August 27, 2009

2H2009 Economic Outlook

The Road to Recovery?

Economic Outlook

The Ukrainian economy is suffering its worst crisis since the mid 90s. GDP is expected to decline by 12.9% y-o-y in 2009, largely due to a decline in demand for industrial goods exports and an outflow of foreign capital. Since last fall the crisis has spread into the whole economy, hitting banks, trade and government finances hard.

Nevertheless, we are optimistic about the economy in 2010. We expect 4.5% y-o-y GDP growth. The crisis began in exports and so will the recovery. International trade recovers faster than global output, and as it recovers it will pull up Ukraine's export-oriented metallurgy and machinery sectors.

The major threats for the economy are poor government finances and the poor quality loan portfolios of Ukraine's banks. The consolidated budget deficit is expected to reach 7% of GDP this year and the share of non-performing loans has already reached 28.8%.

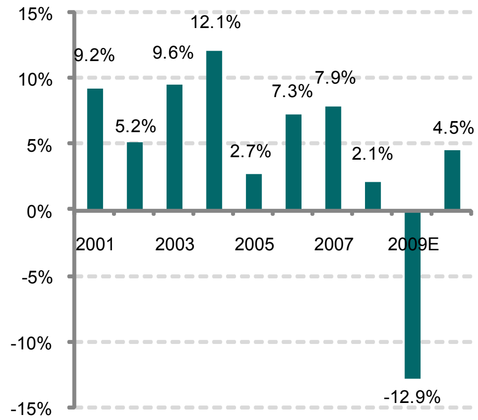
USD/UAH exchange rate

Source: NBU

GDP decline reached 20.3% y-o-y in 1Q2009; the decline in 2Q2009 is estimated to be 18.0% y-o-y. The Ukrainian economy is suffering under a downturn in industrial output by 26.7% y-o-y, in trade by 21.5% y-o-y, in transportation by 44.3% y-o-y as of 7M2009. Agriculture still shows positive dynamics with 3.8% y-o-y growth as of 7M2009, however, once the harvest is complete that dynamic will decrease—the grain harvest is estimated to be 37 mln t, much lower than 53 mln t harvested in the previous year.

We revise our major economic forecasts for 2009. We based our forecasts on a sharp decline in exports, an increase in NPL share to 25-30%, a deep crisis in retail trade, a decline in the grain harvest to 42-43 mln t, and a budget deficit of 7-10% of GDP (see *PHNC Ukrainian Strategy 2009, Dec 23, 2008*). Though these forecasts were fairly accurate, we underestimated the pace of decline. We alter our GDP growth forecast from -9.9% y-o-y to -12.9% y-o-y in 2009. In contrast, we based our exchange rate forecast on the assumption that the NBU's administrative pressure on the interbank market would prevent Ukraine from receiving the IMF loan. However, the IMF allowed the NBU to use its administrative power to hold the exchange rate. As a result we change our UAH/$ forecast from 12.0 to 8.5 as of the end of 2009.

GDP growth in Ukraine



Source: Ukrstat, Phoenix Capital forecast

We believe industry will drive the 4.5% y-o-y GDP recovery in 2010. Industrial output is growing on recovering external demand for Ukrainian steel and machinery. Steel output increased by 76% in July 2009 after a low in November 2008. We expect the pace of recovery to slow in the coming months, but the metallurgy sector will still grow 17% y-o-y 2010. At the same time, weak domestic demand will hold back the growth.

Key macroeconomic indicators

	2004	2005	2006	2007	2008	2009E	2010F
GDP growth y-o-y, %	12.1%	2.7%	7.3%	7.6%	2.1%	-12.9%	4.5%
Nominal GDP, $bln	65	86	108	143	176	117	134
GDP per capita growth y-o-y, %	13.0%	3.4%	8.0%	8.3%	3.7%	-12.3%	5.1%
Industrial output growth y-o-y, %	12.5%	3.1%	6.2%	10.2%	-3.1%	-21.0%	11.5%
CPI, % eop	12.3%	10.3%	11.6%	16.6%	22.3%	20.0%	22.0%
PPI, % eop	24.1%	9.6%	15.6%	23.3%	23.0%	14.0%	20.0%
UAH/$, eop	5.33	5.31	5.05	5.05	7.70	8.5	8.5
UAH/$, avg	5.32	5.12	5.05	5.05	5.35	8.2	9.0

Source: Ukrstat, NBU, Phoenix Capital forecast

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Real Economy

We expect 12.9% GDP decline in 2009

We change our GDP growth forecast for 2009 from -9.9% y-o-y (see *PHNC Ukrainian Strategy 2009 December 23, 2008*) to -12.9%. In general our vision of the Ukrainian economy in 2009 has not changed since December, but we did slightly underestimate the pace of decline in industry and construction. Our expectations regarding banks and retail, however, largely conformed to what actually happened in 1H2009.

The rate of GDP decline will decrease in 2009 relative to the -20.3% experienced in 1Q2009 due to lower basis for comparison and a recovery in industry and in transportation. Banks and retailers are not expected to increase value added till the end of the year. Agriculture is expected to show a -8% y-o-y decline on a decrease in crops harvested from 53 mln t in 2007/2008 to 37 mln t this year.

GDP growth in Ukraine

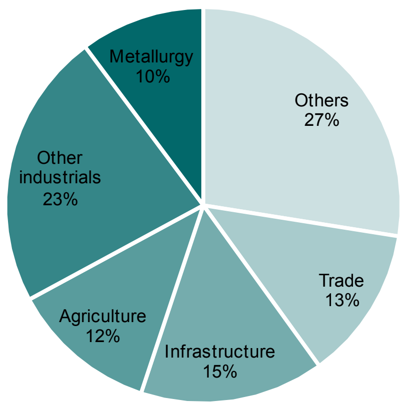
Source: Ukrstat, Phoenix Capital forecast

In contrast, 2010 may be a year of recovery

We expect 4.5% y-o-y GDP growth in 2010, and thus are more optimistic than mainstream analysts who forecast GDP growth ranging from -2% to 3%. Our view differs mostly because we believe industry will recover 11.5% y-o-y.

Its extremely high dependence on foreign markets and the small domestic market make Ukrainian industrial output volatile: it overshoots the market during declines, but leads when recovery starts. As global foreign trade is believed to recover faster than global GDP, we also expect Ukraine to be among the leaders of industrial recovery.

GDP composition in 2008

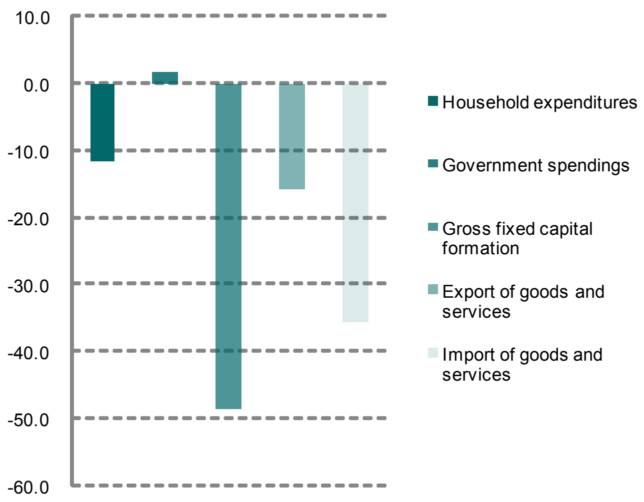


Source: Ukrstat

We expect agriculture to grow by 5% y-o-y in 2010 due to low 2009 numbers and an increase in investments. In our view, unfavorable weather conditions and a lack of investments will led to a drop in this year's grain harvest to 37 mln t from the 53 mln t harvested in the previous crop year. If the weather conditions are favorable next year, the harvest is likely to increase significantly. Agro companies will be able to invest more as well, since this year they are expected to have more profits than in the previous year.

