Macro Outlook Ukraine

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Looking to Get Out

Summary:

- **Public finance is to experience the worst year in a decade as budget revenues would fall sharply. Key triggers to watch: global credit, FX policy, bailout process in the banking system.**

- **Collapse of world trade and risk re-pricing had a devastating effect on Ukrainian economy. Political paralysis coupled with thin reserves will not allow the state to provide any effective support. A hard landing of minus 4.5% is now the base case scenario for 2009.**

- **Recovery of economic activity in 2010 depends on access to credit worldwide by then. In mid-term, Ukraine is well positioned to address the needs of global economy through agriculture, mechanical engineering and transportation.**

- **Merchandise trade deficit is to contract, as the country stepped on the track towards more balanced trade. Much feared energy price shock has been fully absorbed by now.**

- **Financial account will continue to be stretched by a large number of redemptions. Rollover ratio of non-public debt is likely to remain high though. Over 35% of gross external debt is accumulated in cash FX domestic savings.**

- **Local currency looks attractive comparing to CEE peers after devaluation, and is likely to appreciate substantially over coming years. Near-term perspective seems to be shady, as central bank would need to engage on aggressive easing in order to shore up the economy.**

- **Devaluation is to trigger massive defaults as Ukrainian corporates and households are historically long UAH and short FX volatility. Domestic banks are to face dreadful asset quality of their portfolios, the banking system is to go through the bailout.**

	2000	2001	2002	2003	2004	2005	2006	2007	2008E	2009F	2010F
Real Sector and Business Cycle											
Real GDP (% y-o-y)	5.9%	9.2%	5.2%	9.4%	12.1%	2.7%	7.3%	7.6%	2.4%	-4.5%	3.8%
Household Consumption (% y-o-y)	2.5%	9.6%	9.5%	11.5%	13.1%	20.6%	15.9%	17.1%	8.5%	-5.0%	1.5%
Gross Fixed Capital Formation (% y-o-y)	12.4%	6.2%	3.4%	22.5%	20.5%	3.9%	21.2%	20.0%	5.0%	-7.0%	3.5%
Nominal GDP (UAH bn)	170.1	204.2	225.8	267.3	345.1	441.5	544.2	712.9	915.0	1090.0	1226.9
Nominal GDP ($bn)	31.3	38.0	42.4	50.1	64.9	86.1	107.8	141.2	172.6	132.9	204.5
GDP per Capita (at F/X rate; $)	634	785	883	1 053	1 372	1 836	2 310	3 044	3 713	2 859	4 397
Real Industrial Output (% y-o-y)	13.2%	14.2%	7.0%	15.8%	12.5%	3.1%	6.2%	10.2%	-3.0%	-8.0%	8.0%
Real Agricultural Output (% y-o-y)	9.8%	10.2%	1.2%	-11.0%	19.9%	0.0%	0.4%	-5.6%	18.5%	-4.1%	5.0%
Prices											
Consumer Price Index (e-o-p; % y-o-y)	25.8%	6.1%	-0.6%	8.2%	12.3%	10.3%	11.6%	16.6%	22.1%	14.5%	12.0%
Consumer Price Index (avg.; % y-o-y)	20.8%	0.9%	5.8%	11.2%	24.1%	9.6%	14.1%	23.3%	24.2%	13.8%	10.5%
Producer Price Index (e-o-p; % y-o-y)	23.1%	9.9%	5.1%	8.0%	15.1%	24.5%	14.8%	21.7%	19.2%	14.0%	17.0%
Producer Price Index (avg.; % y-o-y)	-	-	-	-	-	-	6.2%	10.8%	10.2%	15.7%	18.5%
External Sector											
Current Account Balance ($bn)	1.5	1.4	3.2	2.9	6.9	2.5	-1.6	-5.9	-12.4	-5.8	-1.5
Current Account Balance (% of GDP)	4.7%	3.7%	7.5%	5.8%	10.6%	2.9%	-1.4%	-4.2%	-7.2%	-4.4%	-0.7%
Merchandise Trade Balance ($bn)	0.8	0.2	0.7	-0.3	3.7	-1.1	-5.2	-10.6	-18.4	-11.7	-9.5
Services Trade Balance ($bn)	0.6	0.4	1.1	1.6	1.2	1.8	2.1	2.7	4.9	5.6	6.7
Capital and Financial Accounts Balance ($bn)	-0.9	-0.2	-1.1	0.3	-4.2	8.0	3.7	15.8	10.3	-4.2	1.8
FDI Inflow ($bn)	0.6	0.8	0.7	1.4	1.7	7.8	5.6	9.3	11.5	6.5	12.5
FDI Inflow per Capita ($)	12.1	16.4	14.4	29.9	36.3	160.5	123.0	198.8	247.3	139.8	268.8
FDI (cumulative since 1991, $bn)	3.9	4.4	5.3	6.6	8.3	16.3	21.2	32.8	42.1	53.6	60.1
Gross F/X Reserves ($bn)	1.5	3.1	4.4	6.9	9.5	19.4	22.3	32.5	30.4	20.5	20.8
Gross F/X Reserves months of imports)	1.0	1.8	2.5	3.0	3.1	5.3	5.0	5.4	4.7	3.9	5.1
Public Finance											
Revenues (% of GDP)	27.7%	25.8%	26.8%	28.2%	26.5%	30.4%	31.6%	30.8%	24.6%	30.0%	28.0%
Expenditures (% of GDP)	28.3%	27.2%	26.2%	28.4%	29.4%	32.1%	32.3%	31.9%	25.6%	35.5%	29.0%
Balance (% of GDP)	-0.7%	-1.4%	0.6%	-0.2%	-2.9%	-1.8%	-0.7%	-1.1%	-1.0%	-5.5%	-1.5%
Balance (UAH bn)	-1.1	-2.8	1.3	-0.5	-9.9	-7.7	-3.7	-7.7	-9.2	-60.0	-18.4
Privatization Revenues (UAH bn)	2.1	2.1	0.6	2.0	9.4	20.7	0.5	2.5	0.9	2.5	16.0
Debt											
Total Public Debt ($bn)	14.2	14.1	14.2	14.5	16.1	15.5	15.9	17.6	21.2	36.0	34.8
Total Public Debt (% of GDP)	45.3%	36.5%	33.5%	29.0%	24.7%	17.7%	14.8%	12.6%	12.3%	27.1%	17.0%
External Public Debt ($bn)	10.4	10.1	10.2	10.2	12.1	11.7	12.7	13.8	15.5	32.5	31.3
Gross External Debt ($bn)**	-	-	-	23.8	30.6	38.8	54.3	84.5	110.5	115.3	113.0
Gross External Debt (% of GDP)	-	-	-	47.5%	47.1%	44.4%	50.4%	59.9%	64.0%	86.7%	55.3%
Monetary Indicators & Exchange Rate											
Monetary Base (% y-o-y)	39.9%	37.4%	34.0%	29.8%	34.1%	53.9%	17.5%	46.0%	27.5%	10.0%	18.0%
Money Supply (M2, % y-o-y)	46.0%	41.9%	41.8%	46.5%	32.4%	54.3%	34.5%	51.7%	29.0%	13.5%	15.2%
Credit Rates (avg.; UAH; % p.a.)	41.5%	31.9%	24.8%	20.2%	17.9%	16.4%	15.1%	14.4%	16.0%	21.0%	19.0%
Deposit Rates (avg.; UAH; % p.a.)	13.7%	11.0%	7.9%	7.0%	7.8%	8.5%	7.9%	8.6%	9.0%	12.5%	10.0%
UAH:USD (official rate; e-o-p)	5.43	5.30	5.33	5.33	5.31	5.05	5.05	5.05	8.5	7.4	6.0
UAH:USD (official rate; avg.)	5.44	5.37	5.32	5.33	5.32	5.12	5.05	5.05	5.3	8.2	6.3

Source: SSC, NBU, Ukrsibbank

Ukrainian politics remains noisy and chaotic, political paralysis to persist over 2009

Ukrainian politics remains noisy and chaotic, political paralysis to persist over 2009. Key political camps remain Party of Regions and BYT. Liberal universe (formerly Our Ukraine) is splitting up, with some of parties drifting towards BYT and the rest drifting towards President. There is little hope for a scenario, under which Ukrainain policymakers could agree for effective national program, aimed at combating the credit crunch.

In December 2008 Ukrainian Parliament formed yet another ruling coalition of BYT, Our Ukraine and Lytvyn Bloc, with Mr. Lytvyn becoming the speaker of Ukrainian Parliament and Mrs. Tymoshenko keeping the prime-minister office. This coalition is unlikely to hold for a long time as it gets on to Presidential elections, there should be increased pressure to replace Mrs. Tymoshenko (a key Presidential candidate) with another person since both PoR leader Mr. Yanukovych and current President have their own plans for elections.

A sharp economic decline in 1Q2009 should facilitate possible change of power. Due to high concentration of industrial enterprises in the Eastern regions of the country, these will face skyrocketing unemployment. Simultaneously, abilities of the government to provide social aid might be substantially limited. Coupled with ongoing deterioration in economic activity it would lead to massive protests against the government, and, subsequently, to replacement of PM. In the baseline scenario, the person to substitute Mrs. Tymoshenko will have higher chances to become the new president, as the economy is likely to stop contracting in 2H2009 and UAH might break the devaluation trend.

The new President-government vertical may be formed in 2010[1], most likely as coalition of two political camps as no single political force is able to win a majority. Since major Ukrainian parties share fairly similar concepts of economic policy, the new block will quickly embark on a program for economic recovery. Structural reforms (with some exceptions) are most likely to be postponed which would negatively impact business environment and competitiveness.

