the latest statistical data show, and real disposable income of households has been declining since early 2009. And, secondly, the banking sector's lending activity has been in a standstill since late 2008. In fact, local commercial banks have been hoarding cash in their balance sheet, and have limited their lending activities not only to customers, but also to bank-to-bank lending (see Chart 22 and Chart 23 on page 26).

Seasonally adjusted quarterly GDP data shed light on structural changes needed to the economy

At constant prices of December 1995, developments in the seasonally adjusted components of quarterly GDP by expenditure during the period of 1996-2009 show how the economy changed structurally, from the second half of the 1990s to the early 2000s, and for the period of 2005-08 (see Chart 19 above).

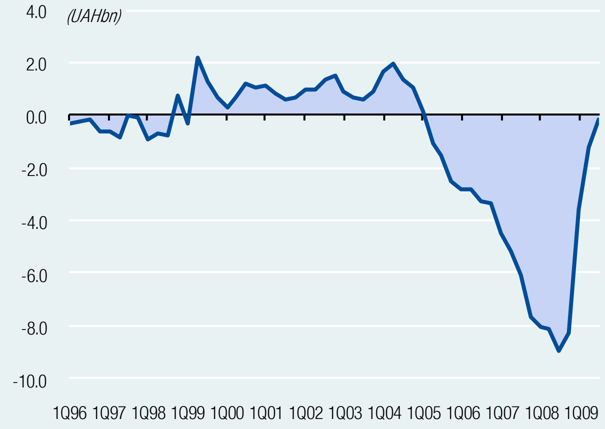
In fact, household consumption has nearly tripled, from UAH10bn per quarter in the late 1990s to UAH30bn in early 2008. Over 2009, it slowed fractionally to UAH25bn, but rebounded to UAH26bn in 2H09.

Another integral component of consumption—government consumption—has been fairly constant from 1996 to 2009, staying in the range of UAH3.8-4.5bn.

As for investments into fixed assets, these grew sizably, as well, nearly tripling from UAH4.0bn in the early 2000s to UAH11.7bn in 2Q08, but in 2009, this was the most severely hit component of GDP, dropping to a low of UAH4.9bn in 2Q09, but recovering slightly to UAH6.5bn in 3Q09. Net exports, which previously led the economic recovery in the early 2000s, amounting to UAH1.0-2.0bn at the time, turned negative in 2Q05, effectively moving into net imports, which quickly reached an unprecedented level of UAH9.0bn. Devaluation of the local currency and the economic recession of early 2009 have thrashed the negative trade gap and moved the net exports level close to zero (see Chart 20 below).

Chart 20. Net exports as a component of quarterly GDP

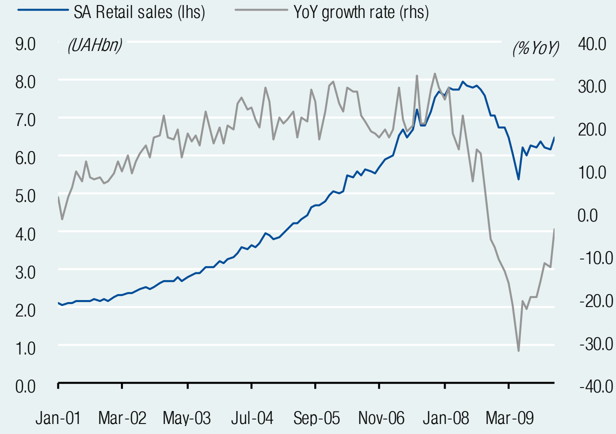
At constant prices of December 1995 and seasonally adjusted, history from 1Q96 till 3Q09



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

Chart 21. Monthly retail sales

At constant prices of December 1999 and seasonally adjusted, history from January 2000 till January 2010



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

The important question now is: How will the economy grow in 2010? Taking into account that the true fiscal position of the government does not allow further expansion, instead, the government will be asked by creditors to show its commitment to return back towards a balanced fiscal position, where public sector-dependent consumers are likely not to be those driving the growth. The same applies to total household consumption, as we argued above that the macro backdrop needs to improve first, to provide additional capacity to consumers to drive the growth.

The most sizable contraction in 2009 took place in fixed-assets investments and net exports, which are believed to be the largest growth drivers of 2010

Furthermore, the most heavily hit sectors of the economy in 2009 were those who were dependent on leveraged consumption, like real estate development and purchases of big-ticket durable goods and cars. With bank lending to households provided largely in foreign currency, the local currency devaluation provided an increased debt burden on Ukraine's households, or at least a part of them, rendering their ability to spend, and provide a strong boost to household consumption, unrealistic this year.

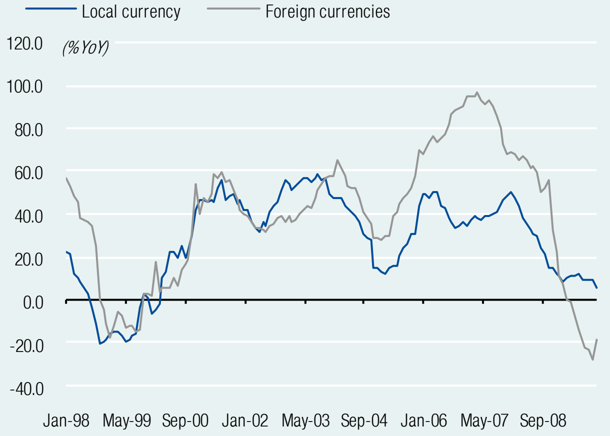
However, risks to the new structure of economic growth are likely to materialise

The key source of economic demand, and hence the country's economic growth engine in 2010, is likely to come from foreign demand and fixed assets' investments. But, these two variables are also subject to risk factors:

- **Lack of credit in the economy.** Indeed, q weak banking sector and miniscule domestic capital market, coupled with limited access of local entities to the international capital markets, are the main threats to the prospect that fixed-assets investments (into infrastructure and industrial projects) may become an engine for economic growth in 2010. However, the banking sector, despite all of its woes, showed that it had been hoarding cash on its balance sheet and curbing bank-to-bank lending operations (see Chart 22 below). In such a position, the banks are likely to seek healthy borrowers and extend credit to them, after which government guarantees (of explicit or implicit nature) are likely to bolster the flow of bank credit to the borrowers. The government itself may encourage infrastructure and industrial sector projects by acting together with the NBU to bolster long-term credit to such enterprises via the state-owned banks.
- **Political instability.** History proves that during periods of political turbulence, domestic businesses and their foreign counterparts that operate in countries of developing economies tend to cut their investment programmes in order to mitigate uncertainty regarding their decisions. Starting from 1Q10, such a risk is likely to begin to subside, encouraging foreign businesses to make fixed-assets investments.
- **The global economy recovery is fragile.** As we noted above (see "Global economy" section on page 10), foreign demand may slow as the global economy recovery stumbles on a withdrawal of government stimulus. For Ukraine, key economic indicators to follow include Russia's economy recovery and China's economic policymaking, with the former accounting for more than a 20% share of merchandise trade, and the latter carrying out the policies that drive up the global market price for steel. If China's policymaking tumbles over, say, inflation fear or bank loan book quality, or Russia's economy recedes due to a steep decline in the crude oil price, Ukraine's economic growth stands to lose hugely, as foreign demand on its products will subside as a result.

Chart 22. Real growth of loan book of the banking sector: breakdown by currency

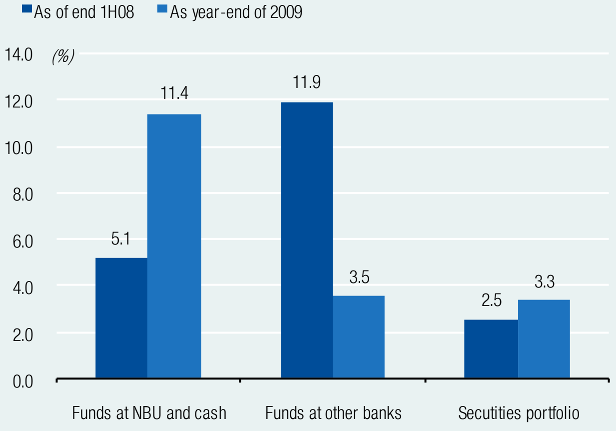
Percentage change over a year; at constant prices of December 1996



Notes: headline CPI in the US was used to adjust the foreign-currency loan book; headline CPI in Ukraine was used to adjust the local-currency loan book.
Sources: National Bank of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

Chart 23. Ukraine's commercial banks hoarding cash: movements within the asset side of banks' balance sheet

Share of total assets



Notes: the data of top two groups of commercial banks by assets was used for calculations.
Sources: National Bank of Ukraine, Investment Capital Ukraine LLC

Fiscal balance: deficit cuts to follow

Official data on fiscal deficit likely understated

We believe the official fiscal deficit of 2% of GDP for 2009 is unrealistic,…

Official statistics on the FY09 fiscal balance of 2.0% of GDP arrived recently, which appear to be too optimistic, showing that the government was eager to conceal the true picture on the fiscal balance from the public. Much earlier, indeed since late 2008, the capital market had already been pricing in the heightened risk of solvency of the government.

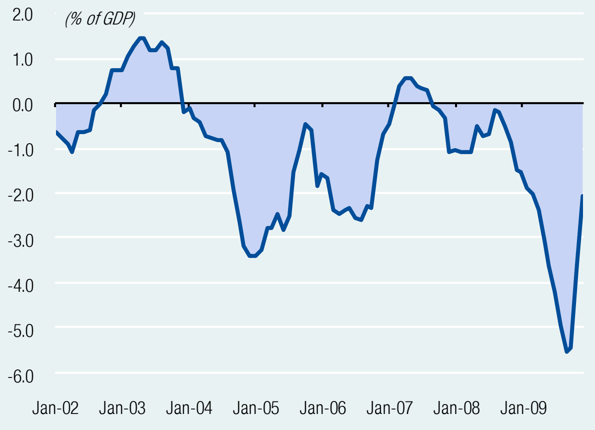
Over the course of 2009, the government had been operating on a quickly deteriorating fiscal balance that spiked beyond 5%, according to the official statistics in 3Q09 (see Chart 24 below). However, in November, the MoF surprised ICU by reporting an abnormal one-month volume of budget revenues of UAH40bn, a nearly doubling from the previous month's volume of revenues of UAH22.4bn. In fact, as critics of the government pointed out, it had used the IMF's Special Drawing Rights (SDR) allocation of 2H09 to the country, totalling to US$2.0bn, for budget revenues. Earlier in the year, the government asked the IMF to allow it to use parts of the IMF's credit tranches, extended within the framework of its Stand-By Agreement, to finance the country's fiscal expenditures (in total, the Fund provided the government with US$4.8bn.

…given the size of the make-up of GDP and public borrowings

In addition, the government has been borrowing sizably from the local capital markets, elevating yields predominantly of up-to-one-year tenors beyond a 20% threshold. As a result of acceleration of borrowing activity by the government, the stock of public debt rose from a low of 10% (as share of GDP) in the pre-crisis period, i.e., in the middle of 3Q08, to 33% as of year-end of 2009 (see Chart 25 below).

Chart 24. Official rosy picture on fiscal balance in 2009...

