



Erste Bank analysts: Ukraine shows strong growth, but has yet to find a way to battle inflation

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- Strong economic growth to stay driven by domestic demand
- External deficits may widen but should stay covered by investment inflow
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- Adoption inflation targeting is not on agenda yet, but widening of FX band is likely this year
- Government plans large-scale privatization this year

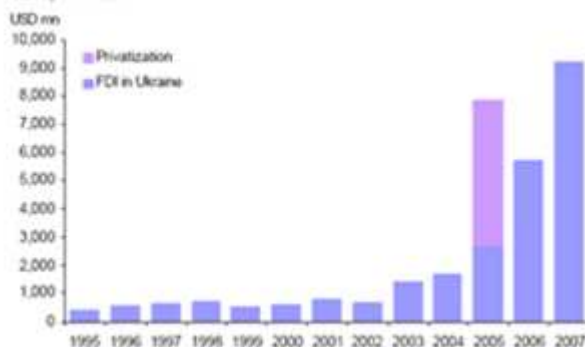
Strong economic growth remained driven by domestic demand

The real economy continued its hefty growth during the second half of 2007, benefiting from ongoing strong domestic demand and the favourable growth momentum in CIS countries (i.e. Ukraine's main trading partners). "We expect economic growth at around 6.6% in 2008. Household consumption, supported by buoyant real income and credit growth, is going to be the cornerstone of growth this year. The increase in social benefits implemented by the new government as of January should support spending as well. Surging investment activity (estimated at 20% y/y in 2007) provides a solid base for lasting economic growth in the periods ahead, especially should business activity be supported by reforms in the entrepreneurial environment (such as the labour tax code)," assumes Juraj Kotian, co-Head CEE Macro and Fixed Income Research at Erste Group.

Strong FDI inflow to continue in 2008 on M&A activities and large-scale privatization

The banking sector was the absolute leader of FDI last year, with a 37.9% share in FDIs (USD 3.5bn). In 2007, 47 banks in Ukraine had a foreign stakeholder (out of 173 registered banks). Foreign capital coming to the banking sector played an important role in speeding up economic convergence. The Ukrainian banking sector has shown impressive growth, posting an 84.5% rise in loans and a 55.5% increase in deposits for 2007. The construction and real estate sector showed impressive growth as well in 2007, attracting 21% of all FDIs. "We expect the FDI growth to continue its strong momentum in 2008. M&A in banking will continue to be a driving factor, as large deals were announced in January-March 2008. Moreover, the USD depreciation made Ukrainian assets cheaper and more attractive for European investors. Large-scale privatization should contribute greatly to FDI inflow in 2008," states Kotian.

FDI in Ukraine, 1995-2007



Source: NBU, Erste Bank Ukraine

Privatization may net USD 4-5bn in 2008

The government plans to privatize around 318 companies in 2008. There are 13 large strategic companies that are expected to bring the most revenues for the state. The government is counting on receiving about USD 1.7bn from privatization in 2008. The Erste Group analysts view this as a conservative assessment, taking into consideration the list of companies to be privatized. The sale of Ukrtelecom (67.8%) alone could exceed the government's estimates. "We think that the government will succeed in its privatization plan and might collect up to USD 4-5bn from privatizations in 2008," comments Kotian on the upcoming privatization processes.

Companies	Industry	Stake for Sale
Ukrtelecom	Telecommunications	68%
Odesa Portside Plant	Chemicals/Fertilizers	100%
Turboatom	Engineering/Turbines	75%
Poltva-oblenenergo	Electricity Distributors	25%
Lvivoblenenergo	Electricity Distributors	27%
Odesaoblenenergo	Electricity Distributors	25%
Chernihivoblenenergo	Electricity Distributors	25%
Pykarpattyaoblenenergo	Electricity Distributors	25%
Sumyoblenenergo	Electricity Distributors	25%
Centreneuro	Electricity Generators	60%
Donbasenergo	Electricity Generators	60%
Zakhdenergo	Electricity Generators	60%
Dniproenergo	Electricity Generators	60%

Notes: *The stake has not been finalized yet, the case is in court
Source: SPF, Erste Bank Ukraine

Inflation will stay near 20% until midyear

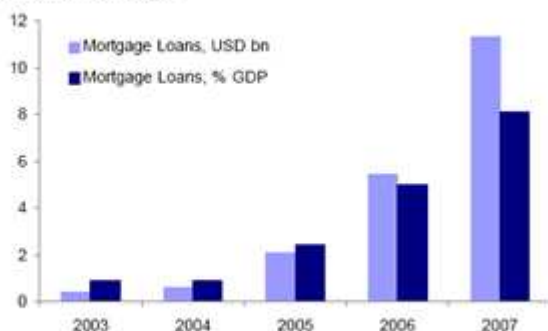
Inflation remains one of the most problematic issues for the Ukrainian economy. Consumer inflation gradually increased to above 20% at the beginning of this year and will stay near this level until the middle of the year. Later in the year, a favourable harvest is expected to help the disinflationary process. Nevertheless, inflation will likely finish the year at around 15%. The government has declared that it will adopt anti-inflationary measures, which should get inflation down from the recent highs. "We expect the anti-inflationary package to consist of a set of mutual tasks for both the government and the central bank. We expect the anti-inflationary package to be primarily focused on limiting the adverse effect of the

expansionary fiscal policy on inflation. However, it is unlikely that the government will come up with an explicit proposal to reduce the planned budget deficit," suppose the Erste Group analysts.

Real estate growth will vary, depending on market segmentation

Ukrainian real estate has been growing at an astonishing pace. According to the Ukrainian Association of Realtors, the average residential prices increased by 40% p.a. for the past three years. Investments in Ukrainian real estate increased dramatically over the past few years, starting from USD 24mn in 2005 and reaching USD 1.1bn in 2007. The capital city of Kyiv, with a population of 2.74mn (6% of the total Ukrainian population), was the absolute leader in terms of real estate deals (residential real estate prices have increased by 49% p.a. for the past three years in Kyiv).

Mortgage Loans in Ukraine, 2003-07



Source: NBU, Erste Bank Ukraine, UNIA

Mortgage loans doubled in 2007

The affordability of mortgage loans, growing disposable income and the change in people's attitude toward credit (more trust in LT borrowing) have been contributing to the real estate boom in Ukraine. The interest rates on mortgage loans (currently about 11-14%), although high compared to European standards (5-6%), have substantially declined over the past few years. In 2007, the outstanding volume of mortgage loans doubled to USD 11.3bn (8.1% of GDP). Retail clients preferred foreign currency for mortgage loans (89% in 2007). The city of Kyiv and the Kyiv region accounted for 27% of mortgage loans issued in 2007. "We think that the Ukrainian real estate market will continue with wealthy growth in 2008. Although the pace of growth in residential real estate prices decelerated in 2007, we are confident that the market has not reached the level of saturation. There is a different dynamic of growth among the regions, depending on the level of the economy in each region and the different segmentation of the housing market," so Erste Group analysts.

