Ukraine:
Current Economic Situation and Prospects

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The International Liquidity Crisis Hit Ukraine Hard

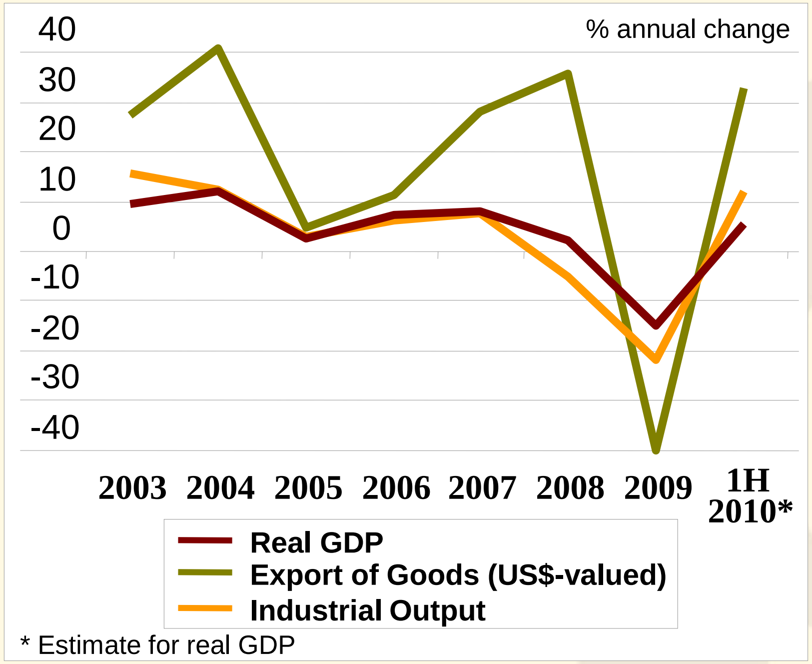
- Export of goods: **- 40%** yoy (2009)
- Industrial production: **-22%** yoy (2009)
- Real GDP: **-15.1%** yoy (2009)
- Unemployment (ILO): **9.4%** (4Q 2009)
- Real households' income: **-10.5%** yoy (9M 2009)
- Fiscal balance: **-8.5%** of GDP (2009)
- PFTS stock index: **-74%** (2008-09)
- UAH/$ Exchange Rate: **65%** Depreciation (2008-09)

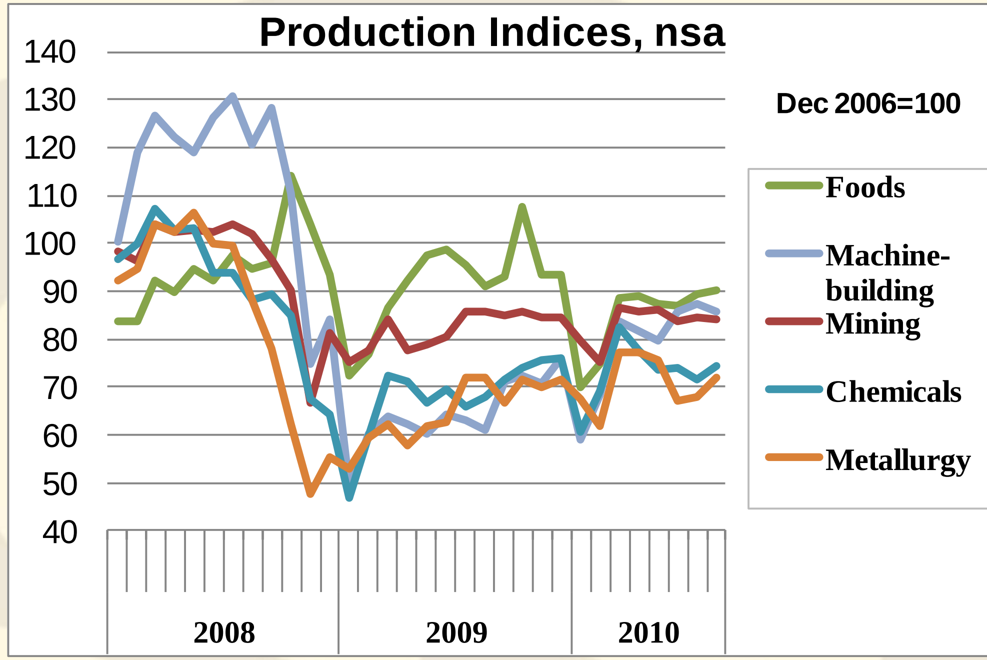
The Crisis Affected Ukraine Harder than other EMs

Country	GDP, % yoy 2009*	Local Currency Depreciation vs. US Dollar (mid-2008 to end-2009)
Ukraine	**-15.1**	**65%**
Latvia	-18.0	9%
Lithuania	-15.0	9%
Estonia	-14.1	9%
Russia	-7.9	29%
Mexico	-6.5	27%
Romania	-7.1	27%
Hungary	-6.3	26%
Taiwan	-3.5	6%

Sources: IMF, The Economist, Central banks of the respective countries, The Bleyzer Foundation

Ukraine's Economic Recovery in 2010





Source: State Statistics Committee of Ukraine, National Bank of Ukraine, The Bleyzer Foundation

- In early 2009 Ukraine already started recovery from the deep 2008-09 recession.
- The collapse of exports was one of the main channels through which the international liquidity crisis hit Ukraine in 2008-2009.
- The other channel was the reversal of capital inflows that depressed consumption.
- Likewise, export-oriented industries and capital inflows led the recovery since 2009.
- In the first half of 2010, a 33% yoy rebound in exports and net financial inflows of about $5 billion, underpinned a strong real GDP growth of 5.5% yoy.

What Factors will Affect Ukraine's Recovery?

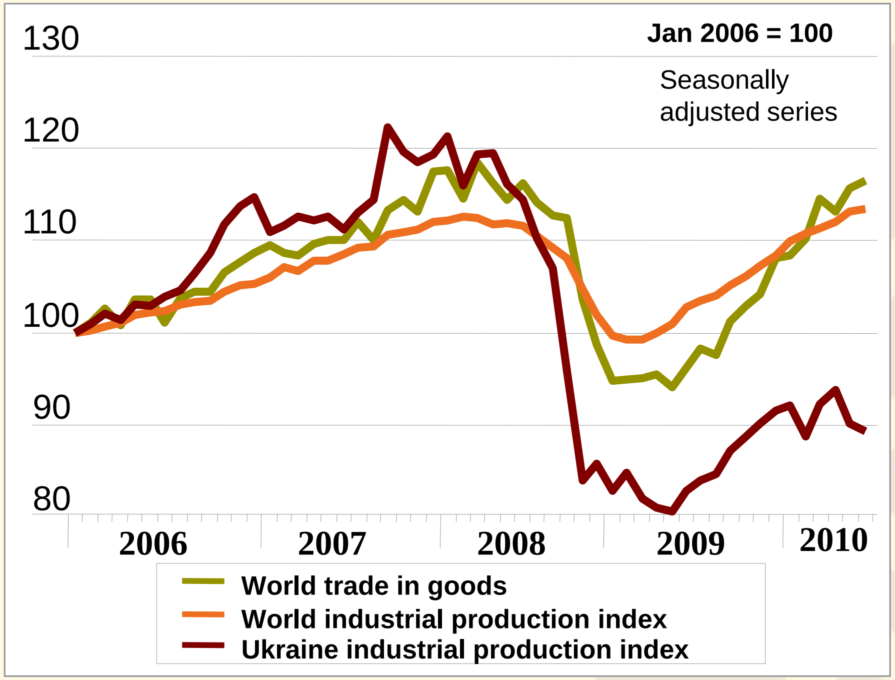
External Environment:

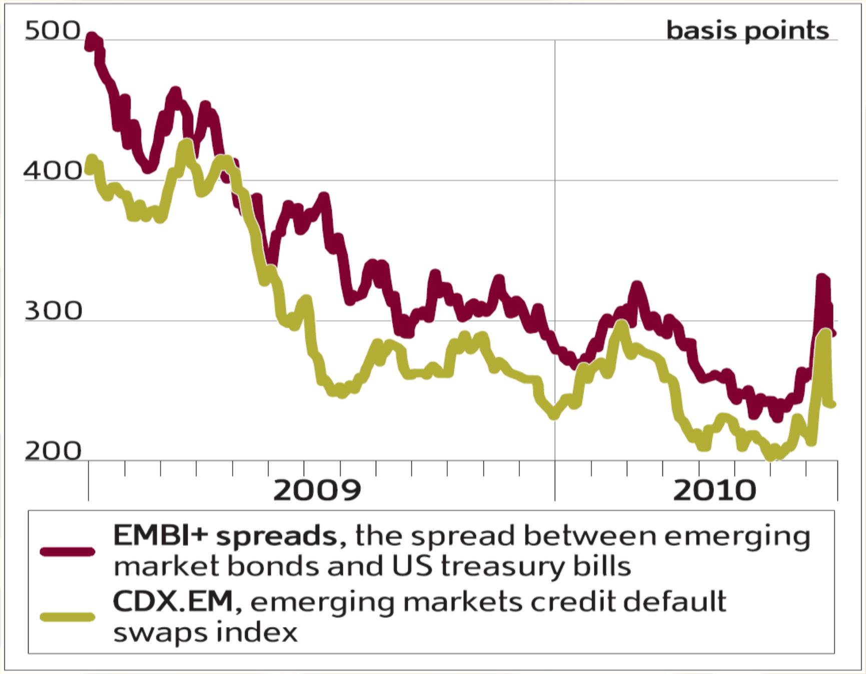
1. The pace of economic recovery in Ukraine's main trading partners
2. The prospects for Ukrainian exports
   a) Prospects for steel and metallurgical exports
   b) Prospects for agricultural exports
   c) Degree of international competitiveness of Ukraine
3. Ability of Ukraine to secure external financing and roll-over its large foreign debt

Domestic Factors:

4. Adequacy of Macroeconomic Stabilization Policies
5. Pace of recovery of Domestic Demand and Banking Credit
6. Adequacy of Economic Policies to **sustain** long-term growth by improving the business climate to attract investments

Factor 1. Pace of Global Economic Recovery

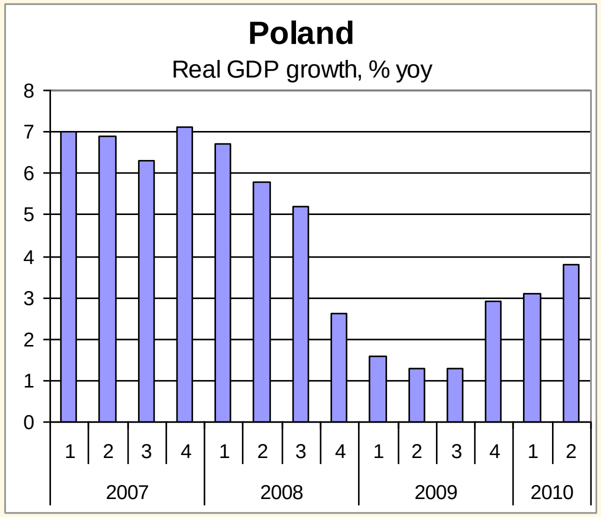


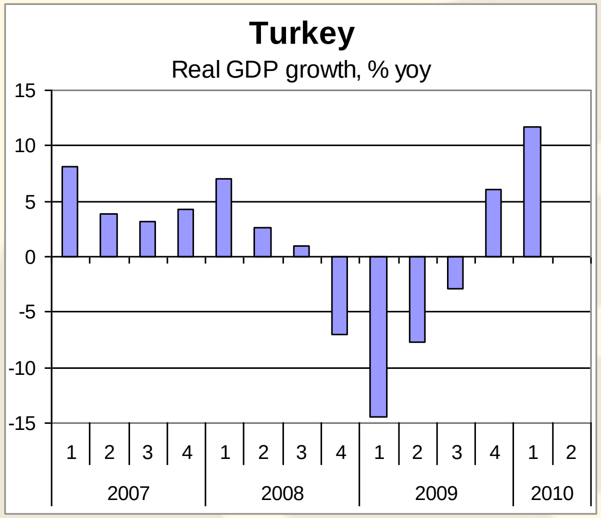


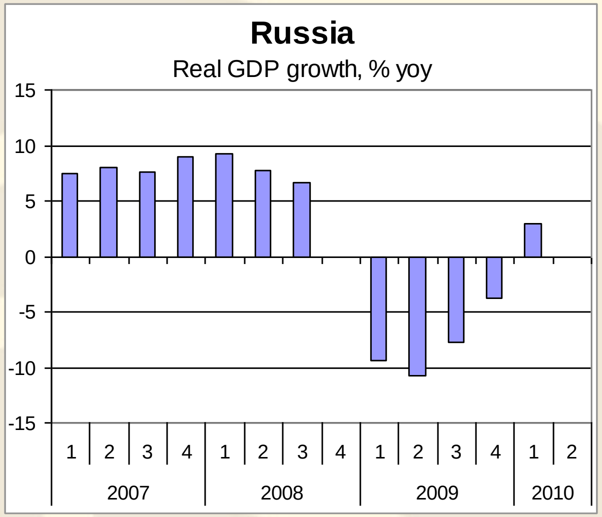
Source: Cbonds.net, CPB Netherlands Bureau for Economic Policy Analysis, The Bleyzer Foundation

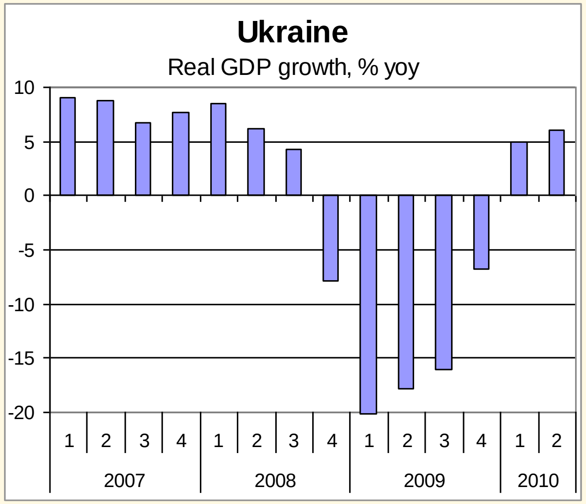
- The world economy expanded fast in 1H 2010: world industrial production and trade reported double-digit growth rates of 11.5% yoy and 19% yoy, respectively.
- But the speed of recovery was different across regions.
- Investors' appetite for emerging market assets continued to improve since early 2009, helping to re-open foreign capital markets for these countries.