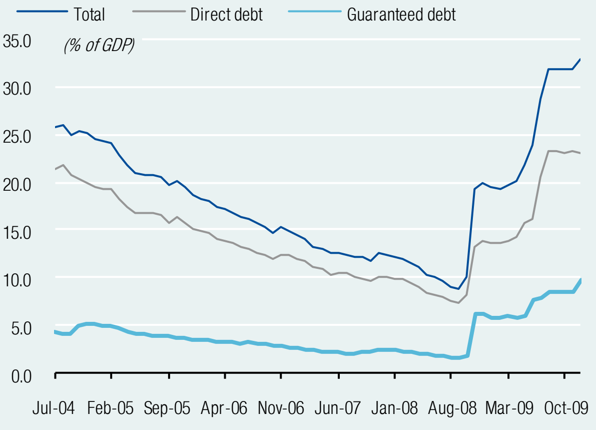
History 2002-09; as a percentage of nominal GDP



Sources: Ministry of Finance of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

Chart 25. ...does not match with steep rise with public debt

History 2004-09; as a percentage of nominal GDP



Sources: Ministry of Finance of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

We apply our own approach in determining the true fiscal balance for 2009,…

Our own approach to uncovering a realistic fiscal balance for 2009 is based on the simple notion that the public debt increase, adjusted for exchange-rate movements over a certain period, say, of one year, equals the primary fiscal balance during the year, plus debt servicing payment (interest payments), and less privatisation proceeds. In our case, the unknown variable of this equation is budget expenses, while all other components of the formula are at hand, and deemed as reflecting reality. The table below (Table 5 on page 28) provides details of our own assessment of the true volume of budget revenues, and hence, the fiscal balance for 2008-09.

…based on changes in public debt,…

This table provides a calculation of the realistic fiscal balance, which is based on the stock of the public direct debt, i.e., debt that is a direct liability of the government to its creditors. As a result of our calculations, it appears that there is a statistically important discrepancy between the officially reported fiscal balance and the obtained results for the years of 2008 and 2009. Hence, budget revenues for these years have been overstated, and conversely, the fiscal deficits understated, by UAH8.2bn and UAH49.5bn, respectively. In relation to nominal GDP, fiscal deficits in 2008 and 2009 were at 2.4% and 7.5%, or marginally higher than official figures of 1.5% and 2.0%.

…with our calculations showing a fiscal deficit of 7.5% of GDP in 2009

If the stock of total public debt is considered, which combines direct and guaranteed debt, then it appears that at such an increase of debt over the 2008-09 period—from UAH88.7bn as of year-end 2007 to UAH301.5bn as of year-end 2009, or by UAH164bn, if adjusted for exchange-rate movements—this results in an even wider fiscal deficit of 5.2% in 2008 and 10.7% in 2009.

Table 5. Calculation of actual consolidated fiscal balance for 2008 and 2009 (UAHbn, if not otherwise indicated)

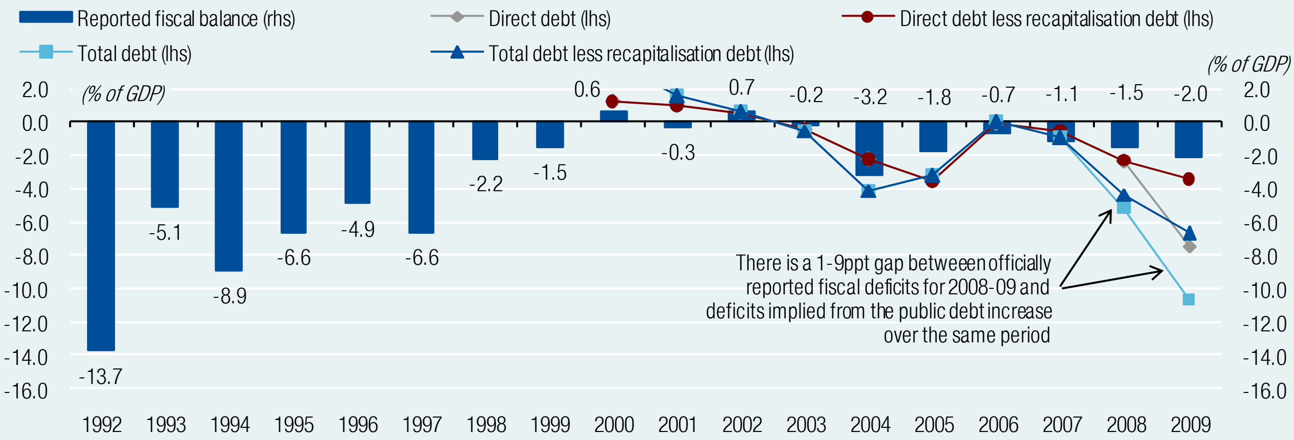
Year	Direct debt[1]	New debt[2]	Debt service	Expenses	Revenues			Deficit		Deficit (% of GDP)		Notes		
					Calculated[3]	Actual	Difference	Calculated	Actual	Calculated	Actual	GDP	Privat'n[4]	Recap'n[5]
2000	64.2	0.4	4.6	48.1	50.2	49.1	1.1	2.1	1.0	**1.2**	0.6	170.1	2.1	0.0
2001	63.3	0.0	4.1	55.3	57.2	54.0	3.2	1.9	-1.3	**1.0**	-0.6	204.2	2.1	0.0
2002	64.5	1.1	3.0	59.1	60.4	60.8	-0.4	1.3	1.7	**0.6**	0.8	225.8	0.6	0.0
2003	66.1	1.7	2.6	75.7	74.5	75.2	-0.7	-1.2	-0.5	**-0.5**	-0.2	267.3	2.2	0.0
2004	67.3	1.3	3.1	102.4	94.7	90.6	4.1	-7.7	-11.8	**-2.2**	-3.4	345.1	9.5	0.0
2005	63.1	-1.8	3.1	141.7	125.9	134.0	-8.1	-15.8	-7.7	**-3.6**	-1.7	441.5	20.7	0.0
2006	66.1	2.9	3.0	175.5	175.1	171.8	3.3	-0.4	-3.7	**-0.1**	-0.7	544.2	0.6	0.0
2007	71.3	4.9	3.9	227.6	224.1	219.9	4.2	-3.5	-7.7	**-0.5**	-1.1	712.9	2.5	0.0
2008	130.7	26.4	4.4	312.0	289.6	297.8	-8.2	-22.4	-14.2	**-2.4**	-1.5	949.9	0.4	8.5
2009	211.6	77.3	9.8	307.3	239.1	288.6	-49.5	-68.3	-18.7	**-7.5**	-2.0	915.6	0.8	36.8

Notes: 1) direct public debt as of end of the period; 2) new debt means net borrowings in local currency terms; 3) calculated revenues were computed as sum of expenses and total debt servicing less new debt borrowed in the current year and less of privatisation proceeds for the current year; 4) privatisation proceeds during the period; 5) bonds issued for the purpose of recapitalisation of state-owned banks and Naftogaz of Ukraine.

Sources: Ministry of Finance of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

Chart 26. Calculation of factual consolidated fiscal balance for 2001-09 derived from the public debt stock (% of GDP)

Bars represent official statistics on fiscal balance, while lines depict ICU's own assessment of the consolidated fiscal balance derived from the stock of public debt



Sources: Ministry of Finance of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

Aside from the recapitalisation costs for banks and Naftogaz, the fiscal balance for 2009 was 3.4%

For the purpose of this analysis, we tend to consider the fiscal balance, which is derived from the increase of direct debt, as it represents the immediate claim on the government by its lenders. Over the course of 4Q08 and 2009, the increase in the public direct debt was a result of market borrowings by the government as well as the issuance of local-currency government bonds that were used for the purpose of recapitalisation of state-owned banks and natural gas monopoly Naftogaz of Ukraine. If we trim the recapitalisation bonds from the direct-debt stock as of the end of 2008 and 2009 (according to our assessments, these amount to UAH8.5bn and UAH36.8bn, respectively), then fiscal deficits for 2008 and 2009 stand at 2.4% and 3.4%, respectively.

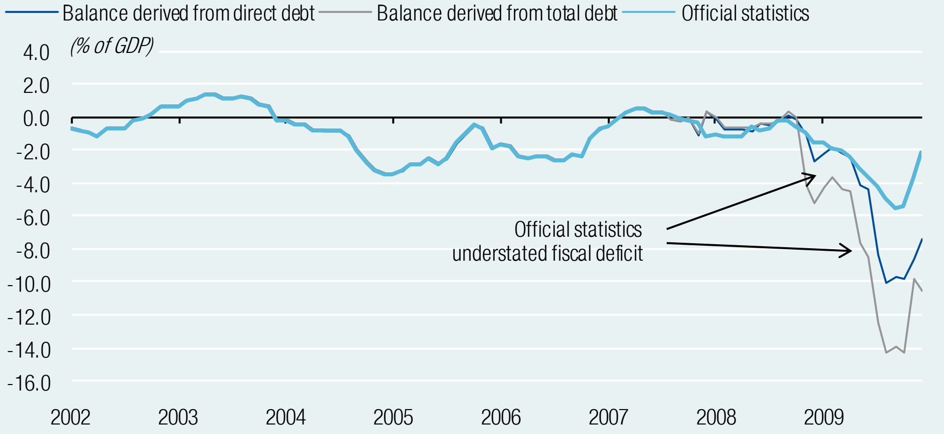
Inflation and some austerity measures to cut the deficit as a share of GDP

The Parliament will be considering a state budget law with a 2010 fiscal deficit of 3.6% of GDP,…

As new government is yet to take shape under the newly-elected president Yanukovych, the Parliament has in its portfolio of bills a draft law on the 2010 state budget to be considered this March. It states that public expenditures of the (non-consolidated) state budget for FY10 are to be at UAH324.3bn, making the deficit at UAH39.6bn, given the expected revenue volume of UAH284.7bn.

Chart 27. Consolidated fiscal balance: official and estimated

As a percentage of nominal GDP; monthly history for the period of 2002-09



Sources: Ministry of Finance of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

…while our assessment for the 2010 fiscal deficit is 4.2% of GDP

Such a fiscal deficit accounts for a 3.6% share of nominal GDP forecast by us in FY10. At the same time, our own assessment of the pace of economic growth in 2010, coupled with inflation rates still in double-digit territory, provide deficit of 4.2% of GDP, while expenditures of the consolidated state budget are forecast at UAH339bn and revenues of UAH293bn. In the end, the expectation for a 4.2% fiscal deficit in 2010 represents a reasonable reduction from the 7.4% cast in 2009, a realistic figure that is derived from the rise of direct government debt over the course of 2009.

The new government should keep expenditures in check

We base our forecast for the 2010 fiscal balance on the following:

- Yanukovych's government is likely to be one consisting of technocrats, and likely led by top-notch technocrat Mykola Azarov as prime minister, who previously presided in two Cabinet of Ministers over public finances, serving as minister of finance and first deputy to prime minister. Azarov's track record in these posts leads us to expect that he would concentrate on restoring the fiscal credibility of the government.
- Firstly, Azarov vowed to adopt the 2010 state budget law as early as March. Despite the fact that Yanukovych's populist rivalry with Tymoshenko, which partially aided him in eventually winning the presidential post, the new government will take measures to bring the deficit down in relative terms (as a share of GDP). This notion stems from the notion that Azarov's stance on managing the government finances is about

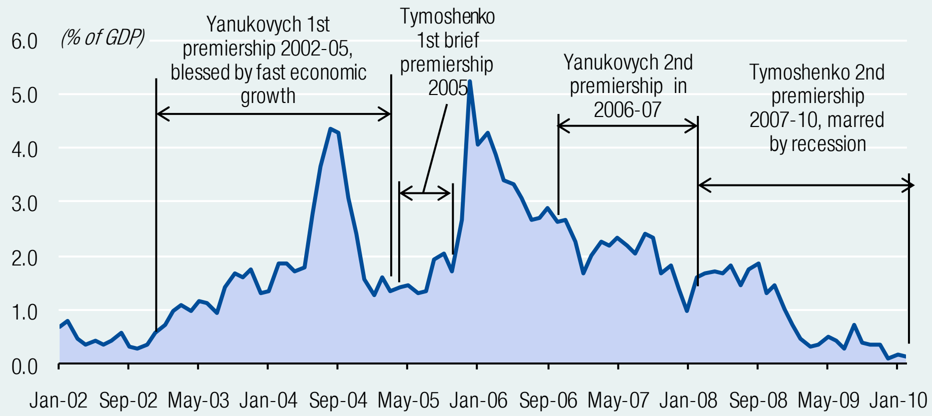
having sufficient cash at hand on the state treasury account. Chart 28 below provides evidence for this, showing that during Azarov's stay in the government, it managed to preside over a cash amount in the state treasury averaging 1.4% during 2002-05 and 2.3% during 2006-07.

