Ukraine:
Current Economic Situation and Prospects

Dr. Edilberto Segura
Partner and Chief Economist, SigmaBleyzer
President of the Board, The Bleyzer Foundation

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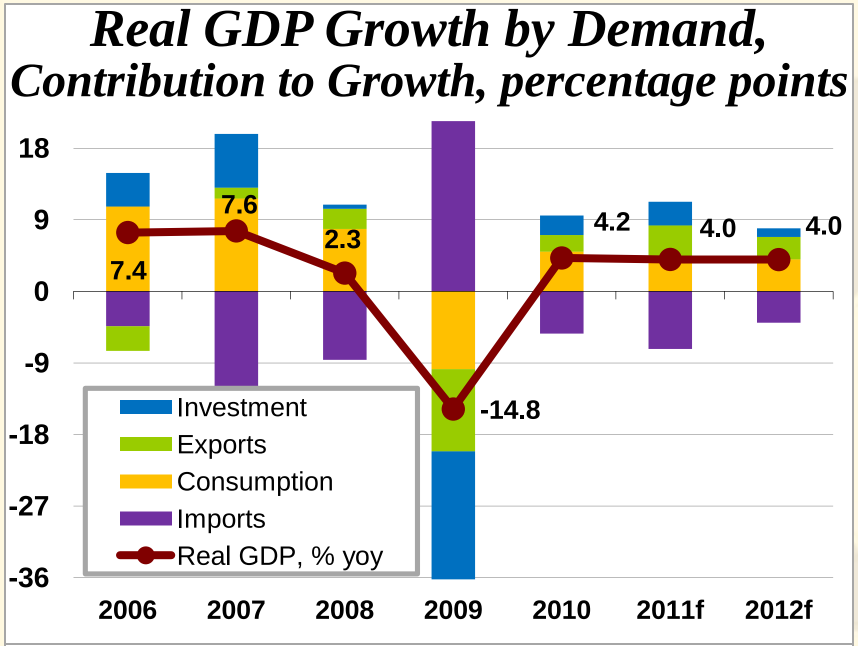
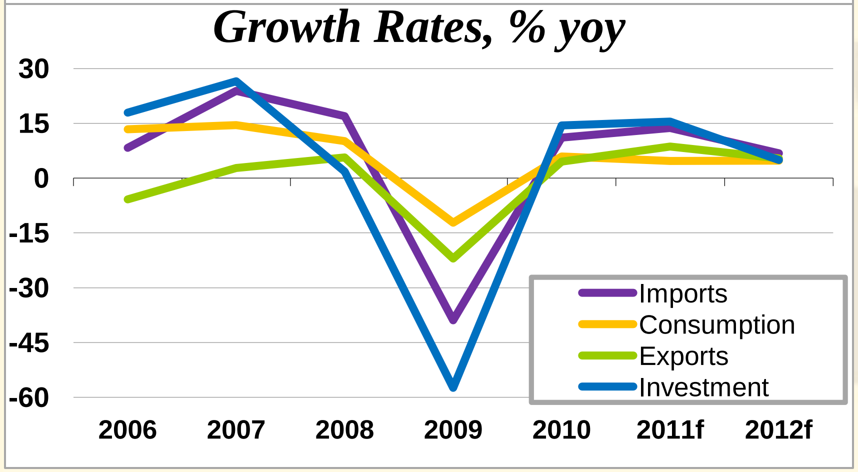
Main Macroeconomic Indicators

	2006	2007	2008	2009	2010	2011f	2012f
Real GDP Growth, % yoy	7.3	7.9	2.3	-14.8	4.2	4.0	4.0
Fiscal Balance, % GDP*	-0.7	-1.7	-2.0	-8.8	-6.5	-4.0	-3.0
Consumer Inflation, %, eop	11.6	16.6	22.3	12.3	9.1	10-11	9.0
UAH/$ Exchange Rate, eop	5.1	5.1	7.7	8.0	8.0	8.0	8-8.5
Current Account, % GDP	-1.5	-3.7	-7.0	-1.5	-1.9	-4.5	-4.5
Gross Int. Reserves, $ bn	22.4	32.5	31.5	26.5	34.6	35.0	31.0
Foreign Gov't Debt, % GDP	11.0	8.7	9.2	20.5	25.5	24.5	23.0
Foreign Private Debt, % GDP	39.6	47.4	47.1	68.1	63.8	56.4	50.0

* *Includes implicit pension fund deficit (credits from unified Treasury account (state budget) to cover pension fund expenditures) for 2007-2008 and Pension Fund and Naftogaz imbalances since 2009, excluding bank recapitalization and VAT bonds*

