September 2011 Olga Pogarska, Edilberto L. Segura

- **Real sector performance improved in August despite a more challenging external environment.**
- **Industrial production growth accelerated to 8.9% yoy, benefiting from stronger domestic demand.**
- **Ukraine may have the second largest harvest this year; however, due to grain export duties and a good harvest in neighboring countries, Ukraine's grain export potential remains untapped.**
- **State budget deficit amounted to UAH 8.6 billion, or 0.8% of full-year forecast GDP. However, due to higher Naftogaz imbalances, the broad fiscal deficit is projected to reach 4% of GDP in 2011.**
- **The government amended the pension law in September and developed a draft 2012 budget law, targeting a general government sector deficit of 2.5% of GDP. However, the IMF is unlikely to restore financing without an increase in natural gas tariffs to the population.**
- **Thanks to a generous harvest, consumer inflation eased to 8.9% in August but is likely to speed up to about 10-11% yoy at the end of the year.**
- **High volatility on international financial markets, worse economic growth prospects and vulnerability of the Ukrainian economy to external shocks caused Hryvnia depreciation pressures to intensify in August-September.**
- **The National Bank of Ukraine is following a tight monetary policy to both reduce inflationary pressures and maintain Hryvnia stability.**
- **The current account gap widened to $3.3 billion over January-August, or 2% of full-year GDP, and is projected to reach 4.5% of GDP in 2011.**
- **Ukraine's external debt financing needs remain high. From July 2011 to June 2012, Ukraine has to repay more than $53 billion.**
- **With the current level of international reserves at $38 billion and assuming there is no major external shock, Ukraine's foreign currency needs look manageable. However, as external risks are high, restoration of cooperation with the IMF looks crucial to reduce Ukraine's vulnerabilities.**

Executive Summary

January-August 2011 real sector data showed improvement despite a more challenging external environment. Thanks to both stronger domestic consumption and favorable base effects for selected industries, industrial production accelerated to 8.9% yoy in August. Faster growth in retail trade, non-financial services and domestic-market-oriented industries indicate stronger domestic demand. In turn, domestic consumption growth was underpinned by acceleration in real monthly wage growth as well as increased uncertainties over Hryvnia stability, government foreign trade policy (the possibility of introduction of import duties on cars), and vulnerability of the Ukrainian banking system to the European sovereign debt crisis (due to the high presence of European bank subsidiaries in Ukraine).

In 2011, Ukraine is likely to have the second largest harvest in its history. According to the Ministry of Agriculture and Food of Ukraine, by mid-September 35.7 million tons of grain was already collected, not including the corn harvest, which is projected at about 17 million tons. As a result, the sector was an important contributor to overall improvement of real sector performance over the period. However, we have kept our 2011 real GDP growth forecast at 4% yoy amid worse export prospects, higher natural gas prices and completion of large infrastructure projects.

Thanks to a generous harvest, slower increase in regulated prices, and easing inflationary pressures from abroad, consumer inflation eased to 8.9% yoy in August. However, inflation may speed up to 10-11% yoy at the end of 2011 due to reinstatement of higher excises on gasoline products and a low statistical base effect. During August-September, the NBU kept Hryvnia liquidity tight in order to both reduce inflation and contain Hryvnia depreciation pressures. The latter intensified during these months due to rising concerns over existing vulnerabilities of the Ukrainian economy amid continuing global financial turmoil and worsened global economic growth prospects.

High foreign currency financing needs remain one of the main vulnerabilities of the Ukrainian economy to external shocks. Although import growth lost speed in August due to lower volumes of imported natural gas, the foreign trade deficit and current account gap kept widening. For January-August 2011, the current account deficit reached $3.3 billion, or 2% of GDP, and is forecast to reach 4.5% of GDP for 2011. In addition to the need to cover the growing current account gap, Ukraine needs to repay about $53 billion of external debt liabilities from July 2011 to June 2012, according to NBU data. Given the current level of gross international reserves, foreign currency needs look manageable unless there is a major external shock. However, given rising external risks, resumption of IMF financing looks crucial to reduce Ukraine's vulnerabilities.

Following the approval of necessary amendments to pension reform law, the increase in natural gas tariffs (and therefore the likely higher than planned general fiscal deficit) remains the main impediment towards restoring IMF co-operation. Despite better-than-projected fiscal revenues this year and development of the 2012 draft budget law with a targeted 1.6% of GDP state budget deficit, which signaled the firm intention of the Ukrainian authorities to bring its finances to a sustainable level, the IMF is unlikely to resume funding without the increase in tariffs.