- Secondly, the government will need to borrow not only from the IMF, which may provide the next tranche of its loan to the authorities in early 2Q10–as it promised to revisit Ukraine after the presidential elections–but from the markets, especially from the Eurobond market, as local market borrowings have been mostly of short-term and high-yield nature to date. In talking with private creditors, the government understands that it needs to settle its programme the with IMF first by adopting a realistic budget and showing its commitment to beginning to address the natural gas tariff issue in 2010.

Despite the fact that Azarov used to be a harsh critic of Tymoshenko's government's practices of borrowing from the IMF, he is likely to show flexibility while talking to the Fund.

Chart 28. State coffers under oversight of different governments

Treasury account balance as a share of nominal GDP



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

Primary fiscal balance under spotlight

The primary fiscal balance is likely to be cut from 6.3% in FY09 to 2.6% in FY10,…

While considering Ukraine's fiscal position, which naturally deteriorated since 4Q08, and making a forecast for 2010 the following thing should be taken into account. Firstly, expected volume of revenues under the pace of economic recovery this year; secondly, nominal growth of GDP; and, lastly, the changes of primary fiscal balance.

Our forecast for economic growth for 2010 yields the following results (for more details see Table 6 on page 31):

- Firstly, we assumed that growing economy (in real terms) is likely to provide the government with a recovery in revenues. In total, consolidated budget revenues are to amount to UAH293bn in FY10, up from the estimated level of UAH240bn in FY09. Given the expected size of fiscal expenditures for entire 2010 at UAH339bn, fiscal deficit in 2010 is forecast at UAH46.2bn or 4.2% of GDP, representing a UAH21.2bn nominal reduction from UAH67.5bn deficit in 2009. In relative terms, cut of deficit arrives at 3.2ppt of GDP. Double-digit inflation expected to prevail this year aids to provide such a result.

…leading to a moderation of public debt growth, towards 35% of GDP

- Secondly, from a primary fiscal balance point of view, our 2010 forecast calls for larger cuts in the deficit—in nominal terms, it is forecast to shrink by UAH28.9bn from UAH57.7bn in FY09 to UAH28.7bn in FY10, while in relative terms—as a share of nominal GDP—reduction arrives at 3.7ppt. We assumed that quarterly volumes of debt servicing expenses will rise towards UAH4.5bn a quarter in 9M10 slowing to UAH4.0bn in 4Q10. This assumption is based on the expected shift of the government towards a wider pull of creditors (mainly to Eurobond market after successful restoration of talks with IMF that would culminate with disbursement of the next tranche under the Stand-By Arrangement) than the previous government enjoyed (borrowing short-term and expensive funds from the local market).
- In the end, such a development is likely to result in considerable moderation of public debt growth in nominal terms—towards 28% YoY as of the end 2010 (see Chart 30 below), while in relatives terms there is even the possibility of stabilisation of the public debt ratios—at 34.9% and 23.3% of GDP respectively of total public debt (that includes direct and guaranteed parts of public debt) and direct public debt (see Chart 29 below) as of the end of 2010.

Table 6. Primary balance of consolidated budget in 2008-09 and its 2010 forecast (UAHbn, if not otherwise indicated)

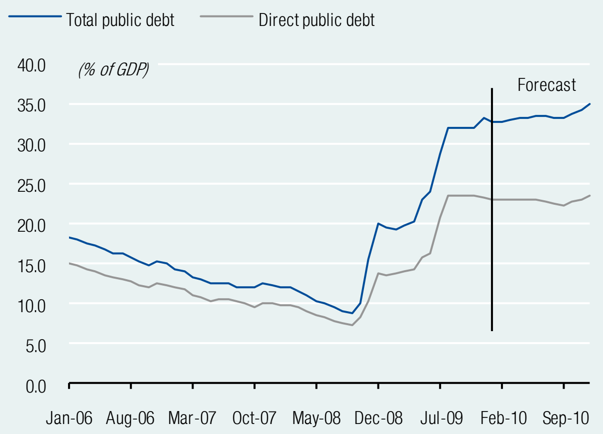
Period	Revenues	Expenses	Balance	Balance (% of GDP)	Debt servicing	Primary balance	Primary balance (% of GDP)	GDP	Nominal GDP growth (% YoY)
2008[1]									
1Q08	61.7	56.0	5.7	3.0	0.8	6.5	3.5	187.7	36.4
2Q08	74.8	74.0	0.8	0.3	1.2	2.0	0.8	233.7	41.5
3Q08	81.4	76.2	5.2	1.9	0.7	5.9	2.2	275.8	39.7
4Q08	79.9	105.8	-25.9	-10.3	1.7	-24.2	-9.6	252.7	18.7
Total	**297.8**	**312.0**	**-14.2**	**-1.5**	**4.4**	**-9.8**	**-1.0**	**949.9**	**33.2**
2009[2]									
1Q09	68.2	65.0	3.2	1.7	1.1	4.3	2.3	183.2	-2.4
2Q09	59.4	78.4	-19.0	-9.2	2.4	-16.6	-8.0	207.1	-11.4
3Q09	33.5	74.1	-40.7	-16.2	2.0	-38.7	-15.4	250.6	-9.1
4Q09	78.7	89.8	-11.0	-4.1	4.4	-6.7	-2.5	271.6	7.5
Total	**239.8**	**307.3**	**-67.5**	**-7.4**	**9.8**	**-57.7**	**-6.3**	**912.6**	**-3.9**
2010 forecast[3]									
1Q10	57.9	62.2	-4.3	-1.9	4.5	0.2	0.1	219.2	19.7
2Q10	67.7	78.9	-11.2	-4.4	4.5	-6.7	-2.6	256.1	23.7
3Q10	80.7	86.8	-6.1	-2.0	4.5	-1.6	-0.5	305.2	21.8
4Q10	86.6	111.3	-24.7	-7.5	4.0	-20.7	-6.3	327.6	20.6
Total	**292.9**	**339.2**	**-46.2**	**-4.2**	**17.5**	**-28.7**	**-2.6**	**1,108.1**	**21.4**

Notes: 1) actual figures reported by official agencies; 2) all figures but revenues are officially reported, revenues are derived from the stock of direct debt in 2009; 3) forecast by Investment Capital Ukraine.

Sources: Ministry of Finance of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

Chart 29. Forecasted public debt stock in 2010

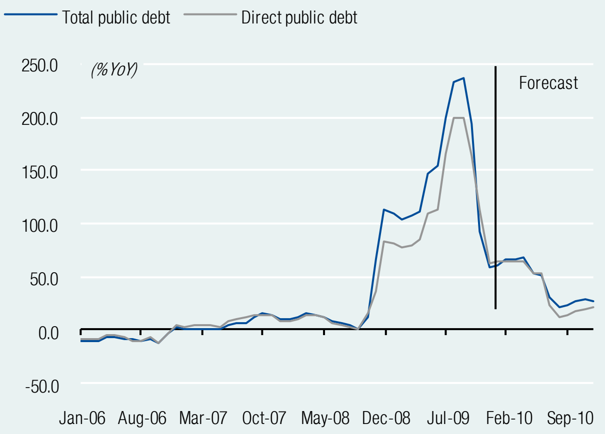
As a percentage of GDP



Sources: Ministry of Finance of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

Chart 30. Forecasted public debt increase in 2010

Perchance change over a year ago



Sources: Ministry of Finance of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

Comparing Ukraine's debt sustainability with other countries

Ukraine's debt sustainability measures have a reasonable chance of improving in 2010,…

Aside from the political risk involved in sovereign credit, it is interesting to compare Ukraine's public debt sustainability with other countries. We compared Ukraine's indicators on debt sustainability with selected OECD countries ranked by *The Economist* magazine (see the 12 February, 2010 issue, page 72). The ranking (see Table 7 on the next page) takes into consideration such debt measures as:

- Primary budget balance forecast for 2010. The table and following charts below contain the indicator for Ukraine's primary fiscal deficit for the years of 2009 (assessed by us to be at 6.3% of GDP) and 2010 (our forecast of 2.6% of GDP).
- Net public debt as a percentage of GDP as of end of 2010. For Ukraine, the net debt indicator is derived from the gross debt figure less net FX reserves expected at year-end 2010. Assuming a further increase in public debt in nominal terms, Ukraine's economy still remains among those with the lowest government debt ratios (in net debt terms, it is hovering around 25% of GDP).

…as the primary fiscal deficit is to shrink, debt size is still low,…

- Combining the above-mentioned two debt measures—primary fiscal balance and net debt size (see Chart 31 below)—Ukraine is likely to improve its standing by moving away from the group of countries (including many developed nations that opted for sizable fiscal stimulus in 2009) that are to experience still primary fiscal balances of 4-7% of GDP. The good thing for Ukraine is that its debt size ratio allows it to be among the low-indebted countries (mainly countries of continental northern Europe and Canada, all depicted on the charts and table below).
- Other pairs of debt measures considered in this ranking are weighted average years to maturity of public debt and percentage difference between nominal GDP growth and cost of financing (see Chart 32 on page 34).

…and nominal GDP growth is expected to be a bit faster than the cost of financing

- For Ukraine, we calculated the weighted average years to maturity of publicly traded debt securities—both in local currency (those placed via bond auctions and excluding bonds issued for recapitalisation purposes) and foreign currencies (Eurobonds in US dollar, euro and Japanese yen)—and on total size of public debt. The result yielded 3.0 years for tradable public debt and nearly 7 years on entire debt. Applying a conservative approach to Ukraine's debt sustainability considerations we used included weighted average years to maturity on publicly traded government debt with a 3-year YTM.

A key risk to Ukraine's debt sustainability position is the relatively short term to maturity of government debt

- Another measure for Ukraine—the difference between nominal GDP growth and cost of financing—has been calculated with a forecast of a 21.4% YoY increase of nominal GDP and taking into account the cost of financing to the government, derived from the most recent government bond auction on 2 March, 2010, during which a 3-year bond was sold at a 24.3% YTM. Hence, this measure is 3ppt for Ukraine. Effectively, this measure adopts very conservative view on the financing cost, as it assumes that all year long in 2010, the government will borrow at this punitive rate (24.3% YTM), but this definitely holds true. Our FY10 forecast on debt servicing of UAH17.5bn (see Table 6 on page 31), if considered against the expected increase of the public direct debt stock, provides us with an average cost of financing of 8% (assuming the US$3.8bn IMF tranche goes in its entirety to the government, as well as a US$1bn Eurobond issue, and the rest of financing borrowed from the local market), hence, allowing us to reasonably suggest that Ukraine's economy growth is likely to grow a bit faster in nominal terms than the expected cost of the financing of public debt in 2010 in weighted average terms.
- Out of all debt measures, the key risk source of risk is Ukraine's quite low measure of the average time to maturity of outstanding government debt (about 3 years, if outstanding tradable debt securities are taken into account). This risk centres on the refinancing problems that have heightened since 4Q09, as the outgoing government borrowed expensive short-term funds from the local market.