After strong rally in 2007, the Ukrainian Stock market PFTS faced correction in early 2008, in line with global markets

The Ukrainian stock market showed an incredible performance of 135.4% for the PFTS Index, a 142.5% increase of the market capitalization to USD 111.8bn in 2007, and was not strongly affected by fluctuations on international markets (as it has low liquidity). Ukrainian companies became more transparent in 2007, which led to greater interest among foreign investors. Metallurgical companies, machine builders and distributors/generators of electricity were the top-performing sectors. Kyivenergo (KIEN UZ) was a top-performing Tier-1 stock, returning a 429% gain for the year. The market is mostly supported by foreign institutional investors with an investment horizon of more than one year, who expect their investments to grow no less than 20-30% per year.

Last year successful for IPOs, this year looks more moderate

2007 was a record year for Ukrainian IPOs. The total volume of IPOs with additional share issuance amounted to USD 1.89bn. Ukrainian companies preferred foreign exchanges for their IPOs - the London SE, Frankfurt SE

and Warsaw SE. The Ferrexpo (the leading Ukrainian iron producer) IPO raised USD 420mn on the London SE (the first listing of the Ukrainian company on this exchange). Real estate and food processing companies were also active on the international exchanges. The sub-prime mortgage turmoil had a negative impact on IPOs of Ukrainian companies. Thus, many companies that had planned an IPO for 2008 have postponed it until later this year or next year. "We believe, that the global sentiment will play a major role in the performance of the PFTS in 2008. Among positive factors that could help the market to rebound could be the upcoming privatization and auctioning of state-owned company stakes (some of them will be auctioned directly on the PFTS), improved transparency of the companies and better financial results. It is positive that internal demand has been on the rise, as asset managers have increased the share of internal capital in their portfolios. Moreover, the large government pension funds, such as the state post office and state railway company, have hired asset management companies to manage their funds. If the global markets calm down in 1H08, the PFTS Index has a good chance to gain back the lost positions and show moderate double-digit growth in 2008," sum the Erste Group analysts up.

Equity market performance



Political status quo is expected to be preserved until next presidential election in 2010

Political situation in Ukraine has stabilized after the 2007 parliamentary elections. "We think that, despite the increased risk of political vulnerability in the country, the economy will continue on its path to growth. It is most likely that the current status quo will remain in the political framework of Ukraine until the next presidential election," means Kotian. The popularity of the current governing coalition is increasing, although the disputes between the coalition and opposition have been causing blocking of parliamentary work. One of the disputable issues – NATO membership – was agreed to be resolved by putting the issue to a state referendum. On March 13th another critical issue was resolved - Naftogaz of Ukraine and Gazprom agreed on the gas price of 179.5 tcm as of 2008. Despite this Ukraine is at serious risk of gas prices climbing up next year, as Central Asian countries declared that they will start selling gas to Ukraine at European prices starting 2009.

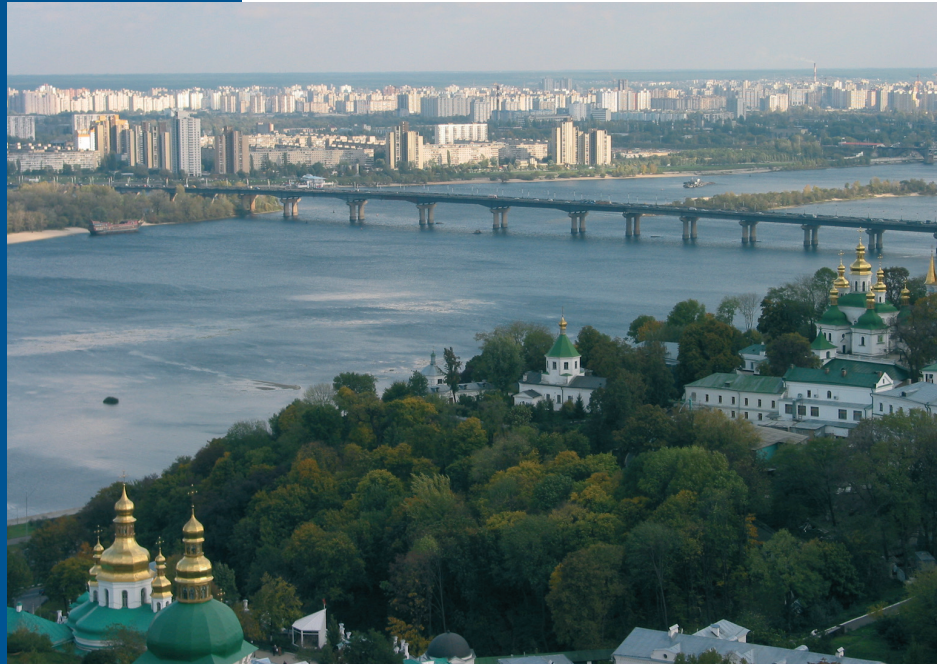
After the 14 years of negotiations Ukraine's accession to the WTO is almost complete – waiting only on ratification by Parliament. In the long term, WTO entry would enhance the competitiveness of the Ukrainian economy. Export-oriented sectors such as metallurgy and chemicals should benefit the most from WTO entry. The most sensitive industries, such as agriculture, food-processing and the automotive industry will get a 5-year transition period to adjust to the WTO standards.

[Country Report Ukraine \[pdf; 1,5 MB\]](#)

[Country Report Ukraine - Presentation \[pdf; 266,8 KB\]](#)

Country Report

Ukraine



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Introduction

At the time that we published our last country report on Ukraine six months ago, it was shortly before the elections and there was a lot of uncertainty about the ability of the country to escape from political deadlock. The situation has improved since then, as Parliament has started to function. Now, the main question is how fast the pace of economic convergence is, with GDP per capita of EUR 2,100, about a quarter of the average for CEE countries. Entering the WTO (World Trade Organization) should be a significant step forward in this area, as liberalization of trade will accelerate the catch-up process by taking advantage of Ukraine's many competitive advantages.

Ukraine is a very interesting market in terms of size, location and growth potential. The economy now enjoys strong growth of income, consumption and investments, without severe external imbalances like the Baltic and Balkan countries have been facing. However, double-digit growth of household consumption, well above the productivity growth, will translate into a worsened external balance. Fortunately, the surplus of the balance of services (thanks to income from oil and gas transport), together with strong FDI inflows, have sufficiently covered trade deficit financing needs. Furthermore, the government outlined an ambitious privatization plan, ensuring that strong FDI inflow will continue this year.