Economic Growth

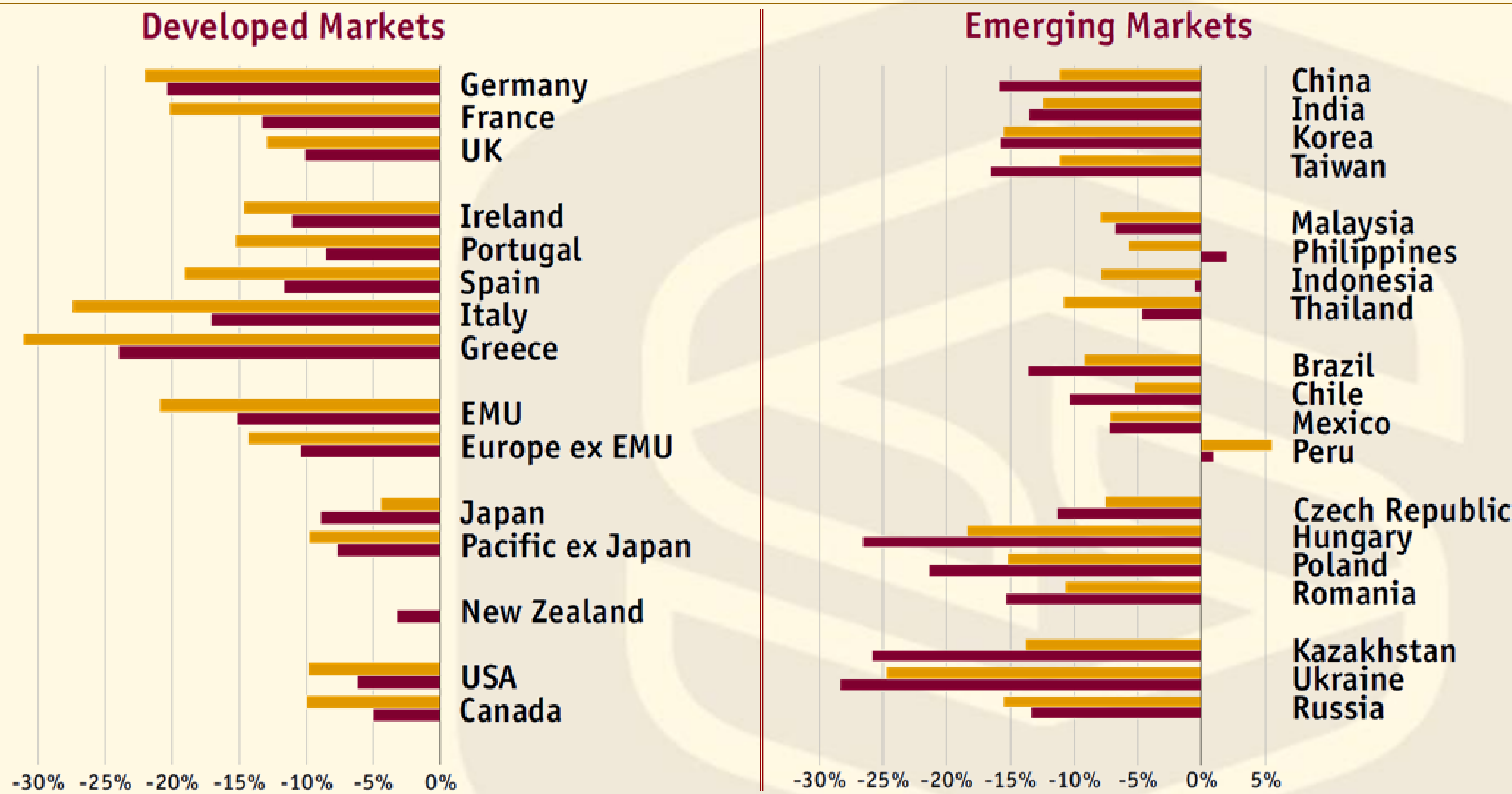




Source: State Statistics Committee, The Bleyzer Foundation

- Real GDP grew by 4.4% yoy in 1H 2011 (3.5% yoy in 2H 2010).
- This growth was broad-based, driven by robust domestic consumption, strong investments, and solid exports.
- But the outlook for 2H 2011 has recently worsened due to:
  - deterioration of global economic growth prospects; and
  - weakening consumer demand.
- Therefore, our GDP growth forecast was revised slightly downwards to 4.0% both in 2011 and 2012.

External Environment – August Global Equity Plunge



Data as of Aug. 30, 2011 Source: MSCI

There were two major factors that caused the sell off in stock markets in August:

1. A sudden realization of weaker economic fundamentals across the world.
2. A panic response to the S&P downgrade of US and political infighting over debt.

1. Weaker Economic Fundamentals

- Disappointing real GDP data in most developed economies:
  - **US** GDP growth estimates were revised downwards to 0.4% yoy for 1Q 2011 and 1.0% for 2Q 2011 (against estimates of 1.8%, and 1.3%, resp).
  - In addition, new estimates for previous years showed that the depth of recession in the US was underestimated by a wide margin.
  - In the **Euro zone**, data for the 2Q 2011 on GDP growth showed that economic growth slowed down to 0.2% from 0.8% in 1Q 2011.
  - Unlike in the previous quarter, economic growth stalled in core Euro zone countries – France and Germany.
  - The slowdown in the European countries was driven by the severe fiscal austerity measures that are being taken to contain the debt crisis.
  - However, there were also temporary factors: Japan’s disaster, high energy prices, unfavorable weather, etc.
  - But the new data signaled that the growth weaknesses started even before the disruptions caused by Japan’s disaster.

2. Worsening Investor Sentiments

- The deterioration of economic fundamentals, and even the Euro zone crisis (whose situation was known earlier) do not explain the severity of the stock price collapse of August 2011.
- Rather, the collapse was magnified by a crisis of confidence caused by:
  - The downgrade by S&P of the US debt rating;
  - Political infighting in the US over raising the US debt ceiling and fiscal measures, with little prospects of long term solutions;
  - Inadequate EU policy measures to deal with sovereign debt crises.
- In addition, the massive sell-off of stocks may have been caused by technical/trading factors (program trading, increases in ETFs, etc).
- The impact of some of these factors should be temporary because:
  - The Fed "commitment" to keep interest rates low for two years should reassure stock investors that high interest rates will not affect prices.
  - Many investors feel that the S&P action may have been unwarranted.

Outlook for the World Economy

	% of Ukraine's exports	GDP growth, %	AVERAGE	
	2010	2010	2011	2012
World Output		**5.1**	**3.8**	**3.7**
Advanced Economies		**3.0**	**1.5**	**2.0**
United States	**1.6%**	**2.9**	**1.8**	**2.2**
European Union	**25.4%**	**1.8**	**1.7**	**1.9**
Euro Area	**14.5%**	**1.8**	**1.7**	**1.6**
Germany	2.9%	3.5	3.0	2.0
France	0.9%	1.4	1.5	1.7
Italy	4.7%	1.3	1.0	1.3
Spain	0.8%	–0.1	0.8	1.5
Japan	0.2%	4.0	-0.5	2.4
United Kingdom	1.0%	1.3	1.2	1.5
Canada	0.1%	3.2	2.9	2.8
Emerging Economies		**7.4**	**5.8**	**5.5**
CEE		4.5	5.3	3.2
Poland	**3.5%**	**3.8**	**4.0**	**3.7**
CIS	36.4%	4.6	5.1	4.7
Russia	**26.1%**	**4.0**	**3.7**	**3.5**
Ukraine	**-**	**4.2**	**4.0**	**4.0**
Kazakhstan	2.5%	7.0	6.4	6.0
Belarus	3.7%	7.6	3.0	3.6
Developing Asia		**9.6**	**7.8**	**7.9**
China	2.6%	10.3	9.0	8.9
India	2.8%	10.4	7.5	8.0
Brazil	0.7%	7.5	4.0	4.0
Mexico	0.4%	5.5	4.4	3.7
Turkey	**5.9%**	**8.9**	**5.9**	**4.5**
Egypt	2.6%	5.2	1.1	3.8
World Trade Volume		**12.4**	**8.1**	**7.6**

- As the impact of temporary factors dissipates, asset prices will be driven by economic fundamentals.
- European GDP growth will be slowed down by the austerity measures taken by Italy and EU countries in the periphery, though developed countries should be able to avoid second recessions (but the risks of recessions have increased).
- Despite recent slowdowns in economic growth in developed economies, emerging markets' growth is still sound at 5.8%.