Factor 1a. Economic Recovery in Emerging Economies





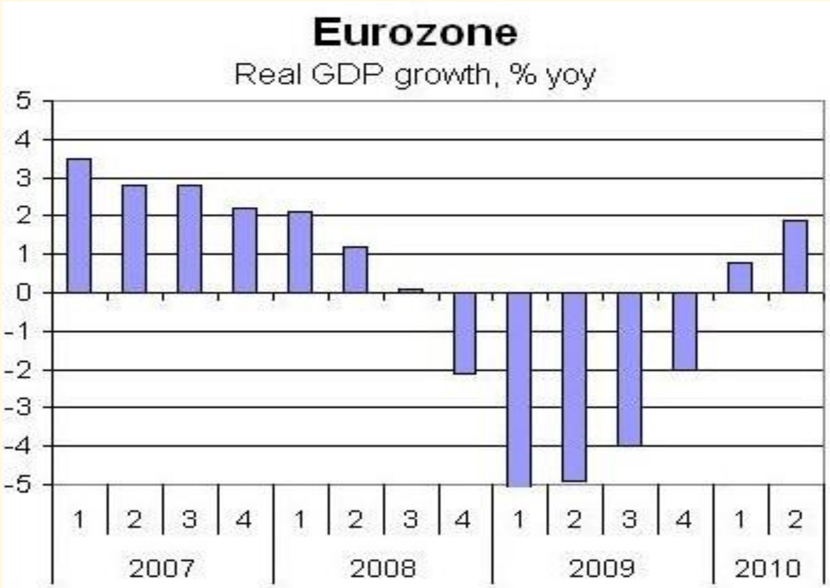


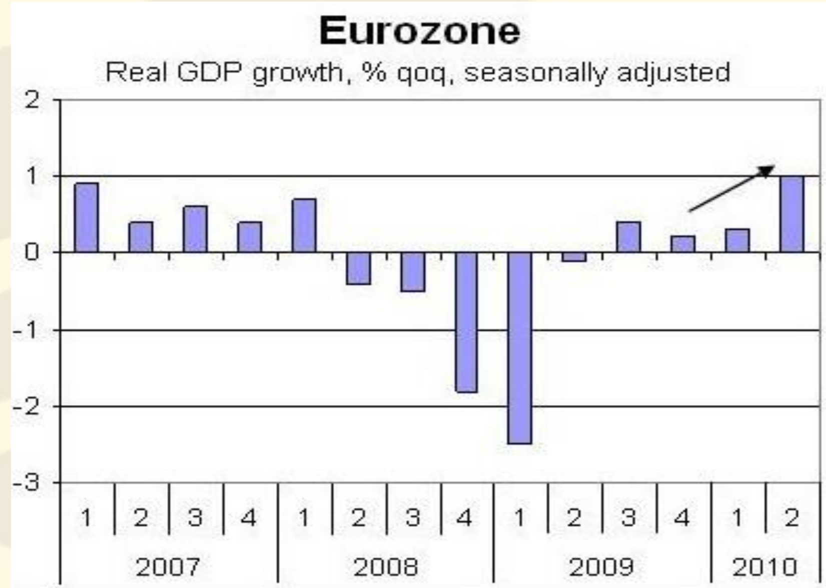


- The pace of recovery in Emerging Markets has been better than expected, particularly in Asia, Latin America, as well as a number of CIS economies.
- Many of these countries (i.e., Russia, Turkey, Poland, India, etc.) are Ukraine's major trading partners.

Source: Eurostat, Russia Federal Statistical Committee, Ukraine SSC

Factor 1b. Economic Recovery in the Eurozone

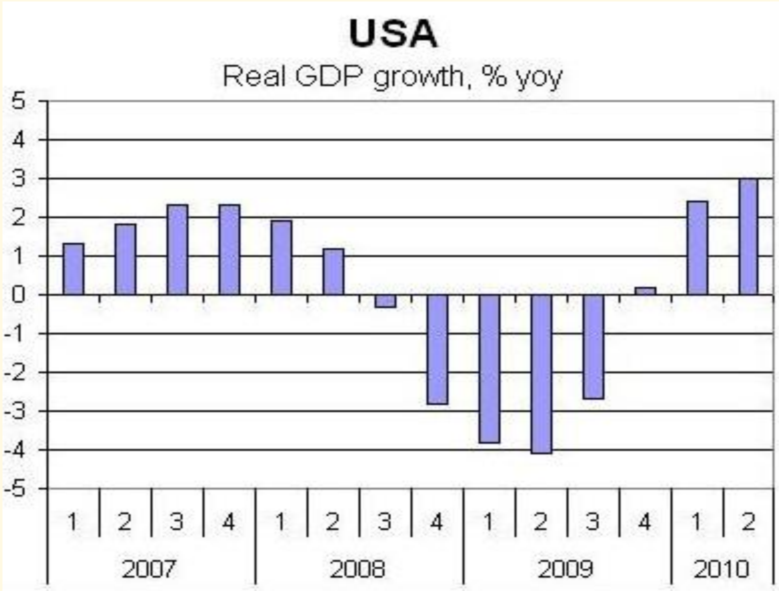


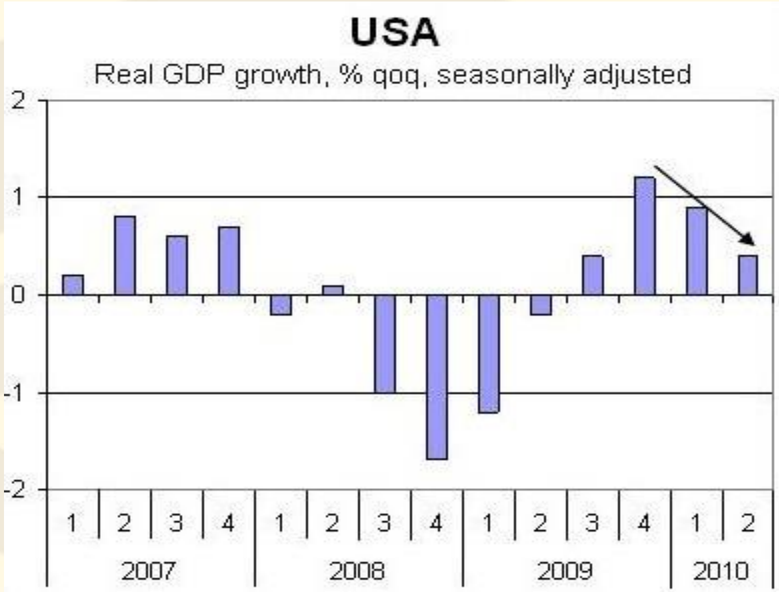


Source: BEA, Eurostat

- The Eurozone also had a reasonable recovery in 1H 2010, both yoy and sa-qoq.
- The markets reacted positively to the May 2010 bailout by the EU (€750 bn for troubled members, €110 bn for Greece, €60 bn to buy bonds) and the publication of the stress tests for European banks which showed that most banks are resilient (except for German and Spanish banks, which can be handled).
- But there are concerns about the negative impact of fiscal austerity measures and tighter credit conditions on the pace of EU’s economic recovery.

Factor 1c. Economic Recovery in the USA

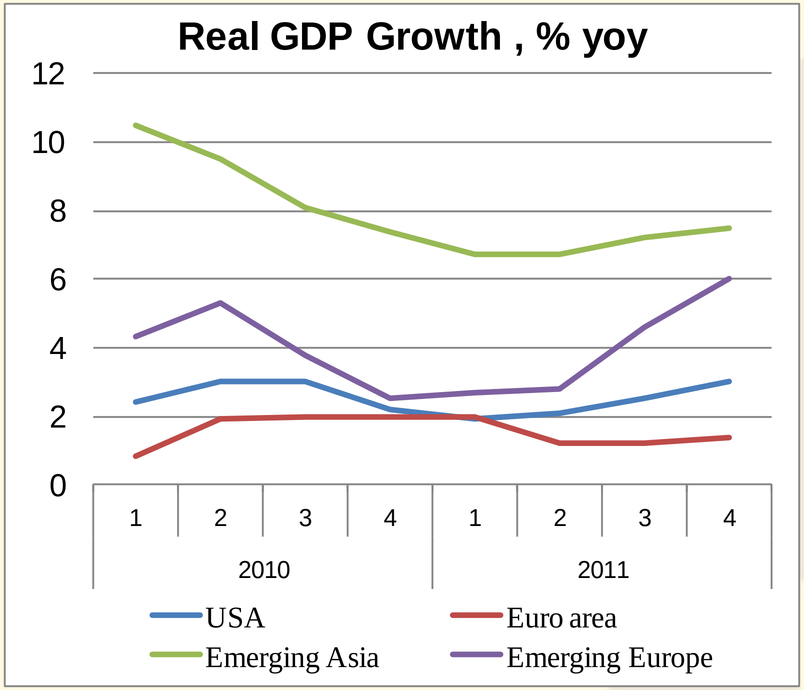




Source: BEA,

- During the first half of 2010, the rate of growth of the US economy slowed down.
- This was because of lower domestic consumption caused by higher unemployment, cautiousness by consumers and financial institutions, and high government debt.
- As the US government plans to half its fiscal deficit by 2013, and with the expectation that government debt will need to be stabilized, consumers may have anticipated higher taxes in 2011 and beyond, reducing consumption now.
- In fact the IMF had recommended the US to cut tax deductions and enact higher taxes on energy, a national consumption tax, or a financial activities tax.