Table 7. Ukraine versus the selected OECD countries ranked by the Economist in accordance with these countries' sustainability of debt (2010 forecast)

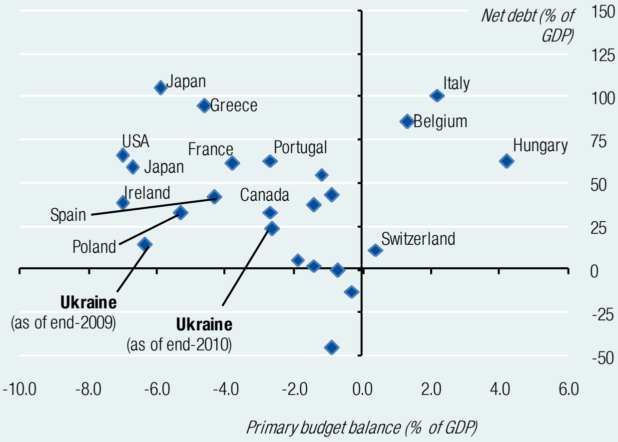
Country	Primary budget balance (% of GDP)	Net debt (% of GDP)	GDP nominal growth less cost of finance (ppt)	Sovereign debt (weighted average years to maturity)
Greece	-4.6	94.6	-3.2	7.7
Ireland	-7.0	38.0	-5.1	6.8
UK	-6.7	59.0	-1.5	13.7
Japan	-5.9	104.6	0.1	5.4
Portugal	-2.7	62.6	-2.3	6.5
Spain	-4.3	41.6	-3.0	6.7
France	-3.8	60.7	-0.7	6.9
USA	-7.0	65.2	1.4	4.8
Poland	-5.3	32.4	-0.7	5.2
Italy	2.2	100.8	-1.0	7.2
Hungary	4.2	62.1	-3.5	3.3
Belgium	1.3	85.4	-0.6	5.6
Netherlands	-1.4	36.5	-0.6	5.4
Austria	-0.9	42.9	-0.6	7.0
Germany	-1.2	54.7	-0.5	5.8
Czech Rep.	-1.9	5.3	0.0	6.4
Norway	-7.8	-143.6	2.4	4.9
Canada	-2.7	32.6	2.0	5.2
Denmark	-1.4	1.6	0.1	7.9
Australia	-0.7	-1.3	0.2	5.0
Switzerland	0.4	11.0	0.5	6.7
Finland	-0.9	-46.4	0.9	4.3
Sweden	-0.3	-13.1	1.5	6.4
Ukraine[1]	**-2.6**	**22.9**	**-2.9[2]**	**3.0**

Notes: the OECD countries are ranked by the sum of the countries' rank for the first three debt measures; 1) forecast by Investment Capital Ukraine LLC; 2) difference between 2010 nominal GDP growth forecast of 21.43% and effective yield-to-maturity of 24.30% on a three-year bond reported during the 2 March 2010 government bond auction.

Sources: Economist, Investment Capital Ukraine LLC

Chart 31. Ukraine versus OECD countries by net public debt and primary budget balance

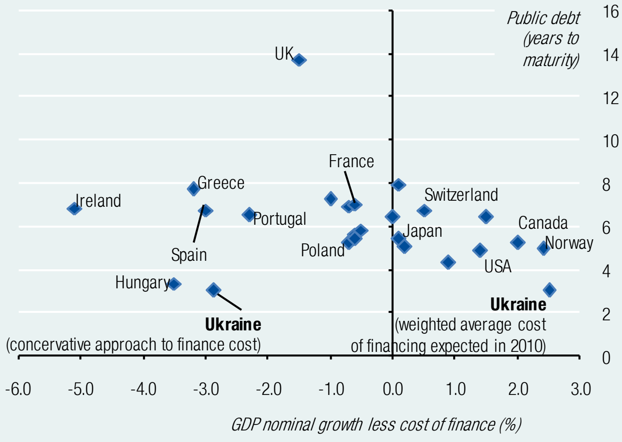
As of year-end 2010 and percentage of GDP in 2010



Sources: Economist, Investment Capital Ukraine LLC

Chart 32. Ukraine versus OECD countries by debt maturity and difference between GDP growth and financing cost

As of year-end 2010



Notes: the figure on public debt years to maturity is weighted average.
Sources: Economist, Investment Capital Ukraine LLC

External balance: focus on minerals trade

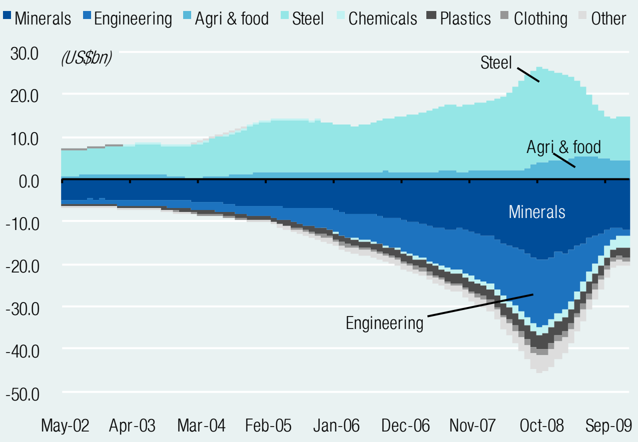
Despite a 15% real GDP drop in 2009, Ukraine's C/A balance did not move into the black,…

In our view, the balance of payments of the economy is going to maintain its shift towards a more balanced shape in both of its parts—in current operations as well as financial flows.

The former changed considerably after the deep recession of early 2009 by shrinking to a C/A deficit of 1.6% of GDP as of year-end of 2009, down from a 7.0% of GDP deficit as of year-end of 2008. The reason why the economy that dropped by 15.0% YoY in real terms did not cut its demand for imports—effectively, the C/A deficit remained in place, albeit with a sizable shrinking in size—and did not produce a surplus on current operations can be largely explained by the terms of trade effect.

Chart 33. Breakdown of merchandise trade balance by merchandise groups

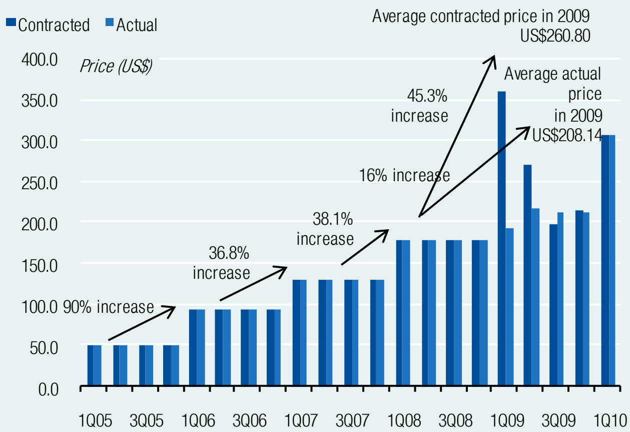
12-month rolling data, history from May 2002 till December 2009



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

Chart 34. Quarterly price for natural gas paid by Naftogaz of Ukraine to Gazprom (Russia)

History from 1Q05 till 1Q10



Note: contracted price is price set up by the parties Naftogaz of Ukraine and Gazprom for a period; actual price is the price derived from Ukraine trade statistics reflecting an average price actually paid for natural gas delivered during the respective period.
Sources: Interfax-Ukraine, Investment Capital Ukraine LLC

…due to the negative terms of trade effect

In fact, the price of steel (particularly of hot-rolled steel products), which is the main export of the economy, declined sharply on the eve of 2009 and bottomed out in mid-2Q9, staying all year long at a level (US$447 a tonne) that was nearly half of the 2008 price level in monthly average terms (US$852/tonne).

Prices of the country's key fuel, natural gas, moved up by 16% in 2009

At the same time, the price of natural gas, which is the key source of primary energy in the country (accounting to a 40.9% share of energy consumed during 2008 in oil equivalent terms, according to the BP Statistical Review of World Energy), rose by 16.0% YoY, from US$179.50 per 1,000 cubic metre in 2008 to an FY09 average of US$208.14, according to statistical data on imported volumes of natural gas.

In fact, the contracted price for natural gas in 2009 was higher (at US$280.80) than the actual price (US$208.14), as the government manoeuvred to consume the natural gas at a cheaper price than was supplied in the previous year. That is why, given the sizable contraction in consumption of natural gas—FY09 imports amounted to 38.0bn cubic metres (bcm), or 27.8% YoY less than the 52.6 bcm imported in FY08—natural gas imports in US dollar terms dropped by 15.1% over the same period.

This differs strikingly with declines of imports of other minerals like crude oil and petroleum products during 2009. Thus, imports of minerals, where hydrocarbons account for the lion's share of the trade volume, excluding natural gas, dropped by 52.0% YoY in US dollar terms. Imports of these goods (crude oil and petroleum products) measured in tonnage changed much less dramatically in 2009 compared to previous year: in fact, imports of crude oil rose by 11.9% YoY, while imports of petroleum products decreased by 25.9% YoY. This underlines the fact that the domestic oil market in Ukraine is much more liberalised than the domestic natural gas market. The former is governed by market-based regulation relating to demand and supply, while the latter is governed and subsidised by the state.

The natural gas price is an essential element for the BoP in 2010,…

Looking forward, the economy's external balance is still to experience an echo of 2009's terms of trade effect, as the natural gas price contracted between Naftogaz of Ukraine and Gazprom is likely to rise, as it is indirectly linked to crude oil, and hence incorporate the previous pick-up in the crude oil price. Our own forecast for the FY10 natural gas price, which is derived from the formula contained in the Naftogaz-Gazprom agreement and market prices on oil products in 2009 and their expected movement in early 2010, is US$330 per 1,000 cubic metres on average terms.

But, it is likely that newly elected president Yanukovych is going to strike a deal with the Russian government to lower the actual price on natural gas to be paid this year. This development has a good chance of materialising, given the following factors:

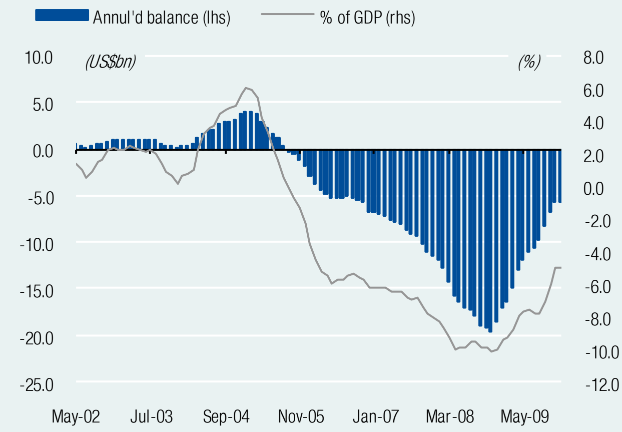
- Firstly, Ukraine is one of the largest clients of Russia's Gazprom, rubbing elbows with the likes as Germany.
- Secondly, the Kremlin has long been seeking a kind of partnership in the natural gas transportation business with Ukraine, involving Ukraine's vast infrastructure of transit pipelines and storage facilities.
- Thirdly, spot prices on natural gas on the global marketplace have trended lower than prices in the long-term contracts between Gazprom and its main consumers (reportedly with German ones), forcing the former to lean towards the latter in order to satisfy its customers' needs. In the end, Gazprom changed its formula on contracts incorporating spot prices.

…but further adjustments in natural gas consumption are likely

But nevertheless, the domestic economy is going to continue its adaptation to the market-based price of its primary source of energy by all means such as substitution, raising energy efficiency, and eventually, cutting consumption. This will especially take hold when the government eventually decides to go ahead with the liberalisation of energy tariffs to households, which is one of the IMF's policymaking requirements for Ukraine's authorities.