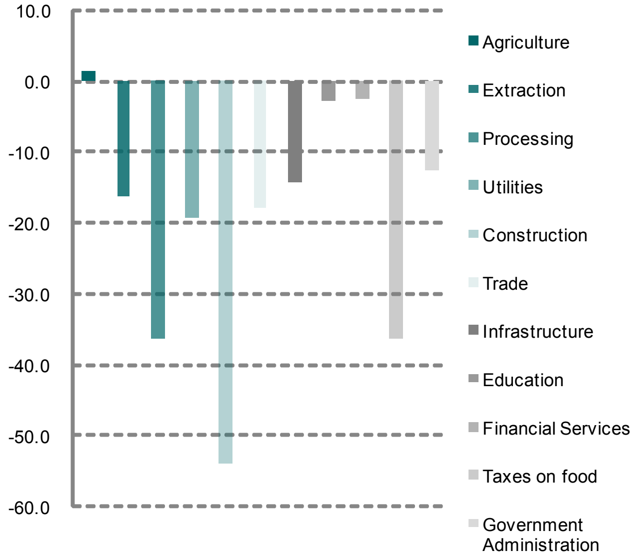
In contrast, domestic private and public demand will remain weak, holding back growth. Real household' income decreased by 12.9% y-o-y in 1Q2009 and we expect it to decrease by 20% y-o-y in 2009 with a further drop by 5% y-o-y in 2010. Public demand is likely to fall in 2010 when the government cuts spending after the presidential elections. In our view, consolidated budget expenditures in 2010 may be 20-30% lower than this year's spending in real terms. The one positive aspect of falling domestic demand is that demands for imports shrink faster than demand for domestic goods.

GDP growth rate by final use in the 1Q2009, % y-o-y



Source: Ukrstat

GDP growth rate by sector in the 1Q2009, % y-o-y



Source: Ukrstat

Given weak domestic demand, we are pessimistic about retail, banks, education and health care. Construction may rebound slightly only against the background of an expected 40% y-o-y decline this year.

Domestic Demand

Domestic demand will be weak due to...

Private demand deteriorates in the presence of four major factors: increasing unemployment, decreasing wages, inflation and the collapse of retail lending.

Unemployment

Unemployment grew to 10.3% as of 1Q2009 (ILO methodology) compared to 7.6% in 1Q2008. We expect unemployment to grow to 12% by the end of the year, even though unemployment at the end of the year is usually lower than in the first quarter. Significant employee layoffs can be expected in the banking sector, retail and other service industries, while seasonal summer employment in agriculture and construction will be much less than in past years.

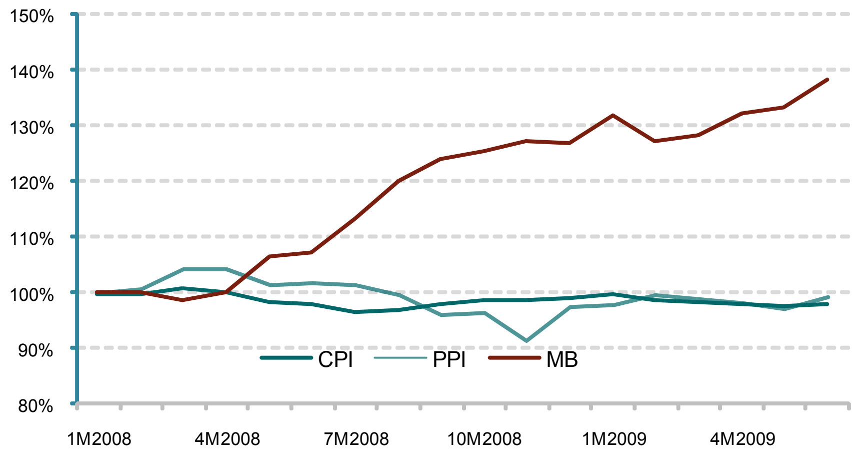
Decreasing real wages

Real wages decreased by 10.1% y-o-y in 1H2009 and we expect them to decrease by 13% in 2009 due to accelerating inflation. Meanwhile, nominal wages remain virtually flat. The government's administrative pressure makes cutting nominal wages at large enterprises almost impossible. Nominal wages at small and medium enterprises are also more or less sticky. Thus, companies prefer to cut "gray" wages, widespread in Ukraine, and maintain a show of stable wages in official reports.

Inflation

Inflation is expected to accelerate in 2H2009 even though it is currently slowing. The CPI is expected to be pushed up by the low grain harvest, an increase in the price of natural gas for individuals, and the continuing growth of the monetary base while real output falls. Our view on inflation in 2010 is different to the view of mainstream researchers. We do not expect Ukraine's CPI to slow in 2010. In fact, we believe it can increase from an expected 20% (December to December) this year to 22% (December to December) next year. This rise will come thanks to an expansionary monetary policy, high government spending, hryvnia depreciation and growth in commodity prices after the global recovery starts.

Monetary base growth still did not boost inflation



Source: Ukrstat, NBU

A lack of retail lending

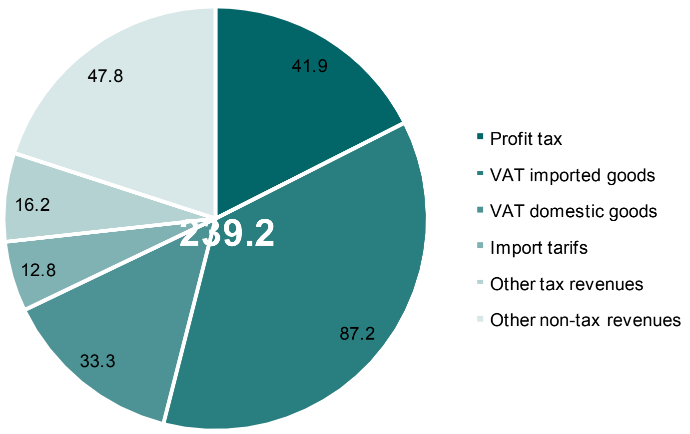
Retail lending seems to be ready for a recovery next year, but its volume will still be insignificant compared to pre-crisis levels. Ukrainian banks suffered $1.8 bln in losses in 1H2009 mostly due to increasing provisions for bad loans. We expect this trend to continue through the end of the year. In the short-term, therefore, banks will seek to minimize losses rather than increase their loan portfolio. In addition, banks will have a hard time attracting additional funding from sources other than their shareholders. Borrowing from abroad is now restricted (see PHNC Banking Monitor July 2, 2009), while domestic resources are very scarce due to the poor financial situation in the banks and the distrust of individuals

Budget

Only 43.5% of expected annual revenues have been collected in 7M2009

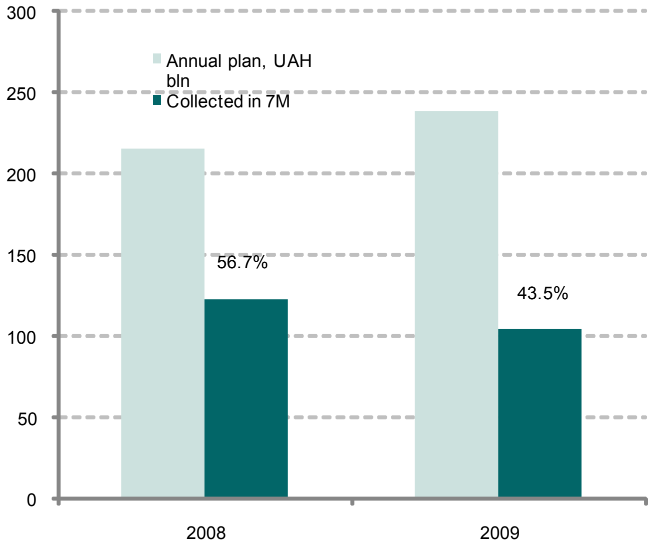
Planned budget revenues for 2009 are 11% higher than the previous year, a number that looks unrealistic to us. Though the State Treasury reported that consolidated budget revenues in 7M2009 exceeded expectations by 3.6%, prospects for the budget are gloomy. In the first seven months the government collected UAH 104 bln, or 43.5% of expected annual revenue. As a comparison, the government collected 56.7% its annual revenue in the corresponding period of 2008. It seems obvious that budget revenues will be significantly below UAH 239 bln.