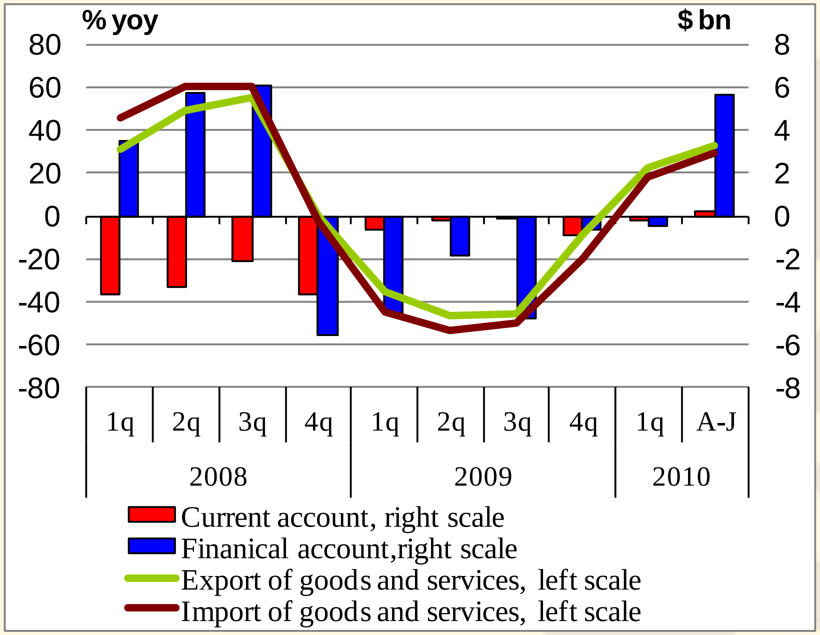
Factor 1d. Global Economic Growth Prospects for 2011



Source: JP Morgan

- The 2011 outlook for Emerging Markets remains positive supported by strong capital inflows and cautious policy tightening (leading to average GDP growth rates of over 6% in 2011).
- In the EU, despite strong performance in the first half of 2010, the concerns about the impact of austerity measures in most countries, and lingering concerns about sovereign debts, should depress average GDP growth rates to 1% - 2% in 2011.
- The US growth prospects for 2011 have recently improved to 3% pa thanks to stronger corporate profits, better investment prospects as monetary policy will remain loose through 2010, more stable banks, and the growing expectations that the tax cuts enacted in 2001/03 will be extended.
- Altogether, the global economic growth prospects are favorable to support the continuation of recovery in Ukraine.

Factor 2. Exports, Financing and the Balance-of-Payments

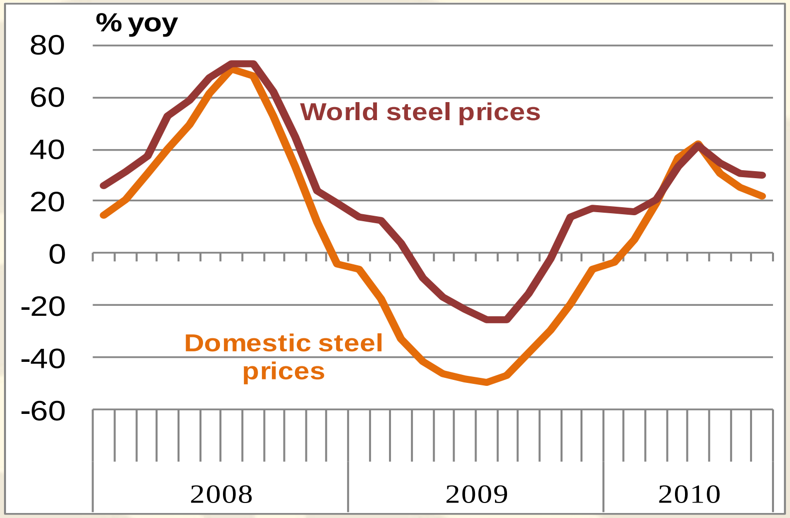


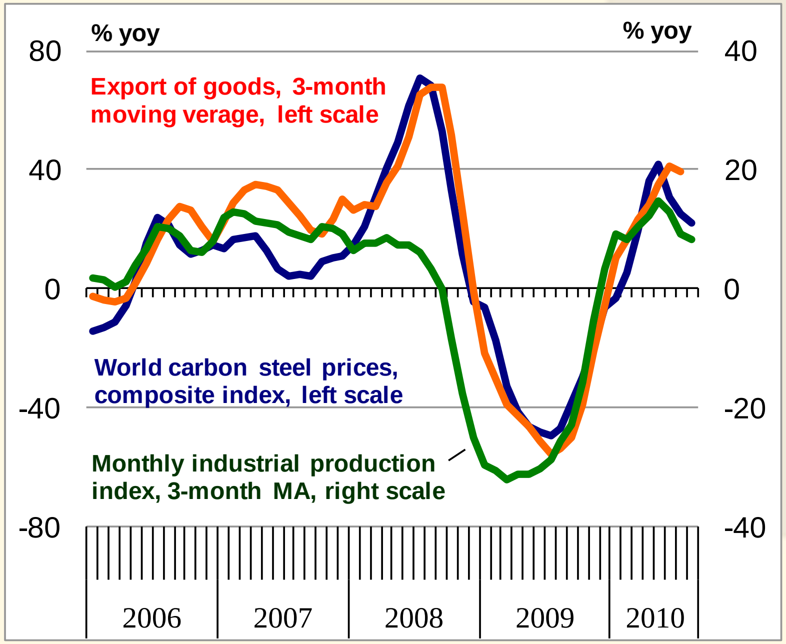
Source: NBU, Bloomberg

- Exports of goods and services grew by 28.5% yoy in 7m 2010 while imports was up by 25% yoy. The current account balance was in small surplus.
- The financial account surplus stood at $5.1 bn in 7m 2010 as a result of high private sector external debt rollover (96%) and external deficit financing (including a $2 bn loan from Russia's state-run VTB bank).
- As a result, by the end-August, gross international reserves increased to $33 bn.

Factor 2a. Prospects for Steel Exports

- Metallurgy is one of the most important sectors for the Ukrainian economy as many industries and sectors are tied to it.
- Steel exports and industry performance closely follow world steel price trends.
- In most of 1H 2010, developments of world steel prices were favorable to Ukraine.



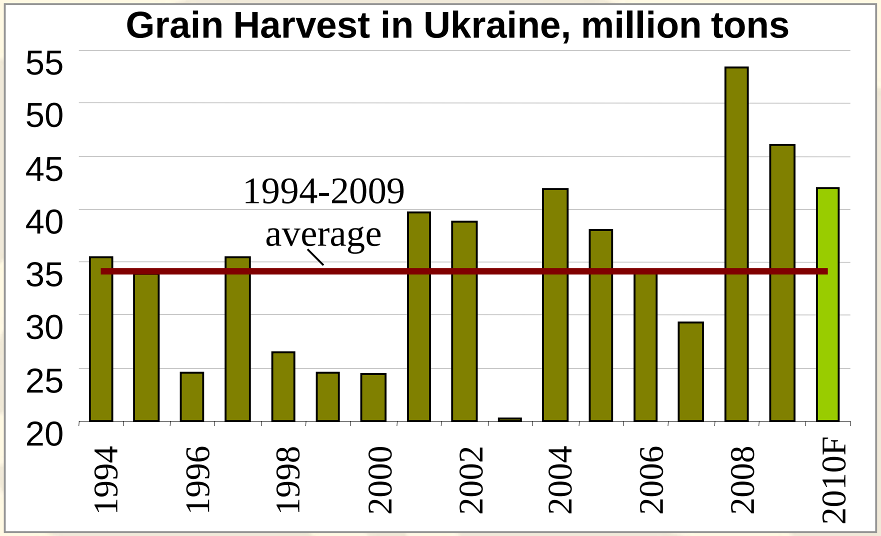


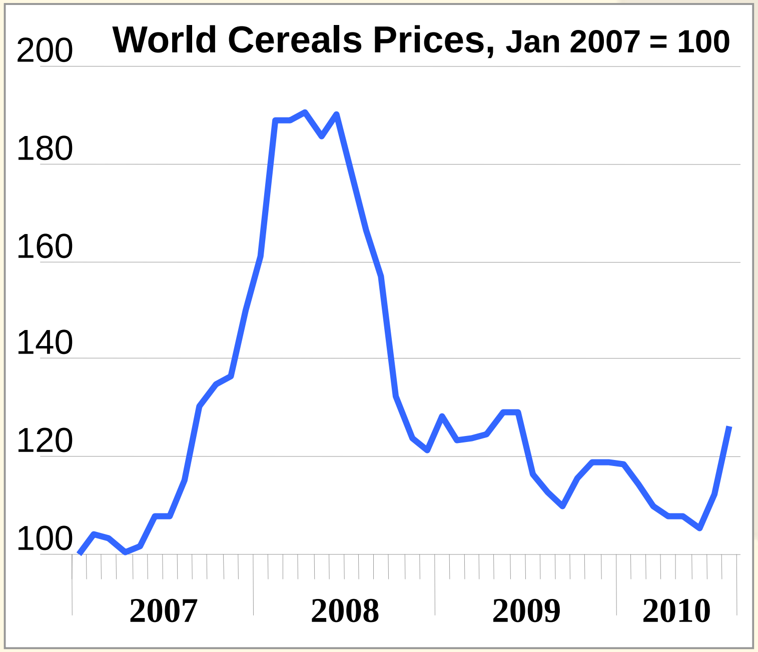
Source: State Statistics Committee, NBU, MEPS, TBF