Source: Average projections from the updates by the IMF, WB,OECD, EBRD, EIU, JP Morgan, Deutsche Bank, Morgan Stanley, TBF

Impact on Ukraine

Ukraine will be affected by the international slowdown through the following channels:

I. Exports:

a) Weaker growth in main trading partners may reduce their imports.

b) This may put a downward pressure on commodity prices, including steel – Ukraine's main export commodity;

II. Sector Inter-dependence:

a) Metallurgy accounts for 25% of total industrial production and production of many other industries and sectors are tied to it.

b) But performance of other sectors may compensate.

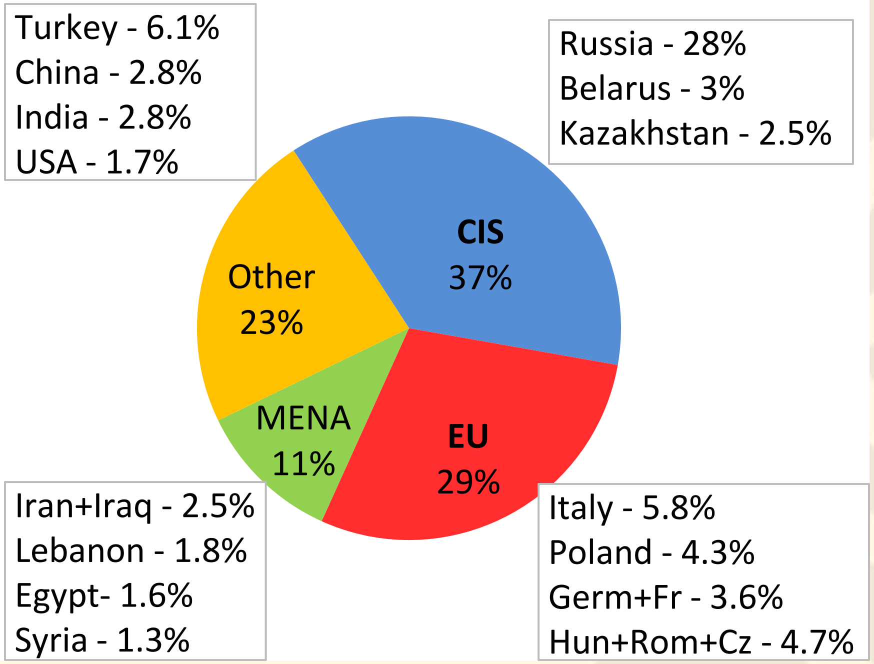
III. Foreign Capital:

a) The health of Ukrainian banks depends on European banks: due to higher global risk aversion, European banks may be more reluctant to maintain past external debt rollover ratios;

b) FDI and External Debt inflows may be below potential.

I. Exports: (a) Growth in Main Trading Partners

Ukraine's Goods Exports by Regions and Selected Countries, % of total , 1H 2011



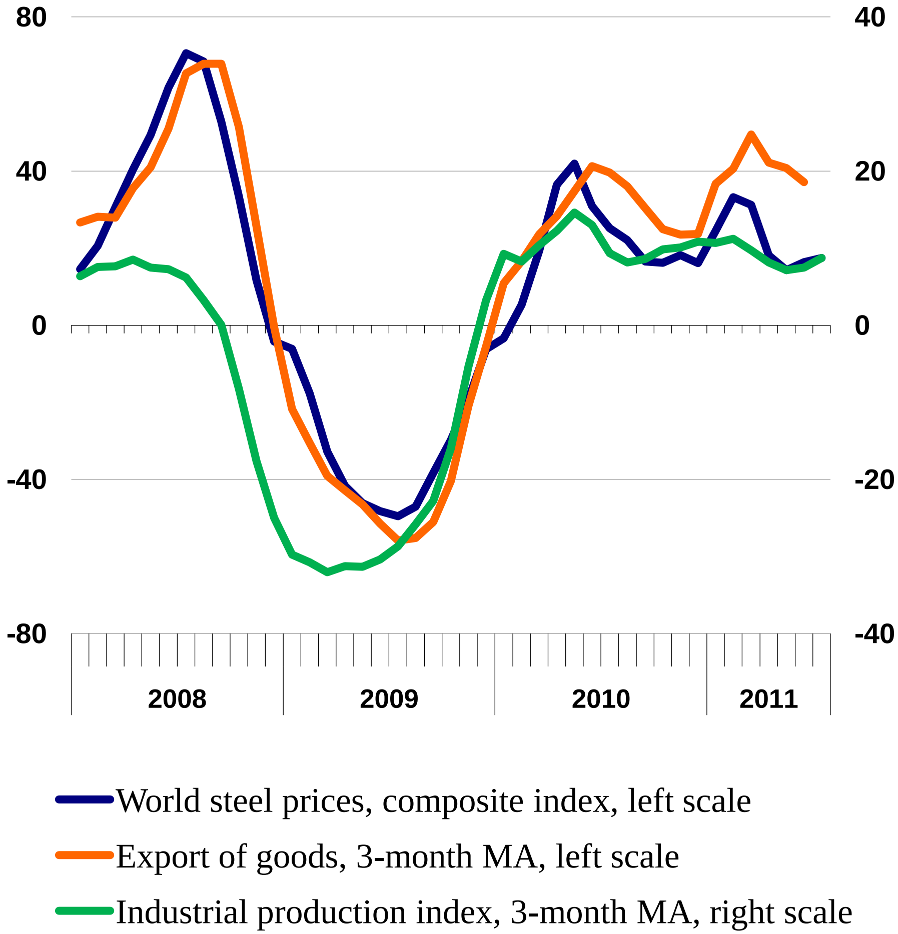
Source: State Statistics Committee, The Bleyzer Foundation

- Demand for Ukraine's exports is likely to weaken in 2H 2011.
- Exports to Russia and other CIS countries may slow due to:
  - Weaker growth in Russia, economic downturn in Belarus;
  - Trade restrictions, imposed by Russia during June-July 2011, and which were automatically imposed by other members of the Customs Union.
- There is continuing turbulences in MENA region.

- The second largest market for Ukraine's exports, the EU, will also experience slow downs, even though exports to the periphery are small.
- Turkey may also grow at a slower pace, due to its close ties with EU.
- Slower growth in the CIS, EU and Turkey will affect Ukrainian exports.