Government budget revenues plan for 2009, UAH bln



Source: Verkhovna Rada

Budget revenues collection



Source: State Treasury

Budget revenues decrease on declining imports

The decrease in imports and the decline in company profitability are the major reasons for the poor performance of the budget. VAT on imported goods and import tariffs account for 42% of budget revenues, making imports vital for government financials. If we count in hryvnia, average monthly imports declined from UAH 37 bln in 2008 to UAH 27 bln in 1H2009. We expect monthly imports to be UAH 30 bln in 2009FY, implying a 19% decline compared to 2008.

Company profits totaled UAH 9.6 bln in 5M2009 compared to UAH 53.7 bln in the corresponding period of 2008. We expect company profitability to improve in 2H2009 due to rising producer prices. However, revenues from taxes on profits may be 20-40% lower than in the previous year.

As much as UAH 120 bln may be needed to finance debt

If we add government debt repayments to the deficit budget, the total needed for financing debt may reach UAH 120 bln. The government has already found around UAH 70 bln (in local government bond issues and in loans from international finance organizations), meaning UAH 50 bln remains to be paid. This money will probably be attracted through the sale of local bonds to the National Bank of Ukraine, which amounts to an increase in the money supply.

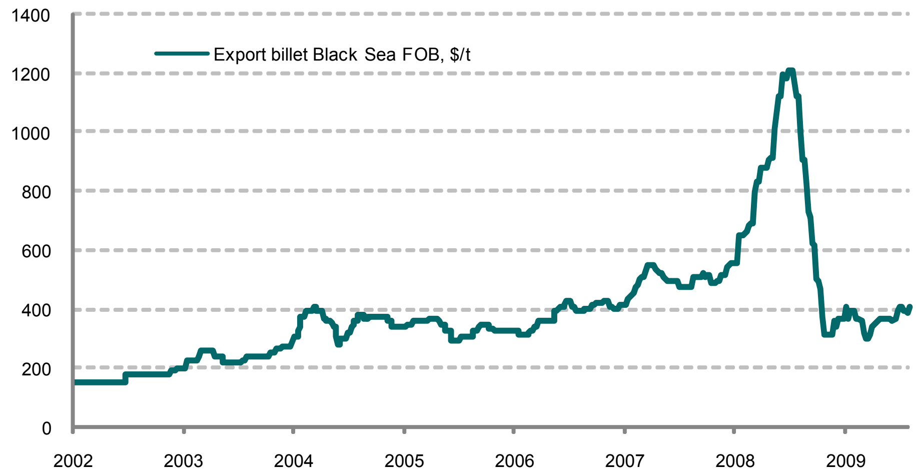
After the presidential elections in January, government policy will probably become less populist, allowing the government to cut the budget and combat the deficit. Cutting the budget without significant changes in fiscal policy will have a negative effect both on government spending and on private consumption.

Metallurgy

Metallurgy will be a driver of recovery due to...

Metallurgy is expected to grow by 17% y-o-y in 2010 and be the main driver of recovery. Having suffered because of its orientation toward exports, the Ukrainian metallurgy will benefit from it next year. The global crisis came to Ukraine largely through a fall in the demand for steel, but now global trade is recovering faster than global output and domestic demand. Thus the recovery will come to Ukraine also through metallurgy.

Steel price: back to 2006



Source: Bloomberg

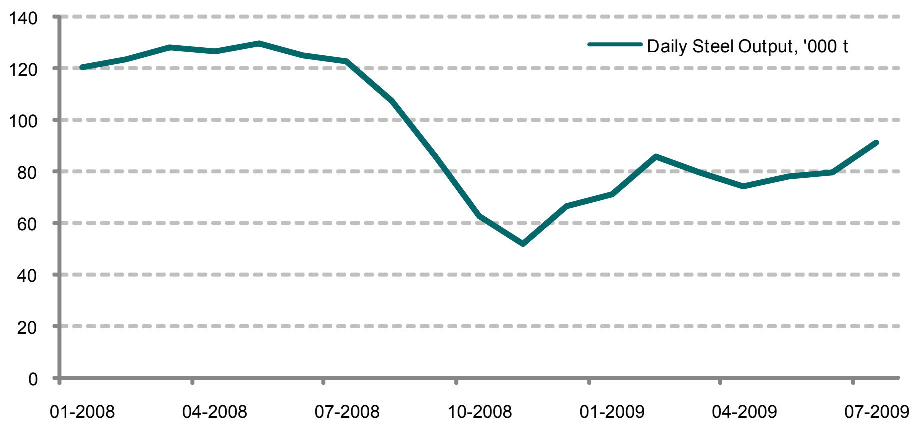
Its heavy weight in GDP

Metallurgy will be the key driver of recovery not only because of its rapid growth, but also due to Ukrainian economy's extremely high dependence on the sector. Steel production creates demand for iron ore, coke, coking coal, electricity, etc. Steel-driven sectors contribute nearly 25% to Ukrainian GDP.

And rapid growth

Daily steel output increased from 52,000 t in December to 91,000 t in July. Moreover, the Industrial Policy Ministry expects 7% y-o-y growth in August based on the increase in the number of orders for steel products. We expect daily output to grow much more slowly in 2010 to an average of 103,000 t. Because of the low output in 1H2009, the increase will result in 17% y-o-y growth in 2010.

Steel output increased by 76% since December



Source: Ukrstat

Banks

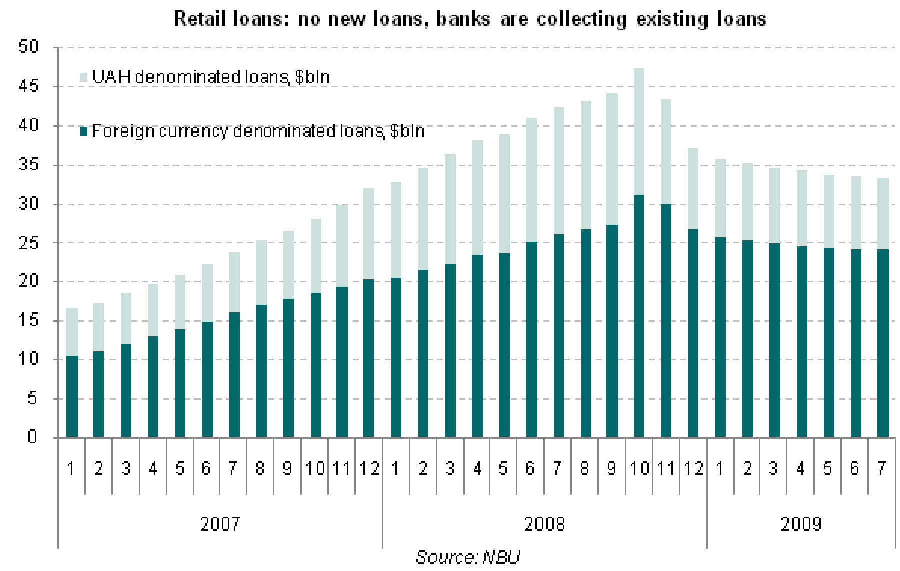
Banks are currently the biggest trouble for the economy

Banks will probably be the biggest trouble spot for the Ukrainian economy over 2H2009-2010. Banks have already suffered UAH 18.4 bln in losses in 7M2009 due to the increase in provisions for non-performing loans. We expect this trend to continue. The current provisions-to-loans ratio of 10.6% at Ukraine's largest banks is unjustifiably low, given the 28.8% NPL share at these banks. Under our base case scenario, banks have to increase their provisions-to-loans ratio to 20% over 2H2009-1H2010. This means that banks will continue to post UAH 2-4 bln of losses per month over the next 12 months.

The post-crisis recovery of the banks will be slowed by the ban on foreign currency lending. The Verkhovna Rada, or Ukrainian Parliament, has adopted anti-crisis law #3585 on the banking sector, which restricts foreign currency lending. If not cancelled, the law will change the architecture of the post-crisis banking system. Before, banks grew mostly because they attracted foreign currency loans from abroad, which was necessary because of the scarcity of domestic credit resources. If banks cannot lend in foreign currencies, they cannot attract foreign currencies, which makes borrowing from abroad more expensive and slows the growth of assets.