Inflation, which recently climbed to 20%, has started to create worries. Besides external factors, such as the increase of food, oil and natural gas prices, there have been some strong local specifics. In order to tackle the high inflation, the government and central bank are likely to present a package of anti-inflationary short-term and mid-term measures, which should help to compress inflation. After some discussions with Ukrainian officials, we had to conclude that a switch of the currency regime to free float is very unlikely in the next two years, as there is only limited room for implementation of strict inflation targeting (inflation would be the only nominal anchor). In any case, widening of the fluctuation band remains our expected scenario for this year.

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Macroeconomic indicators

	2005	2006	2007E	2008F	2009F
Nominal GDP (Loc. Curr., mn)	441452	537667	709445	908090	1098788
Population (mn)	46.9	46.6	46.4	46.1	45.8
GDP per capita (Loc. Curr.)	9407	11527	15301	19703	24009
Real GDP (growth y/y %)	2.6	7.1	7.3	6.6	6.0
Private Consumption (growth y/y %)	20.6	14.4	17.4	8.7	10.0
Fixed Capital Formation (growth y/y %)	3.9	18.7	22.0	10.0	10.0
Nominal Wages (Loc. Curr.)	806	1043	1353	1799	2249
Nominal Wages (growth y/y %)	36.5	29.4	29.7	33.0	25.0
Retail sales (growth y/y %)	23.4	25.3	28.8	23.0	20.0
Industrial production (y/y %)	3.1	6.2	10.2	10.0	8.0
CPI (y/y, average%)	13.5	9.2	12.8	19.6	13.6
CPI (y/y, year-end%)	10.3	11.6	16.6	15.2	12.0
Unemployment (ILO, %)	7.8	7.4	7.2	7.1	6.7
Exports fob (USD, mn)	34287	38368	49248	60575	75113
Imports cif (USD, mn)	36141	45034	60669	77050	95542
Trade balance (% of GDP)	-2.2	-6.3	-8.1	-9.0	-9.0
Foreign direct investment (% of GDP)	8.8	5.0	6.5	6.6	3.8
Current account balance (% of GDP)	2.9	-2.9	-4.2	-5.8	-5.6
Govt. budget balance (% of GDP)	-1.8	-0.7	-1.1	-2.0	-3.0
Public debt (% of GDP)	17.7	14.8	13.0	11.2	11.0
Foreign debt to GDP (%)	46.6	51.0	60.0	55.0	52.5
Central bank intervention rate, average	9.2	9.0	8.2	10.0	9.5
Central bank intervention rate, year-end	9.5	8.5	8.0	10.0	9.0
Short term interest rate (3 months) average	12.7	13.5	9.8	10.9	10.0
Short term interest rate (3 months) year-end	16.0	15.0	11.4	10.5	9.5
Loc. Curr./USD average	5.12	5.05	5.03	4.95	4.82
Loc. Curr./USD year-end	5.05	5.05	5.05	4.85	4.75
Loc. Curr./EUR average	6.39	6.34	6.89	6.98	6.27
Loc. Curr./EUR year-end	5.97	6.65	7.42	6.55	5.94

Source: Ukrstat, NBU, SLSP, Erste Bank Ukraine

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Politics

Political status quo is expected to be preserved until next presidential election in 2010

After the 2007 early parliamentary elections, the political situation in Ukraine has stabilized, although disputes between the coalition parties occasionally appear and the blocking of parliamentary work by the opposition remains a usual tactic. Currently, both the coalition and opposition parties aim for reform of the Constitution, even though the implementation would be a challenging task (300 votes are needed to implement changes).

NATO issue will be put to state referendum

The work of Parliament was paralyzed for almost a month at the beginning of this year by the opposition parties, which protested against closer ties with NATO. Finally, on March 6, consensus was reached between the coalition parties and the opposition Party of the Regions and Parliament resumed its work. Both sides agreed that the NATO issue should be put to a state referendum, but the deadline for the referendum has not been scheduled. Closer ties with NATO will be discussed during the NATO summit in Bucharest on April 2-4.

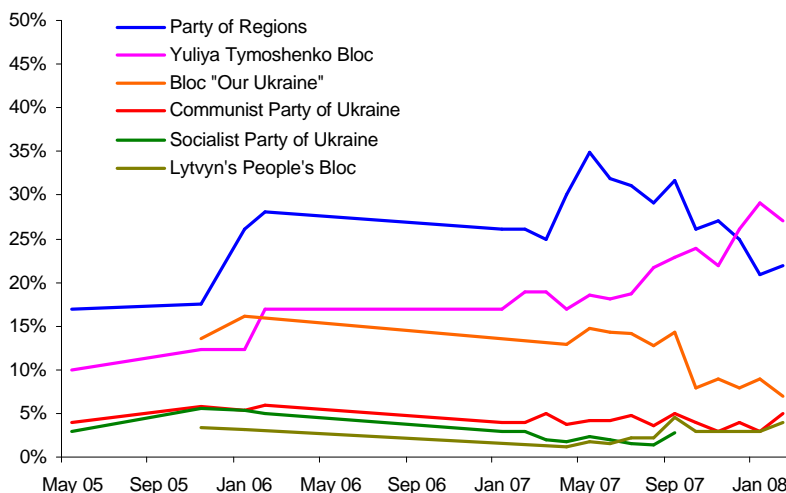
Ukraine to pay originally agreed price for natural gas in 2007

After the gas disruption in March, when Gazprom decreased the volume supply to Ukraine by 25-50% for two days as a result of several disputed issues (such as the gas debt to Gazprom and the existence of intermediary companies), an agreement was reached on March 13, 2008. As a result, Naftogaz of Ukraine (a gas distribution company) will pay USD 179.5 tcm as of 2008, the price which was settled originally in 2007. In addition, Gazprom will be allowed to sell 7.5 bcm of gas to Ukrainian industrial consumers under direct contracts (12-15% of the industrial market share) in 2008. Central Asian countries declared that they will start selling gas at European prices starting in 2009. This provides a serious upward risk for gas prices next year, as Ukraine is a main consumer of Central Asian gas (Russia buys all gas from Central Asian producers and resells it to Ukraine).