I. Exports: (b) Commodity Prices

World Carbon Steel Prices, Ukraine's Goods Exports and Industrial Output, % yoy



Source: State Statistics Committee, MEPS, NBU, The Bleyzer Foundation

- Slower global GDP growth will reduce not only world demand for commodities, but also their prices, including the price of steel.
- In fact, from May to July 2011, steel prices already fell by 6%.
- Although during July steel prices were higher than last year, the full-year increase in steel prices will be lower than projected at the beginning of the year.
- Ukraine's exports and industrial production will be affected as they closely follow steel price trends.
- They will have lower growth rates than initially anticipated.

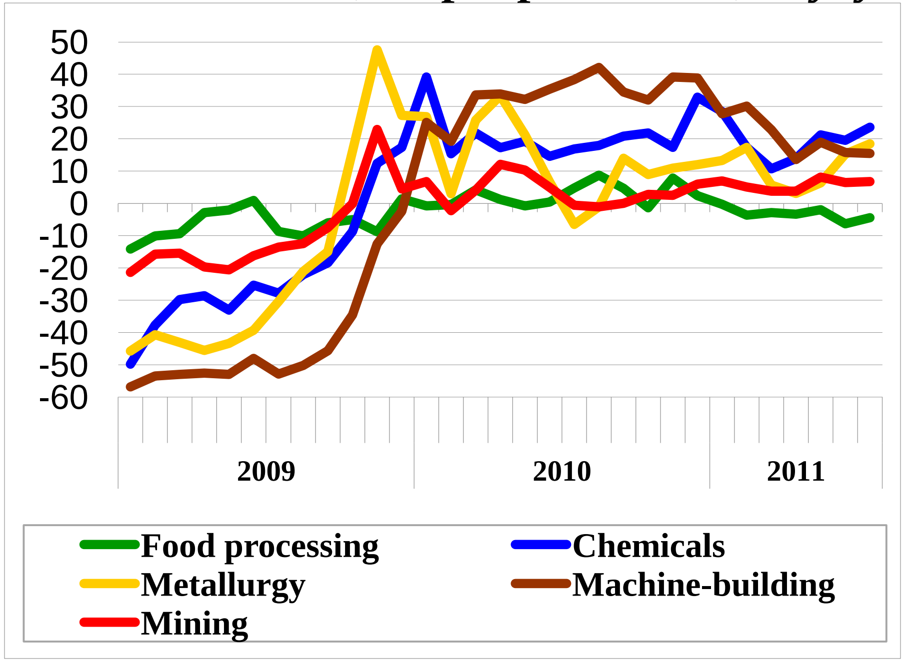
II. Sector Inter-dependence: (a) Metallurgy

Selected Industries and Sectors Dependence on Metallurgy, %*

Extraction of non-energy materials	70
Coke manufacturing	89
Electricity, gas, water	18
Construction materials	12
Transportation	11
Domestic trade	4.5

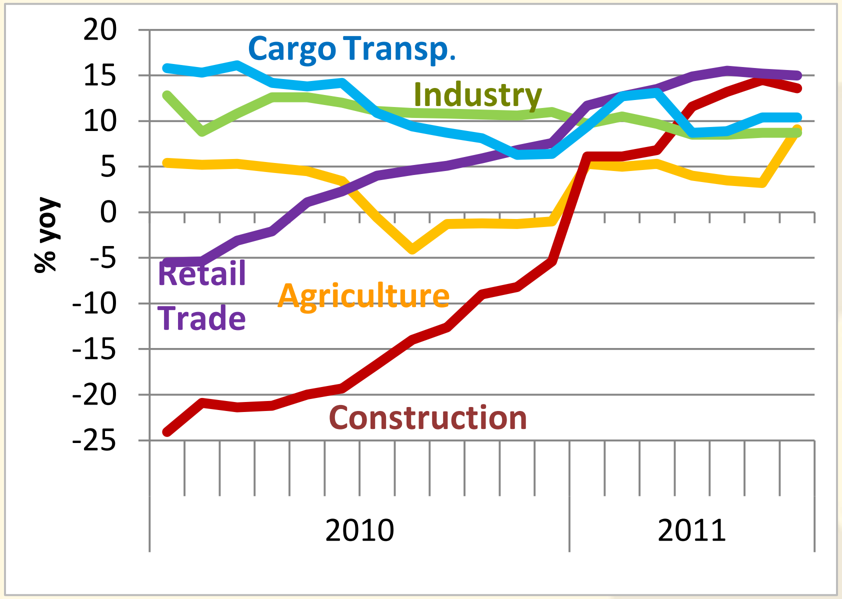
** Share of Industry/Sector total output used as intermediate consumption for Metallurgy*
Source: 2008 National Accounts, The Bleyzer Foundation

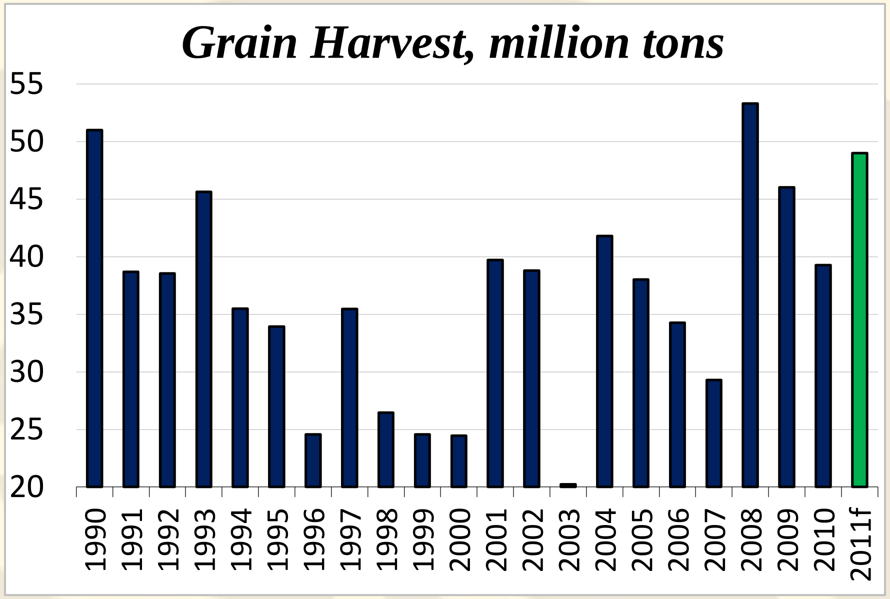
Industrial Sector, output production, % yoy



- Metallurgy accounts for 25% of total industrial production and drives the performance of many other sectors (1st chart).
- From Jan-July 2011 Ukraine's metallurgy grew by about 11% yoy, though output suffered large fluctuations during the year.
- Similar trends were observed for the coke industry, non-energy mining etc., which are closely tied to metallurgy.