Stabilization, but not recovery

The rapid decline in the size of banks' loan portfolios has ceased, but there are no signs of growth. Right now banks rarely grant new loans, and instead are merely refinancing existing loans. It is unlikely banks will turn to granting loans in order to regain profitability. Banks now need additional capital injections and additional subordinated loans to cover their losses, and cannot use these funds for new loans.



NPLs in Ukrainian banks
Data on Group 1 banks, $ mln, as of 1 July 09

#	Bank	Total assets	Net income	Loan loss reserves, % of gross loans	Subprime and worse lending operation, % of total lending operations*	Doubtful and worse lending operations, % of total lending operations*	Irretrievable lending operations, % of total lending operations*
1	Privatbank	10 407	53	15.50%	46.9%	10.2%	2.3%
2	Raiffeizen Bank Aval	7 490	-142	12.40%	19.5%	8.2%	3.5%
3	Ukreximbank	7 425	2	6.40%	11.1%	4.2%	3.1%
4	Oshchadbank	7 008	99	3.0%	6.3%	1.7%	1.2%
5	UkrSibbank	6 672	-109	10.9%	29.2%	10.8%	2.2%
6	Ukrsotsbank	5 887	8	7.2%	17.3%	3.3%	1.9%
7	Alfa Bank Ukraine	4 239	-25	11.3%	45.4%	9.5%	5.1%
8	OTP Bank	3 892	-74	11.6%	19.5%	11.8%	1.3%
9	Prominvestbank	3 647	-49	12.5%	36.0%	14.2%	4.6%
10	VTB Bank	3 571	0	5.4%	17.2%	3.5%	1.6%
11	Nadra	3 441	-136	9.7%	36.5%	18.3%	1.8%
12	Forum	2 504	-37	7.2%	14.7%	2.0%	0.2%
13	FUIB	2 324	-79	13.9%	33.5%	12.2%	4.0%
14	Finance and Credit	2 302	-25	6.6%	20.7%	6.1%	0.9%
15	Brockbusinessbank	1 873	1	5.1%	14.2%	3.8%	1.5%
16	Swedbank	1 812	-63	14.0%	28.7%	11.6%	4.6%
17	Ukrgazbank	1 589	-10	5.5%	19.0%	3.3%	0.4%
18	Ukrprombank	1 240	-603	40.4%	79.6%	56.1%	15.1%
	Group 1 total	**77 323**	**-1 188**	**10.6%**	**28.8%**	**9.3%**	**2.8%**
	Banking system total	**113 180**	**-1 875**	**10.4%**	**n/a**	**n/a**	**n/a**

**includes both on-balance and off-balance operations*

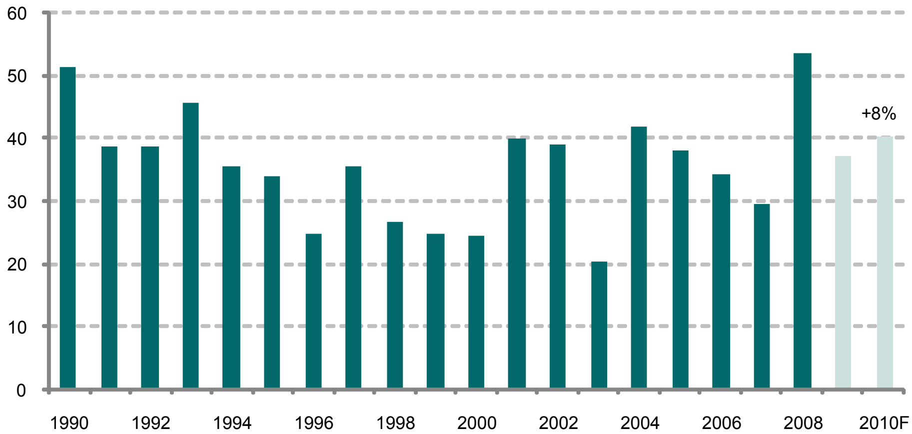
Source: NBU, Phoenix Capital calculations

Agriculture

Grain harvest falls from 53 mln t to 37 mln t

We expect 8% y-o-y growth in the grain harvest in 2009/2010 because of a low basis for comparison. According to preliminary data from the Agriculture Ministry, the grain harvest declined from 53 mln t in 2007/2008 to 37 mln t in 2008/2009. The major reasons for the decline were the insufficient working capital of agro companies and unfavorable weather conditions. Next year, we expect a slight rebound in grain production thanks to easier access to capital resources. However, a significant rebound will be restrained by nevertheless poor access to funding and low revenue from this year's harvest.

Grain harvest will increase in 2010 because of low comparison base, mln t



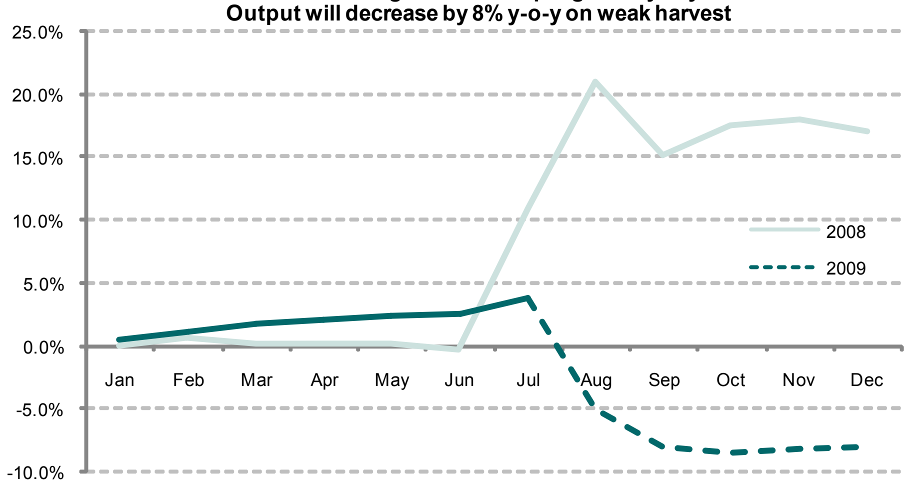
Source: Ukrstat, Phoenix Capital forecast

The 3.8% y-o-y growth in agricultural output in 7M2009 does not show the real picture in the sector. The early harvest this year resulted in abnormally high numbers for July. We expect an 8% y-o-y decline in 2009, and believe agriculture output statistics will begin to reflect the poor harvest after August.

We expect a rebound next year

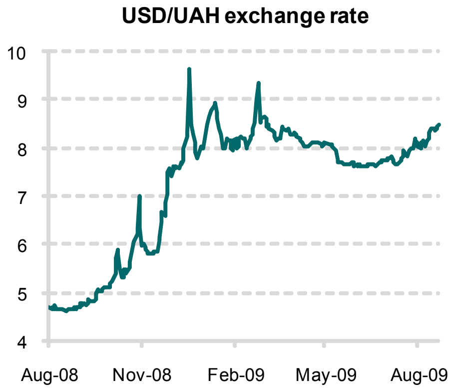
Though the crop sector is showing poor results, the livestock sector is growing thanks to the cheap hryvnia. Hryvnia devaluation has made domestic livestock more competitive on both domestic and international markets. Gradual growth in this sector was the reason for the 2.6% y-o-y growth in agricultural output in 1H2009.