Popularity of PM has been on rise

The popularity of the current governing coalition is increasing. Recent polls show that Tymoshenko's personal approval rate was much higher than that of opposition leader Yanukovich, at 35% and 24%, respectively. The popularity of Tymoshenko's BYuT party has been on the rise as well. She enjoys the support of 27% of the voters, vs. 22% for the Party of the Regions. Also, other polls conducted by a number of Ukrainian poll agencies have also been showing the increasing popularity of Tymoshenko's government. We think that, despite the increased risk of political vulnerability in the country, the economy will continue on its path to growth. It is most likely that the current status quo will remain in the political framework of Ukraine until the next presidential election.

Current preferences for political parties (May 2005 - Feb 2008)

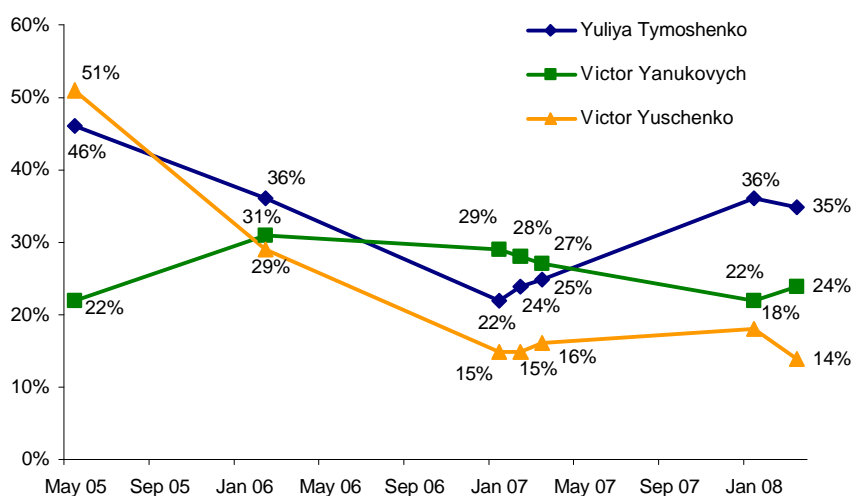


Source: FOM & other agencies, Erste Bank Ukraine

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Rating of Ukrainian Politicians



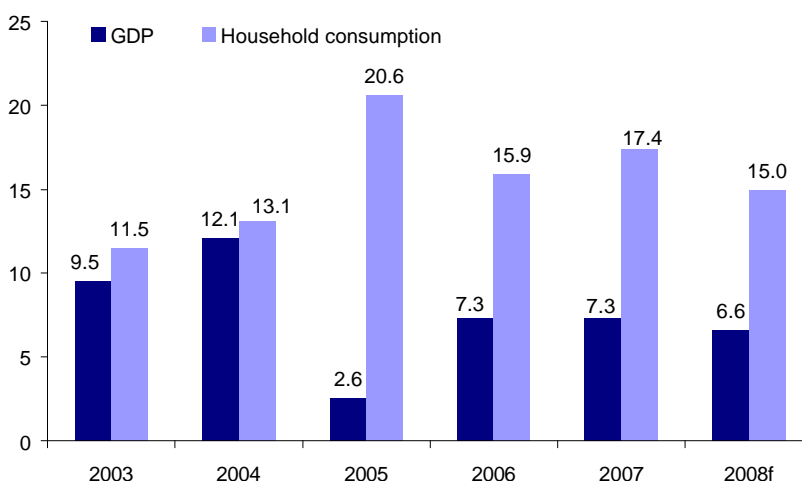
Source: FOM, Erste Bank Ukraine

Real economy

Strong economic growth remained driven by domestic demand

The real economy continued its hefty growth during the second half of 2007, benefiting from ongoing strong domestic demand and the favorable growth momentum in CIS countries (i.e. Ukraine's main trading partners). Real GDP growth reached 7.3% last year, slowing down at the beginning of this year to 5.8% (annual growth for January-February 2008). We expect economic growth at around 6.6% in 2008. Household consumption, supported by buoyant real income and credit growth, is going to be the cornerstone of growth this year as well. The increase in social benefits implemented by the new government as of January should support spending as well. Surging investment activity (estimated at 20% y/y in 2007) provides a solid base for lasting economic growth in the periods ahead, especially should business activity be supported by reforms in the entrepreneurial environment (such as the labor tax code). During last year, investments were made mainly in manufacturing, where companies were trying to increase their energy efficiency (especially by cutting natural gas consumption) in their production processes, and in real estate activities. These two sectors, along with trade, also generated the highest added value.

Real GDP and household consumption growth (%)

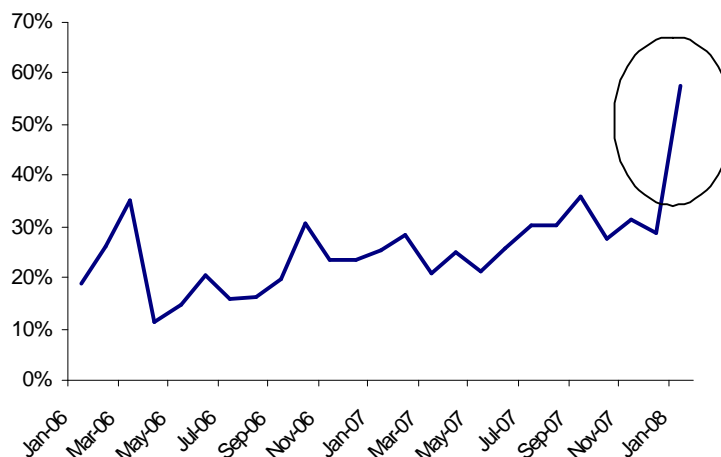


Source: Ukrstat

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New government dramatically increased social benefits as of January



Source: Ukrstat, social benefits and other current transfers, annual growth rate

Improvement on labor market slowed down

Improvement on the labor market slowed down last year, when the number of unemployed people declined by just an estimated 30 thousand. The unemployment rate (based on ILO methodology) stood at 6.7% in September 2007 and is expected to finish the year higher, slightly above 7%. As the labor market shows the lack of qualified labor work, we expect employment gains at a rather modest 0.4% in the coming years. The registered unemployment rate (counted from people who are ready to start working) remains constantly low at around 2.5%. Wage growth in nominal terms will stay strong (at around 30%) this year, putting the real wage growth at slightly above 10%, due to high inflation. Nevertheless, wages remained low in comparison to neighboring countries, officially at less than EUR 200 a month.

Import growth to stay strong this year

Higher investments showed up in ballooning imports, along with higher imports of consumer goods (such as cars) and mineral products (especially natural gas). The fast growth in imports should continue, as all main contributors of last year's increase should stay in place in 2008. More specifically, company profits increased last year by a huge 60%, providing a solid base for capital expenditures this year. Furthermore, real income will likely increase by at least 10%, implying higher demand for consumer goods. Finally, natural gas prices already increased in January by 38%, bolstering energy imports.