September 2011

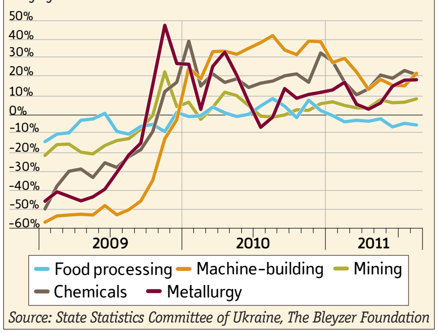
	2006	2007	2008	2009	2010	2011[f]
GDP growth. % yoy	7.3	7.9	2.3	-14.8	4.2	4.0
GDP per capita. $	2 300	3 070	3 880	2 540	3 030	3 500
Industrial production. % yoy	6.2	10.2	-3.1	-21.9	11.0	
Retail sales. % yoy	24.8	28.8	18.6	-16.6	7.6	
Budget deficit. % GDP*	-0.7	-1.7	-2.0	-8.8	-6.5	-4.0
Government external debt. % GDP	11.0	8.7	9.3	20.5	23.8	25.3
Inflation. eop	11.6	16.6	16.6	12.3	9.1	10-11
Gross international reserves. $ billion	22.4	32.5	32.5	26.5	34.5	35.0
Current account balance. % GDP	-1.5	-3.7	-7.0	-1.7	-1.9	-4.5
Gross external debt. % GDP	50.6	56.0	56.4	88.6	88.1	80.0
Exchange rate. Hryvnia/US Dollar. eop	5.1	5.1	7.7	7.99	7.96	8.0

**Including implicit pension fund deficit in 2007-2009. and including Naftogaz and pension fund deficits since 2009 (not including bank recapitalization expenditures and VAT bonds)*
Sources: State Statistics Committee of Ukraine. NBU. Ministry of Finance of Ukraine. 2011 Budget Law. The Bleyzer Foundation

Economic Growth

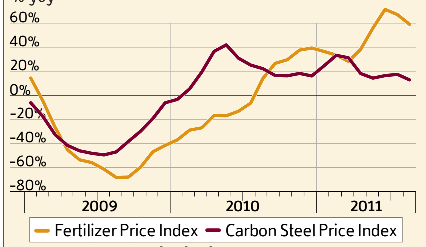
Despite more challenging external conditions, real sector data for January-August 2011 showed improvement over the previous period. Industrial production growth accelerated to 9.6% yoy in August from 8.7% yoy in July. Within the sector, metallurgy and chemicals continued to grow at a rapid pace (18.7% yoy and 21.4% yoy, respectively) though world commodity prices have been weakening. Production of machinery and transport vehicles notably accelerated from 15.5% yoy in July to 22.1% yoy in August 2011. Better growth in these industries compensated for deeper contraction in food processing and oil-refining. The food processing industry faces supply shortages of raw milk and meat as cattle breeding remains depressed – its output production declined by 5.2% yoy in August. Domestic production of oil-refining products fell by almost 23% yoy in August as Ukrainian refineries cannot compete with cheaper imports from Russia and Belarus[1] while government support of the industry proved unsuccessful[2].

Industrial Production Growth by Select Branches
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

World Steel and Fertilizer Price Indices
% yoy



Source: MEPS, WB GEM databank

August's improvements in other industries can be explained by stronger domestic demand as well as certain inertia of production processes (e.g., due to technological specifics of production processes in metallurgy). Thus, growth acceleration in retail trade (+15.2% in January-August 2011), light industry (+9.7% yoy in August compared to 1% yoy in the previous month) and non-financial services (+18% yoy over the first eight months of the year) signaled stronger domestic consumption. An improvement in consumption was underpinned by stronger real wage growth, which sped up from less than 2% yoy in June 2011 to 8.4% yoy in August. In addition, a surge in private consumption[3] may be attributed to rising uncertainties among the population. High vulnerability of the Ukrainian economy amid worsening global economic growth prospects for 2H 2011 and turmoil on international financial markets, and growing risks for the Ukrainian banking system due to the European sovereign debt demand for durable goods and foreign currency.