Lack of commitment to implement reforms, unstable government (on average more than one government per year) and absence of consolidated political power create a shaky environment for investments and delay technology spillovers. It implies that over the years to come Ukraine is not likely to develop additional competitive advantages besides those already in place (soils and ores). The economy will be poised to remain strongly commodities dependent and thus vulnerable to external shocks. The good news is that given weak and unstable government Ukraine will preserve its advantages as liberal open economy and thus may utilize possibilities, stemming from government programs (restrictions) in other countries, primarily in the EU[2].

Given dare needs for funds the state will be forced to speed up privatization (very likely) and land reform (likely), which might be necessary to generate cashflow in order to avoid even harder landing of the economy (and massive loss of electorate). A comprehensive land reform would allow for creation of large agricultural holdings, able to attract capital, invest into infrastructure and control costs of production. An important pre-requisite for privatization and land reform remains global credit recovery. Should risk pricing remain at current levels, any transparent sale of state property or land is unlikely.

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[1] Presidential elections should be held in Jan 2010

[2] E.g. Ukrainian egg producers may benefit from a ban on chicken battery cages which introduces significant additional costs for EU manufacturers.

Public finance to live through the worst year in a decade

Public finance is to experience the worst year in a decade as budget revenues would fall sharply. Over the last years, government spending has increased dramatically, crossing 30% of GDP and demonstrating 30..40% nominal growth per year. Since lion's part of the increase was social spending, it would be very difficult to cut the expenses as demanded by drying out revenues.

Ukrainian state is not only short of funds to support extensive government programs (big-scale government), but will be forced to cut the expenses disproportionally. The government policy is poised to be procyclical and contractionary as there are little opportunities to cover budget deficit when external financial markets are closed.

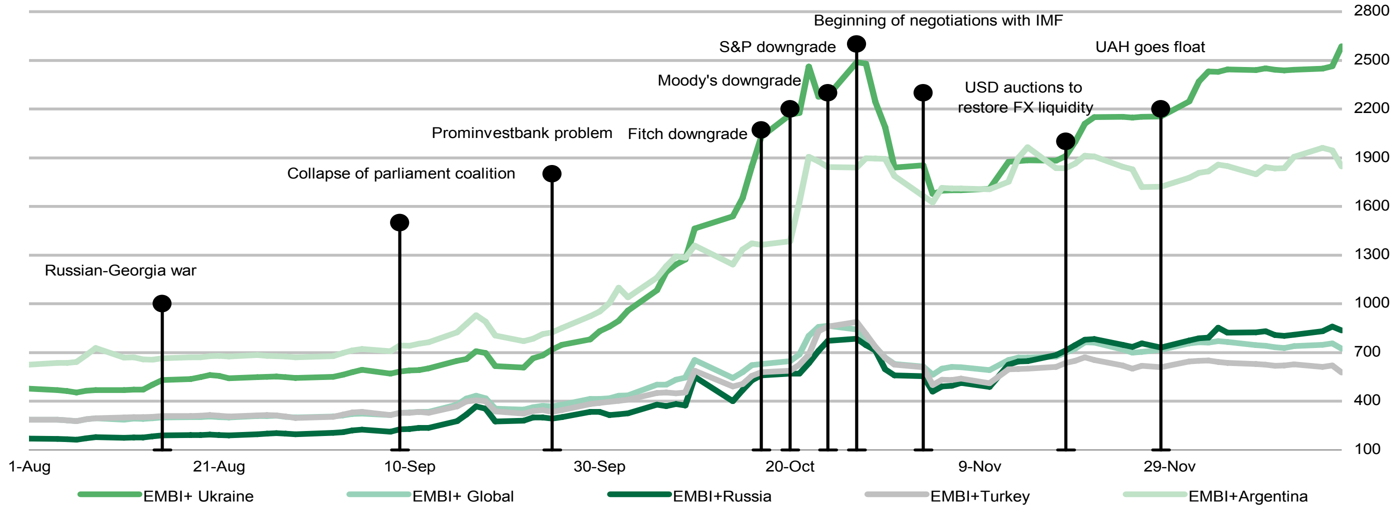
The drop in budget incomes will reach a bottom of -40% y/y growth in 1Q2009 and will be followed by still weak results over the rest of the year. This is to generate huge **full year fiscal deficit of at least UAH 60 bn. or 5.5% GDP**, partly financed via direct monetary emission (literally by printing money), partly via delayed payments. Debt-to-GDP ratio will double in 2009, reaching 30% of GDP.

Ukrainian sovereign risks are on the rise and may further increase should the country fail to formulate a clear strategy of bailing out its banking system or should global recession deepen and turn into L-shape Japanese style one. A default by one of the CEE nations would also contribute to spreads widening even further.

On the other hand, Ukraine is very sensitive to risk appetite and should the sentiment on financial markets improve, Ukrainian spreads would be the fastest to contract. Also the following events might decrease country risk:

- Improvement in global access to credit, which would stimulate higher demand for Ukrainian export products;
- Successful bailout of the banking system or government support provided to local borrowers;
- Clear FX rate policy which would not undermine the ability of central bank to prevent currency from sharp movements and ability of government to pay the debts.

EMBI+ Ukraine spread



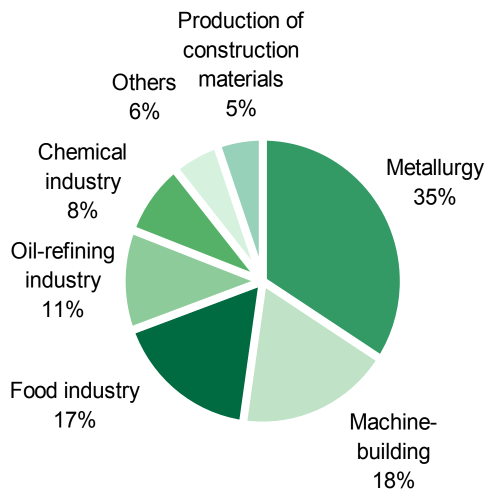
Source: Bloomberg

A key factor, driving Ukrainian economy in the nearest future would still be demand for steel. De-coupling of economic growth in Ukraine from demand for steel in short term is not possible, given the huge reliance of Ukrainian economy on production and exports of steel.

Performance of Ukrainian economy closely linked to demand for steel

Up to a half of Ukrainian industrial production and more than a quarter of GDP is directly or indirectly linked to metals production. Ukraine is also one of the largest steel exporters worldwide in relative terms. Over 70% of steel produced in Ukraine is destined for exports.

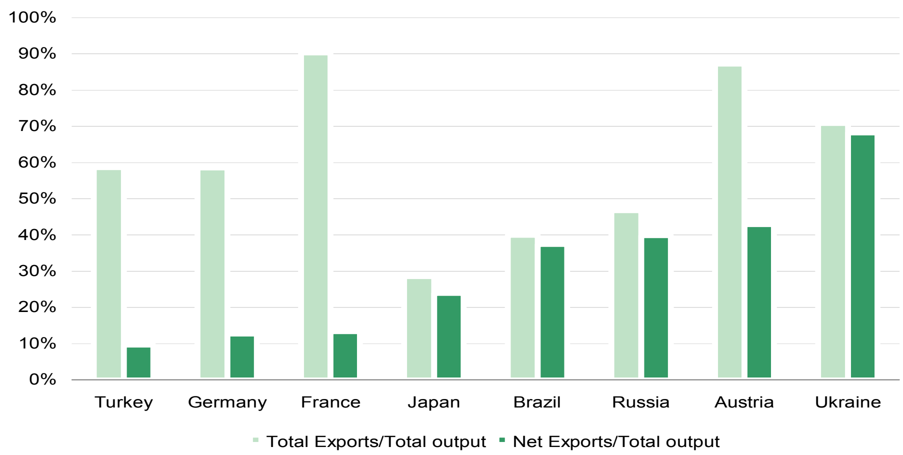
Steel in Ukrainian industrial production, %



Source: State Statistics Committee of Ukraine

Furthermore Ukraine is the largest net exporter meaning it is incredibly vulnerable to global demand for steel. E.g. France, exporting about 90% of produced steel, is well-defended against price shocks as it also imports a substantial amount of steel. Ukraine would not be able to offset fall in external demand by supplying excessive steel products to domestic market – local steel-consuming industries experience even sharper decline than global demand.