II (b) Performance of Other Sectors could Compensate

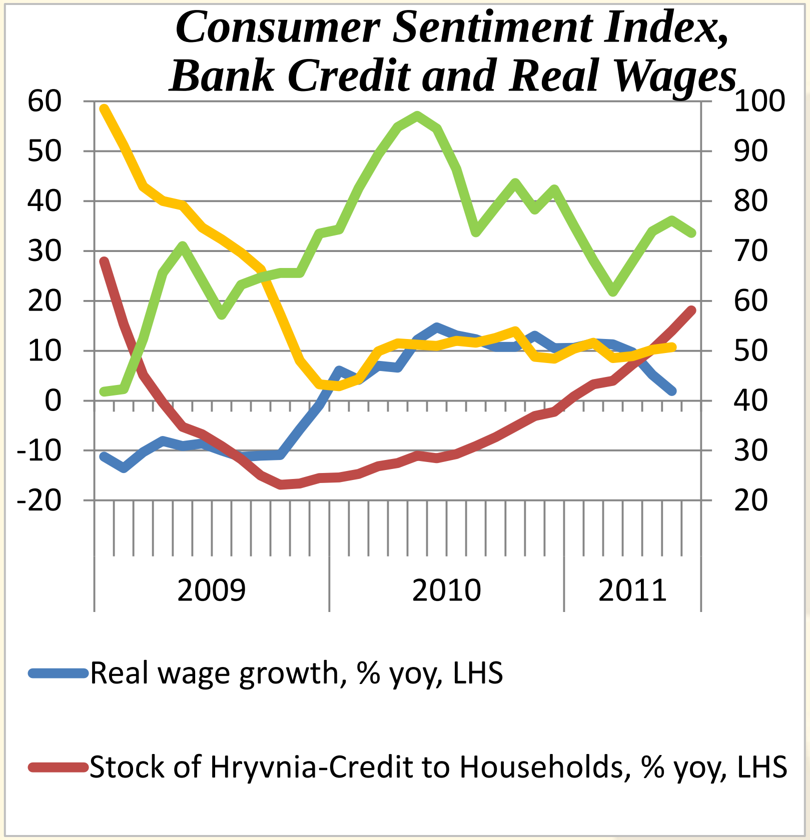




Source: State Statistics Committee, The Bleyzer Foundation

- Agriculture grew by 9% yoy amid a generous harvest: Ukraine collected 48-50 million tons, **the third highest harvest** in its history.
- Other sectors were supported by robust investment and consumption.
- Construction went up by 14% yoy in Jan-Jul 2011, mainly thanks to budget financing of large infrastructure projects.
- However, in June-July both private consumption and investments showed moderation, which may continue during the year as noted in next slides.

Consumption and Investment



Source: State Statistics Committee, NBU, The Bleyzer Foundation

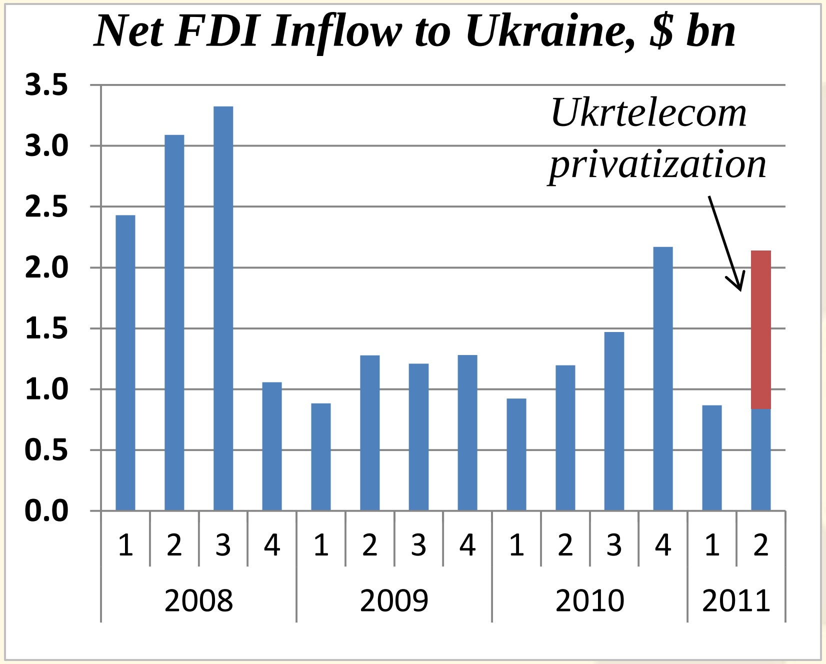
- Real wage growth decelerated sharply from about 10% yoy in 1Q 2011 to less than 2% yoy in June.
- Although the Government wants to increase public sector wages in 2H 2011, fiscal constraints may not allow it.
- Also slower export and industry growth may affect employment and private sector wage growth.
- However, the recent revival of consumer credit (+18% yoy in July) will support private sector consumption.

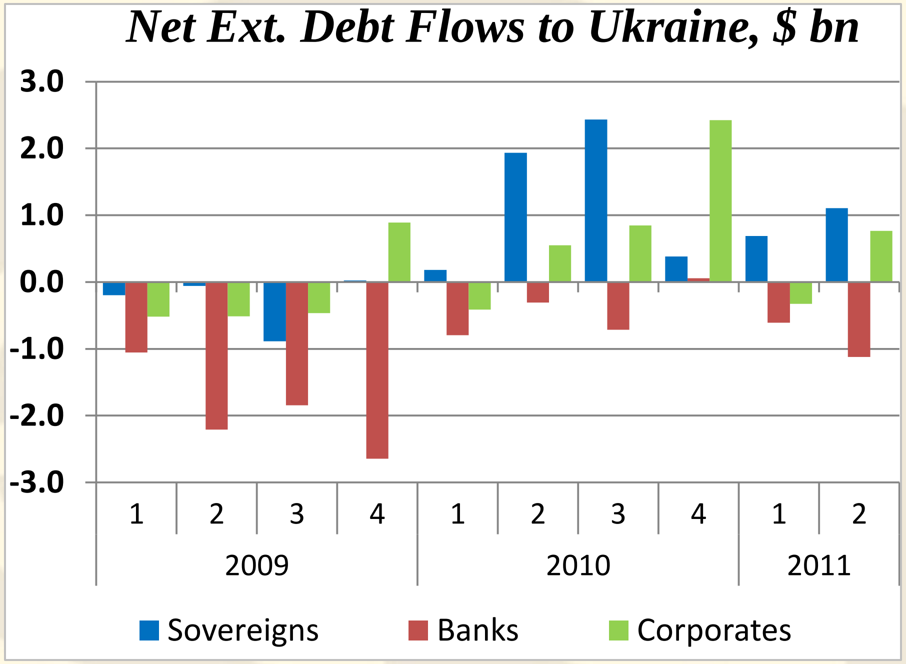
- Private investment activity remains rather weak (excluding investment in inventories) mainly due to sluggish bank credit to private companies.
- In fact, the 16% yoy increase in credit to legal entities as of June 2011 was achieved mainly due to a 180% yoy rise in loans to state-owned companies.