Competitiveness of production did not deteriorate, despite higher natural gas prices

Interestingly enough, production branches such as the chemical and other than metallurgical industries were able to cope with the recent increase in natural gas prices very well. Factories, forced to increase their investments and efficiency, were able to raise their production and profits significantly last year (please see the figure). The key export segment - metallurgy - has been benefiting from high world steel prices. Agriculture is also expected to increase production, as this year's harvest forecasts are optimistic so far. The grain crop is expected to increase to 38-40mn tons, representing a 30-37% increase from last year's drought-hit harvest. Engineering is a rising star within the industrial sector, which is a positive factor, given the narrower segmentation of the Ukrainian economy.

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2007: Increase in industrial production and profits of industries

	Financial result before taxation (mln. UAH)	Change in profit versus 2006 (%)	Change in production volumes versus 2006 (%)
Industrial production, total	42136	21.4	10.2
Mining	8143	51.6	2.7
Production and distribution of electricity, gas and water	2731	-50.1	
Manufacturing	31262	31.1	11.7
of which:			
metallurgy and production of finished metal products	16087	26.5	8.3
engineering	4475	133.5	28.6
manufacture of machinery and equipment	1187	61.6	15.3
manufacture of electrical, electronic and optical equipment	1211	105.9	22.6
manufacture of transport vehicles and equipment	2078	249.4	42.3
production of foodstuffs, beverages and tobacco products	3525	-20.3	10
chemical and petrochemical industry	1983	40.5	6.2

Source: Ukrstat

External deficit covered by investment inflow

While exports increased by a solid 28.4% last year, the trade deficit still widened to 8.1% of GDP. Widening of the trade gap is not necessarily a bad thing in a converging economy with a significant share of investment imports, such as Ukraine. Unfortunately, excessive growth of household consumption - well above the overall GDP growth - suggests that Ukraine might face growing external imbalances. In this environment, a deterioration of the trade deficit is a very likely scenario for this year. What might soften the problem of the deteriorating trade balance is a surplus of the balance of services, which helped to pull up the current account gap to 4.2% of GDP in 2007. Positively, the current account deficit was sufficiently covered by FDI inflow, which reached a record USD 9.2bn last year (and increased by 60.7% over the previous year).

Banking sector attracted biggest share of FDIs

For the past three years, investments in Ukraine have significantly increased, due to the growing economy and attractiveness of Ukrainian assets. The banking sector was the absolute leader of FDI last year, with a 37.9% share in FDIs (USD 3.5bn). In 2007, 47 banks in Ukraine had a foreign stakeholder (out of 173 registered banks). Foreign capital coming to the banking sector played an important role in speeding up economic convergence. The Ukrainian banking sector has shown impressive growth, posting an 84.5% rise in loans and a 55.5% increase in deposits for 2007. The construction and real estate sector showed impressive growth as well in 2007, attracting 21% of all FDIs.

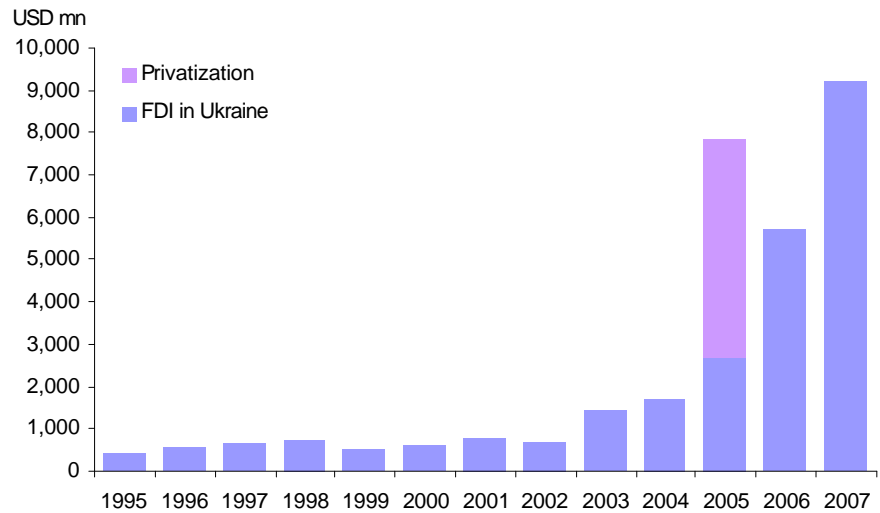
Strong FDI inflow to continue in 2008 on M&A activities and large-scale privatization

We expect the FDI growth to continue its strong momentum in 2008. M&A in banking will continue to be a driving factor, as large deals were announced in January-March 2008. Moreover, the USD depreciation made Ukrainian assets cheaper and more attractive for European investors. Large-scale privatization should contribute greatly to FDI inflow in 2008.

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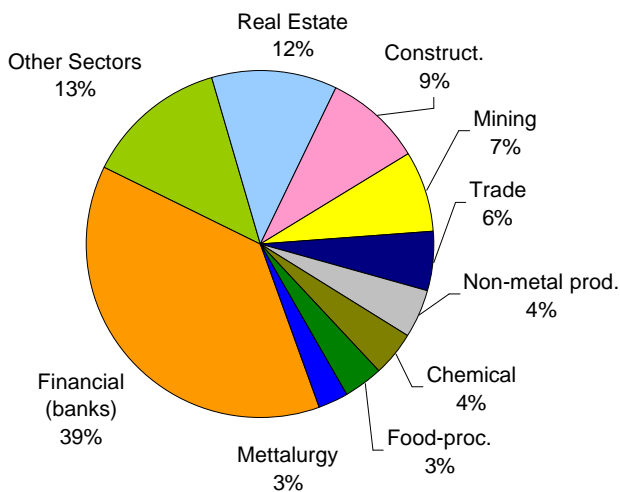
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FDI in Ukraine, 1995-2007