Cumulative agricultural output growth y-o-y: Output will decrease by 8% y-o-y on weak harvest

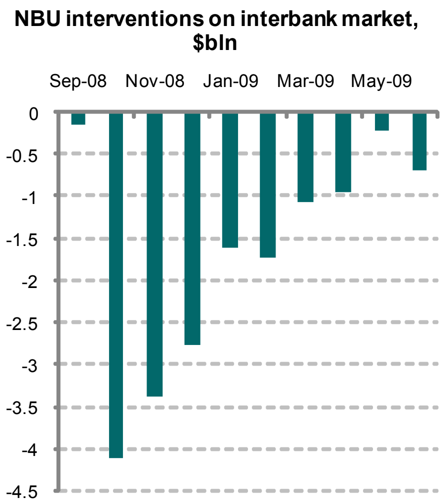


Source: Ukrstat, Phoenix Capital forecast

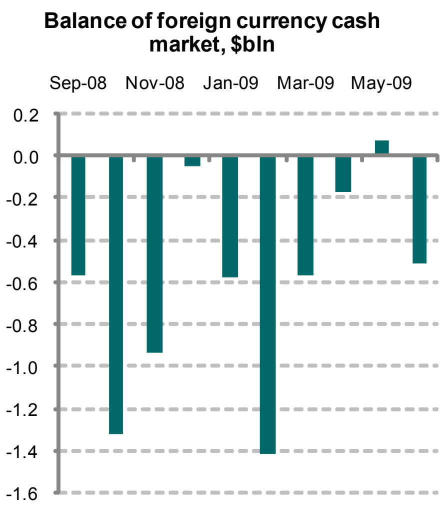
Currency



Source: NBU



Source: NBU



Source: NBU

- **We are changing our forecast for the UAH/$ exchange rate from UAH 12.0/$ to UAH 8.5/$ by the end of 2009 and from UAH 12.0/$ to UAH 8.2/$ on average for the year.**

- **The major factor in the hryvnia's appreciation is the NBU's regulations on the interbank market.**

- **There is a threat of depreciation in autumn because of rising natural gas imports, foreign debt repayments and decreasing exports of grain. However, we believe that the NBU will shift to administrative regulation after the exchange rate crosses the boundary of UAH 8.5/$, holding the rate to UAH 8.5/$ at the end of 2009.**

- **In our view, the current equilibrium exchange rate lies in the range UAH 9.0/$ - UAH 10.0/$. This level, however, will not be reached this year, since the NBU has the necessary resources and stimuli to keep it at UAH 8.5/$.**

We are changing our forecast for the UAH/$ forecast from UAH 12.0/$ to UAH 8.5/$ by the end of 2009 and from UAH 12.0/$ to UAH 8.2/$ on average for the year. When we made our previous forecast we believed the following three factors could not exist at the same time:

- Ukraine's receiving of the IMF loan
- The introduction of tight regulations in the currency market
- The persistence of an unrealistic government budget

However, the IMF decided to grant the second, $2.8 bln tranche of its $16.5 bln loan despite capital controls introduced by the NBU and despite a government budget with a real deficit of UAH 70-100 bln (7-10% of GDP). As a result, the NBU now can hold off the pressure of a populist budget policy on the exchange rate using both administrative regulations and the loan from IMF. In fact, administrative regulations of the interbank market are the precise reason the hryvnia appreciated this spring.

The NBU in March-April issued resolutions #107, #108 and #109, which:

- Made it possible for banks to buy foreign currency on the interbank market only for the purpose of paying matured obligations.
- Obligated banks to create provisions in hryvnia for foreign currency denominated loans. As a result, banks have to sell dollars and buy hryvnia, pushing the hryvnia exchange rate up.

These changes forced banks to increase FX supply and frozen demand. In addition, enterprises launched restructuring of their external debt, reducing pressure from the demand side.

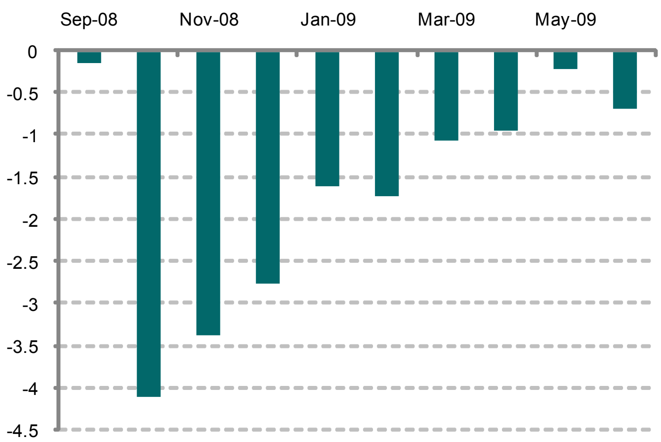
We believe that the NBU's regulations, together with the second $2.8 bln tranche, were the background for the appreciation of the hryvnia from UAH 8.7/$ to UAH 7.6/$ this spring. Unlike officials and media, we do not see the trade balance contributing significantly to the appreciation. The merchandise trade deficit is still $0.5 bln per month, and we expect it to widen in 3Q2009 due to rising gas imports and the effect of hryvnia appreciation.

The NBU weakened its regulatory policy in June by cancelling resolutions and introducing a "manual" regulatory regime. As a result, at the beginning of July the hryvnia weakened for the first time since February. However, it seems that the NBU will return to tight regulations if the exchange rate crosses the psychological level of UAH 8.5/$.

Tight regulations and capital controls are expected to be the main instruments of the NBU's exchange rate policy, while the weak Ukrainian economy and poor fiscal discipline will exert pressure on the exchange rate in the opposite direction.

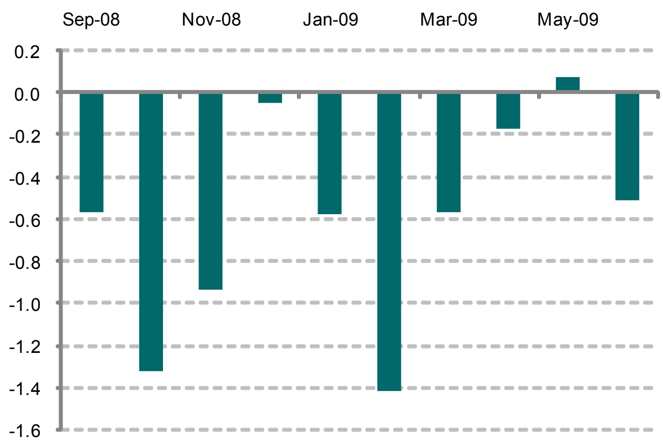
The NBU gradually decreased the volumes of its interventions from $4.2 bln in October 2008 to $0.2 bln in May 2009. Even during the extremely difficult period for the economy in February (which witnessed the delay of IMF loan, unexpectedly rapid economic decline, and political confrontation), the NBU spent only $1.7 bln. This means that the NBU switched from market interventions to administrative regulations on the interbank market in order to maintain the exchange rate. Moreover, the volume of interventions during January-March decreased in spite of panic on the FX cash market.

NBU interventions on interbank market, $bln



Source: NBU

Balance of foreign currency cash market



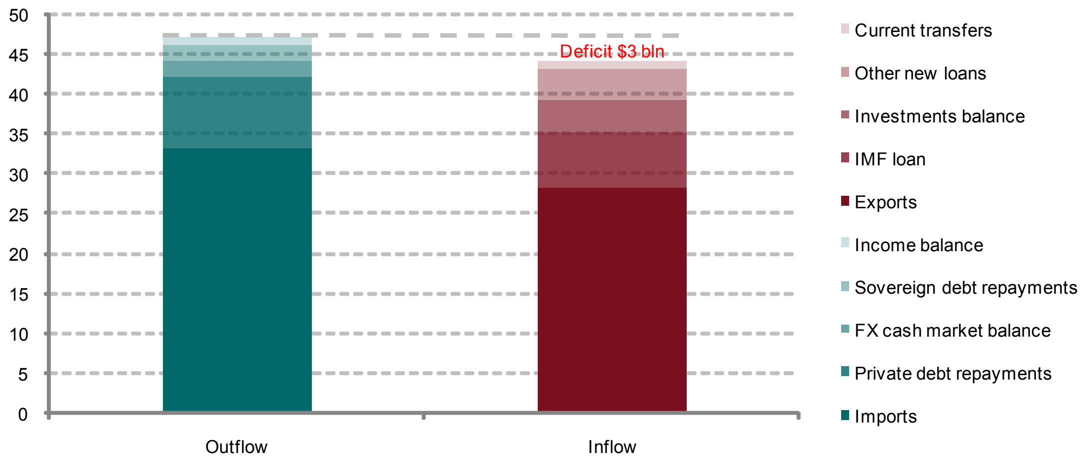
Source: NBU

BoP deficit is expected to be $3 bln in 2H2009

The balance of payments for 2H2009 is expected to be negative. This is due to a trade deficit of $5 bln and foreign debt repayments of $11 bln that will not be fully covered by debt and equity capital inflow. However, the expected BoP deficit is $3 bln, which is far less than the NBU's reserves of $27.5 bln.