- During May-July 2010, steel prices started to decline due to concerns over the pace of global recovery, increasing levels of stocks and evidence that world steel production was expanding faster than demand.
- In August world steel prices started to increase again.
- In 2011, prices should stabilize or even increase, due to the favorable outlook for the recovery of the global economy.

Factor 2b. Prospects for Agricultural Exports

- The 2010 global grain harvest was hit by droughts and floods.
- Russia, one of the largest wheat suppliers, imposed an export ban on wheat for 12 months to combat domestic shortages.
- Global food prices have soared.



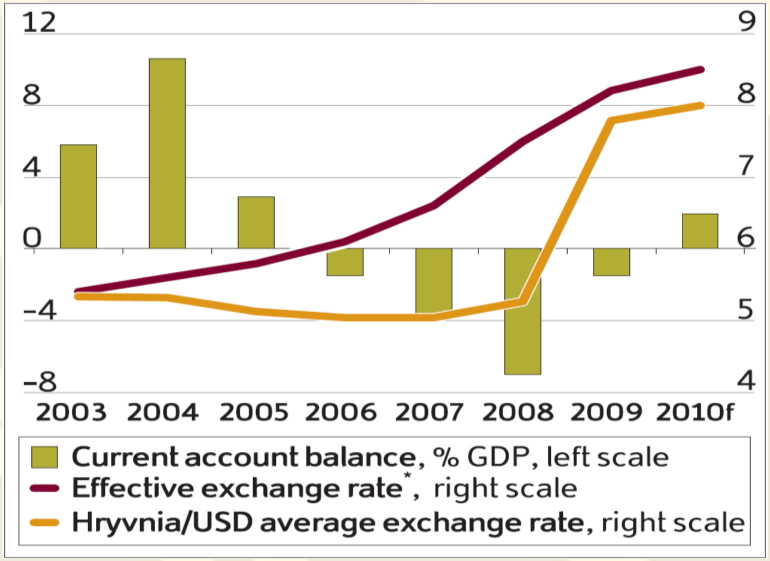


- Agricultural and food products are the second largest export commodities of Ukraine.
- Ukraine is forecast to harvest about 42 m tons of grain, lower than in 2008-2009 but much higher than a 15-year average.
- There is little basis for an export ban or other administrative constraints to exports in Ukraine.
- Stronger world food demand may partially compensate for weaknesses in other sectors.

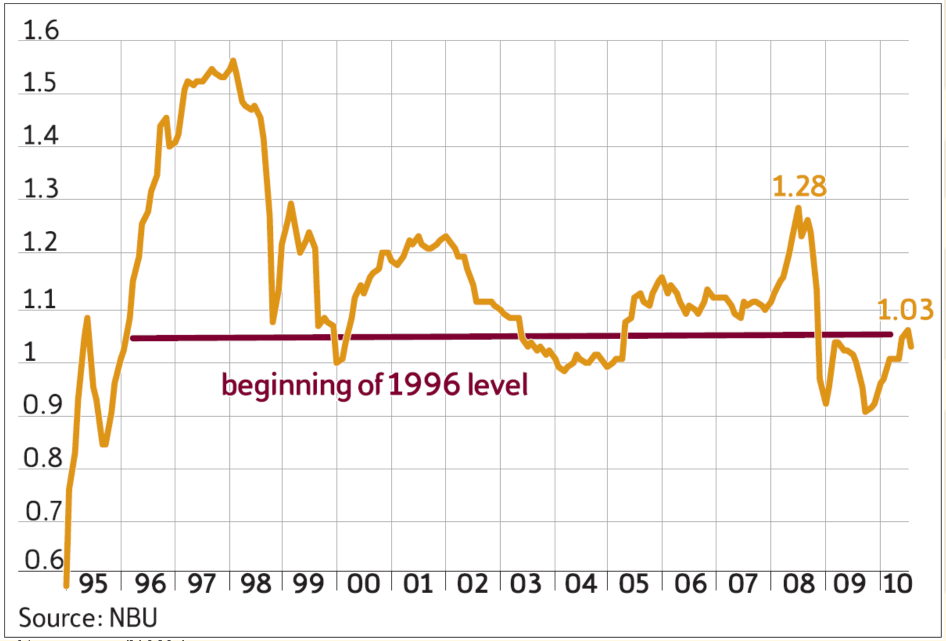
Source: State Statistics Committee, FAO, TBF

Factor 2c. Ukraine's International Competitiveness

- In 2008, the Hryvnia lost more than 50% against the U.S. Dollar.
- This depreciation helped to restore Ukraine's international competitiveness and to reduce external imbalances.



Real Effective Exchange Rate, Dec 1999 = 1



Source: NBU

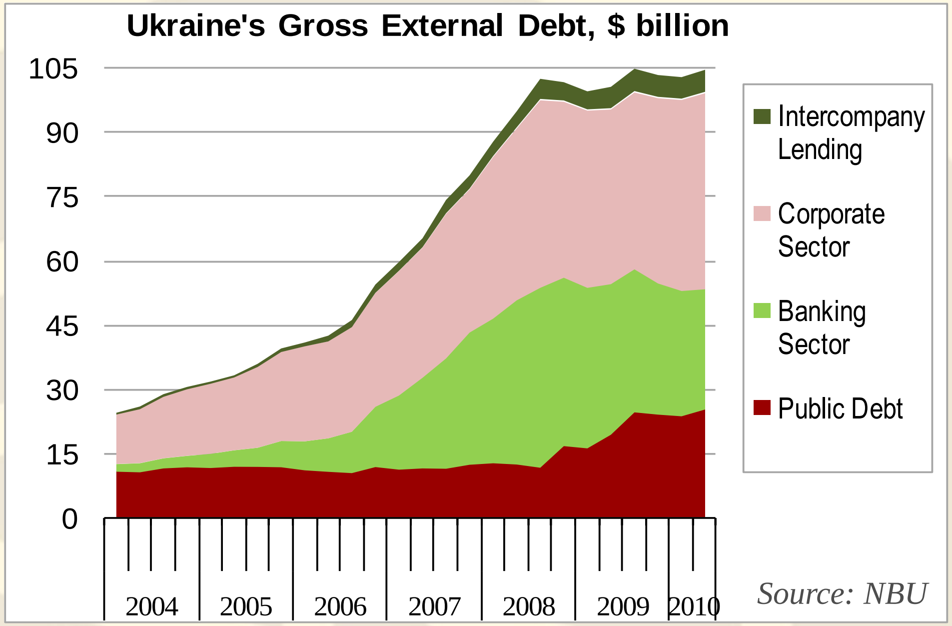
- Although the recent Hryvnia appreciation eroded part of these benefits, the real exchange rate seems to be now close to its equilibrium.
- This is a positive factor for Ukraine's current account balance prospects.

** The effective exchange rate was calculated based on Ukraine's purchasing power parity with respect to Ukraine's main trading partners (2002 as a base year)*

Source: NBU, UN Comtrade, IMF, TBF

Factor 3. Roll-over of Ukraine's Large Foreign Debt

- Foreign debt in Ukraine grew from $35 bn in 2005 to over $100 bn in 2008.
- This made Ukraine more vulnerable, as during the crisis foreign capital markets were virtually closed.
- Ukraine's foreign financing needs in 2009 were partially covered by IMF financing.