Chart 35. Merchandise trade balance

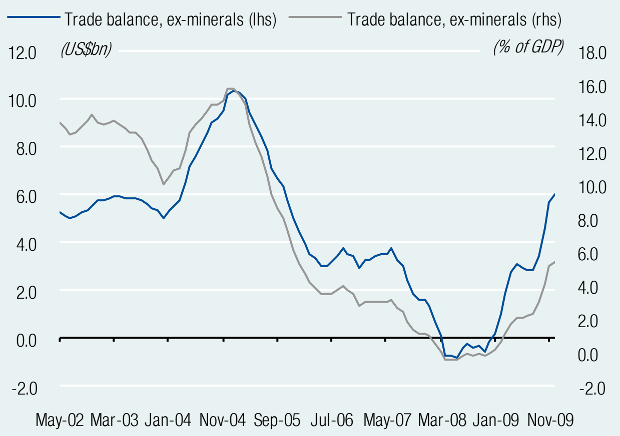
12-month rolling data, history from May 2002 till December 2009



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

Chart 36. Merchandise ex-minerals trade balance

12-month rolling data, history from May 2002 till December 2009



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

Ex-minerals trade surplus has been on the rise,…

Taking a look at the merchandise trade balance that excludes trade in minerals, which, as we showed above, has been a subject of constant increase in the price of natural gas, boosting its volumes, and reflects the low efficiency of the entire economy in natural gas consumption, this proves that demand on imported goods declined on the back of the 2009 recession, and thus provided a surplus in the ex-minerals merchandise trade balance, which rose towards US$6bn during the 12-month period to December 2009. It has been on the rise since early 2009 (see Chart 36 above). In relative terms, as a share of GDP, the ex-minerals trade surplus reached 5.3% as of December 2009; the last time a level of this nature was seen was in January 2006.

…proving that domestic demand has softened considerably

The main driving force behind the rise in the ex-mineral trade surplus has been the sharp reduction in imports of engineering goods, which continued to decline all year long in 2009, with their FY09 volume dropping by 66.9% YoY.

At the same time, the engineering trade balance, which has been in a wide deficit over 2006-08, has declined even faster, by 87.8% YoY, underling that domestic demand for different kinds of engineering goods—from capital goods to personal cars—has been diminishing as one of the key contributors to the overall trade deficit (see Chart 33 on page 34). Thus, imports of passenger vehicles (mostly of personal cars) dropped in FY09 by 83.7% YoY in US dollar terms compared with the previous year and by 83.5% YoY in quantity of imported vehicles, according to the statistical data on this type of imports.

The financial account is likely to see a moderation in outflows of capital in 2010

Regarding the financial account as another part of the BoP, in our view, this is likely to experience the following type of development. Firstly, FDI volumes should be firm and inching higher as investment sentiment improves, thanks to the fact that the elections cycle of 2010 has passed. And secondly, economic recovery and moderation of perceived riskiness of investments into Ukrainian assets are going to support an increase in portfolio investments into the country. Meanwhile, new external borrowings by the private sector are still distant, possibly taking place in 4Q10 at the earliest, as a series of restructurings and occasional technical defaults have put private investors on alert.

Demand for foreign currency cash by local households as a means of retention of savings (to a greater extent) and loan repayments (to a lesser extent) are also likely to moderate. External debt repayments (see table below) seem quite manageable for 2010, both for sovereign and other borrowers.

Table 8. Quarterly volumes of external debt redemptions grouped by type of borrowers (US$m, if not otherwise indicated)
More detailed breakdown of external debt redemptions is provided in Table 9 and Table 10 below

Period	Eurobond market[2]						Syndicated loan market					Total
	Total	Sovereign	Quasi-Sovereign	Foreign-owned	Other[1]	Other (% of total)	Total	Quasi-Sovereign	Foreign owned	Other[1]	Other (% of total)	
1Q10	111.1	20.6	80.2	2.8	7.6	6.8	43.0	0.0	43.0	0.0	0.0	154.1
2Q10	523.5	104.1	28.8	53.5	337.1	64.4	893.5	0.0	116.5	777.0	53.8	1,417.0
3Q10	528.3	20.6	107.5	249.0	151.2	28.6	534.6	0.0	51.0	483.6	90.5	1,062.9
4Q10	602.0	496.5	28.8	53.5	23.2	3.9	284.3	9.3	0.0	275.0	96.7	886.3
1Q11	1,000.5	620.6	107.5	38.2	234.2	23.4	318.0	0.0	38.0	280.0	88.1	1,318.5
2Q11	195.0	97.9	28.8	46.6	21.7	11.1	88.0	0.0	0.0	88.0	100.0	283.0
3Q11	1,126.9	0.0	807.5	281.4	38.1	3.4	1,095.0	0.0	0.0	1,095.0	100.0	2,221.9
4Q11	688.7	97.9	28.8	539.8	22.2	3.2	727.0	0.0	0.0	727.0	100.0	1,415.7
1Q12	643.9	0.0	79.8	13.0	551.2	85.6	0.0	0.0	0.0	0.0	n/m	643.9
2Q12	833.7	597.9	28.8	188.6	18.4	2.2	0.0	0.0	0.0	0.0	n/m	833.7
3Q12	1,018.8	0.0	4.0	896.8	118.1	11.6	2,000.0	500.0	0.0	1,500.0	75.0	3,018.8
4Q12	761.7	81.9	604.6	6.8	68.4	9.0	267.1	37.1	0.0	230.0	86.1	1,028.8

Notes: 1) under 'Other' are meant those borrowers that are domestic and non-government businesses; 2) Eurobond market redemptions include interest payments and redemptions of principal.
Sources: Reuters, Cbonds.Info, DebtWire, Investment Capital Ukraine LLC

Table 9. Quarterly redemptions (US$) for 2010-12 by Ukrainian borrowers of their external debt raised at Eurobond market

Year	Borrower Type	Borrower name	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
2010							
	Sovereign						
		Ministry of Finance	20,625,000	104,146,988	20,625,000	496,542,144	641,939,131
	Quasi-sovereign						
		Kyiv		20,312,500	8,625,000	20,312,500	49,250,000
		Naftogaz of Ukraine	61,031,730		75,763,308		136,795,038
		Ukreximbank	19,125,000	8,500,000	23,115,000	8,500,000	59,240,000
	Foreign-owned businesses						
		Industrial Union of Donbas[1]	2,750,000		2,750,000		5,500,000
		Ukrsibbank		19,375,000	218,937,500	19,375,000	257,687,500
		Kyivstar GSM		6,781,250		6,781,250	13,562,500
		Alfa-Bank		27,320,573	27,320,573	27,320,573	81,961,718
	Other (businesses ultimately owned by Ukrainian shareholders)						
		Azovstal			7,984,375		7,984,375
		Concern Galnaftogaz		2,000,000		2,500,000	4,500,000
		Finance and Credit Bank			4,987,500		4,987,500
		FUIB	7,562,500	7,562,500	7,562,500	7,562,500	30,250,000
		Interpipe[1]			5,500,000		5,500,000
		Nadra Bank		183,093,750			183,093,750
		Pivdenny			105,125,000		105,125,000
		Pryvatbank			20,000,000		20,000,000
		VAB Bank		131,328,125			131,328,125
		XXI Century		13,125,000		13,125,000	26,250,000
Total			**111,094,230**	**523,545,685**	**528,295,755**	**602,018,966**	**1,764,954,637**
	incl. interest payments		111,094,230	223,545,685	228,295,755	209,623,810	772,559,480
	incl. principal redemptions		0	300,000,000	300,000,000	392,395,156	992,395,156

Table 9. Quarterly redemptions (US$) for 2010-12 by Ukrainian borrowers of their external debt raised at Eurobond market

Year	Borrower Type	Borrower name	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
2011							
	Sovereign						
		Ministry of Finance	620,625,000	97,868,665		97,868,665	816,362,330
	Quasi-sovereign						
		Kyiv	8,625,000	20,312,500	208,625,000	20,312,500	257,875,000
		Naftogaz of Ukraine	75,763,308		75,763,308		151,526,615
		Ukreximbank	23,115,000	8,500,000	523,115,000	8,500,000	563,230,000
	Foreign-owned businesses						
		Alfa-Bank	23,905,501	20,490,429	17,075,358	13,660,286	75,131,574
		Industrial Union of Donbas[1]	2,750,000		2,750,000		5,500,000
		Kyivstar GSM		6,781,250		6,781,250	13,562,500
		Ukrsibbank	11,562,500	19,375,000	261,562,500	519,375,000	811,875,000
	Other (businesses ultimately owned by Ukrainian shareholders)						
		Azovstal	182,984,375				182,984,375
		Concern Galnaftogaz		2,500,000		3,000,000	5,500,000
		Finance and Credit Bank	4,987,500		4,987,500		9,975,000
		FUIB	7,562,500	7,562,500	7,562,500	7,562,500	30,250,000
		Pryvatbank	33,125,000		20,000,000		53,125,000
		Interpipe[1]	5,500,000		5,500,000		11,000,000
		XXI Century		11,625,000		11,625,000	23,250,000
Total			**1,000,505,683**	**195,015,344**	**1,126,941,165**	**688,685,201**	**3,011,147,394**
	incl. interest payments		225,505,683	195,015,344	176,941,165	188,685,201	786,147,394
	incl. principal redemptions		775,000,000	0	950,000,000	500,000,000	2,225,000,000
2012							
	Sovereign						
		Ministry of Finance		597,868,665		81,906,165	679,774,830
	Quasi-sovereign						
		Kyiv		20,312,500		270,312,500	290,625,000
		Naftogaz of Ukraine	75,763,308			75,763,308	151,526,615
		Ukreximbank	3,990,000	8,500,000	3,990,000	258,500,000	274,980,000
	Foreign-owned businesses						
		Alfa-Bank	10,245,215	6,830,143	844,048,072		861,123,429
		Industrial Union of Donbas[1]	2,750,000		52,750,000		55,500,000
		Kyivstar GSM		181,781,250		6,781,250	188,562,500
	Other (businesses alternatively owned by Ukrainian shareholders)						
		Concern Galnaftogaz				50,000,000	50,000,000
		Finance and Credit Bank	4,987,500		4,987,500		9,975,000
		FUIB	7,562,500	7,562,500	7,562,500	7,562,500	30,250,000
		Interpipe[1]	5,500,000		105,500,000		111,000,000
		Pryvatbank	533,125,000				533,125,000
		XXI Century		10,875,000		10,875,000	21,750,000
Total			**643,923,522**	**833,730,058**	**1,018,838,072**	**761,700,723**	**3,258,192,374**
	incl. interest payments		143,923,522	158,730,058	28,205,072	211,700,723	542,559,374
	incl. principal redemptions		500,000,000	675,000,000	990,633,000	550,000,000	2,715,633,000

Notes: 1) Interpipe and Industrial Union of Donbas notes are assumed at the volumes left at investors' hands and as being restructured in the following way – a) Interpipe note of US$100m maturing in August 2012 paying a 11% coupon; b) Industrial Union of Donbas note of US$50m maturing in September 2012 paying a 11% coupon.

Sources: Reuters, Cbonds.Info, DebtWire, Investment Capital Ukraine LLC

Table 10. Quarterly redemptions (US$) for 2010-12 by Ukrainian borrowers of their external debt raised at syndicated loan market

Year	Borrower type	Borrower name	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
2010							
	Quasi-sovereign						
		Ukreximbank		84,500,000			84,500,000
		Odesa				9,270,392	9,270,392
	Foreign-owned businesses						
		Forum Bank	12,000,000				12,000,000
		Industrial Union of Donbas			300,000,000		300,000,000
		OTP Bank			37,000,000		37,000,000
		Raiffeisen Bank Aval		116,500,000			116,500,000
		Swedbank	31,000,000		14,000,000		45,000,000
	Other (businesses alternatively owned by Ukrainian shareholders)						
		FUIB			13,570,000		13,570,000
		Grain Trading Co.		100,000,000			100,000,000
		Kernel-Trade			170,000,000		170,000,000
		Nadra Bank		42,500,000			42,500,000
		Poltavsky Iron Ore				275,000,000	275,000,000
		System Capital Management		550,000,000			550,000,000
Total			**43,000,000**	**893,500,000**	**534,570,000**	**284,270,392**	**1,755,340,392**
2011							
	Quasi-sovereign						
		Ukreximbank		50,000,000			50,000,000
	Foreign-owned businesses						
		Industrial Union of Donbas			250,000,000		250,000,000
		ProCredit Bank	38,000,000				38,000,000
	Other (businesses alternately owned by Ukrainian shareholders)						
		Creditprombank		37,996,000			37,996,000
		Donetsk Metalurgic Plant			300,000,000		300,000,000
		Interpipe				187,000,000	187,000,000
		System Capital Management	280,000,000		545,000,000	540,000,000	1,365,000,000
Total			318,000,000	87,996,000	1,095,000,000	727,000,000	2,227,996,000
2012							
	Quasi-sovereign						
		Ukrtelecom[1]			500,000,000		500,000,000
		Odesa				37,081,567	37,081,567
	Other (businesses alternately owned by Ukrainian shareholders)						
		Poltavsky Iron Ore				230,000,000	230,000,000
		System Capital Management			1,500,000,000		1,500,000,000
Total			**0**	**0**	**2,000,000,000**	**267,081,567**	**2,267,081,567**

Notes: 1) Ukrtelecom's debt on US$500m syndicated loan is assumed to be rescheduled to maturing in 2012.