Steel in exports per country, %

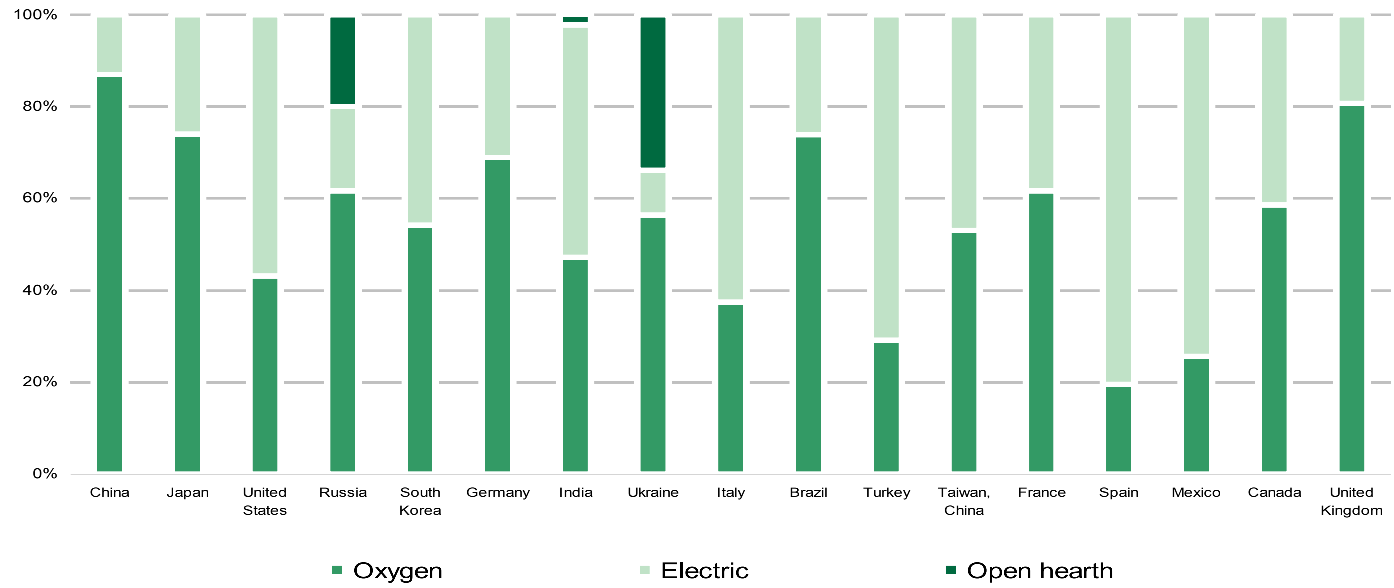


Source: State Statistics Committee of Ukraine

Effectiveness remains an issue

Ukrainian steel sector took the most serious hit, comparing to other countries since it is one of the least energy-efficient worldwide. More than 40% of steel is smelted in open-hearth furnaces, 51% in converters and less than 5% in arc-furnaces. For comparison in Germany more than 70% of steel is smelted in converters and the rest in arc-furnaces. In Ukraine continuous casting makes up only 33%, while in Germany 98%. Furthermore over 54% of cokeries, 89% of blast furnaces, 87% of open-hearth furnaces, 26% of converters and almost 90% of rolling mills function longer than target life. This involves higher power intensity of Ukrainian production and extremely weak positions of Ukrainian metallurgy sector in periods when world production facilities exceed demand. The weakness of Ukrainian metallurgy is confirmed by comparative dynamics of manufacture – steel output in October in comparison with average monthly (2008) has reduced by 32% - the record figure among world top-10 steel manufacturers.

Low efficiency of Ukrainian companies , %



Source: World Steel Association

Furthermore, given reduced to no access to capital markets in the nearest future, Ukrainian companies may find it very hard to attract capital in order to modernize their production. Interest to emerging markets will be scarce within nearest prospects. Throughout 1998 and 2001 capital inflows to emerging markets decreased three-fold vs. pre-crisis levels. This trend is most likely to prevail over 2009-2010, so the competition for a greenback may be very tough, especially as political uncertainty and lack of reforms would continue to weigh on Ukraine's image. Alternative sources of funding are very limited. Local steel holdings were formerly spending significant amount of cash to finance expensive acquisitions and sponsor different elections - the comfortable cushion weathered during good times might not be there at all.

From 1975 till 2007 the world metallurgy recession was observed 3 times - in 1980-1982, 1990-1992 and 1998-1999. The recession and recovery cycles lasted from 1 to 3 years. Albeit it is not clear to which extent the global economy would suffer from ongoing slowdown in economic growth (which indeed represents a downside risk to our forecast), we anticipate recession in steel sector that would last six quarters (2008-2009) and a gradual recovery from 2010. At present the world steel sector is much more concentrated than during previous slumps that gives more room for price control. Furthermore, new technologies introduction considerably shifted fixed/variable costs ratios from about 80/20 to 20/80 that allows steel makers to reduce output without exponential growth of production unit.

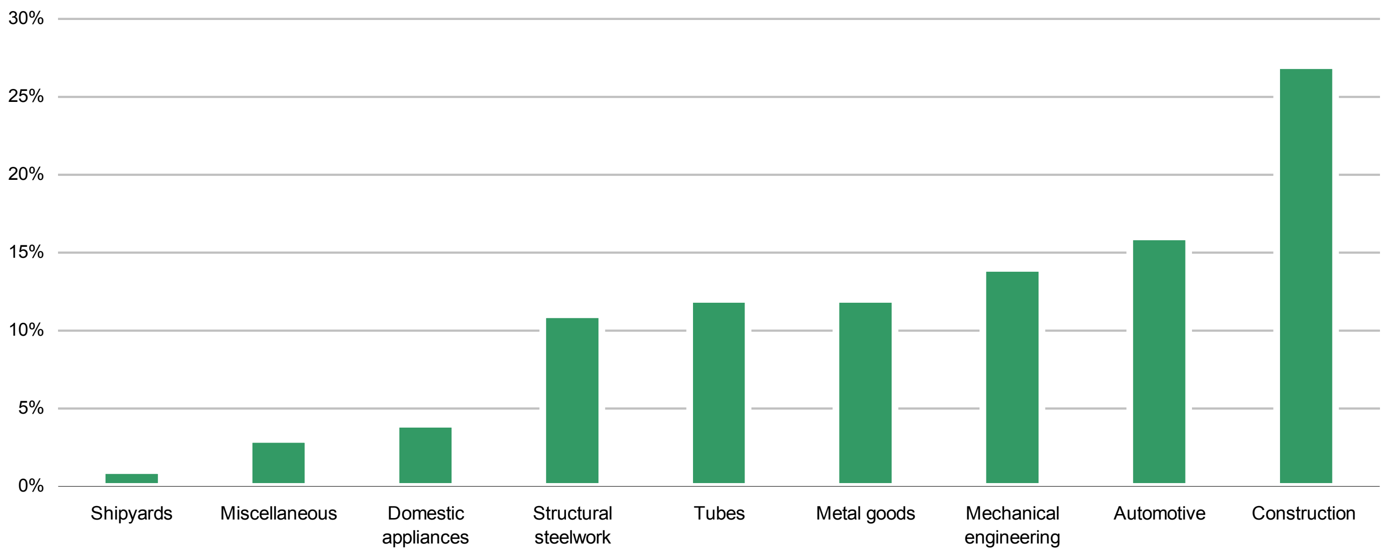
Global credit is essential, since key steel-consuming industries are sensitive to interest rates. This is particularly true for residential construction and automotives are likely to remain depressed for some period of time.

Demand from non-residential construction has all chances to recover quickly, since energy-saving seems to be on agenda globally. Improving energy effectiveness of buildings demands significant refurbishing or even replacement of existing property stock.

Demand from structural steelwork is to increase, driven by generous investment into infrastructure worldwide. Finally, growing number and scale of natural disasters would most likely lead to increased intensity of steel consumption in this segment.

Tubes production isn't likely to explode given that oil&gas prices are falling and construction of new pipelines yet needs to be motivated by higher energy prices. Mechanical engineering is potentially a huge consumer of steel for the very similar reasons as non-residential property. More efficient power plants and new environmentally-friendly equipment will lead to yet another surge in steel consumption.

Steel consumption industries, %

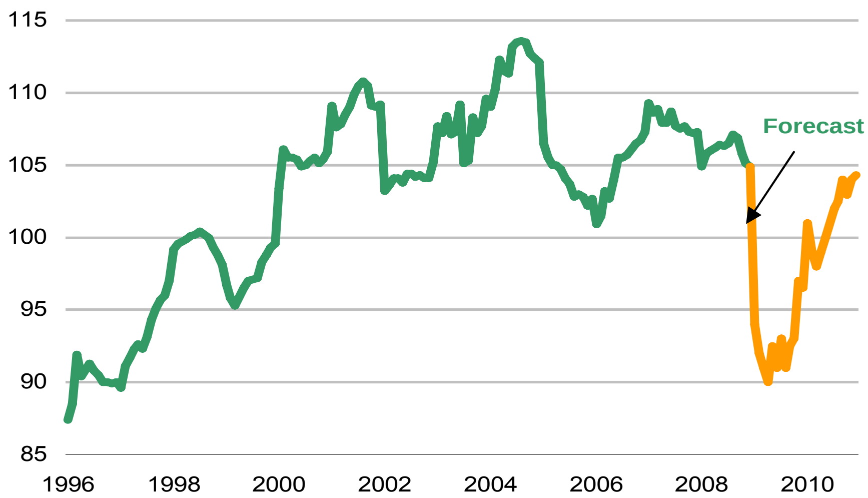


Source: World Steel Association

As the metal industry responds to sharp price declines by cutting production, Ukrainian exports will plunge and GDP should contract for most of 2009. As of year-end we expect a decline of 4.5%, followed by a period of below-potential growth. Economy is unlikely to return well on track earlier than 2011. The extent to which economy may recover in 2010 is primarily dependent on global credit conditions. An improved lending with at least partial recovery of investment into construction would lead to higher demand for steel and would consequently result into U shaped recession.

Risks to our forecast are on the downside for 2009, should industrial recession deepen in mechanical engineering industry and food production (18% and 17% of IP). In this case the economy may face a harsh 7% y/y decline, with recovery beginning no earlier than 2Q2010.

GDP of Ukraine CPPY = 100 Baseline



Source: Reuters, Ukrsibbank Estimates

Giving collapsing consumer credit we expect consumption growth rates to turn negative, albeit picking up slightly on the eve of Presidential (and perhaps parliamentary) elections. The impact of another round of elections on consumption would be modest though, as key political forces are likely to cut the financing of their election campaigns.

Investment is expected to slow down significantly, while the rise in government spending would be insignificant given declining budget revenues and obligations of stronger fiscal discipline demanded by IMF.