Source: NBU

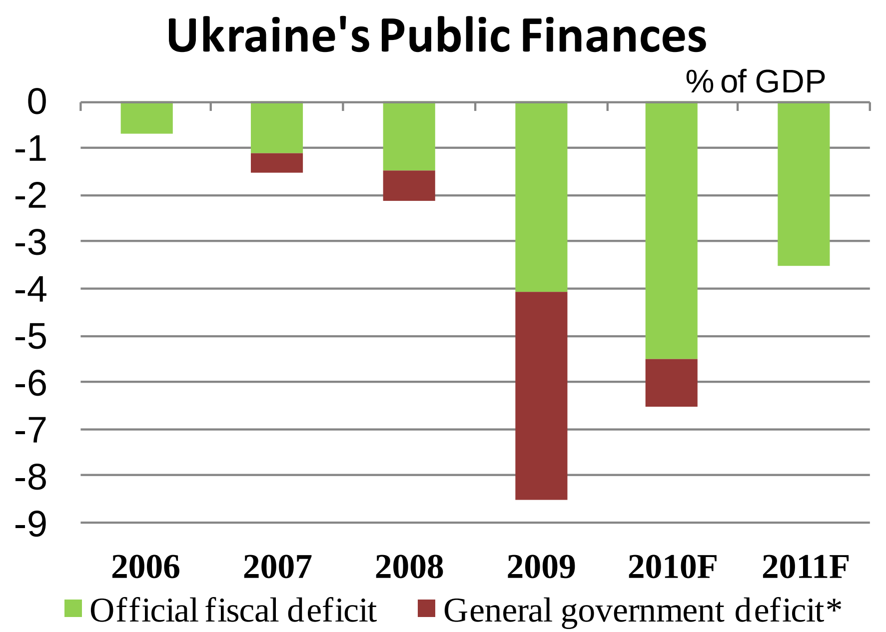
- But Ukraine's foreign debt has not disappeared -- and will need to be served or rolled-over, requiring high confidence by its creditors.
- Since mid-2009, foreign investors sentiments have been improving. Roll-over rate stood at about 95% in 1H 2010.
- In 2010, there were several successful Eurobond placements by Ukrainian private businesses and government.
- If investors' confidence is maintained, debt should be manageable.

Factor 4. Adequacy of Domestic Macro-Economic Policies

- Ukraine has made good progress in stabilizing its macroeconomic situation:
  - Economic activity is recovering
  - Inflation pressures have been kept under control
  - External vulnerabilities have declined
  - The high current fiscal deficit, the major economic risk until recently, is expected to be under control given resumed co-operation with the IMF.
- **Currently the major economic risk** would be a weakening of policy implementation due to the forthcoming local elections: strong political will is needed as the government committed itself to the IMF on a number of painful economic measures, particularly
  - To raise natural gas tariffs to population by tally 2.3 times
  - To raise pension age from 55 to 60 and work service record for women
  - To reform the gas sector
  - To arrest the further deterioration of local banks
  - To improve taxation and the business environment.
- So far, the progress on these issues has been positive, as shown in next slides.

Factor 4a. Macroeconomic Stabilization: Fiscal Deficit

- Until recently, a high fiscal deficit was the major economic risk in Ukraine.
- The fiscal deficit reached 8.5% GDP in 2009, as fiscal revenues declined, and social, Naftogaz and Pension Fund expenditures increased.
- In 2009, Ukraine's fiscal deficit financing needs were covered thanks to domestic borrowing and IMF funds.



** Includes Naftogaz and implicit Pension Fund deficit*
Source: MinFin, IMF, The Bleyzer Foundation

- IMF program was out off-track at end-2009 as implementation of reform and policy measures weakened in the run-up to presidential elections.
- In 2010, budget revenues gradually recovered , but expenditures rose fast.
- As a result, the state budget deficit in 1H 2010 reached UAH 26.5 billion, or about 5.6% of estimated period GDP.
- Agreement with the IMF is critical to overcome fiscal sustainability risks.

Factor 4a. Agreement with the IMF

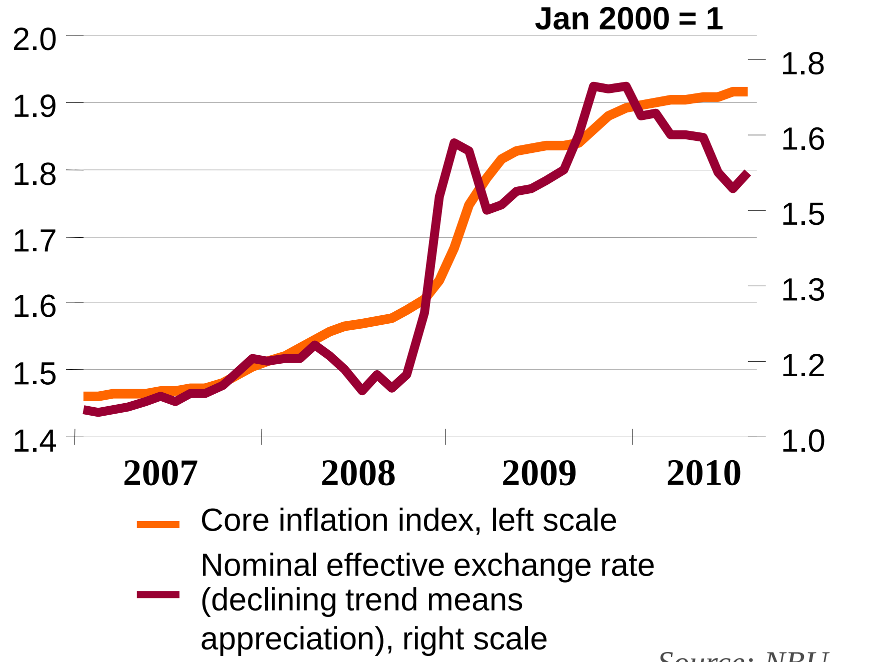
- On July 28th, 2010, the IMF approved a new $15.2 billion program to Ukraine.
- To qualify, the government agreed to the following:
  - Amend the 2010 budget law to make budget revenues more realistic and cut expenditures. These measures should keep the state deficit at about 5.5% of GDP (including the Pension Fund deficit).
  - Increase natural gas tariffs by 50% from August 2010 and raise them by another 50% from April 2011. As a result, Naftogaz should be able to contain its deficit to about 1% of GDP in 2010 and have a balanced budget next year;
  - Implement a number of reform measures (enact a new natural gas law, amend the NBU law, etc.)
- Under the IMF agreement, the government has taken steps to resolve the problem of high arrears in VAT refunds. In August 2010, the government issued 5-year VAT bonds worth UAH 16.4 billion ($2.1 billion).
- The Ukrainian authorities committed to complete the recapitalization of banks by the end of 2010, develop a more robust monetary policy framework focused on domestic price stability with greater exchange rate flexibility.

Factor 4a. Agreement with the IMF (cont.)

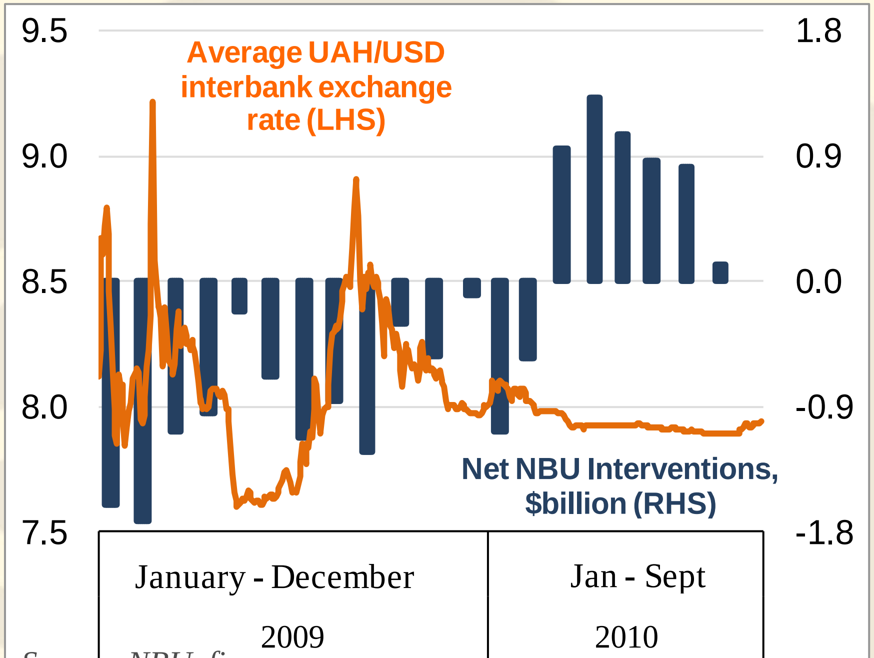
- The resumption of cooperation with the IMF positively affected investor confidence to Ukraine.
- Major international rating agencies upgraded Ukraine's sovereign ratings.
- In September 2010, Ukraine successfully placed $2 billion Eurobonds.