III. Foreign Capital: (a) Health of Banking System

- The external debt of the banking sector stood at $28 billion as of April 2011, with half of it is due within a year.
- There are 56 banks with foreign capital in Ukraine, of which 21 banks are 100% foreign-owned.
- European banks hold about 30% of Ukrainian banking system capital.
- So far, foreign mother banks have provided substantial support to their Ukrainian subsidiaries.
- Nevertheless, the banking sector of Ukraine was a net exporter of capital (repayments exceeded new borrowings) during both 2010 and 1H 2011.
- High exposure of the European banking system to the Euro zone sovereign debts and intensified global risk aversion may make it more difficult for Ukrainian banks to maintain high debt rollover rates.
- This may affect the ability of local banks to provide credits.

III. Foreign Capital: (b) FDI and External Debt





Source: NBU, The Bleyzer Foundation

- FDI inflows remain low despite decent economic recovery.
- Uneven reform progress and increased investors' perceptions of more complicated business environment explain subpar FDI inflows to Ukraine.
- Sovereign and quasi-sovereign borrowings on foreign markets were the main source of BoP financial account surpluses in 2010 and 1H 2011.
- Intensified global risk aversion may adversely affect foreign capital inflows.

Foreign Currency Needs and Sources of Funds

$ billion	2011e Outflow	2011e Inflow	2012f Outflow	2012f Inflow
CA balance	6.8		8.0	
External Public Debt	4.5	5.5	3.0	5.0
External Private Debt	44.3	51.3	45.0	49.2
Banks	*12.7*	*10.2*	*12.0*	*9.6*
*Corporates**	*31.6*	*41.1*	*33.0*	*39.6*
FDI		5.5		4.5
Net purchases of FX by population	7.5		6.0	
Total	**62.8**	**62.2**	**63.0**	**58.7**
Change in Reserves		-0.9		-3.3

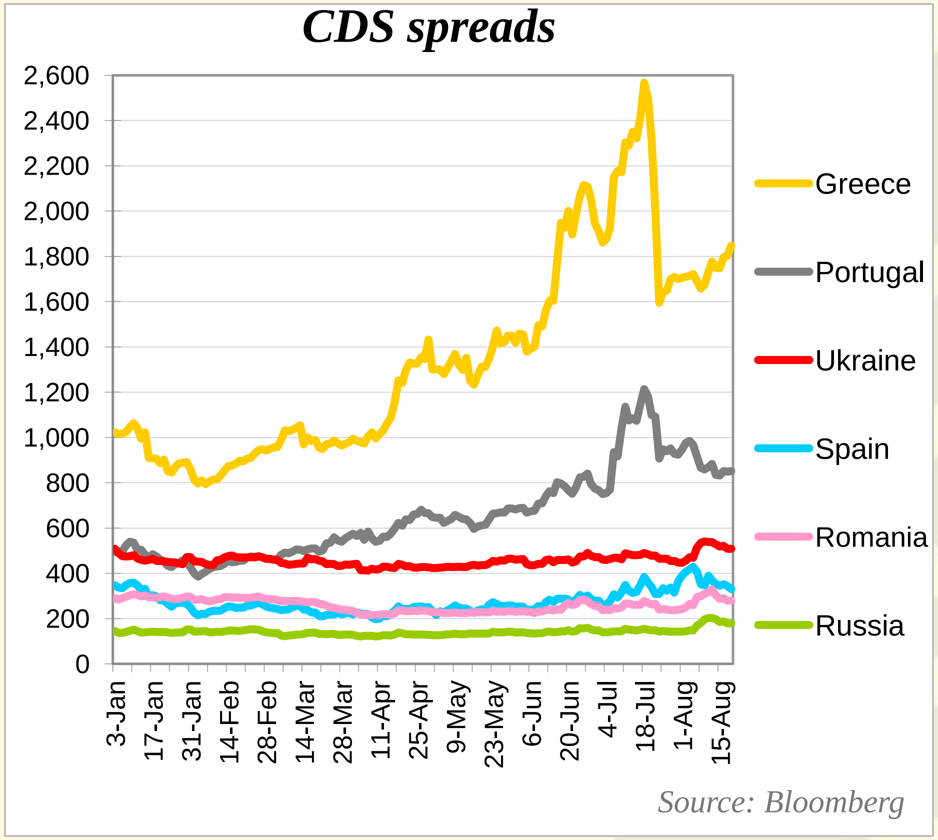
Source: NBU, MinFin, The Bleyzer Foundation

- The table shows projected foreign currency demand and supply balances for 2011-12.
- Unless there is a major, adverse, external shock, Ukraine's foreign currency needs look manageable.
- Projections were developed based on the following additional assumptions:

1. Banking sector rollover at 80% in both 2011 and 2012; and
2. High corporate sector debt rollover (130% in 2011 and 120% in 2012): rollover ratios include trade credit; corporate sector includes external borrowings by quasi-sovereign Naftogaz and other companies.