Real Sector Performance of Ukraine
% yoy

	Jan-Aug 2011	Jan-Aug 2010	2010	2009	2008
Agriculture	10.5	-4.1	-1	-1.8	17.1
Industrial output	8.9	10.9	11	-21.9	-3.1
Construction works	13.0	-14.0	-5.4	-48.2	-15.8
Domestic trade turnover					
Wholesale trade	0.2	2.8	0.4	-19.3	-6
Retail trade	15.2	4.6	7.6	-17.4	18.1
Restaurants	12.7	1.5	3.5	-15.6	4.6
Transportation turnover					
Cargo	8.2	9.4	6.4	-22.5	-0.2
Passenger	3.1	-1.9	-0.2	-11.5	4.5
Services, non-financial	18.0	0.8	2.9	-16.8	15.8

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Agriculture, whose output was up by 10.5% yoy over January-August, made a to improved real sector performance over the period. According to the Ministry of Ukraine, as of mid-September, Ukraine collected 35.7 million tons of grain. Since this which is projected at about 17 million tons, this year's harvest may be the second

Despite August's improvement in real sector performance, we expect moderation the coming months due to worsened export prospects, rising energy cost (the price the 4Q will rise by 12.5% compared with prices in Q3 and will reach a record high completion of large infrastructure projects related to Ukraine co-hosting the Euro- Hence, real GDP is forecast to grow by 4% yoy in 2011.

[1]Russia imposes duties on crude oil exports, which, however, are not applied on other members of the Customs Union (Belarus and Kazakhstan).

[2]To contain soaring fuel prices, in May 2011 the government decided to undertake petroleum sale interventions on the domestic fuel market. For this, Naftogaz Ukrainy started Russian crude oil processing at Lisichansk refinery. This allowed the oil-refining industry to notable improve performance. However, higher purchase prices of crude oil amid low depth of oil refining in Ukraine made domestically produced fuel more expensive relative to foreign gasoline. Correspondingly, Naftogaz fuel sale auctions were of little success.

[3]For instance, according to Auto-Consulting Group, sales of new cars surged up by 54% yoy in August, though to a substantial extent a surge in demand for cars can be attributed to possible introduction of duties on imported cars.

[4]Foreign banks (principally European ones) hold about 40% of the Ukrainian banking system.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666
Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
4A, Baseyna Street, «Mandarin Plaza», 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289 Fax: +38 (044) 284-1283
Email: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180 Fax: +38 (057) 714-1188
Email: kharkov.office@sigmableyzer.com.ua

Fiscal Policy

Solid economic growth, several tax rate increases and tighter tax administration allowed the government to collect almost UAH 170 billion ($21.2 billion) to the state coffers in January-July 2011, 24% yoy higher. Thanks to tight control over spending, state budget expenditures (excluding net lending from the budget) amounted to UAH 175 billion ($21.9 billion), expanding by a moderate 6.3% yoy over the period. As a result, the state budget deficit stood at UAH 8.6 billion, or 0.8% of full-year projected GDP. As budget spending programs are typically skewed towards the last two months of the year, we expect budget expenditures to grow at a faster pace through the rest of the year. In addition, state budget revenue growth may continue losing steam due to weaker-than-projected export duties, a lower profit tax rate and slower economic growth. However, we believe that revenue growth will remain comfortable for the government to meet its state budget deficit target of 2.7% of GDP.

However, as a result of larger Naftogaz imbalances, the broad fiscal deficit is projected at 4% of GDP compared to the planned 3.5% of GDP. At the beginning of the year, the Naftogaz deficit was forecast at UAH 8.5 billion, almost half of the previous year. This amount was estimated taking into account a roughly 30% increase[5] in natural gas tariffs to the population in the first half of 2011. However, due to declining population support of government measures and high inflation pressures during the first half of the year, the government postponed the tariff increase. Furthermore, the Naftogaz budget was developed taking into account an average price of imported natural gas of $269 per 1000 m3 in 2011, while the actual price will exceed $300 per 1000 m3. As a result, in August the government revised the Naftogaz deficit forecast from the previous UAH 8.5 billion (0.7% of GDP) to UAH 11 billion, which still looks underestimated.

Following approval of necessary amendments to the pension reform law at the beginning of September,[6] natural gas tariffs to the population and, hence, the higher general government fiscal deficit remained the main impediments towards resumption of co-operation with the IMF. The Ukrainian authorities are negotiating the possibility of keeping natural gas tariffs unchanged, offering higher than originally expected budget revenues this year. In addition, in September the government developed a draft budget law for 2012 with a targeted state budget deficit of 1.6% of GDP and Naftogaz deficit of 0.8% of GDP. Together, they fully comply with the IMF requirement of 2.5% of GDP deficit next year. The budget draft thus demonstrated the government's firm intention of bringing public finances to sustainable levels. However, as the average imported natural gas price in 2012 is forecast to be higher than this year, the draft budget law was developed based on a rather optimistic macroeconomic forecast and 2012 will be an election year (which increases the risk of pre-election fiscal loosening), we believe an increase in natural gas tariffs will be a necessary step to restore IMF funding.