- If the IMF program is maintained, the fiscal deficit will be reduced to 3.5% of GDP by 2011 and 2.5% of GDP in 2012, containing the growth of public debt.
- Though there is a risk of weaker policy implementation in the run-up to the forthcoming October local elections, so far the Ukrainian government has demonstrated strong commitment to meet the IMF requirements.
- However, in their efforts to contain the fiscal deficit, the state tax authorities are putting strong pressures on businesses, with frequent tax inspections and audits, thereby creating a negative climate.

Factor 4b. Inflation and Forex Markets



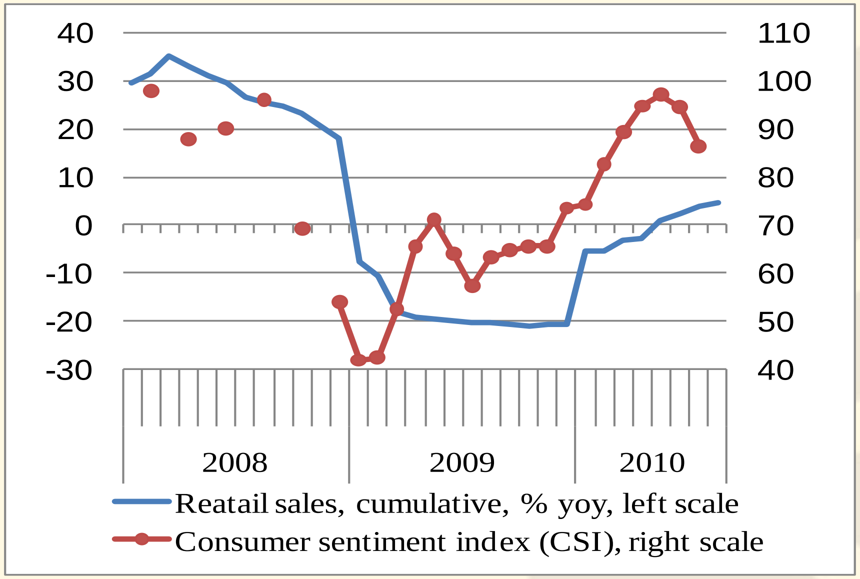
Source: NBU

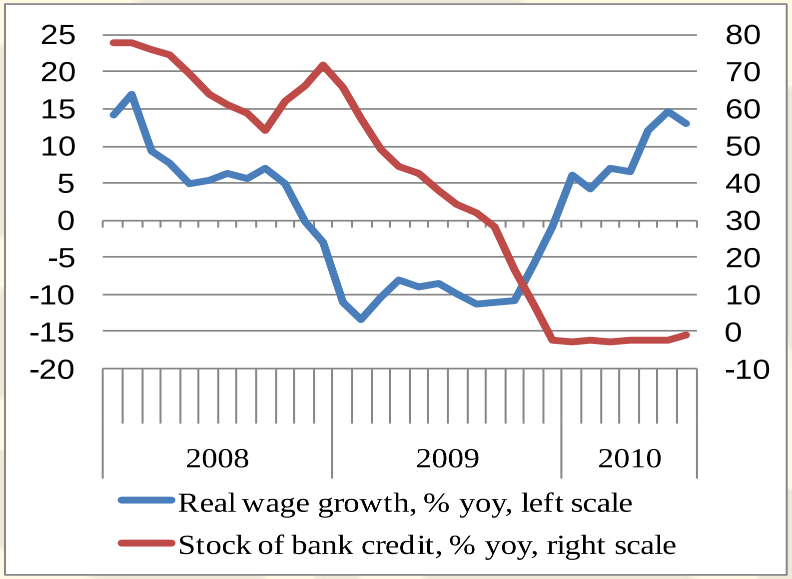


Source: NBU, finance.ua

- During January-August 2010, high BoP surpluses led to Hryvnia appreciation.
- Annual consumer inflation fell from 11% in January to 6.8% in July 2010.
- Since August 2010, inflation pressures re-emerged due to rising utility tariffs, growing global food prices, and higher excise taxes.
- End-year inflation is forecast at about 10% in 2010 and 2011.
- Due to seasonal factors, Hryvnia exchange rate slightly depreciated in September.
- But exchange rate is forecast to stay in the range of UAH 7.9 – 8.0 per USD.

Factor 5. Pace of Recovery of Domestic Demand

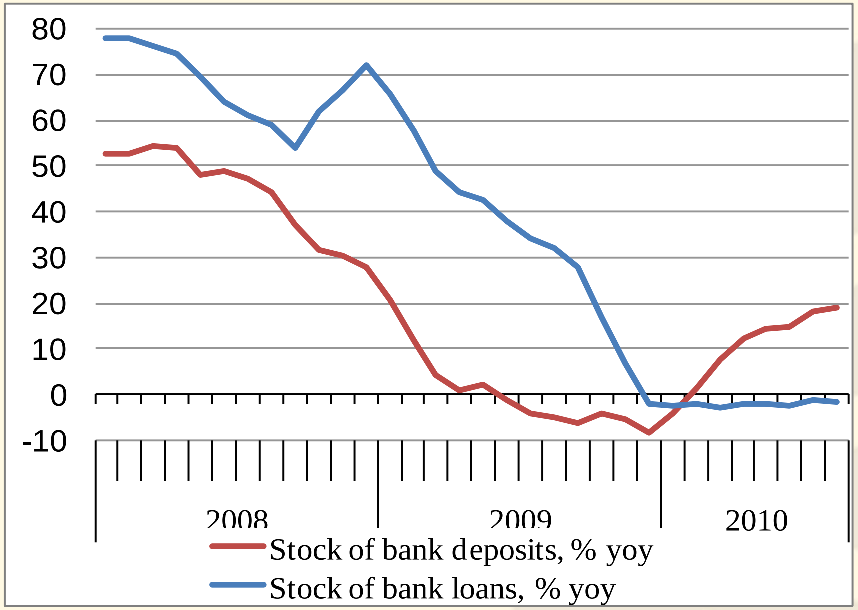


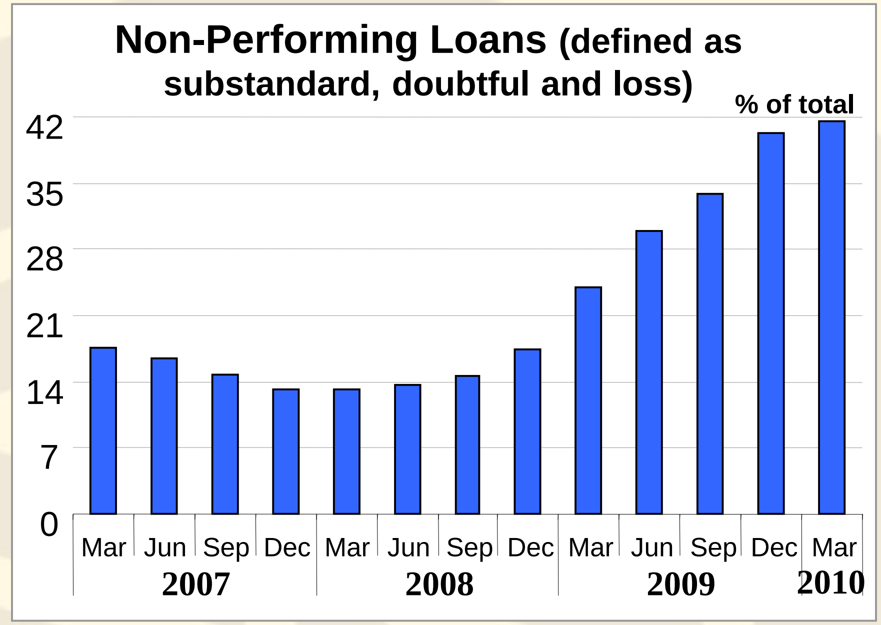


Source: State Statistics Committee, NBU, GFK-Ukraine, TBF

- During 2010, **consumer confidence** has notably improved thanks to above-mentioned developments(recovering economic activity, good progress in disinflation, calm foreign exchange market and stable political environment),.
- **Consumer Purchasing Power** has also been gradually increasing in 7m 2010, supported by real monthly wages increases of 9.3% yoy in 7m 2010 (due to both large social expenditures from the budget and the recovering economy.)
- Nevertheless, despite increasing purchase power, the recently approved increases in gas prices and other utilities may dampen consumer demand.