In 2H2009, Ukraine faces $2 bln of external public debt repayments and $9 bln of external private debt repayments according to a schedule published by the NBU. Part of this debt may be restructured, which will lead to an improvement in BoP. From the inflow side, Ukraine may receive a $7 bln from the IMF, as well as the payment of $4 bln in other debts, including loans from IFOs and commercial banks that have already been agreed or which may be agreed on in the near future . BoP may also be improved if an agreement to loan $2-4 bln to Naftogaz Ukrainy is reached. Delays in receiving the third and fourth tranches of the IMF loan may have strong effects on the exchange rate and macroeconomic stability.

Ukraine's balance of payments in 2H2009, $bln



Source: Ukrstat, NBU, Phoenix Capital estimates

The merchandise trade deficit is expected to stop shrinking

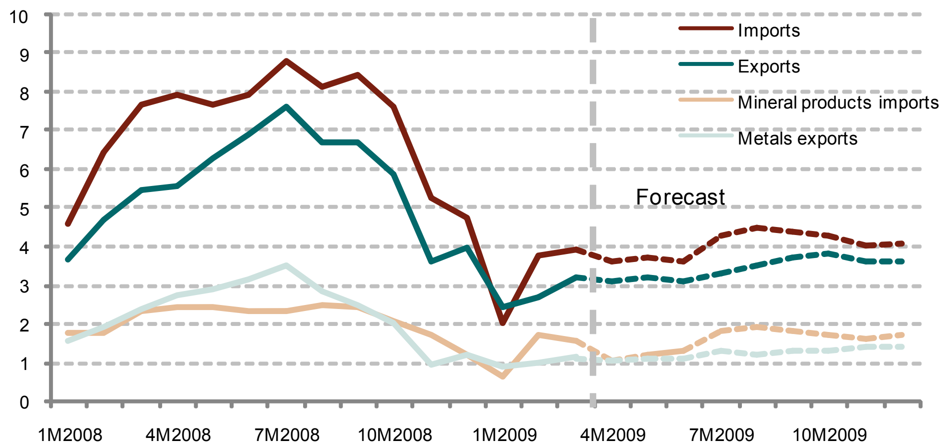
We expect the merchandise trade deficit to widen in 3Q2009 due to increasing gas imports and hryvnia appreciation. Despite a decline in the price of natural gas from $270/tcm in 2Q2009 to 198/tcm in 3Q2009, the volume of gas imports will increase as Naftogaz Ukrainy pumps more gas into storage. We expect Naftogaz will buy only 15 bln cm for this purpose this year compared to the planned 27 bln cm, spending approximately $3.0 bln.

By the end of the year, the monthly deficit will again back to $0.4-$0.6 bln per month, as consumer imports decline under pressure from hryvnia depreciation, gas stores are refilled, and exports of industrial products recover.

The merchandise trade deficit will reach $7 bln in 2009, or 5.8% of projected GDP. The deficit will not disappear, in large part due to the NBU's expensive maintenance of the exchange rate. In addition, the increase in prices for metal (a major export product) will lag behind the increase in the cost of mineral products (a major import product).

This deficit will be partly covered by a traditional domestic surplus in the services trade, as well as current transfers, which we estimate will reach $2 bln this year. As a result, the C/A deficit will total $5 bln this year, and will be a major factor pushing the hryvnia exchange rate down.

Merchandise trade dynamics, $bln



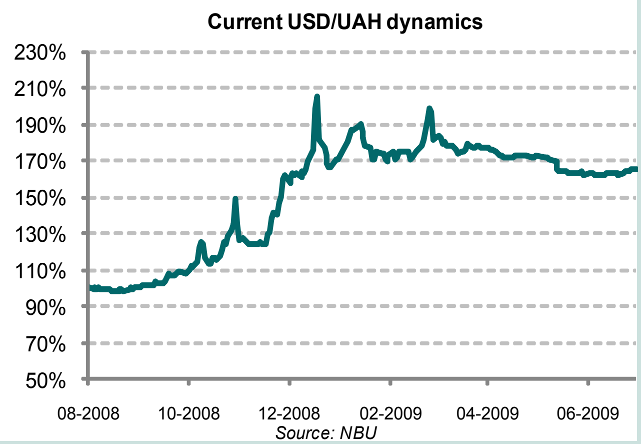
Case studies of currency depreciations

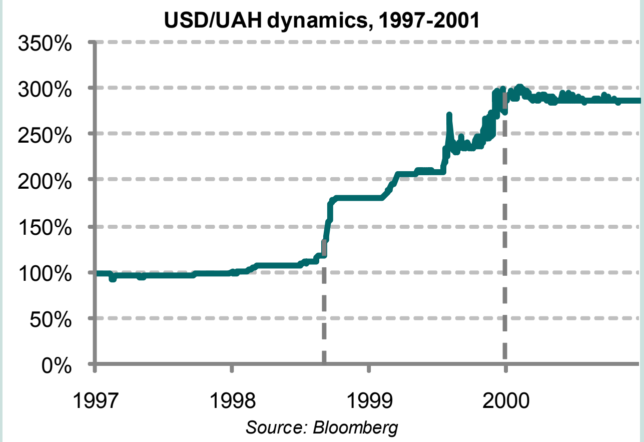
To get an idea of how long and how deep the depreciation of hryvnia may be, we looked at five historical cases where the currency of a developing country lost value after being pegged to a dollar for a few years. In all these cases, central banks tried to keep pegging, losing reserves but not being able to maintain the pre-crisis exchange rate.

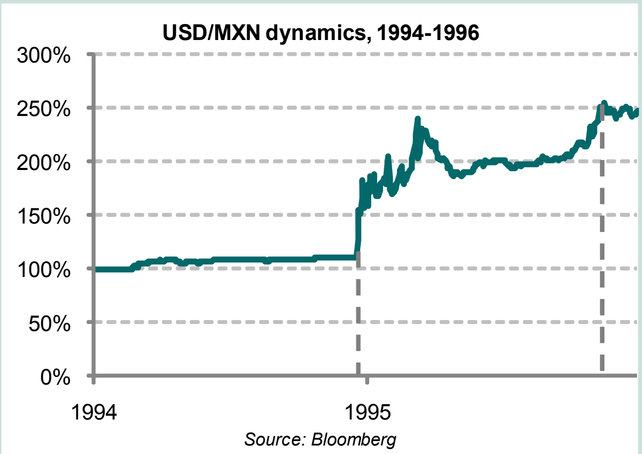
In our cases, depreciation over the 6-18 months after a crisis made a given currency 2.5-5 times cheaper. In all our chosen examples, exactly two significant peaks were observed. The first peak, during the first 6 months, is near the peak of overall depreciation. After depreciation ended, if the currency is not pegged again, it starts to appreciate thanks to a post-crisis inflow of capital.

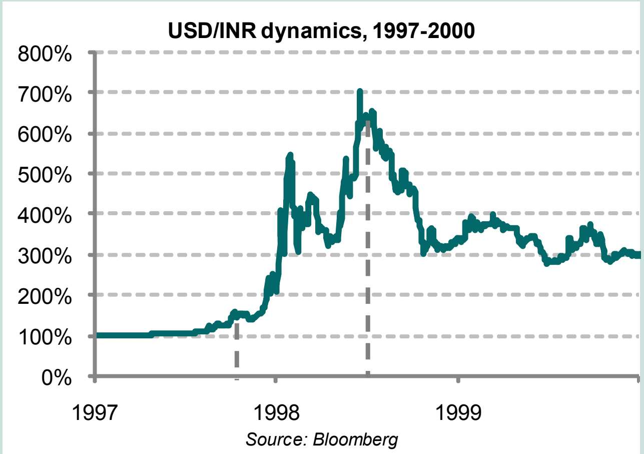
Applying this to the current situation with the hryvnia, we seem to see an end to depreciation within 6-7 months (after the Presidential elections). We've already observed two peaks at the level of UAH 9.5/$ level, which seems to be the greatest extent of the depreciation. Once the recovery starts, the hryvnia is expected to appreciate for several years.