Monetary Policy

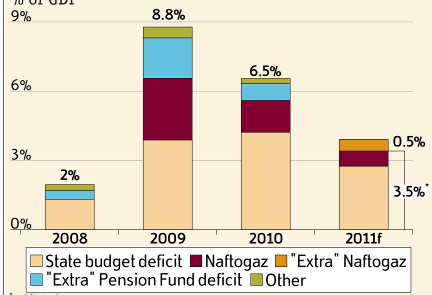
Thanks to a better than projected harvest, slower increase in regulated prices, and easing inflationary pressures from abroad and domestic demand, consumer prices kept slowing in Ukraine. In August 2011, prices for foods and beverages declined by 1.2% on a monthly basis (mom), driving the whole consumer price index down by 0.4% mom. As in the previous month, the monthly price drop was led by fruits and vegetables, particularly potatoes, a staple food in Ukraine. In an anticipation of a record high potato harvest in Ukraine this year, prices on potatoes slumped by more than 60% from June to August 2011. Prices on other vegetables (carrot, onion, cabbage, etc.) retreated 25%-35% from the previous month. Higher supplies of fresh fruits (e.g., apples) explain the sharp reduction in their costs in August (-11.5%

State Budget Execution in 2011

	January-July UAH billion	January-July % yoy	Jan-Jun % yoy
Total Revenues	**168.8**	**23.9**	**24.4**
Total taxes	140	44.9	46.9
EPT	28	49.8	50.4
VAT	70.7	26.1	27.9
Excise taxes, total	17.7	14.7	15.8
Duties	5.4	32.6	27.3
Non-tax revenues	26.8	-23.1	-31.5
Total Expenditures*	**175.3**	**6.3**	**6.3**
State Budget Balance	**-8.6**	**3.2 times lower**	**2.6 times lower**
New public debt borrowings	60.4	-24.2	29.1
Public debt principal payments	26.4	70.7	74.1
Privatization receipts	11	-	-

*Excluding net lending from the budget
Source: Ministry of Finance, The Bleyzer Foundation

General Government Fiscal Balance



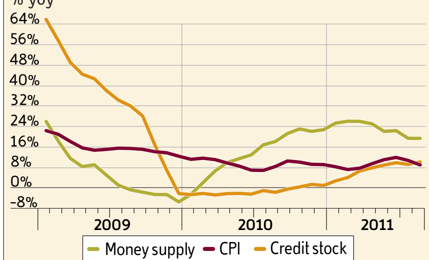
*Official target
Source: Ministry of Finance, The Bleyzer Foundation

Main State Budget Indicators for 2012

	UAH billion 2011f	UAH billion 2012f	% change to 2011
Revenues,	285.1	337.6	18.4%
Expenditures	322.4	361.7	12.2%
Balance	-37.4	-24.1	-35.5%
% of GDP	**-2.9%**	**-1.6%**	
Real GDP growth	4.7%	5.5%	
CPI, eop, %	8.9%	8.7%	

Source: Ministry of Finance, The Bleyzer Foundation

Selected Monetary Indicators



Source: State Statistics Committee, NBU, The Bleyzer Foundation

[5]Originally, according to IMF program requirements, natural gas tariffs were planned to be raised by 50% in April 2011. However, later the Ukrainian government negotiated a more gradual tariff increase - 20% in April and another 10% in June 2011.

[6]During the process of consideration in the parliament at the beginning of August, an amendment to the draft was made, envisaging re-calculation of pension benefits based on average monthly wage of 2009 (instead of previous 2006-2008). According to provisional estimates, this would have required additionally about UAH 50 billion.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666
Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
4A, Baseyna Street, «Mandarin Plaza», 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289 Fax: +38 (044) 284-1283
Email: kiev.office@sigmableyzer.com.ua

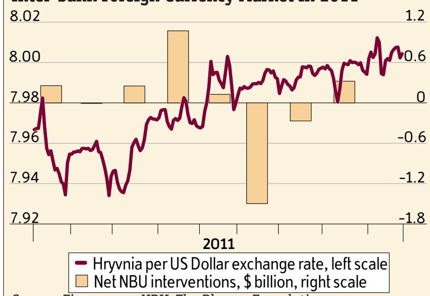
Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180 Fax: +38 (057) 714-1188
Email: kharkov.office@sigmableyzer.com.ua

mom). Rich grain harvest amid grain export restrictions and good harvest in neighboring countries (Russia, Kazakhstan) pressured domestic prices on cereals down. A delay in natural gas price increases and waning pressures from international energy and food prices contributed to domestic price growth slowdown. Indeed, domestic fuel prices remained unchanged in August 2011, while the cost of utility services went up by a moderate 0.5% mom.