Government spending will be cut dramatically. Albeit the budget for 2009 may not change comparing to 2008, the revenues will fall and thus government spending will not be financed in full. This is particularly true for various investment programs which have to wait for a better conjuncture.

Cooling internal consumption would positively impact net exports – while the volume of external trade declines, the net balance would improve following sharp devaluation of local currency.

Besides falling external demand, key forces impacting performance of Ukrainian companies shall be deleveraging and UAH devaluation.

Deleveraging

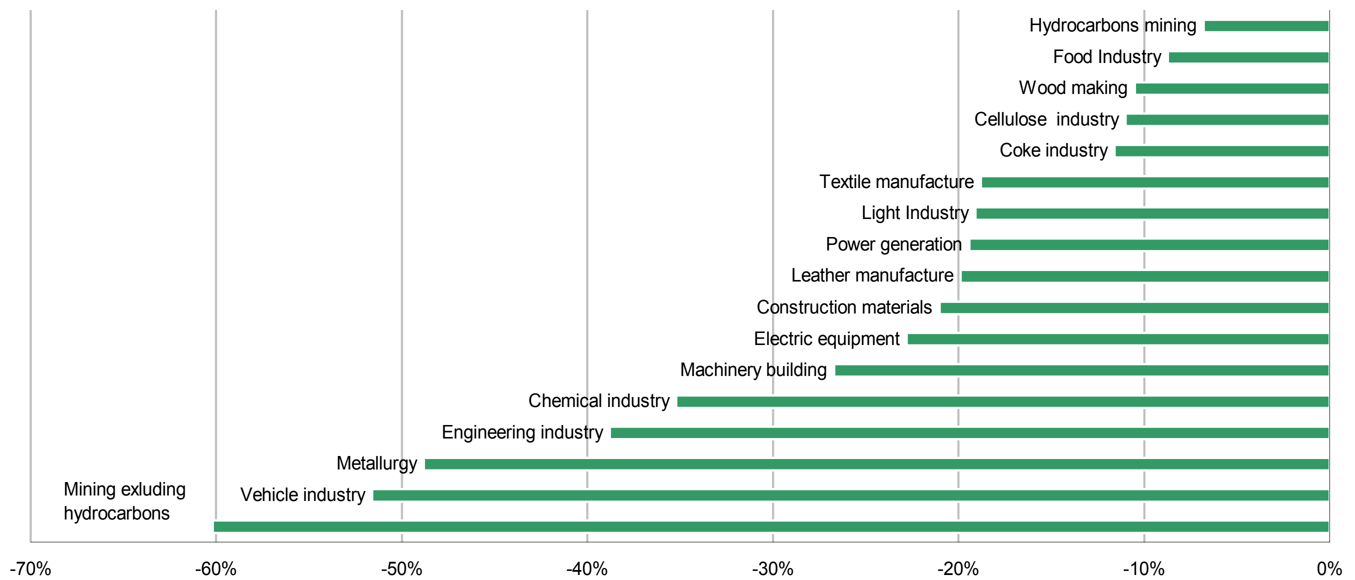
Deleveraging has seriously affected the general economy. Even stronger and competitive industries like food production have to cut output and review their investment plans as their cost of capital has nearly doubled since the beginning of the year. Excessive FX lending would further contribute to rising debt service costs, as low-yielding currencies continue to climb against UAH. Higher cost of capital would be fully priced in on horizon of one to two quarters (when short-term credit lines should be refinanced).

Devaluation

Devaluation of local currency should make companies to cut their costs. However, given that Ukrainian economy is highly dollarized, the effect from devaluation might not be an immediate one and local companies yet have to decouple wages and prices from dollar, after those who adjust prices up would face a decreased demand. A competitive advantage that Ukrainian companies get will be also limited by devaluation of other eastern European currencies.

On the back of bleak economic outlook and disappearing credit, all industrial branches slid into recession by Nov 2008. The most affected was non-energy extracting industry where production fell some 60% comparing to one year ago – overstocked metallurgy did not place any orders on ore. In transportation machine-building production nearly halved due to falling demand for new vehicles. While heavy industries seem to have reached their lowest point in 4Q2008, the deceleration in woodworking, construction materials, pulp and paper etc is yet to deepen. A decline in these industries would last at least till 3Q2009. A production of electronic and energetic appliances shall not recover until 2010 or later, since capex of vast majority of companies is close to zero.

Industrial production Nov 2008 YoY, %



Source: State Statistics Committee of Ukraine

Construction is contracting sharply, declining by 16.1% y/y in the eleven months of the year with the plunge accelerating. Local property market has been extremely overheated over the last few years, serving as by far the largest asset market in the country. Pegged exchange rate and subsequently enormous inflation have made investment into real estate very profitable, decoupling purchasing power from price lists of real estate companies.

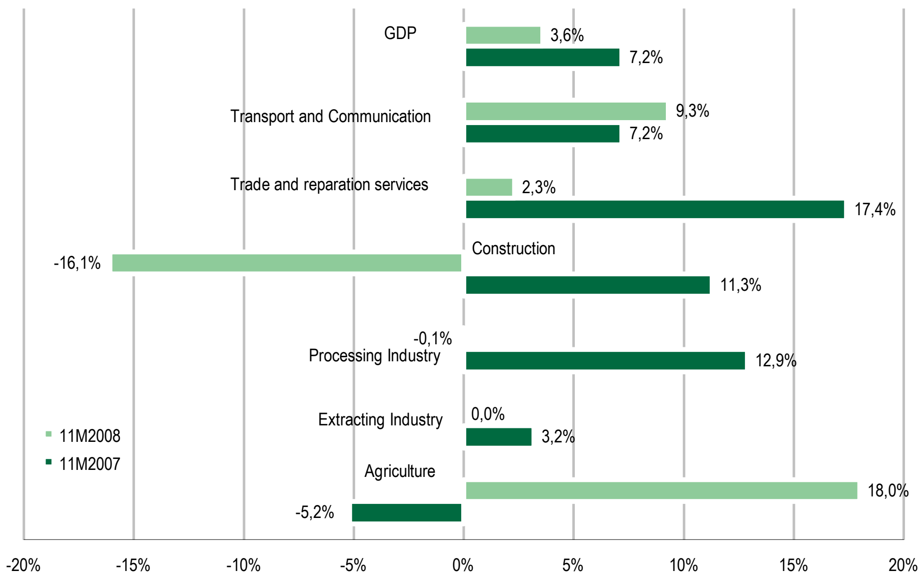
Deleveraging would have a destructive effect on the sector over the next year at least, especially as management of Ukrainian construction companies has very low aptitude to cutting costs as demanded by weaker economic conditions. The only gleam of hope is infrastructure projects. These, however, are unlikely to get enough funding from either government or private investors (in 2009).

So far agriculture remains the only bright spot in the economy, fuelled by this year's excellent harvest. On the other hand, insufficient quality of grain, low efficiency of de-concentrated producers, dramatic lack of infrastructure for storing and transporting foodstuffs abroad undermine the outlook on agricultural sector.

Transportation is to undergo a sharp correction, facing falling industrial orders, decline in external trade and decreased number of passengers, in particular on international routes. Telecoms would feel relatively well, experiencing rising demand for services. However investment plans are likely to be halted or postponed.

Finally, trade would record yet another decline since 2005. Wholesale trade is to collapse given that a large part of it was represented by metal traders which decreased the turnover dramatically. Retail trade will be strongly affected by falling internal consumption. Furthermore, customer migration process from unorganized marketplaces to supermarkets shall stop, or even reverse as former are usually more flexible in offering the best price.

GDP Growth by sectors, 11M2008



Source: State Statistics Committee of Ukraine

The three drivers of Ukrainian economy in mid-term can be agriculture, mechanical engineering and infrastructure.

The ongoing financial crisis will cause a re-location of production facilities and shifting access in investment. The global economy is facing significant constraints (with energy being the most important one) and thus will be forced to seek ways to improve efficiency.

The three drivers of Ukrainian economy in mid-term can be agriculture, mechanical engineering and infrastructure. These sectors have the following fundamental advantages: increasing global demand for their products, natural advantages of Ukraine, absence of large domestic capital within the sectors, dare need for investment and poor efficiency.

While soft commodities experienced a correction over the past year, growing world's population coupled with increasing standards of living and ever greater production of biofuels would lead to increasing demand for foodstuffs. And since marginal efficiency of capital is falling in agrisectors of developed nations, Ukraine is a natural place to produce in, with incredible payoff.

Overall area of lands suitable for farming covers 42 mn. ha, while merely 25 mn. ha are currently under effective utilization. Average harvest in Ukraine lags behind that of developed nations significantly, despite extremely high quality of local soils. Key problems of domestic agrisector are dare need for investment and technology and insufficient utilization of economy of scale. These problems may be solved should moratorium on land sale be removed over the next year. Given that public finances face a difficult period, removal of this moratorium is very likely to become a reality. Certain conditions (such as social obligations) might be applied to foreign investors. Investment in agriculture should become a main driver of FDI in 2011 and 2012.

Over the last years the fastest growing part of Ukrainian mechanical engineering was automobile production, heavily supported by tax preferences and protectionist measures. Efficiency of automotive enterprises was quite low as these were mainly represented by assembly plants, importing vast majority of components from abroad.

The future of local machine-building is in domestic production of turbines, engines, equipment for oil&gas and heavy machine-building. Cheap and qualified labor plus close supply of components should guarantee successful development of mechanical engineering industry, especially as eastern-European nations become increasingly expensive to produce in due to the convergence process with the EU. Lack of technology and equipment is the main handicap, which might be removed if major mechanical engineering companies open production sites in Ukraine.