Sources: Reuters, Cbonds.Info, DebtWire, Investment Capital Ukraine LLC

Local currency: still cheap by real TWI and PPP

The hryvnia is undervalued, according to our assessments;…

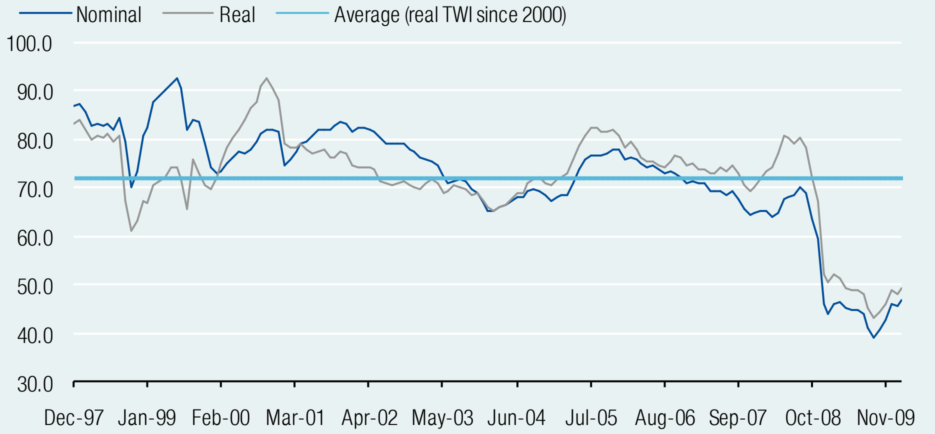
According to our assessments, Ukraine's local currency, the hryvnia, which traded at 7.975/USD on the spot market as of mid-day on 4 March, 2010, is still undervalued. This notion is based on the following considerations:

…its real TWI is well below the long-term average,…

- **UAH's real TWI is deeply below its long-term average.** Our monthly records of the trade-weighted index of the local currency, both in nominal and real terms (for more details on the methodology of this method, please refer to our publication *Quarterly Report* entitled *"Ukrainian jigsaw puzzle,"* published on 14 July, 2009) show that as of the end of February 2010, real TWI was at 49.44 points, up from 49.01 as of year-end 2009, but still quite deeply below its pre-crisis level of 78.51 seen in August 2008. Taking into account that the currency's trade weighted indices in the long run tend to fluctuate around its long-term average level, which for hryvnia's real TWI is 71.90, according to our calculations (see Chart 37 below), hence, Ukraine's currency trade-weighted index is likely to go up (strengthen) during the course of 2010. We discuss this possibility in more detail below on the next page.

Chart 37. Trade-weighted index of the local currency hryvnia (1997-2010)

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



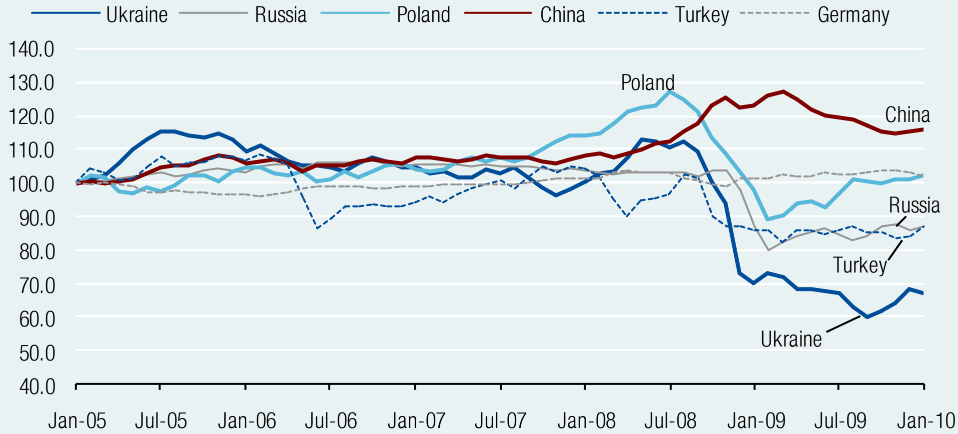
Source: Investment Capital Ukraine LLC

…relative to key trading partners, the UAH's real TWI is the lowest

- **Moreover, Ukraine's currency real TWI is well below that of its main trading partners.** As the following chart shows, the Ukraine's currency's 60% devaluation staged in 4Q08 was not only the deepest one in nominal terms, but the currency also appears to be among the most devalued ones if considered in real terms, i.e., if viewed through the prism of real trade-weighted indices of local currencies of Ukraine's key trading partners (see Chart 38). Thus, since September 2008, when the global economy started to slip into the Great Recession, and until early 2010, the TWI of Ukraine's currency experienced the fastest pace in losing its value. While many emerging market economies experienced the same scenario (most of these currencies devalued both in nominal and real terms, except China, which brought about a *de facto* pegging of its currency to the US dollar) but later recovered previous losses, again, both in nominal and real terms. This was especially true for Poland, whose real TWI strengthened over 2009, while Russia's and Turkey's real TWI remained largely stable after weakening. Such a proportion among the indices, in our view, is also supportive to the above-mentioned idea that Ukraine's currency's real TWI has more of a chance of staging an upward-moving trajectory than a downward-moving one.

Chart 38. Ukraine versus its main trading partners by real TWI

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



Source: Bank for International Settlements, Investment Capital Ukraine LLC

…allowing us to suggest that nominal appreciation of the UAH is one of the key drivers of its real TWI adjustment

- **Hence, UAH real TWI is most likely to strengthen in 2010.** Generally, this movement could take place via a combination of factors such as higher domestic inflation versus inflation in trading partners' economies, nominal appreciation of the local currency hryvnia, and lower inflation (or even deflation) in key trading partners' economies and via their currencies' devaluation. Assuming that external factors are constant, the UAH's real TWI strengthening may take place via an acceleration of inflation beyond the current level of 11.3% YoY (towards, e.g., beyond 15% YoY, or even back to 20% YoY) and/or nominal appreciation of the exchange rate of the UAH against the US dollar beyond its current spot level of 7.975/USD. At the same time, our own assessment of the future movement of inflation (these are derived from the IMF's most recent World Economic Outlook publication) and the exchange rates of the local currencies of Ukraine's key trading partners (taken from Non-Deliverable Forward (NDF) market quotations) indicate that external developments are only going to marginally impact the future path of UAH real TWI. Thus, in Russia, which is Ukraine's largest trading partner, and whose weighting in the index amounts to 34%, inflation is expected to slow by 2-3ppt in 2010, and the RUB/USD is priced by NDF market to be around 30/USD at the end of the year, i.e., largely stable. Furthermore, our own forecast on inflation in Ukraine in 2010 averages 11.4%, down from the 16.0% average consumer price inflation in the previous year, leaving us with the only driver of UAH real TWI strengthening of nominal appreciation.

Purchasing power parity also points to an undervalued UAH

- **ICU PPP measurement points to an undervalued currency, too.** In addition to our UAH real TWI calculations, we began at the end of this February an observation of local prices on certain consumer goods and services in three cities: Kiev, New York, and Moscow. The ICU basket (see table on next page) consists of standardised tradable goods and services, which are very general from the consumer's point of view, to provide an indication, albeit a rough one, of the local currency's over- or undervaluation against the pair of key foreign currencies, which is essential to Ukraine's export economy, applying the purchasing power parity (PPP) theory. It suggests towards what kind of level the exchange rate will seek over the long run. Our first ICU PPP observation held at the end of February and early March supports the above-mentioned stance that Ukraine's local currency, the hryvnia, is still undervalued, for the time being.

Table 11. ICU PPP observation in 1Q10: Ukraine's local currency hryvnia versus US dollar (USD) and Russian ruble (RUB)

Item of the basket	Description	Kiev, central district 20-Feb-10 Price (UAH)	New York, metropolitan area 19-Feb-10 Price (US$)	Moscow, central district 2-Mar-10 Price (RUB)
Consumer goods				
Coca-cola (0.5 litre, plastic bottle)	Non-alcohol beverages	4.50	1.62	34.90
Beer Stella Artois (0.33 litre, glass bottle)	Alcohol beverages	4.97	0.62	32.27
Bunch of fresh bananas (1 kg)	Imported from Ecuador	11.21	1.74	54.90
Pack of milk (1 litre)	Locally produced, soft package, i.e. not glass bottle	6.98	1.10	36.90
Chicken meat (1 kg pack)	Locally produced and branded package	34.98	9.44	259.00
Canned pineapple (0.85 kg, can)	Pineapple circles, Dole brand	18.22	2.70	109.00
Pasta (0.5 kg)	Soft package, produced in Italy	11.91	1.50	62.90
Sugar (1 kg)	Locally produced and branded package	11.25	1.76	38.90
Package of table salt (0.5 kg)	Locally produced and branded package	4.18	0.28	7.95
Chicken eggs (10 units pack)	Locally produced and branded package	8.98	2.33	72.90
Chocolate (100 g)	Made by Craft Foods Corp, Milka brand, no additives	7.99	1.99	55.90
Toothpaste (100ml package)	Colgate brand	15.59	1.68	84.90
Shampoo (200ml package)	Head & Shoulders brand, for normal hair	24.48	2.38	149.00
Toilet paper (4 rolls package)	Kleenex Cottonelle brand, white paper, regular toilet tissue	14.85	2.69	78.90
Magazine	Men's Health, local edition, A4 format	13.00	3.75	110.00
Gasoline (1 litre)	Lukoil, regular or A-95	7.98	0.75	24.07
Services				
Underground commute ticket	Within the central part of the city	1.70	2.00	26.00
Cinema ticket	Thursday's night price for the seat with good location, Hollywood film	50.00	10.75	300.00
Total basket value (in local currency)		**252.77**	**49.08**	**1,538.39**
Exchange rate versus US dollar at spot market as of date of observation		7.993	1.000	29.827
Total basket value (in US$)		**31.62**	**49.08**	**51.58**
Overvalued "+" / undervalued "-" (%)				
UAH vs USD		**-35.57**		
UAH vs RUR		**-38.69**		
Fair value in the long-run				
UAH/USD		**5.150**		
UAH/RUR		**0.164**		

Note: Prices are recorded at supermarkets. Source: Investment Capital Ukraine LLC

Forecast viewpoints

Our three-year forecast for 2010-12 is based upon the following key basic considerations. Firstly, the domestic economy's recovery after a deep 2009 recession is likely to feature a subdued level of real GDP growth, which is to be lower than 2000-07 average of 7%. This is mainly because of domestic demand, in our view, and is likely to be constrained due to the lower ability of the indebted consumer to spend as s/he was able to in the recent past. Moreover, the banking sector, which has been grappling with a deteriorated loan portfolio, appears to be in an environment that does not spur lending to businesses and consumers. Hence, banks may lend only a very weak hand to the economy in terms of fuelling its growth by commercial lending.