On the upside, supply shortages due to continuing stagnation in cattle breeding and inefficient government support programs caused prices for milk, dairy and meat products to rise by 1.4% mom, 2% mom and 3.3% mom respectively. Despite these increases, in annual terms consumer price growth slowed to 8.9% in August 2011. Inflation, however, may speed up again in the coming months due to reinstatement of higher excises on gasoline products and a low statistical base effect. At the same time, tighter monetary policy and slower domestic demand will help contain consumer price growth to about 10-11% yoy at year-end.

Since the end of July 2011, the National Bank of Ukraine has been keeping Hryvnia liquidity tight. Policy tightening was aimed at both reducing inflation pressures and maintaining Hryvnia exchange rate stability. During August, cash balances on correspondent accounts of commercial banks declined to just UAH 12 billion (about $1.5 billion) compared to an average of about UAH 18.6 billion over January-July 2011. Moreover, during the first ten days of September, they were at a six-year low of UAH 9.4 billion. The low liquidity stance of the banking system may be attributed to higher reserve requirements, Hryvnia sterilization operations (though in August they were much less sizable than in the previous few months - UAH 5.3 billion versus a monthly average of UAH 22 billion over February-July) and population withdrawals of Hryvnia deposits, which was not observed since October 2009.

Inter-bank Foreign Currency Market in 2011



Source: Finance.ua, NBU, The Bleyzer Foundation

The stock of population deposits in national currency, which account for almost 60% of total Hryvnia deposits, declined by 0.5% mom in August. Deposit outflow may be explained by declining deposits rates and intensified Hryvnia depreciation concerns. Indeed, flooded with ample liquidity during January-July, commercial banks were gradually reducing deposit rates. Since the beginning of 2011, a weighted average rate on short-term population deposits in national currency fell by about 200 basis points to less than 12% pa in July-August. In addition, during the last few years, the resumption of economic activity after vacation seasons correlated with stronger demand on foreign currency and, hence, higher depreciation pressures on the Hryvnia. Coupled with rising concerns over existing vulnerabilities of the Ukrainian economy amid continuing global financial turmoil and worsened global economic growth prospects, these expectations might explain strong population demand for foreign currency and Hryvnia deposit outflow in August.

Maintaining Hryvnia stability was another reason for liquidity tightening. September was also a month of large domestic debt redemption (UAH 5.5 billion, a 2.3% increase in monetary base and more than 30% increase in banking system liquidity[7], ceteris paribus). Ample Hryvnia liquidity in the banking system could induce the materialization of depreciation pressures, stemming from worse export prospects, high external debt financing needs, strong population demand for foreign currency and fragile banking sector (due to a large number of European bank subsidiaries in Ukraine). In addition, we believe that short-term monetary tightening will have a limited impact on credit activity. Excluding bank loans to state-owned enterprises, credit to private companies rose by less than 10% yoy in August. The high share of non-performing loans in commercial banks' balance sheets and high credit risk requires commercial banks to increase qualification requirements for potential borrowers (e.g., higher collateral). In turn, these requirements and still high credit rate restrict demand on credit resources. Furthermore, scarce liquidity may cause consumer loans to grow at a slow pace (in August, the stock of Hryvnia-denominated consumer loans advanced by 26.2% yoy)[8], which will help contain inflation pressures and import growth. In the longer-term, however, to maintain price and exchange rate stability monetary tightening measures should be complemented by the government policies to ease supply-side rigidities (i.e., measures to support and stimulate private sector development).

International Trade and Capital

Worsening external trade prospects, high external debt repayments and strong population demand for foreign currency intensified depreciation pressures on Hryvnia during August-first half of September 2011. Thus, merchandise export growth slowed sharply to 26.4% yoy in July from about 43% yoy in the previous month, though exports of selected commodity groups reported acceleration amid favorable base of comparison. Thus, export of metallurgical products was up by 25.6% yoy in July, up from 21% yoy in June. However, the acceleration occurred mainly on account of low statistical base as July's value of metallurgical exports was more than 11% lower than the average monthly value in 2Q 2011.