Finally infrastructure is the underlying sector to improve efficiency of both agriculture and mechanical engineering. Ukraine is located at the crossroads of important international traffic routes from the EU to Russia and Caucasus and has several important ports at the Black sea. Road network appeals for complete replacement since old technologies demand constant reparations and thus incur significant maintenance cost.

Since public finances is going to be in a poor shape, the most of infrastructure projects are to be conducted with private-public partnership. We expect PPP to become a hot topic in 2010, when new government is likely to be forced to seek cooperation in order to modernize existing stock of infrastructure.

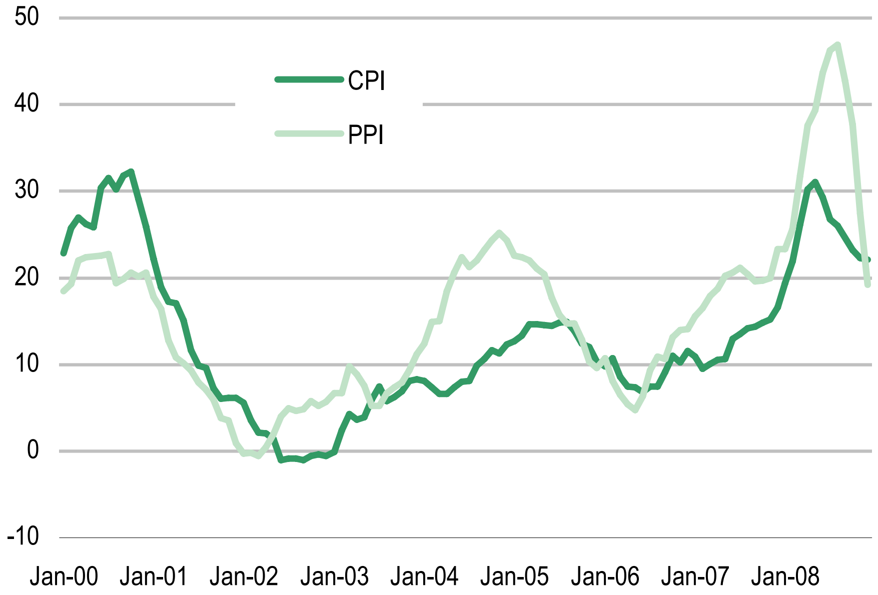
CPI to remain in double digits

The CPI inflation rate remains extremely high at levels over 20% y/y. The outlook for inflation remains grim, overshadowed by the currency's fall and rising prices of imported goods.

We do not expect consumer inflation to return to single-digit territory any time soon. While some moderation is expected in food items of the basket, utilities and government-controlled items will explode since both local and central budgets will get under pressure and would no longer be able to subside. Public transportation, bread, public utilities etc are some of the examples.

The PPI is now falling reflecting the sharp drop in export prices (so the companies adjust in order to sell more on internal market). Falling oil prices also contribute to disinflation in PPI. In October PPI fell 1.4%, followed by massive slump of 6.5% in November. Adjustment of producer's prices would continue further in 2009, albeit is limited by UAH devaluation.

CPI and PPI, Y/Y, %

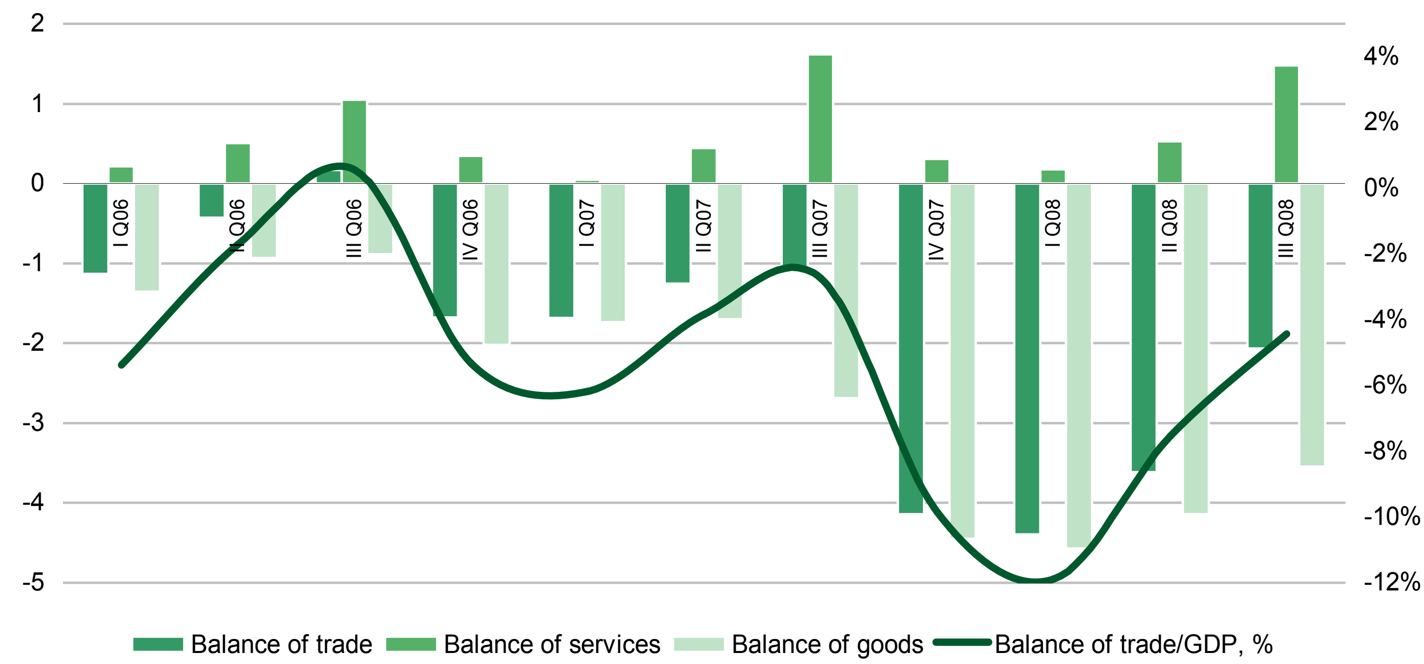


Source: State Statistics Committee of Ukraine

External trade is likely to collapse during 2009, with both imports and exports falling

External trade is to collapse during 2009, with both imports and exports falling. The current account deficit is forecasted to reach a high of 8% of GDP in 2009. We anticipate a sharp 28% decline in exports while imports are expected to contract about 31%, bringing negative merchandise trade balance to -$11.7 bn. A contraction would be fully due to key export and import items (steel&chemicals), so at the end of the day foreign trade would become more diversified.

Balance of trade dynamics, USD Bn



Source: National Bank of Ukraine, State Statistics Committee of Ukraine

We expect gradual improvement of C/A balance. Two of the largest articles of Ukrainian imports – cars and equipment (including electronics) are stalled. UAH has weakened and economic conjuncture fell so that only a few consumers would be able to buy expensive imported products. Overall, consumption will switch to lower priced and domestically produced categories of goods. Favorable lending conditions (a key driving force behind import growth) are unlikely to be restored: UAH interest rates are to remain restrictively high, FX lending will most likely stay banned.

Energy bill to decline

Energy bill, a source of concern over the last years, will also decline. For 2009 the gas price set for European countries is likely to be cut from $400 to $300 per tcm at least. Subtracting taxes and cost of transportation beyond Ukrainian border gives us a price of $150..200. In 2008 Ukraine already paid $179.5. Total consumption of hydrocarbons is to be slashed as key industries consuming imported gas will have their production sinking for the most of the year.

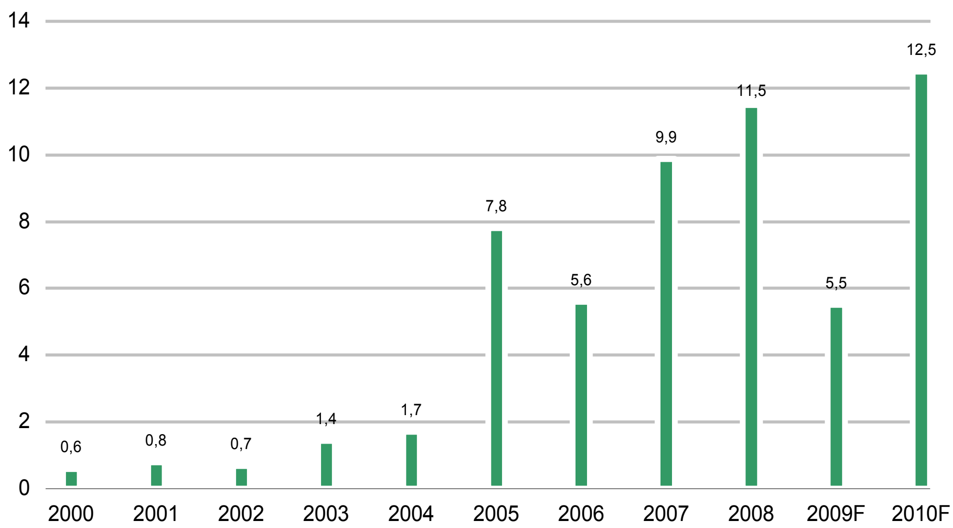
C/A will continue to remain strongly supported by positive balance of services and by transfers (remittances of Ukrainians working abroad) – altogether averaging $10 bn. per year. Still, given that Ukrainian GDP is expected to decline in dollar term, C/A will reach 4.4% of GDP.

In 2010 we expect FDI to pick up at least to $12.5 bn., remarkably improving total balance.