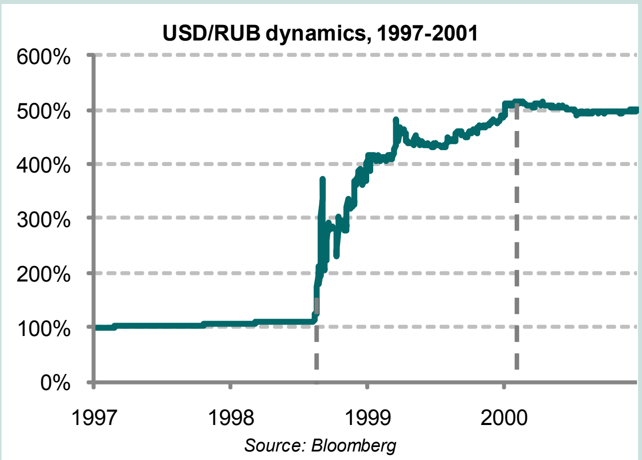
USD vs Ukrainian hryvnia today, the historical hryvnia; the Mexican peso; the Indonesian rupee; the Russian ruble; and the Argentine peso

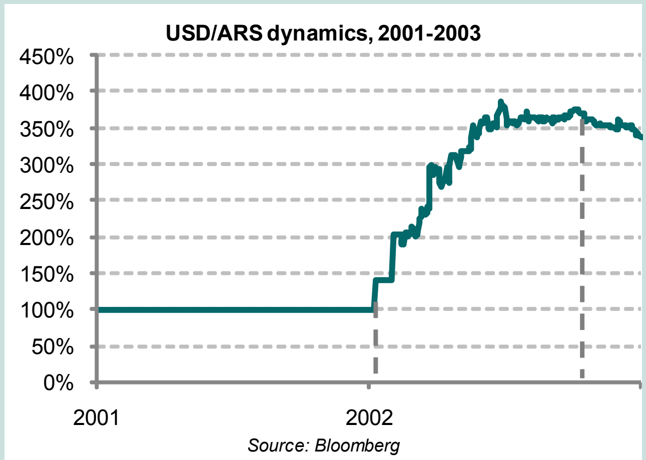












Politics

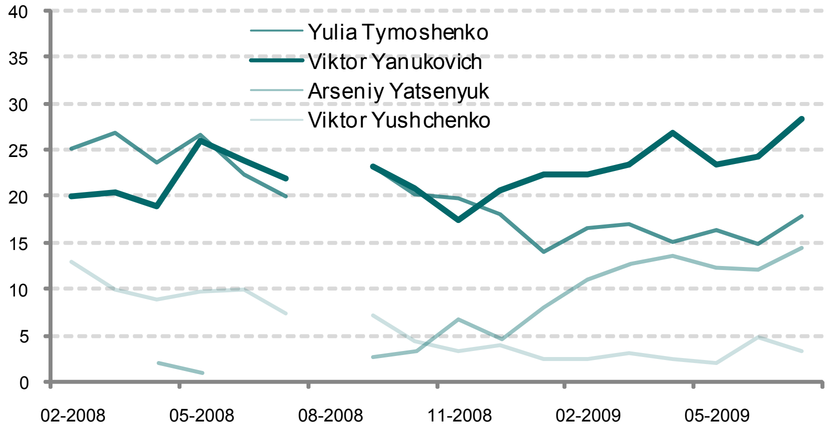
Politics will bring big news

Ukraine is closing in on presidential elections that will likely end in the defeat of current president Viktor Yushchenko. Though parliamentary elections are scheduled for 2011, some politicians are considering the possibility of early elections to the Verkhovna Rada in 2009 or 2010. If both elections take place next year, it will change the picture of political life in Ukraine. President Yushchenko and the Yulia Tymoshenko Bloc, which heads the coalition in parliament, are currently less popular than their competitors.

Yanukovych, Tymoshenko and Yatsenyuk will compete against each other in the presidential elections

We have aggregated popularity rankings made by leading polling agencies. Viktor Yanukovych has the highest approval rating at about 25%, surpassing his closest competitor PM Yulia Tymoshenko by nearly 10 percentage points. Former parliament speaker Arseniy Yatsenyuk is 2-4% behind Tymoshenko and far outstrips the rest of the candidates.

Presidential candidate Yanukovych leads the race. Yastsenyuk pursues Tymoshenko, %

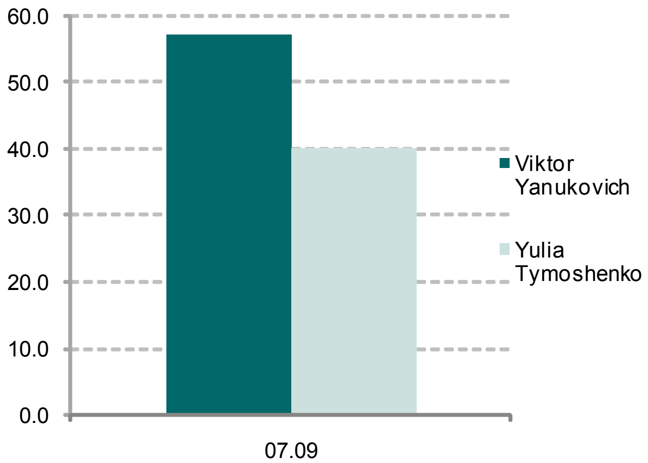


Source: National poll firms

Yanukovych is likely to win the first round, but will he win the second?

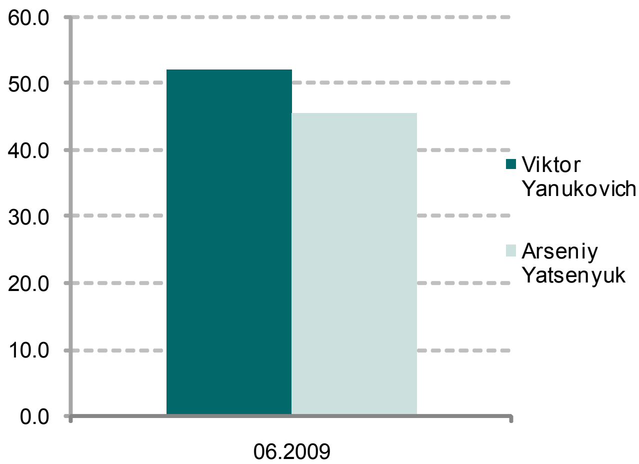
Yanukovych will probably lead in the first round when all candidates compete, but he is unlikely to receive the 50%+1 votes needed to win outright. In the second round, only the two leading candidates will face off. And in the second round Yanukovych has only a 6% advantage over Yatsenyuk, though he polls at a more than 15% gap over Tymoshenko. Thus, even though Tymoshenko has a better chance to reach the second round, Yatsenyuk has a better chance of actually winning the second round.

Tymoshenko will probably lose the second round, %



Source: Socis

Yatsenyuk can beat Yanukovich in the second round, %



Source: Socis

If **Yanukovych** win the elections, his Party of Regions will probably create and lead a coalition in the Verkhovna Rada, as minor parties often join with whichever major party is most powerful. As a result, the Party of Regions could take control over both the executive and legislative branches.. Since the party is sponsored mainly by an export-oriented businessman, an economic policy that stimulates exports will probably be implemented.

What to expect: a relatively weak hryvnia, high import duties, increasing government capital expenditures, decreasing taxes, control of household income growth.

If **Tymoshenko** win the elections, the Yulia Tymoshenko Bloc will probably control the Verkhovna Rada. The party is known for its populist and import-stimulating policy.

What to expect: a relatively strong hryvnia, low import duties, increasing spending on social transfers, increasing taxes, a policy that stimulates household income.

If **Yatsenyuk** wins the elections, he will not have strong support in parliament and so will have to cooperate either with the Party of Regions or with the Yulia Tymoshenko Bloc. It is difficult to say which economic policy will prevail if he's elected. Yatsenyuk is believed to stand for economic liberalization and his opinions on the economy are closer to that of the Party of Regions'.

What to expect: uncertain.