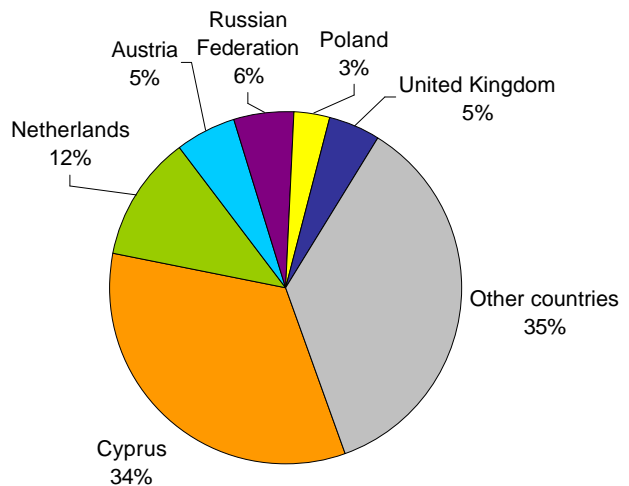
Source: NBU, Erste Bank Ukraine

FDI sector breakdown in 2007



Source: NBU, Ukrstat, Erste Bank Ukraine

FDI country breakdown in 2007



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Privatization

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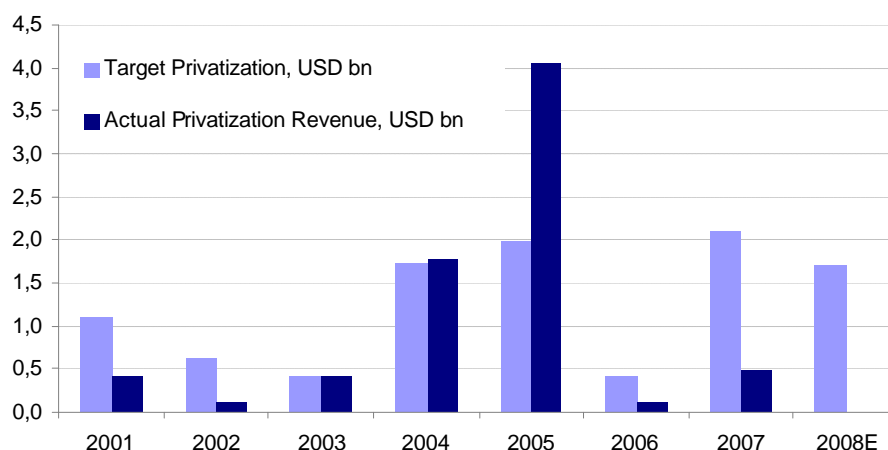
Opposition does not agree on privatization plan

The government privatization plan has been scrutinized by the opposition parties. They are concerned about the sale of strategic enterprises, such as Odessa Portside Plant (the main fertilizer producer in the country), Turboatom (the main turbine producer) and Ukrtelecom (the main fixed-line and telecommunication company). The opposition leaders proposed a moratorium on the privatization of state-owned strategic enterprises.

Privatization may net USD 4-5bn in 2008

We think that the government will succeed in its privatization plan. The government has already announced that in late spring it will proceed with the sale of six electricity distribution companies, selling shares on the local stock exchange PFTS, which is good news for investors and the local stock market. We estimate that the government might collect up to USD 4-5bn from privatizations in 2008.

Target Privatization vs. Actual Privatization Revenue: 2001-2008e



Source: MinFin, SPF, Erste Bank Ukraine

Companies	Industry	Stake for Sale
Ukrtelecom	Telecommunications	68%
Odesa Portside Plant	Chemicals/Fertilizers	100%
Turboatom	Engineering /Turbines	75%
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Sumyoblenergo	Electricity Distributors	25%
Centrenergo	Electricity Generators	60%
Donbasenergo	Electricity Generators	60%
Zakhidenergo	Electricity Generators	60%
Dniproenergo	Electricity Generators	60%*

Notes: *The stake has not been finalized yet; the case is in court

Source: SPF, Erste Bank Ukraine

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WTO membership to bring benefits of free trade and faster growth

After 14 years of negotiation, Ukraine's accession to the WTO is almost complete - waiting only on ratification by Parliament

Main benefits include:

- trade liberalization will accelerate trade flows (quantitative restrictions on the trade flows with Ukraine will be eliminated by the WTO members and all the quotas will be lifted)
- the Ministry of Finance forecasts a positive impact on GDP growth at around 1-2% p.a. in the medium-term, which we see as realistic
- exports and imports are expected to increase by 5-8% p.a., as almost 60% of Ukrainian trade is with WTO members
- the most favored nation treatment
- access to the WTO dispute settlement mechanism
- WTO membership enables the country to begin talks on establishing a free trade zone with the EU

Competitiveness of Ukrainian economy should rise in long term

In the long term, WTO entry would enhance the competitiveness of the Ukrainian economy. Export-oriented sectors such as metallurgy and chemicals should benefit the most from WTO entry. The EU is expected to lift quotas on Ukrainian steel, when a free trade zone agreement with the EU is signed (expected in 2010-12). Ukraine produced 42.8mn tons of steel in 2007, or 3.2% of the world total. The chemical industry is undergoing a modernization process and counterbalancing the 38% gas price increase may get a bit of relief from entering the WTO. The world demand for fertilizers is expected to be strong in 2008 as well. The agricultural and food-processing industries may be hurt in the short term because of market competition, but in the long term, they would benefit, as they would have to modernize and restructure their production chain. The automotive industry would also face tougher competition with WTO entry. The WTO agreement stipulates an import duty reduction on new cars from the current 25% to 10%. New car sales increased last year by an impressive 46%, reaching 542th cars (Ukraine was ranked No. 7 in new car sales in Europe last year). The most sensitive industries, such as agriculture, food-processing and the automotive industry will get a 5-year transition period to adjust to the WTO standards.

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Price development

Inflation will stay near 20% until mid-year

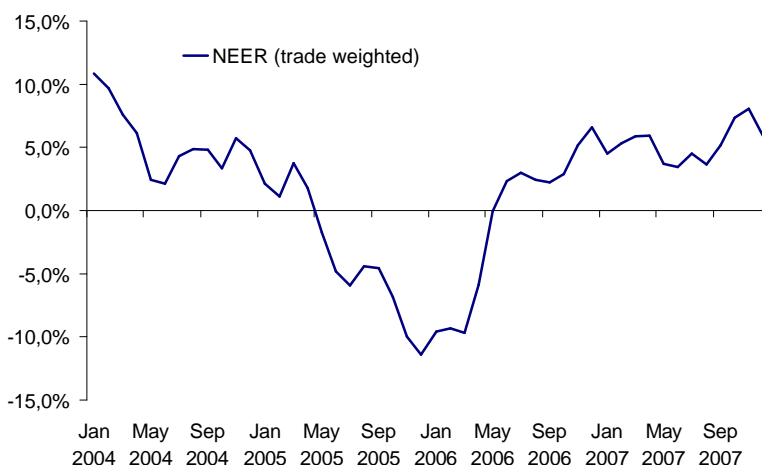
Inflation remains one of the most problematic issues for the Ukrainian economy. Consumer inflation gradually increased to above 20% at the beginning of this year and will stay near this level until the middle of the year. There are plenty of factors that caused the acceleration of price growth. Besides external factors, such as the increase of food, oil and natural gas prices, there have been some strong local specifics. The first one is the extraordinarily high weight of food in the consumer basket (almost 60%), almost triple that of other CEE countries, meaning that Ukrainian CPI captures more or less the development of food prices. Another pro-inflationary factor comes from the currency peg to the weakening US dollar (which lost 11.5% against the euro in 2007 and an additional 6% this year), which effectively means a relative devaluation of the Ukrainian currency measured through the Nominal Effective Exchange Rate (NEER). The depreciating exchange rate does not help in the disinflation effort, as the weaker currency generally eases monetary conditions in an economy.