FDI is to plunge in 2009, after reaching its peak in 2008 roughly at $11.5 bn. A twofold decline may well be expected. One could observe a freeze of long-term investment programs over 2008, as Ukrainian economy became less understandable (skyrocketing inflation, political squabbles, deteriorating business climate) for the foreign companies. Since decision-making of strategic investors usually takes 6-12 months, the trough will be from 1Q2009 to 2Q2010 - volume of new investment will be limited by current needs of existing subsidiaries to support their operational activity. Occasional M&A might be there though as many large holders of diversified assets will be forced to liquidate their non-core businesses in order to support capital intensive development&banking divisions.

Financial sector will be a key FDI recipient in 2009. This year, banks were forced to increase capital in order to comply with NBU regulations. Next year, the FDI driver would be a need for consolidation and recapitalization of Ukrainian banks as non-performing loans are set to explode under pressure of economic slowdown coupled with local currency devaluation.

FDI in Ukraine in 2000-2010F, USD Bn



Source: State Statistics Committee of Ukraine

In 2010 we expect FDI to pick up at least to $12.5 bn., remarkably improving total balance. Despite worsening macro fundamentals, Ukraine shall remain attractive for strategic investors.

First, historically most of investment in Ukraine has come from the EU. European investors do not provide a quick inflow of capital, but on the other hand are less sensitive to moods on financial markets, often pursuing long-term targets.

Second, Ukraine missed a lot of time in preparation to EURO-2012. Chances are, Ukraine would not receive the championship or number of matches would be drastically reduced (which is our base case scenario). Still, the country has enormous infrastructure needs and dramatic shortage of public capital. We look forward to active participation of foreign private capital in PPP, as the state would most likely offer attractive conditions for investment.

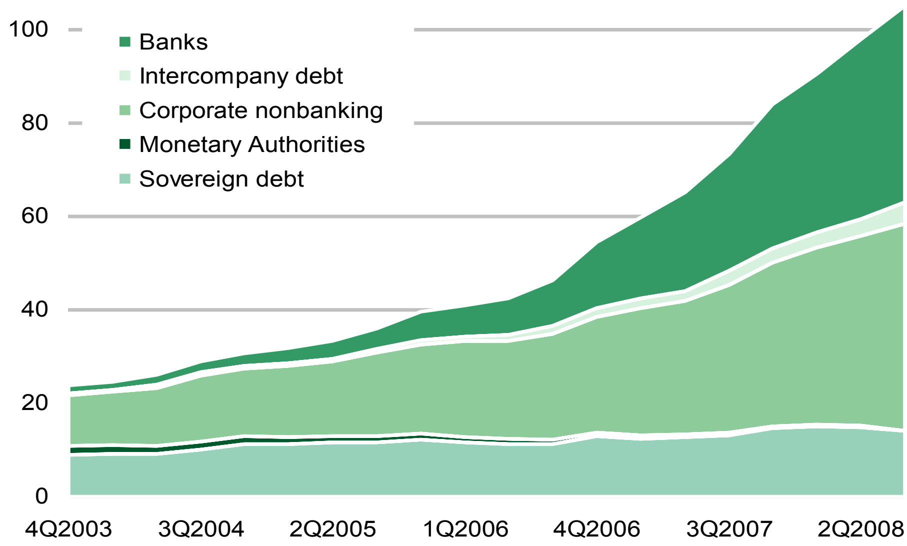
Third, presidential elections in early 2010 are likely to intensify privatization and land sale processes. Albeit the list of attractive property stakes is short and their valuations are down at the moment, we expect at least $2 bn. to be raised via privatization[3].

One of the key concerns regarding Ukrainian external balance is a very large external debt comprising $100 bn as of 1H2008. A short-term (under one year) part of it represents over $28 bn., which raises doubts regarding ability of Ukraine to refinance this debt. A government debt (about 12% of the total amount) is very well diversified, with most of redemptions falling well beyond 2010.

Net redemption volume of corporate debt in 2009 unlikely to exceed $10..15 bn.

Corporate debt remains a huge unexplored area. At the moment there is a little reliable information on the structure of corporate debt, since public deals constitute a miserable percentage of total. According to our estimates, short-term debt is primarily represented by intra-group funding (deals between mother company and its subsidiary in Ukraine) in metallurgy, banking and other industries. For 2009 we assume 100% redemption for all public deals, 30% redemption (i.e. 70% rollover or new loans) for nonpublic banking deals and 40% redemptions for nonpublic corporate deals. Under these assumptions net redemption volume in 2009 should not exceed $10..15 bn.

Total External Debt, USD Bn.



Source: State Statistics Committee of Ukraine

$36.8 bn. landed into FX cash holdings over the last 4 years

Even if redemptions ratio exceeds assumptions, the country as a whole has enough other reserves to cover the debts. Cumulative C/A deficit over 2005-1H2008 landed only at $19.1 bn., while inflows of capital has exceeded this amount by factor of five. **Altogether, the positive surplus of financial account was at $78.7 bn. (!).**

Where did all these money go? $26 bn. landed to FX reserves of the NBU, about $16 bn. is deposited in the banking system. The missing amount of $36.8 bn. is an increase in cash FX holdings used to service intrasparent and highly dollarized Ukrainian economy. A part of these funds in cash FX is to be returned to the banking system as assets will change hands and FX loans are to be paid back by selling property.

[3] Estimation of government stakes to be sold to foreign investors.

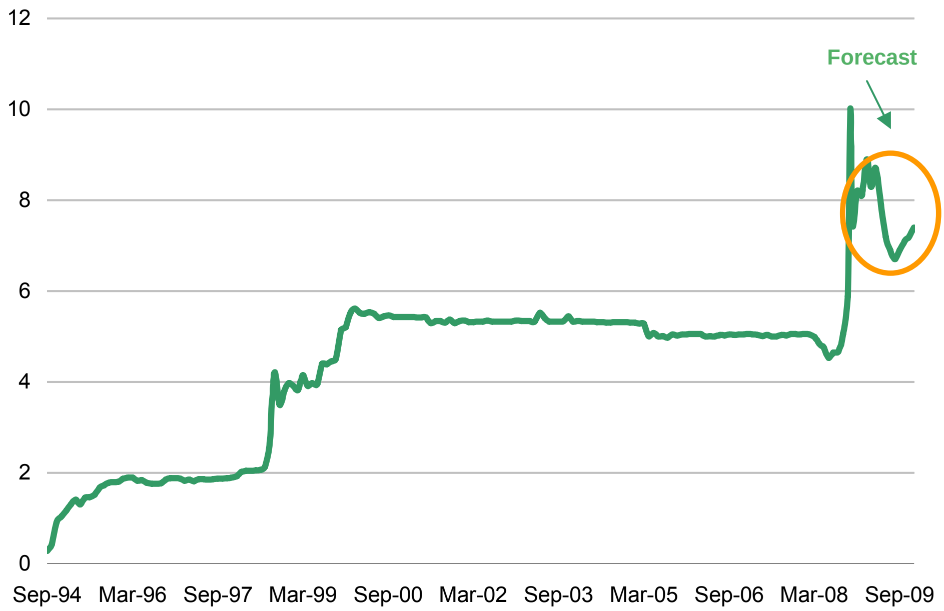
Inflows and outflows of capital during the period of Jan 1 2005 - Jul 1 2008, cumulative, USD Bn.	
Current account*	-11.8
FDI inflow*	29.9
FDI outlow**	-7.5
Balance of portfolio investment*	12.3
Inflow of debt capital*	70.1
Debt service costs*	-14.3
TOTAL	**78.7**
Increase in NBU reserves*	26
Increase in total FX deposits*	15.9
Increase in cash FX holdings	**36.8**
TOTAL	**78.7**

*Source: NBU, calculations: UkrSibbank
**Source: SSC, calculations: UkrSibbank

Ukraine's BOP Forecast	2007	2008	2009	2010
Export of goods	49.8	58.1	41.8	49.3
Import of goods	60.4	76.4	53.5	58.8
M trade balance	-10.6	-18.4	-11.7	-9.5
Current account	**-5.9**	**-12.4**	**-5.8**	**-1.5**
incl trasfers	4.1	3.8	3.2	4.0
incl incomes	-2.1	-2.7	-2.9	-2.7
incl services	2.7	4.9	5.6	6.7
External debt redemptions	11.1	21.3	36.7	25.5
incl public sector	1.2	1.3	2.3	2.2
incl private sector	9.9	20.0	34.4	23.3
Investment abroad and capital flight	13.8	15.0	5.0	10.0
Costs of dual-currency system (net purchase of FX by population)*	-0.8	4.0	7.0	-1.0
Total financing needs	**30.0**	**52.7**	**54.5**	**36.0**
Total borrowings	31.1	39.1	38.0	23.8
incl public sector	1.5	2.5	6.0	2.0
incl IMF	-0.4	4.1	11.0	-1.2
incl private loans, rollover and portfolio investment	30.0	32.5	21.0	23.0
FDI	9.2	11.5	6.5	12.5
Total financing	**40.3**	**50.6**	**44.5**	**36.3**
Change in FX reserves	10.3	-2.1	-10.0	0.3
USD/UAH end of period	**5.1**	**8.5**	**7.4**	**6.0**
USD/UAH average rate	5.0	5.3	8.2	6.3
Gross FX reserves, end of period	**32.5**	**30.4**	**20.5**	**20.8**
Gross FX reserves, months of import	**5.4**	**4.7**	**3.9**	**5.1**

Back in 2007 one of IMF publications depictured Ukrainian exchange rate regime as a good example of slow and cautious progress from peg to float. Perhaps, the process has been indeed too slow and too cautious. When National Bank was forced to act, it had a little understanding of where the market was and what key driving forces were. As a result, USD/UAH underwent a painful correction, serving yet another textbook example of what happens when you peg for too long.