Factor 5a. Domestic Demand and Banking Credit





Source: State Statistics Committee, NBU, GFK-Ukraine, IMF, TBF

- Improved consumer sentiments caused deposits to return to the banking system.
- However, bank lending remains weak: -1.8% yoy in August 2010.
- To stimulate credit activity, the NBU has lowered its discount rate three times in three months from 10.25% pa to current 7.75% pa.
- The role of the discount rate in promoting private sector credit remains limited (due to high NPLs -- up to 42% in March 2010 -- and credit risks).
- Hence, credit is forecast to rebound only very gradually, restraining the rate of growth of domestic demand.

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Factor 6. Economic Reform Progress

- Some progress in economic reforms has taken place, including:
  - Adoption of a new gas law that would gradually liberalize the gas sector and improve efficiency through unbundling production, transit, and distribution to end-users, and allowing new entrants into the gas market.
  - Adoption of a new Procurement Law, which should reduce corruption, develop competition and improve public finance.
  - Improvement of the business regulatory framework by reducing the number of licenses and simplifying procedures for their obtaining.
  - Announcement of a gradual rise in pension age for women since 2011.
  - Initiation of a broad tax reform by developing a new draft Tax Code, aimed at reducing the tax burden, simplifying book-keeping and improving tax administration. The draft Tax Code was recently registered in the parliament.
  - The debates are likely to be tough, as the draft was criticized for its potential to increase administrative pressure on business.

Factor 6. ...Economic Reform Progress

- Less progress has been made in implementation of longer term reforms to improve the business environment over the mid-long term.
- In March 2010, the President created an Economic Reform Committee, which was asked to develop a broad economic reform program with detailed measures. The ERC was divided into several groups including state budget stabilization, tax system reform, pension reform, deregulation, further privatization, development of R&D and innovation, energy sector reform, modernization of infrastructure, agricultural sector reform, public administration reform, social security reform, etc.
- During the Summer, the Committee developed a draft program on these areas economic reform which was recently issued by the COM.
- The Committees report contains a good vision of what has to be done, with aims and objectives. It also includes a broad timetable for the implementation of more specific reform measures in each one of the areas.
- The next step is to develop a more concrete implementation plan.
- But the success in implementation will depend strongly on the degree of commitment of the Prime Minister and the President.
- It is too early to make a judgment about the likelihood that implementation will proceed smoothly.

Summary of Factors that will Affect Ukraine's Recovery

External Environment:	**Summary**
1. The pace of economic recovery in Ukraine's main trading partners	**1. Positive**
2. Prospects for Ukrainian exports	
a) Prospects for steel and metallurgical exports	**2a. Positive**
b) Prospects for agricultural exports	**2b. Positive**
c) Degree of Ukraine's international competitiveness	**2c. Positive**
3. Ability of Ukraine to roll-over its large foreign debt and secure external financing	**3. Positive**
Domestic Factors:	
4. Adequacy of Macro-economic Stabilization Policies	**4. Positive**
5. Pace of recovery of Domestic Demand and Credit	**5. Mixed**
6. Adequacy of Economic Policies to **sustain** long-term growth by improving the business climate to attract investments	**6. Mixed**

WHERE OPPORTUNITIES EMERGE

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Economic Prospects over Medium-Term

- In 2010, overall prospects for the Ukrainian economy has improved:
  - Real GDP is forecast to grow by 4%-5%
  - The current account is expected to report just a very small deficit
  - Foreign capital inflows are forecast to remain robust
  - The exchange rate is likely to remain relatively stable
  - The fiscal deficit will be reduced in compliance with the IMF requirements
  - Inflationary pressures will be moderate.
- The political situation is now much more stable than in the previous few years.
- Given macroeconomic and political stability, the government may be more capable of implementing broader economic reforms.
- Ukraine has a number of competitive advantages to support economic growth in the medium-term (large population, educated and cheap labor, agricultural potential, reasonable infrastructure, border with the EU).
- But the country must now implement reforms to improve its investment climate.
- Ukraine should be able to grow by 4-5% per year over the next few years.

Main Macroeconomic Indicators

	2000-07 average		2008	2009	2010F	2011F
Real GDP Growth, % yoy	7.5		2.3	-15.1	4.0	4.5
Fiscal Balance, % GDP	-0.8		-2.1*	-8.5**	-6.5#	-3.5#
Consumer Inflation, %, eop	11.3		22.3	12.3	10.0	10.0
UAH/$ Exchange Rate, eop	5.2		7.7	8.0	7.9–8.0	8.0
Current Account, % GDP	2000-05: 5.7	2006-07: -2.6	-7.0	-1.5	-0.5	-1.5
Gross Int. Reserves, $ bn	2000: 1.5	2007: 32.5	31.5	26.5	32	35
Foreign Gov't Debt, % GDP	2003: 21.3	2007: 8.7	9.2	20.5	21.5	24
Foreign Private Debt, %GDP	26.2	47.4	47.1	68.1	57	54

** Includes implicit pension fund deficit (credits from unified Treasury account (state budget) to cover pension fund expenditures)*

*** Includes capital injections to Naftogaz (2.7% GDP), implicit Pension Fund deficit (1.7% of GDP) and expenditures covered by IMF's special SDR allocation to Ukraine (1.7% GDP).*

 # Includes Naftogaz imbalances.

Other Forecasts of Main Macroeconomic Indicators

	GDP growth, % yoy		Fiscal balance, % GDP		Inflation, eop, %		Exchange rate UAH per USD		CA balance, % GDP	
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
The Bleyzer Found'n	4.0	4.5	-6.5	-3.5	10.0	10.0	7.9-8.0	8.0	-0.5	-1.5
BofA Merrill Lynch	4.2	4.0	-5.0	-4.0	9.0	8.0	7.9	8.0	-1.5	-2.7
CASE Ukraine	3.6	5.5	-5.5	-3.5	9.8	11.9	7.95	7.98	0.5	0.6
Citigroup	2.4	3.9	-7.7	-6.5					1.1	-2.0
Credit Suisse	4.0	4.4	-6.0	-4.5	9.9	10.0	8.0	7.95	0.2	-1.0
Deutsche Bank	3.3	4.6			13.3	11.0	7.9	7.9	-1.6	-2.2
HSBC	5.5	4.0	-6.4	-4.2	6.9	9.8	8.5	8.5	-0.6	-0.7
ING	4.5	4.6	-7.5	-4.5	11.8	11.3	7.98	7.69	0.2	2.3
JPMorgan	5.0	4.5	-5.3	-4.2			8.4	8.0	-0.9	-1.7
Morgan Stanley	4.8	4.0	-6.5	-4.0	10.6	11.0	7.7	7.6	0.0	-1.5
Raiffeisenbank	5.0	4.5	-6.5	-3.5	11.0	10.0	7.8	7.6	0.0	-1.0
UBS	3.2	5.0			10.0	6.0			-1.2	-1.3
UniCredit	3.0	4.0	-6.1	-3.8	10.4	11.5	7.4	6.9	0.2	-0.7

Source: FocusEconomics, August 2010, The Bleyzer Foundation