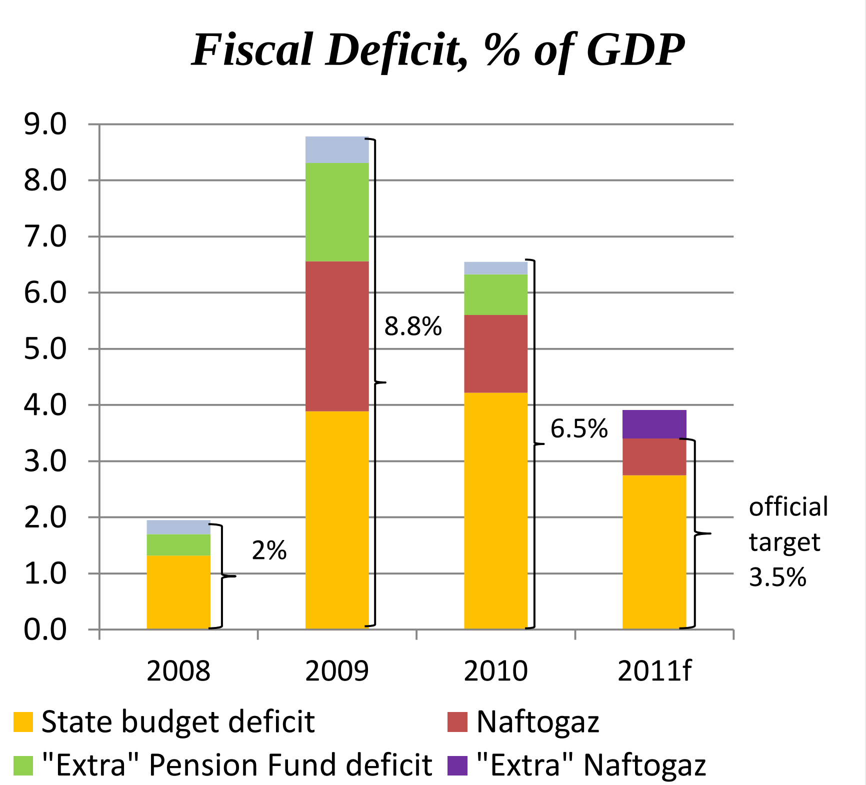
- Hence, Hryvnia exchange rate to US Dollar should remain stable in the ST.

Ukraine's BoP and Hryvnia Outlook



- Due to weaker exports but still high imports, Ukraine's CA deficit may widen to 4.5% of GDP in 2011.
- The financial account may be under pressure due to high debt financing needs and strong population demand for foreign currency.
- In 2011, net population purchases of foreign currency amounted to $7 bn.
- However, foreign creditors still believe Ukraine is less risky than some countries in the EU periphery.
- In addition, high level of NBU gross international reserves ($37.8 billion as of end-July 2011) should provide some confidence.
- Hence, we do not expect massive capital outflows from the country.
- The Hryvnia exchange rate to US Dollar should remain stable in 2011.

Fiscal Policy



Source: MinFin, The Bleyzer Foundation

- State budget revenues exceeded original estimates, rising by 47% yoy in 1H 2011 (in nominal terms).
- The revenue increases resulted from:
  - selected tax rate increases (excises, rent payments, etc.);
  - a general improvement in the economic situation in 1H 2011;
  - a change in tax administration rules after Tax Code enforcement.
- As expenditures grew by only 6% yoy, the state budget deficit amounted to about 1.7% of period GDP.
- Despite announced increases in budget spending in 2H 2011, the state budget deficit target of 2.7% of GDP looks realistic.
- However, due to the authorities' reluctance to raise natural gas tariffs to the population and higher energy prices, Naftogaz will face above-target deficit.

Reform Progress and Cooperation with the IMF

- Ukraine's progress in implementing IMF conditions is mixed:
  - The 2011 state budget law was amended in June to keep broad fiscal deficit target at 3.5% of GDP.
  - However, natural gas tariffs were not raised as planned. As a result, Naftogaz deficit may reach 1.3% of GDP, almost twice as high as the initial target.
  - The Pension reform bill was approved by the parliament on July 8th. However, it introduced increases in pension payments unacceptable to the IMF. The President still has not signed it into law.
  - During May-June, the domestic currency market was liberalized and NBU independence was ensured by eliminating a requirement to mandatorily purchase government bonds issued for recapitalization purposes.
- Due to lack of full implementation of these conditions, the IMF program funding to Ukraine has been suspended since March.
- The next IMF mission is now expected in late October.
- Though currently there is no fiscal need for IMF funds, the presence of the IMF would increase the country's resilience to adverse external shocks.

Short Term Outlook

- Despite weaker export prospects, real GDP should increase by 4% in 2011.
- Without additional compensatory measures to sustain Naftogaz, the broad fiscal deficit target of 3.5% of GDP will be missed in 2011.
- It is therefore unlikely that the IMF program will be revived this year.
- But the country seems firm to continue fiscal consolidation, though at a slower pace than initially expected.
- If so, the country may be able to manage its vulnerabilities without the IMF funds in the short-run, provided that:
  - The EU debt crisis is contained and European banks can roll-over debt;
  - The world economy avoids another recession that would depress Ukrainian exports and reduce steel prices.
- Due to slower GDP growth, lower pressure from international energy prices and good harvest, inflation will ease to 10-11% yoy in 2011.
- The Current account deficit will widen to 4.5% of GDP in 2011, but external financing needs will be manageable, allowing the Hryvnia to remain stable.

Medium Term Outlook

- In 2012, the Ukrainian economy is likely to grow below its potential at 4% yoy.
- This growth will be supported by private consumption, fueled by election-driven budget spending, and export of services (due to the hosting of the Euro-2012 football championship).
- Depreciation pressures on the Hryvnia, stemming from high external financing needs and gradual loss in competitiveness (as inflation in Ukraine remains much higher than in its main trading partner countries), should materialize with the exchange rate moving to 8.0 -8.5 UAH/$ by the end of 2012.
- After the 2012 Rada elections, there will be 3 years without elections that could allow for the implementation of reforms to improve the business environment.
- The signing of a FTA with the EU may become a locomotive of future growth and a strong driver of structural changes in the economy.
- However, there is a risk of increasing Russia's pressure on Ukraine to join the Customs Union; but so far the Ukrainian government has been clear that it will only agree to a TFA with the CU and pursue deeper trade relations with the EU.