USD/UAH exchange rate since 1994



Source: Reuters

Spillover of domestic savings caused a sharp correction of FX rate.

National Bank of Ukraine had to abandon the peg after it lost control over FX rate and depositors started to run on the banks, converting their UAH deposits into hard currency. That of course created enormous pressure on FX rate as deposit withdrawals volume was comparable to monthly volume of imports. Just before the first round of depreciation Ukrainian depositors held an equivalent of $25 bn. in local currency or roughly 2/3 of NBU's FX reserves.

Furthermore, NBU printed almost UAH 40 bn. of cash in order to support domestically owned banks. Some of these banks received extremely generous refinancing exceeding 20% of their assets. Chances are, a part of these funds was used to play against UAH. At the same time NBU has spent close to $10 bn. of reserves, mimeticing the experience of Banxico[4] in the mid-90s

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[4] Mexico had a fixed exchange rate system that accepted pesos during the reaction of investors to a higher perceived country risk premium and paid out dollars. However, Mexico lacked sufficient foreign reserves to maintain the fixed exchange rate and was running out of dollars at the end of 1994. The peso then had to be allowed to devalue despite the government's previous assurances to the contrary, thereby scaring investors away and further raising its risk profile. When the government tried to roll over some of its debt that was coming due, investors were unwilling to buy the debt and default became one of few options. A crisis of confidence damaged the banking system which in turn fed a vicious cycle further affecting investor confidence.

A few days after a private meeting with major Mexican entrepreneurs, in which President's administration asked them for their opinion of a planned devaluation, the President announced his government would let the fixed rate band increase to 15 percent (up to 4 pesos per US dollar), by stopping the previous administration's measures to keep it at the previous fixed level. The government, being unable even to hold this line, decided to let it float. The peso crashed under a floating regime from four pesos to the dollar to 7.2 to the dollar in the space of a week.

In order to provide some assistance in combating deteriorating external environment, IMF has supported Ukraine with $4.5 bn. transaction in terms of two-year stand by agreement, totaling $16.5 bn. Given the speed of decision, it looks like IMF would provide additional support to Ukraine should the situation demand. On the other hand, we expect further transactions with the fund to be difficult as Ukraine might eventually violate some of loan conditions (past experience shows that it was always the case when Ukraine embarked on one of IMF programs).

Low transparency of NBU actions on FX market in Oct-Nov may trigger a resignation of NBU head over the quarter to come. BYT, one of key political forces already demanded immediate resignation and will push the issue further. However parliament alone cannot discharge the NBU governor since according to law "On National Bank of Ukraine" only the President can hand in such proposal.

Until January 2008 NBU adopted managed peg, limiting working hours of FX market by two hours per day. In February, however, this approach needs to be changed if NBU would like to continue cooperation with IMF.

FX rate is a random walk in short term, but is increasingly attractive comparing to CEE peers.

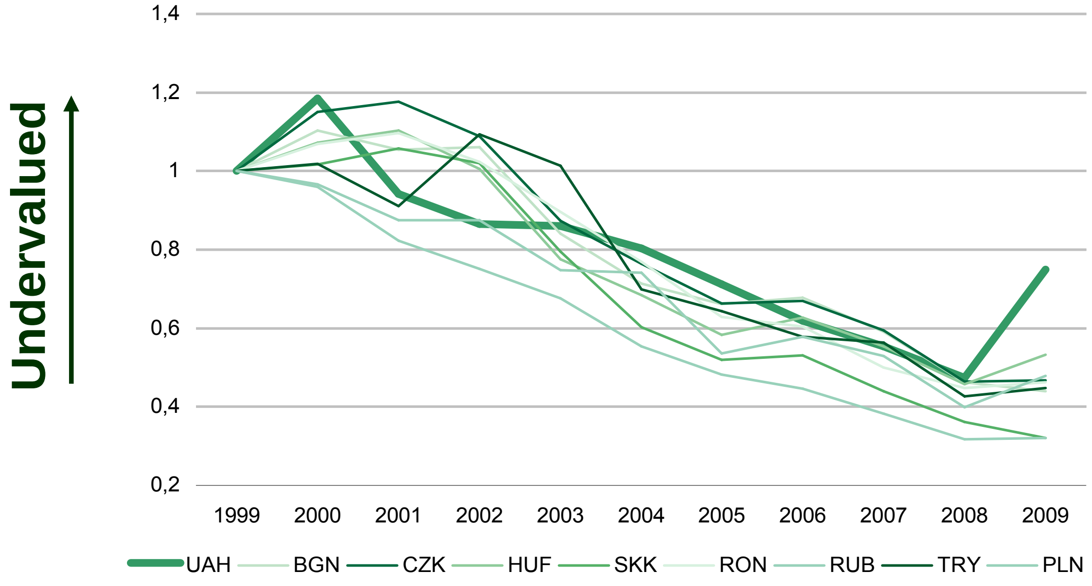
FX rate is a random walk in short term but is increasingly attractive comparing to CEE peers. Any short term USD/UAH forecast is associated with significant uncertainty. The FX rate is facing different types of *currency regimes* – during the last couple of months NBU tried the peg, managed float, float, managed peg. There is absolutely no certainty of what would come into play next.

Note that float is not an answer to the question of how much UAH should cost - there is no market rate when banking system is in the middle of bank run. Prophecies of UAH devaluation are self-fulfilling and the panicking market can see any rate it can anticipate, especially as NBU continues to defend liquidity of local banks. Therefore, USD/UAH went overshot reaching 9.5 as of mid-December.

Given that UAH is so volatile and unpredictable we compared Ukrainian currency to CEE peers in order to determine its deviation from long-term historical relationships. First, we graphed REER of CEE currencies vs USD (see next page). The outcome was that all these currencies were appreciating vs USD in real terms since early 2000, following very similar patterns. Second, we analyzed deviations of FX rates from the mean.

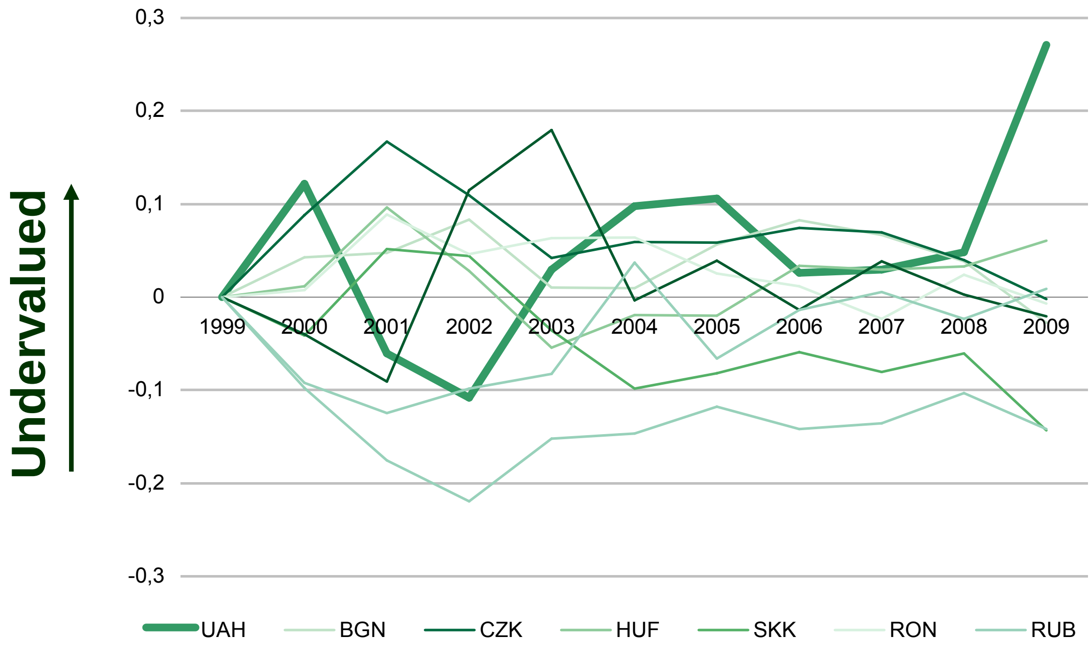
Our finding was that RUB and SKK are overvalued relative to their long-term average, whereas UAH seems to be drastically undervalued, reflecting its poor macroeconomic performance and vulnerability to external shocks. The graph does not tell us that UAH is set to appreciate, but what it tells us is that *excessive inflation that Ukraine experienced over the last few years was already offset by exchange rate correction*. Should the country solve banking system problems stemming from sharp UAH devaluation, UAH is likely to outperform other CEE currencies.