Key viewpoints in detail

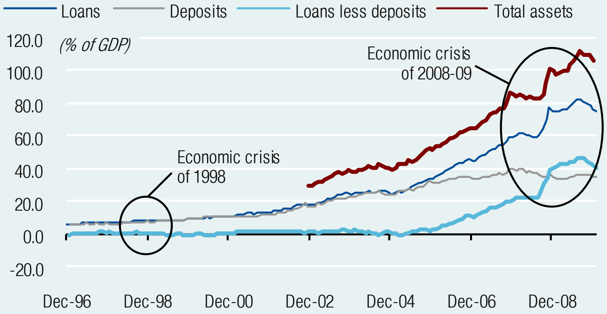
Domestic demand

The banking sector is not likely to be an engine for economic growth in 2010

During 2005-07, the banking sector made a powerful contribution to the country's economic growth. Banking sector assets doubled as a share of GDP from early 2005 to the middle of 2008, while growth rates of bank lending volumes adjusted for inflation reached nearly 93% in July 2007 (a historical high), with regard to lending in foreign currencies, and was hovering within 35-50% range, if considering only the bank lending in the local currency (see Chart 39 below).

Chart 39. Banking sector as a weak element of the economy: banking sector's troubles of 2008-09 are apparently more sizable than during the country's past economic crisis of 1998

Evolution of banking sector's balance sheet as a percentage of GDP since December 1996 till January 2010



Note: total assets statistics is available since December 2002.
Sources: National Bank of Ukraine, State Statistics Committee of Ukraine, Investment Capital Ukraine LLC

Percentage change over a year ago of the inflation adjusted loan portfolio of the banking sector: local currency loan book is adjusted for UAH headline CPI and foreign currency portfolio is adjusted for USD headline CPI

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

Concerning the banking sector and its participation in the country's economic activity, there is one vivid similarity between two economic crises that hit the country during the span of the last 10 years—the one that occurred in 1998, and the 2008-09 one—a faster build-up of foreign currency loans in the banking sector loan portfolio versus local currency loans on the eve of each crisis. While origins of these crises differ by nature, they raised concerns on the banking sector's ability to rebuild its balance sheet and resume lending, which would in turn support business and consumer demand.

After the 1998 economic crisis, which featured a local currency devaluation, it took about a 1.5-year period for the banking sector to resume its lending towards a sustainable growth path. But, back in the second half of the 1990s, the local banking sector was much smaller in sizable than nowadays—the loan portfolio of the entire banking sector was just 8.0% of GDP as of August 1998. Moreover, the banking sector's book was quite balanced between the volume of deposits on the balance sheet and volumes of loans extended mainly to businesses (household lending was nearly non-existent at that time).

It may take more time than in the past to return lending to a sustainable growth path

The banking sector's shape on the eve of the 2008-09 economic crisis, which again featured a deep devaluation of the local currency and a steep, while, short recession, was strikingly different if compared to 1998. It grew massively in size—the loan book of the banking sector as a share of GDP increased more than 7x in 10 years, from 8.0% in August 1998 to 59.5% in August 2008. Furthermore, it became more unbalanced if volumes of loans and deposits are compared—in August 1998, the loans-to-deposits ratio was at 1.0x, while in August 2008, it was 1.6x. The financing gap has been filled by wholesale borrowings from capital markets and the syndicated loan market, mainly from abroad.

As banks continue to remedy their balance sheets—via all available means of additional capital injections, restructuring of wholesale borrowings (that kill possibilities of new borrowings from this type of lenders), and recrafting of their lending practices—this may take a longer period this time for the sector to put its lending back on a sustainable growth path. In our view, this may not take place until the end of 2H10 at the earliest.

Hence, an economic recovery is unlikely to come about quickly without such a powerful tool as bank lending in 1H10 and major part of 2H10. The government appears to have its hands tied as its fiscal stimulus has ended up with supporting public sector wages and pensions alongside rescuing Naftogaz, the state-owned natural gas supplier, from high natural gas prices (as it sells natural gas to households and public service enterprises at a regulated tariff that is markedly lower than the wholesale price paid by Naftogaz for the fuel). Hopefully, private businesses may restart their investment programmes on the back of lowered political risk (thanks to the end of presidential elections, a factor that created uncertainty and hence influenced the actions and decisions of private businesses); as in 2009, fixed investments as a component of GDP declined by their fastest historical pace of 48.1% YoY.

Foreign demand

Net exports are an aid to economic growth

Due to the fact that the real trade-weighted index of the local currency, as we argued above, declined sizably and provided local producers of tradable goods with greater external competitiveness, foreign demand is likely to be one of the main engines of economic growth this year.

While domestic demand, as we expect, is likely to be weak—due to an undervalued local currency, limited new bank lending due both to banks' heighted risk perception and borrowers' low demand for new debt—import growth may lag behind export growth. Another important factor is the economy's shift, albeit a slow one, to raise its energy efficiency as higher natural gas prices are to make slow progress on reaching wider ranks of consumers, i.e., household consumers are to face a step-up increase in the natural gas tariff, as the government will have less scope in which to finance the gap.

Prices and exchange rate

Inflation acceleration is again a risk for 2010

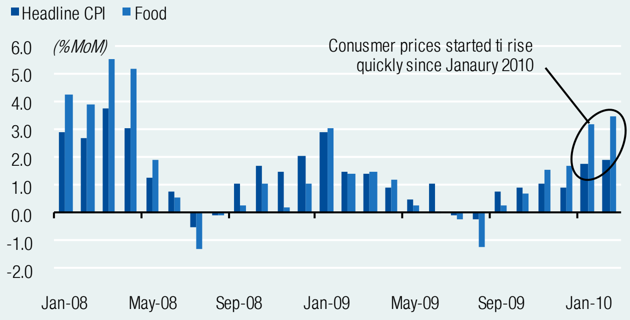
Dynamics of prices, i.e., headline price indices, in our view have the potential to slow their downward movement and return back to a path of increasing. Indeed, headline CPI ended 2009 at 12.3% YoY and at 16.0% on average terms for entire year. This is marginally down from 22.3% YoY in December 2008 and the 25.3% average headline CPI for 2008. However, in first two months of 2010, headline CPI started steadily rising, by 1.8% MoM in January and 1.9% in February (see Chart 40 below) mainly due to sharply higher prices on certain foods.

Policymakers will face a challenging choice,…

In our view, the countries' authorities, who are currently undergoing changes following presidential elections due to a win of opposition forces, are to face a challenge in terms of adopting proper policymaking choices. This challenge has its roots in the following factors: politicians called for stability in the exchange rate more loudly than for stability of prices. Naturally, the public remembered the steep devaluation of the local currency of 4Q08, and continued to accumulate savings in foreign currencies—the central bank's statistics on net volume of foreign currency purchases, averaging to US$0.7 a month in 2009, proves that. However, the fact that prices are moving up again, in our view, is partially explained by a weak currency, the real and nominal value of which have bottomed in late 2008, and, in fact, have not recovered markedly since then (see Chart 41).

Chart 40. Inflation stepped up in 1Q10

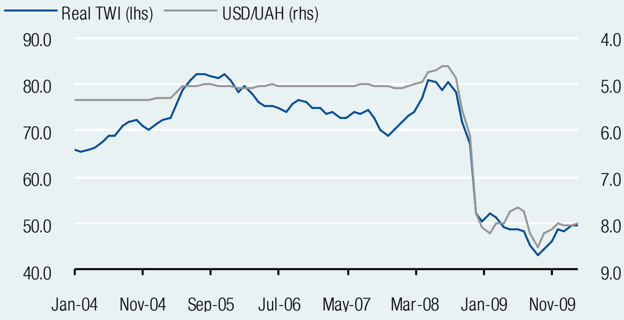
Percentage change over a previous month of headline CPI and food component of the CPI basket



Source: State Statistics Committee of Ukraine

Chart 41. UAH remains on the bottom

UAH real TWI versus monthly average spot exchange rate of UAH against USD (reversed axis)



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

…balancing the potential for an inflation increase,…

While local goods, due to an undervalued currency, have become much more competitive to external buyers, a kind of inflation potential has been created as local prices are likely to shift gradually upward to eliminate this advantage once domestic demand recovers from the shock of recession. Apparently, the recent pick-up in monthly headline CPI figures leads us to acknowledge that the above-mentioned hypothesis has started to materialise.

…with a currency appreciation potential

Hence, the authorities, i.e., the newly elected president and likely his government, are bound to take a closer look at this development. As one public opinion poll recently revealed that the local public considers price instability, i.e., inflation, as its biggest concern, followed by employment considerations, among other factors, exchange-rate stability did not top the list of public concerns, and instead won just a middle ranking among them. Hence, there is the probability that politicians will stick firmly with exchange-rate stability and allow greater flexibility of the exchange rate, which is one of conditions of the Stand-By Arrangement with the IMF—to ease inflationary pressures that are stemming the local currency weakness.

At the same time, authorities will be cautious on exchange-rate flexibility; if they see the first gleams of easing of inflation growth, their attitude regarding the exchange rate is likely to remain at an orthodox approach of nominal stability, albeit within some implicit and unofficial bans. This is also explained by the fact that those leaders who have come into power following the presidential elections are by nature viewing economic growth with regard to the exporters. That is why we based our view on the currency that its appreciation potential, albeit with some wiggle room, will be limited to 7.7/USD as of year end 2010.

Quarterly forecast

Table 12. Forecast of key macroeconomic indicators for 2010-12 (quarterly)