Consumer inflation (annual growth, %)



Source: Ukrstat, Erste Bank Ukraine

Nominal effective exchange rate (NEER)



Source: Bloomberg, Erste Bank Ukraine

Good harvest should help reduce inflation only partially

Later in the year, a favorable harvest is expected to help the disinflationary process. Nevertheless, inflation will likely finish the year at around 15%. A good harvest seems too little to compensate for other factors fuelling Ukrainian inflation and raising

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inflationary expectations from the medium-term point of view. The government has declared that it will adopt anti-inflationary measures, which should get inflation down from the recent highs.

Government to adopt anti-inflationary measures in accordance with NBU

It is clear that neither the government nor the NBU alone can successfully curb inflation. That is why we expect the anti-inflationary package to consist of a set of mutual tasks for both the government and the central bank. In countries with an explicit inflation targeting regime, the responsibility for inflation is at the central bank. In Ukraine, the responsibility of the central bank is to keep the currency stable; the still unliberalized energy and transport prices provide only limited room for maneuvering with inflation. That is why we expect the anti-inflationary package to be primarily focused on limiting the adverse effect of the expansionary fiscal policy on inflation. However, it is unlikely that the government will come up with an explicit proposal to reduce the planned budget deficit. Thus, strictly adhering to the ceiling for expenditures might be a more feasible measure. This would secure a scenario in which higher than budgeted tax intake and privatization receipts do not increase expenditures further and provide additional stimulus for inflation growth. Any initiatives in terms of structural changes of public expenditures would be welcomed, especially those that limit growth of government transfers and consumption, which have been boosting average disposable income of households above productivity growth.

Deceleration of credit growth among main goals

The central bank's contribution in the fight against inflation will likely be to slow credit growth. Some initiatives have already been introduced (see the monetary policy section) that have been focused on the reduction of excessive liquidity from the market. Now, the government might be supportive in this area through issuing primary local currency-denominated debt, which would drain liquidity further and constrain credit growth. Some minor measures might appear in the area of stronger supervision focused on currency misalignments on balance sheets and prudence of credit risk policy, which would help to restrict credit growth.

Medium-term goal is to switch to inflation targeting and free float

The evidence from other transition countries has been that it is not possible to keep inflation low without having an open currency channel, which would take over part of price convergence from inflation. Thus, one of the mid-term goals for the Ukrainian central bank remains to switch to free float and inflation targeting. However, before switching to inflation targeting, utility prices have to be liberalized, or at least a binding deregulation schedule has to be approved by Parliament, which would make price adjustments more predictable and help to avoid sudden sharp increases of utility prices.

Short-term price caps might at least help to anchor inflation expectations

However, most of above-mentioned measures will have a positive impact on inflation only in the mid-term. That is why the government obviously needs to buy time with a proposal of some short-term measures, which would be easy to understand by the public and cut inflation expectations in the economy. The Ministry of the Economy on March 15, 2008, proposed administrative measures to regulate the situation on the food market. According to the draft, retail prices for main food products such as bread, sunflower oil, meat and dairy products will be limited to 15% above wholesale prices, excluding transport costs. Moreover, to elevate the inflation pressure, the government proposed to limit profits of food producers to 12% above costs.

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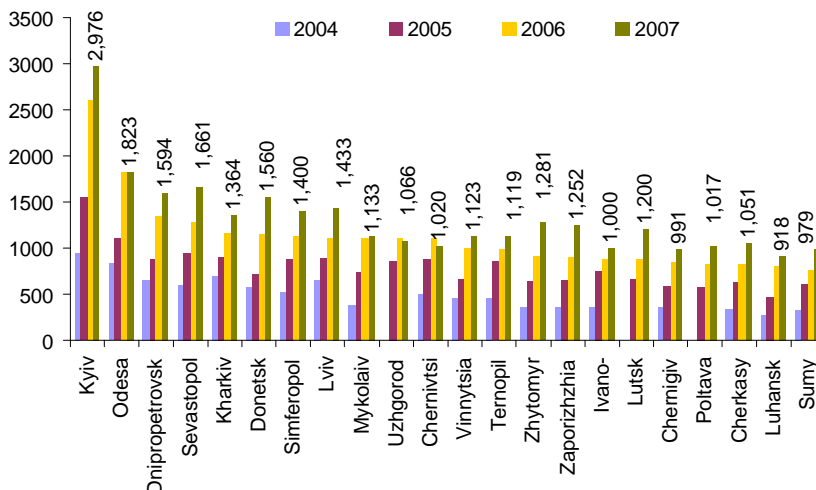
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Housing market

Real estate growth will vary, depending on market segmentation

Ukrainian real estate has been growing at an astonishing pace. According to the Ukrainian Association of Realtors, the average residential prices increased by 40% p.a. for the past three years. Investments in Ukrainian real estate increased dramatically over the past few years, starting from USD 24mn in 2005 and reaching USD 1.1bn in 2007. The capital city of Kyiv, with a population of 2.74mn (6% of the total Ukrainian population), was the absolute leader in terms of real estate deals (residential real estate prices have increased by 49% p.a. for the past three years in Kyiv).