[7]Cash balances at correspondent accounts of commercial banks were used as a measure of banking system liquidity.

[8]Though there are no restrictions on lending in foreign currency to households, due to very high provisions on such loans (unless a household has proven income in foreign currency), volumes of new foreign-currency loans to households are very small.

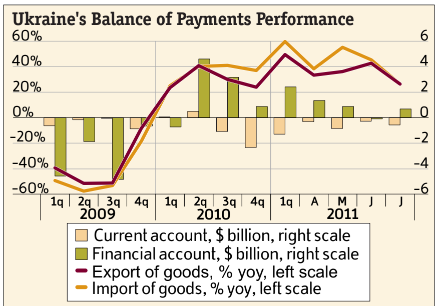
Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666
Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
4A, Baseyna Street, «Mandarin Plaza», 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289 Fax: +38 (044) 284-1283
Email: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180 Fax: +38 (057) 714-1188
Email: kharkov.office@sigmableyzer.com.ua

Slower economic growth in Ukraine's main trading partners in 2Q 2011, downward correction of world commodity prices amid increased concerns over global economic slowdown in the second half of the year and untapped grain export potential were among the main reasons of weaker exports. In particular, export of agricultural products fell by 1.6% yoy in July compared to a 72.2% yoy increase in June. Despite generous harvest this year, grain exports virtually stalled in July as grain export duties made Ukrainian grains less competitive compared to Russian and even Kazakh ones (both countries enjoyed large harvests this year and exported large amounts during July-August, driving prices down).

Ukraine's Balance of Payments Performance



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Anticipating an increase in natural gas prices in the second half of the year, Ukraine has imported the lion's share of planned natural gas supplies for this year during the first half of 2011 (about 17.8 billion m3 in 1Q and about 9 billion m3 in 2Q). Hence, due to much lower volumes of natural gas imports in July, total import growth fell to 26.3% yoy in July compared to 45.4% yoy in June. However, although imports lost steam, foreign trade deficit in goods kept widening. In July, it amounted to $1.2 billion. The seven-month deficit reached $6.6 billion, more than twice larger as in the corresponding period last year. Widening foreign trade deficit was the primary reason of worsening current account balance in 2011. For January-July, the current account gap amounted to $3.3 billion, or more than 2% of projected full-year GDP. Due to recently worsened prospects for Ukraine's exports and high value of energy imports in 2H 2011, current account deficit may reach 4.5% of GDP in 2011.

Ukraine's External Debt Statistics by Sectors

	External Debt Stock				External Debt due from July 2011 to June 2012	
	$ billion		% GDP*			
	2010	Jan-Jun 2011	2010	Jan-Jun 2011	$ bn.	% of sector's total
Public Sector	32.5	35.1	23.6	21.7	6.2	17.8%
Banking Sector	28.1	27.5	20.4	17	13.4	48.8%
Private Sector	56.7	60.8	41.1	37.7	33.9	55.7%
Total	**117.3**	**123.4**	**85.1**	**76.4**	**53.5**	**43.4%**

For 2011, full-year projected GDP
Source: NBU, The Bleyzer Foundation

In addition to the widening current account gap, Ukraine requires significant inflow of foreign capital to cover its high external debt financing needs. According to recent NBU data, Ukraine's gross external debt stood at $123.4 billion as of end-June 2011, or about 76% of forecast full-year GDP. Furthermore, about 50% of banking and private sector external liabilities are due within one year. Due to continuing turmoil on international financial markets and intensified risk aversion amid existing vulnerabilities of the Ukrainian economy, Ukraine's access to foreign financing may become more difficult and costly. The current level of gross international reserves ($38.2 billion as of end-August 2011) will be sufficient to keep Hryvnia exchange rate stability for some time. Moreover, unless there is a major external shock (e.g., Greece default or disorderly restructuring), Ukraine's foreign currency needs looks manageable even without the IMF program. However, as external risks are high, restoration of cooperation with the IMF looks crucial to reduce Ukraine's vulnerabilities as it not only gives access to scarce and cheap foreign financing but helps maintaining foreign investors' confidence, and thus higher debt rollover ratios.

SigmaBleyzer

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666
Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
4A, Baseyna Street, «Mandarin Plaza», 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289 Fax: +38 (044) 284-1283
Email: kiev.office@sigmableyzer.com.ua

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Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180 Fax: +38 (057) 714-1188
Email: kharkov.office@sigmableyzer.com.ua