Real effective exchange rates (REERs) of Eastern European currencies vs USD, Jan 1999 = 1



Source: Reuters, UkrSibbank, IMF

REERs – deviation from the mean



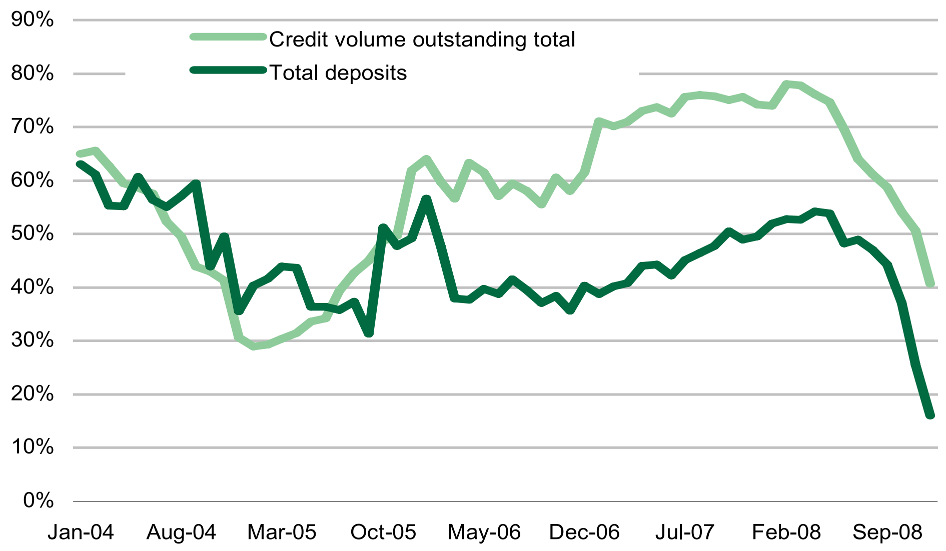
Source: Reuters, UkrSibbank, IMF

Banking system faces funding problems

Majority of banks had to stop issuing new loans completely after their balance sheets started to contract. Balance sheet problems were looming since April, when domestic banking system faced a liquidity crunch. However, many financial institutions (primarily small foreign banks) were still lending in order to capture the market share.

The banking sector growth since the beginning of this year decelerated to 40% as of December, and will turn negative next year, as liabilities' side is shrinking. With international capital markets closed, retail deposits move to state and international banks, while many smaller local banks facing a liquidity problem. This implies we might see peak of consolidation processes next year, with at least one-fifth of Ukrainian 180-strong banking sector being taken over by competitors which managed to maintain liquidity.

Banking system growth, %, y/y



Source: National Bank of Ukraine

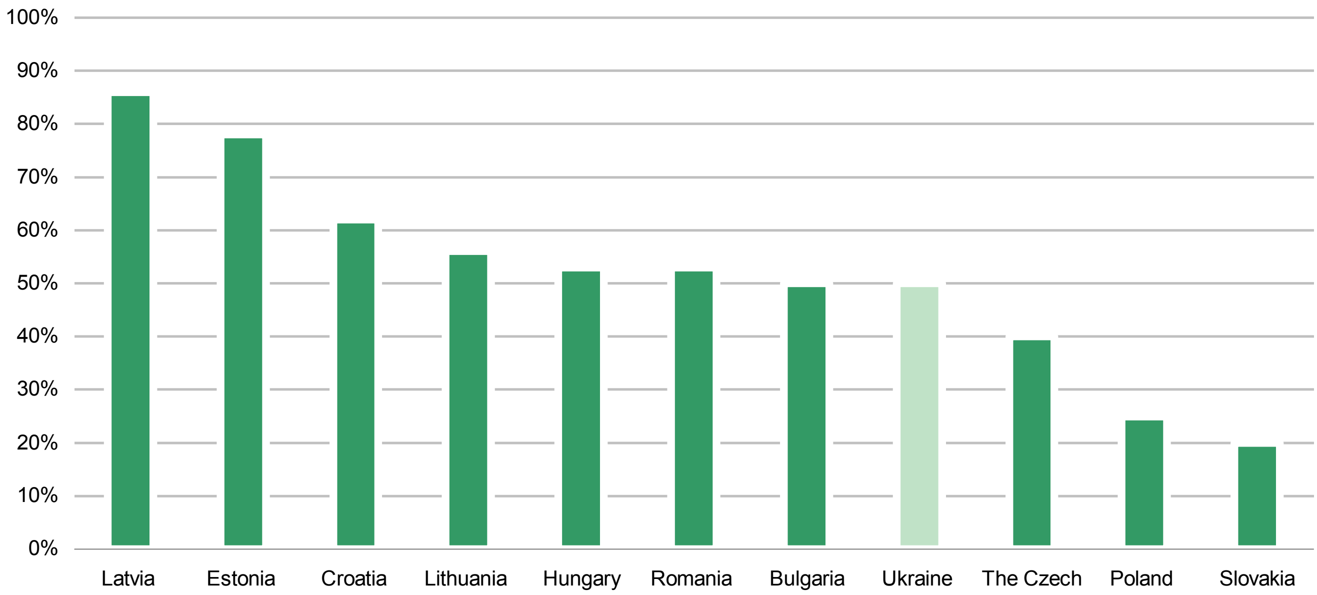
Ukrainian borrowers were increasingly long UAH and short FX volatility over the last four years

Local currency devaluation may tousle assets of domestically owned banks as Ukrainian borrowers were increasingly long UAH and short FX volatility over the last four years. However, these banks which are in a better shape to allow for restructuring of FX loans, should not experience a significant problem unless UAH collapses completely.

Growing private sector borrowing in foreign currencies has become a familiar feature of the catching-up process in CEE. Over the last few years volume of FX – denominated bank loans in Ukraine has more than quadrupled, reaching USD 59.3 bn. (about one half of total loans) at the beginning of November 2008.

Now, the borrowers would face a 70% growth in service costs due to local currency devaluation. Furthermore, deteriorating economic environment provides few opportunities for increasing the income and more risks of losing current cash flow. And the most important – this is not compensated by lower interest rates. Indeed, interest rates rise from two to fifteen percentage points, both for corporate and individual loans.

FX lending, % of total credits



Source: Ukrssibank estimates

Loans totaling $17.5 bn. may be impaired under moderate scenario

According to our moderate baseline forecast, NPL may reach up to 10% on UAH loans and up to 25% on FX loans – roughly $17.5 bn.! At the same time, it would be extremely difficult to clean the balance sheets as Ukrainian property market (currently serving as the largest asset market in the country) is about to collapse.

There are to ways how to solve the problem of declining asset quality – help the borrowers or help the banks. Albeit we do consider that the first way is far more efficient (total spending in order to protect individual borrowers from UAH devaluation lands somewhere between $2 to 3 bn. per year), the government is unlikely to find resources for respective action.

That is, significant number of borrowers would have to ask for restructuring of their loans or announce defaults. Should the bank be not flexible enough, it would lead to significant deterioration of credit portfolio, with subsequent need for recapitalization in order to cover losses stemming from NPL.

We expect at least two international organizations to participate in banking system recapitalization – IMF and EBRD. From 60 to 70% of recap may be provided by NBU/government with the help of IMF ($11..12 bn.), the rest – by foreign banking groups. NBU has already prescribed 34 major banks (two groups of 17 banks) to conduct audit in order to determine current and prospective solvency of the banks and their viability in the crisis environment (Regulation No 389). Following this procedure, National Bank plans to hold talks with bank owners, trying to identify the level of support banks can get from their shareholders. Those largest financial institutions having asset quality problems will be supported by government in exchange for their equity. The government will pay with sovereign bonds which then must be refinanced by National Bank. EBRD will participate indirectly, acquiring up to 25% of Ukrainian banks' equity with an option of future resale.

Date	Ukraine in financial crisis
18 Sep	USD/UAH cash ask rate jumps from 4.85 to 5.02
26 Sep	Run on Prominvest bank in Donetsk
29 Sep	NBU granted Prominvest bank UAH 1 bn as a part of UAH 5 bn refinancing loan
30 Sep	Interbank overnight UAH ask rate increased to 20% from 10%
07 Oct	NBU introduced Temporary Administration in Prominvest bank by Resolution 308 from 07Oct2008. All branches of the bank were closed this day
08 Oct	USD/UAH cash ask rate climbs to 5.7 from 5.3 two days before
09 Oct	President dissolved Rada by Decree and called for early elections to be held on 7Dec2008
10 Oct	NBU Head held consultations with President and commercial banks senior management
13 Oct	NBU published the emergency regulation No 319 (from Saturday, Oct 11)
17 Oct	Fitch Downgrades Ukraine to B+ (negative outlook) on significant and rising concerns of a large depreciation of the currency, further stress in the banking system and significant damage to Ukraine's real economy.
20 Oct	President suspended Decree on early elections to Rada in order to allow Parliament to vote anticrisis laws
20 Oct	Moody's changed outlook on Ukraine from positive to stable
24 Oct	S&P Lowered Ukraine rating to B (negative outlook) on uncertain effect of IMF package
30 Oct	NBU started two-way interventions in USD/UAH market
31 Oct	Ukraine applies to the IMF for stand-by credit
03 Nov	President signed the anti-crisis Law
04 Nov	Cabmin approved Provisional Order of using the Stabilization Fund and Order on the State's Participation in Capitalization of Banks
05 Nov	Anti-crisis Law came into force (published, No. 639-VI).
05 Nov	IMF approves USD16.4 bn stand-by arrangement for Ukraine; USD4.5 bn. for immediate use
19 Nov	NBU launches USD auctions to restore FX liquidity
28 Nov	UAH GOES FLOAT: NBU official USD/UAH exchange rate is set to be equal to previous day interbank rate according to NBU's amendment to Regulation on setting hryvnia official exchange rate to other currencies
04 Dec	NBU replaced anticrisis Reg 319 by Reg 413 that objected early deposit withdrawals, obliged banks to re-appraise collaterals for the purpose of recalculating reserves on the loans, allowed keep a blind eye on loans to goods producers prolongation
05 Dec	NBU reduced reserve requirements on demand and term deposits starting: 0% reserves on all hryvnia accounts
09 Dec	Rada constituted Volodymyr M. Lytvyn as the Chairman of the Verkhovna Rada
22 Dec	NBU has set new regulations № 435-436 to introduce new trading rules on FX market, NBU resumes interventions

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