International Comparisons (latest year available)

	GDP real growth, %		GDP pc, $, rank*	CPI % yoy, eop	Fiscal Balance/GDP		Public debt/ GDP	External debt/ GDP**	CA Balance/GDP		National Savings/ GDP	Unempl. rate
	2010	2011f	2010	2011f	2010	2011f	2010	2010	2010	2011f	2010	2010
Ukraine	**4.2**	**4.0**	**106**	**10.0**	**-6.5**	**-4.0**	**40**	**86%**	**-2.0**	**-4.5**	**17.8**	**8.1**
US	2.9	1.8	9	2.1	-8.9	-9.3	91.2	99%	-3.2	-3.5	11.6	9.6
Japan	4.0	-0.5	16	0.1	-9.6	-10.5	220.4	47%	3.6	2.3	23.8	5.1
Germany	3.5	3.0	19	2.2	-3.3	-2.3	83.2	157%	5.7	5.1	22.8	6.9
Italy	1.3	1.0	23	2.0	-4.6	-4.1	119.0	118%	-3.5	-3.5	16.7	8.5
Spain	-0.1	0.8	27	2.1	-9.2	-6.6	62.0	164%	-4.5	-4.2	18.5	20.1
Portugal	1.4	-1.5	33	1.4	-9.1	-6.0	83.4	231%	-9.9	-7.5	8.9	11.0
Ireland	-1.0	0.5	12	0.7	-32.4	-10.5	96.2	1128%	-0.7	1.5	10.1	13.6
Greece	-4.5	-3.0	30	1.4	-10.4	-8.0	142.8	179%	-10.4	-8.5	4.1	12.5
Russia	4.0	3.7	55	8.5	-4.0	-0.7	9.2	33%	4.8	4.0	24.7	7.5
Poland	3.8	4.0	47	3.8	-7.9	-5.6	55.0	67%	-4.5	-4.8	17.3	9.0
Romania	-1.3	1.6	69	4.8	-6.5	-5.0	37.8	76%	-4.2	-4.8	22.2	7.6
Kazakhstan	7.0	6.4	62	8.9	-2.9	-3.0	15.5	86%	3.5	5.4	35.3	5.8
India	10.3	9.0	92	4.2	-1.6	-1.5	17.1	19%	5.2	4.0	54.0	4.1
China	10.4	7.5	133	7.7	-7.6	-7.5	73.5	9%	-3.2	-3.5	34.7	10.8
Brazil	7.5	3.4	52	6.3	-2.9	-3.1	58.7	17%	-2.3	-2.5	17.0	6.7
Argentina	9.2	7.0	61	11.0	0.2		45.1	35%	0.9	0.1	22.9	7.7
Mexico	5.5	10.0	60	3.5	-2.8	-2.5	32.0	24%	-0.5	-1.4	25.1	5.4

** Out of 176 countries ; **Gross external debt position*

Source: IMF, OECD, The Economist, JP Morgan, E&Y, TBF, World Bank

International Comparisons (latest year available)

	CDS spread, September 2nd	Bank capital to asset ratio, %	NPL in banks	Growth of retail sales, % yoy	S&P rating	Exports, % of GDP (5 year average)
Ukraine	**545**	**14.5**	**41.6**	**13.5**	**B+**	**46.2%**
US	52	10.9	5.5	2.9	AA+	11.4%
Japan	105	4.7	1.7	1.1	AA-	15.6%
Germany	79	4.3	3.3	-1.6	AAA	44.3%
Italy	403	7.9	7	-1.2	A+	27.1%
Spain	392	6.8	5.5	-7	AA	25.8%
Portugal	980	6.5	3.3	-5.8	BBB-	30.3%
Ireland	800	5.7	10.4	-0.6	BBB+	82.6%
Greece	2350	6.1	9	-10.9	CCC	21.9%
Russia	194	15.7	9.5	5.6	BBB	31.6%
Poland	227	9	7.6	8.2	A-	39.4%
Romania	327	8	17.5	-9.4	BB+	31.5%
Kazakhstan	210	-8.7	26.9	14.7	BBB	50.7%
India	na	6.4	2.3	na	BBB-	20.8%
China	116	5.6	1.6	17.2	AA-	35.3%
Brazil	153	9.1	3.8	7.1	BBB-	13.5%
Argentina	842	12.3	2.7	na	B	24.1%
Mexico	153	9.7	2.8	4.8	BBB	27.9%

Source: S&P, Bloomberg, World Bank, National Statistical Offices, IMF

International Comparisons (latest year available)

	Population				Energy			Agriculture (wheat, barley, maize)					
								Arable land		Largest exporters		Largest producers	
	Elderly population (65+)	Elderly support ratio	HDI	Homicide rate, per 100,000	Energy self-sufficiency	Energy use per unit of GDP	Energy use per capita	% of world total	% of county's total	Rank	% of world exports	Rank	% of world production
Ukraine	**16%**	**5**	**0.710**	**6.3**	**67.0%**	**0.400**	**2.51**	**2.4%**	**56%**	**5**	**6.0%**	**8**	**2.9%**
US	13%	5	0.902	5.2	77.9%	0.191	7.199	11.8%	18%	1	30.9%	1	26.3%
Japan	23%	3	0.884	0.5	19.2%	0.140	3.900	0.3%	12%	40	0.1%	89	0.1%
Germany	20%	3	0.885	0.8	39.0%	0.143	4.055	0.9%	34%	8	3.7%	9	2.8%
Italy	20%	3	0.854	1.2	16.9%	0.114	2.836	0.5%	23%	29	0.3%	22	1.0%
Spain	17%	4	0.863	0.9	26.5%	0.122	2.770	0.9%	25%	23	0.5%	19	1.0%
Portugal	18%	4	0.795	1.2	25.4%	0.121	2.215	0.1%	12%	48	0.1%	94	0.1%
Ireland	11%	6	0.895	2.0	13.0%	0.107	3.287	0.1%	16%	50	0.0%	66	0.1%
Greece	19%	4	0.855	1.1	34.0%	0.106	2.394	0.2%	20%	36	0.1%	40	0.3%
Russia	13%	6	0.719	14.2	183.0%	0.420	4.560	8.8%	7%	6	5.1%	4	5.5%
Poland	13%	5	0.795	1.2	66.7%	0.172	2.668	0.9%	41%	32	0.2%	20	1.0%
Romania	15%	5	0.767	2.2	82.0%	0.170	1.600	0.6%	38%	14	1.2%	23	0.9%
Kazakhstan	8%	10	0.714	10.6	221.0%	0.490	0.570	1.7%	9%	9	2.9%	16	1.3%
India	5%	13	0.519	2.8	74.0%	0.150	0.590	11.4%	53%	12	1.4%	3	6.5%
China	8%	9	0.663	1.2	92.0%	0.180	1.700	8.0%	12%	31	0.2%	2	18.6%
Brazil	7%	10	0.699	11.6	96.0%	0.150	1.240	4.4%	7%	10	2.6%	6	3.7%
Argentina	10%	6	0.775	5.2	109.0%	0.120	1.840	2.2%	11%	3	9.6%	7	2.2%
Mexico	6%	10	0.751	22.0	128.2%	0.143	1.568	1.8%	13%	18	1%	13	1.6%

Source: United Nations, FAO, International Energy Agency