Early parliamentary elections are not likely

Elections to the Verkhovna Rada are scheduled for 2011, though early elections could take place next year. Although the president and other officials have been considering holding early parliamentary elections, we doubt they will take place so soon. PM Tymoshenko, whose position would be eroded by parliamentary elections, has enough power to delay early elections at least until next year. Moreover, the two major political parties—the Party of Regions and the Yulia Tymoshenko Bloc—seem to be satisfied with the current configuration of the Verkhovna Rada. Furthermore, the president can hardly dismiss parliament without support in parliament. Therefore we doubt early Rada elections will occur.

The first round of presidential elections will take place on January 17, 2010. Unless a single candidate receives the majority of votes in the first round, the second round will be held three weeks later. According to current legislation, the election campaign begins 120 days prior to the election date. The official nomination of candidates takes place between 120 to 95 days prior to the election date.

Annual Economic Indicators

	2004	2005	2006	2007	2008	2009E	2010F
Real economy							
GDP growth, % y-o-y	12.1%	2.7%	7.3%	7.9%	2.1%	-12.9%	4.5%
Nominal GDP, UAH bln	345	441	544	721	939	956	1,208
Nominal GDP, $bln	65	86	108	143	176	117	134
GDP per capita, % y-o-y	13.0%	3.4%	8.0%	8.3%	2.7%	-12.3%	5.1%
GDP per capita, $'000	1.4	1.8	2.3	3.1	3.8	2.5	2.9
Industrial output , %	12.5%	3.1%	6.2%	10.2%	-3.1%	-21.0%	11.5%
Construction, % y-o-y	17.2%	-6.6%	9.9%	15.6%	-15.8%	-40.0%	6.0%
Agricultural output, % y-o-y	19.9%	0.0%	0.4%	-5.6%	17.5%	-8.0%	5.0%
Inflation							
CPI e-o-p, % y-o-y	12.3%	10.3%	11.6%	16.6%	22.3%	20.0%	22.0%
CPI avg, % y-o-y	9.0%	13.5%	9.1%	12.8%	25.2%	18.0%	21.0%
PPI e-o-p, % y-o-y	24.1%	9.6%	15.6%	23.3%	23.0%	14.0%	20.0%
PPI avg, % y-o-y	20.5%	16.7%	9.6%	19.5%	35.5%	10.0%	17.0%
GDP deflator, % y-o-y	15.1%	24.5%	14.8%	22.7%	27.4%	17.0%	21.0%
External							
UAH/USD e-o-p	5.33	5.31	5.05	5.05	7.70	8.5	8.5
UAH/USD avg	5.32	5.12	5.05	5.05	5.35	8.2	9.0
C/A, $bln	6.9	2.5	-1.6	-5.9	-11.9	-0.5	1.0
C/A, % of GDP	10.6%	2.9%	-1.5%	-4.1%	-6.8%	-0.4%	0.7%
FDI inflow, $bln	1.7	7.5	5.7	9.2	9.9	3.7	6.8
NBU reserves, $bln	9.5	19.4	22.3	32.5	31.5	25.0	22.0
Consolidated budget							
Revenues, UAH bln	91.4	134.1	171.9	219.9	298.6	280.0	n/a
Expenditures, UAH bln	101.4	142.0	175.2	227.8	312.7	350.0	n/a
Banance, UAH bln	10.0	7.9	3.3	7.9	14.1	70.0	n/a
Balance, % of GDP	2.9%	1.8%	0.6%	1.1%	1.5%	-7.3%	n/a
Monetary and debt							
Monetary base, % y-o-y	34.1%	53.9%	17.5%	46.0%	31.6%	19.0%	21.0%
M2, y-o-y	32.8%	53.9%	34.3%	50.8%	31.0%	11.0%	14.0%
Total external debt, $bln	30.6	38.8	54.5	82.7	107.2	101.0	98.0
Total external debt, % of GDP	47.2%	45.0%	50.6%	57.9%	61.1%	98.0%	98.0%
External public debt, $bln	12.1	11.7	12.7	13.8	18.4	28.0	35.0
External public debt, % of GDP	18.7%	13.6%	11.8%	9.7%	10.5%	24.2%	26.3%

Source: Ukrstat, NBU, Phoenix Capital estimates

Monthly Economic Indicators

	7M2008	8M2008	9M2008	10M2008	11M2008	12M2008	1M2009	2M2009	3M2009	4M2009	5M2009	6M2009	7M2009
Economic growth, % y-o-y cumulative growth													
Industry	7.3%	6.3%	5.1%	2.3%	-0.8%	-3.1%	-34.1%	-32.8%	-31.9%	-31.9%	-31.9%	-31.1%	-30.4%
Extracting industry	5.0%	4.6%	4.0%	2.6%	-0.7%	-2.4%	-21.4%	-18.6%	-17.5%	-18.0%	-18.5%	-18.1%	-17.5%
Food processing	4.4%	3.3%	2.3%	0.4%	-0.6%	-0.9%	-14.3%	-12.2%	-11.1%	-8.7%	-7.3%	-5.8%	-6.3%
Light industry	2.5%	1.0%	0.6%	-0.1%	-2.0%	-3.4%	-22.2%	-20.9%	-37.5%	-35.8%	-35.3%	-33.1%	-31.3%
Wood processing	20.3%	19.1%	18.4%	16.7%	13.9%	9.6%	-46.4%	-40.3%	-40.3%	-38.7%	-38.7%	-36.7%	-35.6%
Paper industry	14.6%	13.8%	13.7%	12.3%	10.0%	7.3%	-30.6%	-25.5%	-23.9%	-22.7%	-22.9%	-22.8%	-22.4%
Coke & oil	-12.7%	-11.7%	-12.9%	-16.0%	-15.7%	-15.0%	2.4%	-6.6%	-7.4%	-9.7%	-12.5%	-13.4%	-13.6%
Chemicals & petrochemicals	5.3%	3.4%	2.9%	0.4%	-3.1%	-6.2%	-52.0%	-48.7%	-38.7%	-36.4%	-35.8%	-34.2%	-33.2%
Metallurgy	3.6%	2.1%	0.0%	-3.6%	-7.6%	-10.6%	-46.0%	-43.3%	-43.3%	-43.8%	-43.7%	-43.0%	-41.2%
Machinery	28.7%	26.6%	25.1%	20.5%	14.1%	8.6%	-64.3%	-63.8%	-54.6%	-53.7%	-53.6%	-52.5%	-52.5%
Electricity, gas and water distribution	2.2%	2.5%	2.6%	0.9%	-1.3%	-2.5%	-15.2%	-17.1%	-15.2%	-16.3%	-17.1%	-17.4%	-17.3%
Agriculture	10.9%	21.0%	15.1%	17.6%	18.0%	17.5%	0.5%	1.1%	1.7%	2.1%	2.3%	2.6%	3.8%
Construction	-2.1%	-2.6%	-7.2%	-9.6%	-13.0%	-16.0%	-57.3%	-57.6%	-56.7%	-55.6%	-55.8%	-54.9%	-54.3%
Retail trade turnover	26.6%	25.6%	24.8%	23.1%	20.5%	17.9%	-7.8%	-10.7%	-14.0%	-16.9%	-19.5%	-19.7%	-20.4%
Prices, m-o-m													
CPI, %	-0.5%	-0.1%	1.1%	1.7%	1.5%	2.1%	2.9%	1.5%	1.4%	0.9%	0.5%	1.1%	-0.1%
PPI, %	3.6%	1.8%	-1.8%	-1.4%	-6.5%	-0.4%	0.2%	1.8%	1.1%	0.4%	-0.7%	1.4%	0.7%
Money and banking													
M1, UAH bln	208	213	215	217	209	225	215	210	212	214	218	227	226
M2, UAH bln	463	471	474	477	480	513	490	468	461	463	466	470	469
M3, UAH bln	467	475	478	481	484	516	493	471	464	465	468	473	472
Reserves, $mln	37,914	38,062	37,528	31,923	32742*	31,543	28,820	26,458	25,392	24,495	27,792	27,343	29,635
Foreign currency deposits, $mln	15,229	15,360	15,662	13,882	14,078	13,667	13,044	12,233	11,922	11,940	12,122	12,531	12,929

Source: Ukrstat, NBU, Phoenix Capital estimates
** $4.5 bln IMF loan was received*

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