	4Q09	1Q10E	2Q10F	3Q10F	4Q10F	1Q11F	2Q11F	3Q11F	4Q11F	1Q12F	2Q12F	3Q12F	4Q12F
Activity													
Real GDP (%YoY)	-7.0	2.0	3.5	2.5	2.0	3.5	3.5	3.0	3.0	3.5	3.5	3.5	3.5
Nominal GDP (UAHbn, qtly)	271.6	219.4	256.1	305.2	327.6	265.0	302.2	357.7	382.0	308.4	352.5	415.8	443.7
Nominal GDP (US$bn, qtly)	33.5	27.3	31.8	38.4	42.0	34.4	40.3	47.7	50.9	42.5	49.6	59.4	63.4
GDP per capita (US$, ann)	2,469	2,575	2,693	2,863	3,053	3,211	3,401	3,609	3,810	3,991	4,200	4,461	4,739
Unemployment rate (%)	8.8	8.9	8.7	8.2	8.0	7.8	7.8	7.6	7.6	7.4	7.1	7.1	7.1
Prices													
CPI headline (%YoY, eop)	12.3	11.7	11.7	11.4	12.7	9.9	9.4	10.1	9.0	8.3	7.2	6.0	6.6
CPI headline (%YoY, average)	13.4	11.4	11.9	11.7	12.1	10.9	9.4	9.7	9.6	8.5	7.8	6.4	6.2
PPI (%YoY, eop)	15.3	18.3	22.7	18.1	19.6	16.1	12.3	12.3	10.7	11.0	12.7	12.7	12.7
PPI (%YoY, average)	11.6	17.7	22.0	20.5	18.7	17.3	13.2	12.3	11.2	10.8	12.1	12.7	12.7
Fiscal balance													
Cons'd budget balance (UAHbn)	-11.0	-4.5	-11.5	-6.6	-25.2	0.8	-8.4	-2.2	-24.3	1.0	-9.5	-2.7	-28.4
Cons'd budget balance (% of GDP)	-4.1	-2.1	-4.5	-2.2	-7.7	0.3	-2.8	-0.6	-6.4	0.3	-2.7	-0.6	-6.4
Budget balance (UAHbn)	-11.3	-4.2	-9.6	-6.0	-20.3	-0.2	-7.4	-2.9	-19.9	-0.2	-8.4	-3.4	-23.2
Budget balance (% of GDP)	-4.2	-1.9	-3.8	-2.0	-6.2	-0.1	-2.5	-0.8	-5.2	-0.1	-2.4	-0.8	-5.2
External balance													
Exports (US$bn)	14.6	14.2	14.9	16.0	16.4	16.1	17.0	18.2	19.0	18.4	19.1	20.1	21.3
Imports (US$bn)	15.7	13.6	14.0	16.1	16.7	15.8	15.9	17.7	18.8	18.1	18.2	20.2	21.7
Trade balance (US$bn)	-1.1	0.6	0.9	0.0	-0.3	0.3	1.1	0.5	0.2	0.3	0.9	-0.1	-0.4
Trade balance (% of GDP)	-3.1	2.1	3.0	0.0	-0.7	0.7	2.6	1.0	0.5	0.7	1.9	-0.2	-0.6
Current account balance (US$bn)	-0.7	0.8	1.3	0.2	0.0	0.5	1.4	0.8	0.6	0.6	1.3	0.2	0.0
Current account balance (% of GDP)	-2.1	2.7	4.1	0.5	0.1	1.4	3.5	1.7	1.2	1.4	2.6	0.4	0.0
Net FDI (US$bn)	1.2	1.0	1.3	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.4	1.4	1.5
Net FDI (% of GDP)	3.4	3.8	3.9	3.1	2.9	3.5	3.3	2.7	2.6	3.2	2.9	2.4	2.3
C/A bal. + net FDI (% of GDP)	1.4	6.6	8.0	3.7	3.1	4.9	6.8	4.4	3.9	4.6	5.5	2.8	2.3
External debt (US$bn, eop)	107.5	108.4	108.6	108.9	110.6	109.8	111.0	111.0	111.9	112.2	113.0	111.2	112.9
External debt (% of ann'd GDP, eop)	94.6	91.7	87.9	83.1	79.2	74.9	71.6	67.5	64.5	61.9	59.2	54.9	52.5
FX reserves (US$bn, eop)	26.5	26.4	26.1	26.1	26.0	25.4	25.3	25.8	25.6	24.9	25.3	25.1	25.2
FX reserves (% of ann'd GDP, eop)	23.3	22.4	21.2	19.9	18.6	17.3	16.3	15.7	14.8	13.7	13.3	12.4	11.7
External debt / FX reserves (x, eop)	4.1	4.1	4.2	4.2	4.3	4.3	4.4	4.3	4.4	4.5	4.5	4.4	4.5
FX reserves imports cov. (months)	7.1	6.9	6.7	6.6	6.5	6.1	5.9	5.9	5.7	5.3	5.3	5.1	4.9
Interest rates													
Central bank key rate (%, eop)	10.25	10.25	11.00	11.00	10.50	10.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
3-month rate (%, average)	15.00	13.00	12.00	12.00	11.50	10.00	7.50	7.50	7.50	7.50	7.50	7.50	7.50
Exchange rates													
UAH trade-weighted index (nominal)	46.09	46.91	47.01	47.44	47.96	48.54	49.91	49.85	50.11	51.66	52.63	53.33	53.27
UAH trade-weighted index (real)	49.01	49.54	49.74	50.29	51.36	51.59	52.64	52.18	52.05	52.15	52.83	53.22	54.09
UAH/US$ (eop)	8.00	7.98	8.05	7.95	7.80	7.70	7.50	7.50	7.50	7.25	7.10	7.00	7.00
UAH/US$ (average)	8.10	8.02	8.05	7.95	7.80	7.70	7.50	7.50	7.50	7.25	7.10	7.00	7.00
UAH/€ (eop)	11.45	10.82	10.95	11.13	11.08	10.78	10.43	10.43	10.28	9.93	9.87	9.80	9.80
UAH/€ (average)	11.96	11.18	10.95	11.13	11.08	10.78	10.43	10.43	10.28	9.93	9.87	9.80	9.80
US$/€ (eop)	1.43	1.36	1.36	1.40	1.42	1.40	1.39	1.39	1.37	1.37	1.39	1.40	1.40
US$/€ (average)	1.48	1.36	1.36	1.40	1.42	1.40	1.39	1.39	1.37	1.37	1.39	1.40	1.40
Population													
Population (million, eop)	45.9	45.8	45.7	45.7	45.6	45.6	45.5	45.5	45.4	45.4	45.4	45.4	45.2
Population (%YoY)	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5	-0.5	-0.5	-0.5	-0.3	-0.3	-0.3	-0.3

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

Source: Investment Capital Ukraine LLC

Annual forecast

Table 13. Forecast of key macroeconomic indicators for 2010-12 (annual)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010F	2011F	2012F
Activity													
Real GDP (%YoY)	5.9	9.2	5.2	9.6	12.1	2.6	7.1	7.6	2.1	-15.0	2.5	3.2	3.5
Nominal GDP (UAHbn)	170	204	226	267	345	441	544	713	950	913	1,108	1,307	1,520
Nominal GDP (US$bn)	31	38	42	50	65	87	108	142	184	114	140	173	215
GDP per capita (US$, ann)	629	779	874	1,044	1,371	1,850	2,319	3,058	3,981	2,476	3,062	3,821	4,754
Unemployment rate (%)	11.6	10.9	9.6	9.1	8.6	7.2	6.2	6.4	6.4	8.8	8.0	7.6	7.1
Prices													
CPI headline (%YoY, eop)	25.8	6.1	-0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	12.7	9.0	6.6
CPI headline (%YoY, average)	28.2	12.3	0.8	5.2	9.0	13.6	9.1	12.8	25.3	16.0	11.8	9.9	7.2
PPI (%YoY, eop)	20.6	0.9	5.8	11.2	24.3	9.6	15.4	23.2	21.1	15.3	19.6	10.7	12.7
PPI (%YoY, average)	20.9	8.9	3.1	7.8	20.3	17.0	9.6	20.5	33.6	7.4	19.7	13.5	12.1
Fiscal balance													
Cons'd budget balance (UAHbn)	1.0	-1.3	1.7	-0.5	-11.8	-7.7	-3.7	-7.7	-24.9	-67.5	-46.2	-32.1	-37.3
Cons'd budget balance (% of GDP)	0.6	-0.6	0.8	-0.2	-3.4	-1.7	-0.7	-1.1	-2.6	-7.4	-4.2	-2.5	-2.5
Budget balance (UAHbn)	N/A	-1.3	1.2	-1.0	-10.2	-7.9	-3.8	-5.5	-25.6	-68.2	-40.1	-30.4	-35.3
Budget balance (% of GDP)	N/A	-0.6	0.5	-0.4	-3.0	-1.8	-0.7	-0.8	-2.7	-7.5	-3.6	-2.3	-2.3
External balance													
Exports (US$bn)	19.5	21.1	23.4	29.0	41.3	44.4	50.2	64.0	85.6	53.0	61.6	70.3	79.0
Imports (US$bn)	17.9	20.5	21.5	27.7	36.3	43.7	53.3	71.9	100.1	55.7	60.4	68.2	78.3
Trade balance (US$bn)	1.6	0.6	1.9	1.3	5.0	0.7	-3.1	-7.9	-14.5	-2.7	1.2	2.0	0.7
Trade balance (% of GDP)	5.1	1.6	4.4	2.6	7.7	0.8	-2.8	-5.6	-7.9	-2.4	0.9	1.2	0.3
Current account balance (US$bn)	1.5	1.4	3.2	2.9	6.9	2.5	-1.6	-5.9	-12.9	-1.8	2.3	3.3	2.2
Current account balance (% of GDP)	4.8	3.7	7.5	5.8	10.6	2.9	-1.5	-4.2	-7.0	-1.6	1.6	1.9	1.0
Net FDI (US$bn)	0.6	0.8	0.7	1.4	1.7	7.5	5.7	9.2	9.7	4.4	4.7	5.2	5.7
Net FDI (% of GDP)	1.9	2.0	1.6	2.8	2.6	8.7	5.3	6.5	5.3	3.9	3.4	3.0	2.6
C/A bal. + net FDI (% of GDP)	3.4	3.4	4.8	5.7	9.5	11.2	3.7	0.6	-7.7	2.1	5.7	6.3	4.8
External debt (US$bn, eop)	N/A	N/A	N/A	23.8	30.6	40.7	54.5	80.0	101.7	107.5	110.6	111.9	112.9
External debt (% of ann'd GDP, eop)	N/A	N/A	N/A	47.5	47.2	46.9	50.4	56.4	55.3	94.6	79.2	64.5	52.5
FX reserves (US$bn, eop)	1.4	3.0	4.2	6.9	9.5	19.4	22.3	32.5	31.5	26.5	26.0	25.6	25.2
FX reserves (% of ann'd GDP, eop)	4.3	7.8	10.0	13.8	14.7	22.3	20.6	22.9	17.2	23.3	18.6	14.8	11.7
External debt / FX reserves (x, eop)	N/A	N/A	N/A	3.4	3.2	2.1	2.5	2.5	3.2	4.1	4.3	4.4	4.5
FX reserves imports cov. (months)	1.1	2.1	2.8	3.6	3.8	6.4	6.1	6.4	4.5	7.1	6.5	5.7	4.9
Interest rates													
Central bank key rate (%, eop)	27.0	12.5	7.0	7.0	9.0	9.5	8.5	8.0	12.0	10.3	10.5	8.0	8.0
3-month rate (%, eop 4Q)	N/A	N/A	N/A	17.9	15.0	11.5	9.9	7.6	21.6	15.0	12.0	10.0	11.0
Exchange rates													
UAH trade-weighted index (nominal)	81.57	83.45	77.64	66.81	67.19	77.84	70.90	64.93	45.89	46.09	47.96	50.11	53.27
UAH trade-weighted index (real)	88.20	77.13	70.35	67.18	70.41	80.93	74.89	70.19	52.41	49.01	51.36	52.05	54.09
UAH/US$ (eop)	5.43	5.34	5.33	5.33	5.31	5.05	5.05	5.05	7.80	8.00	7.80	7.50	7.00
UAH/US$ (average)	5.48	5.37	5.33	5.33	5.32	5.10	5.03	5.03	5.25	8.03	7.95	7.55	7.09
UAH/€ (eop)	5.24	5.12	4.75	5.60	6.71	7.20	5.97	6.66	7.36	10.90	11.08	10.28	9.80
UAH/€ (average)	5.06	4.81	5.04	6.04	6.62	6.35	6.32	6.89	7.67	11.19	11.01	10.48	9.85
US$/€ (eop)	0.94	0.89	1.05	1.26	1.36	1.18	1.32	1.46	1.40	1.30	1.42	1.37	1.40
US$/€ (average)	0.92	0.90	0.95	1.13	1.24	1.24	1.26	1.37	1.47	1.39	1.39	1.39	1.39
Population													
Population (million, eop)	49.4	48.9	48.5	48.0	47.3	47.0	46.6	46.4	46.1	45.9	45.6	45.4	45.2
Population (%YoY)	-1.0	-1.0	-1.0	-0.9	-1.4	-0.8	-0.7	-0.6	-0.5	-0.6	-0.6	-0.5	-0.3

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

Source: Investment Capital Ukraine LLC

Disclosures

ANALYST CERTIFICATION

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.

Office 44, 11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kiev, 01030 Ukraine
Phone/Fax +38 044 2200120

CHAIRMAN OF THE BOARD OF DIRECTORS
Valeria Gontareva
valeria.gontareva@icu.ua

MANAGING DIRECTOR, TRADING & SALES
Konstantin Stetsenko
konstantin.stetsenko@icu.ua

MANAGING DIRECTOR, CORPORATE FINANCE
Makar Paseniuk
makar.paseniuk@icu.ua

DIRECTOR, CORPORATE FINANCE
Volodymyr Demchyshyn
volodymyr.demchyshyn@icu.ua

RESEARCH DEPARTMENT

Alexander Valchyshen
Head of Research
alexander.valchyshen@icu.ua

Olga Nosova
Analyst
olga.nosova@icu.ua

Lee Daniels
Editor
lee.daniels@icu.ua