Average retail prices for main Ukrainian cities USD per sqm, 2004-07

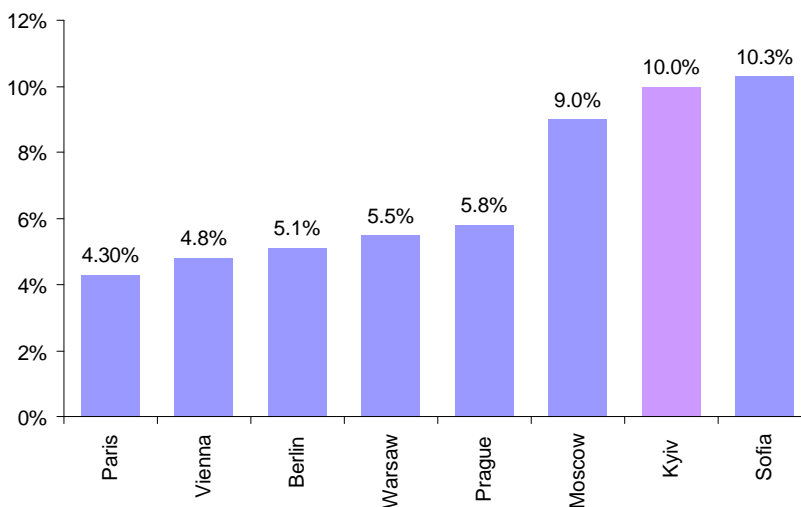


Source: Ukrainian Association of Realtors, Erste Bank Ukraine

Small supply of commercial real estate pushed yields up

Besides residential real estate, commercial real estate has been in high demand, as Ukraine has lagged in developing modern offices, retail stores and warehouse properties. The shortage of commercial real estate has driven yields upward, giving Ukraine the leading position in the CEE region. Vacancy rates in Ukraine are below 2%, much lower than in neighboring Poland (Warsaw: 4%). Ukraine qualified for the top-5 most attractive countries for retail worldwide in A.T. Kearney's 2007 Global Retail Development Index. In warehousing space, there is also a large misbalance in supply and demand. The stock of quality commercial warehousing of 320ths sqm was five times lower than in Warsaw.

Office Prime Real Estate Yields (2006)

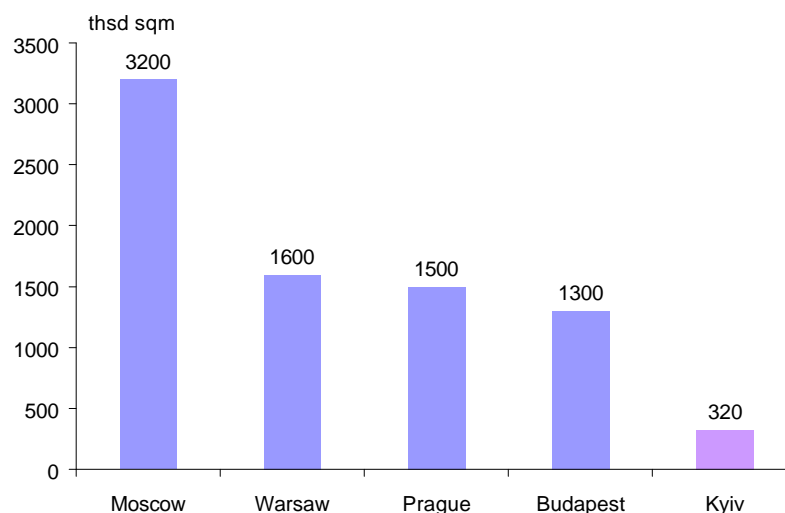


Source: CB Richard Ellis, Erste Bank Ukraine

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Stock of Warehousing Space (thsd sqm, 3Q07)

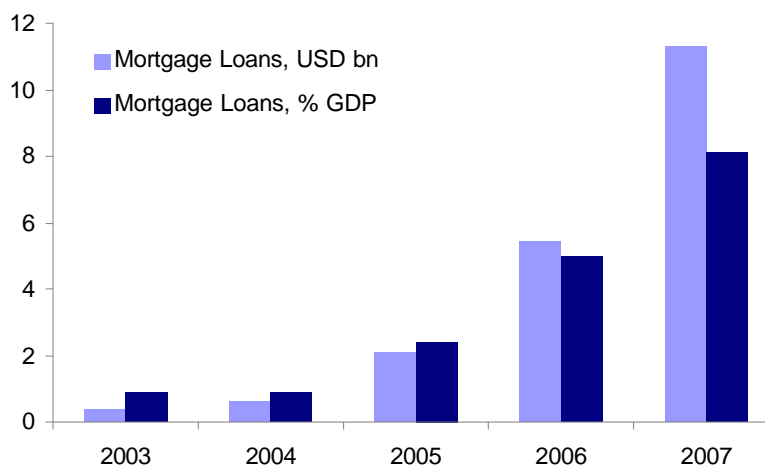


Source: DTZ, Erste Bank Ukraine

Mortgage loans seeing boom

The affordability of mortgage loans, growing disposable income and the change in people's attitude toward credit (more trust in LT borrowing) have been contributing to the real estate boom in Ukraine. The interest rates on mortgage loans (currently about 11-14%), although high compared to European standards (5-6%), have substantially declined over the past few years. In 2007, the outstanding volume of mortgage loans doubled to USD 11.3bn (8.1% of GDP). Retail clients preferred foreign currency for mortgage loans (89% in 2007). The city of Kyiv and the Kyiv region accounted for 27% of mortgage loans issued in 2007.

Mortgage Loans in Ukraine, 2003-07



Source: NBU, Erste Bank Ukraine, UNIA

Housing market to expand in coming periods

We think that the Ukrainian real estate market will continue with healthy growth in 2008. Although the pace of growth in residential real estate prices decelerated in 2007, we are confident that the market has not reached the level of saturation. There is a different dynamic of growth among the regions, depending on the level of the economy in each region and the different segmentation of the housing market. It is important to note that the moratorium on the sale of land to foreigners in Ukraine has been upheld for next year by Parliament.

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Monetary policy

Inflation targeting regime will not become reality soon

On the monetary policy front, the status quo in the current pegged FX regime is a very likely scenario for the central bank. Although the widening of the current band this year remains our baseline scenario, a switch towards an inflation targeting regime will not be delivered so soon - not in 2008, and probably not next year either. Why? The fixed FX regime is seen by the NBU as the only nominal anchor that it can keep under control. The first reason why the NBU does not switch to inflation targeting and sticks to the currency peg is the still unliberalized prices in the energy and transportation sectors. Hence, there are exogenous factors affecting inflation in Ukraine, which are less predictable and beyond the scope of NBU policy. For example, prices of natural gas are still to rise in the coming years - in total, by around 70%, in order to reach European standards. However, the schedule of adjustment is not known. Another factor for the NBU's sticking with the FX peg is a missing measure of core inflation. Another reason arguing against hurrying to float the currency is the lack of political stability. In politically unstable times, the chances of currency depreciation are not negligible; free float has served on some occasions as a disciplining device for government actions in CEE countries in recent years.

We expect widening of band this year

Although a widening of the currency band is very likely this year, in the medium term, the price convergence will take a path almost solely through inflation, rather than through a combination of exchange rate appreciation and inflation, as was the case in CEE countries. For this year, we stick to our older forecast of a shift in the stronger band to 4.85 UAH/USD from the current 4.95UAH/USD.

Central bank tightened its policy...

Interest rates are not seen as a very efficient monetary policy tool that could significantly help the central bank in its disinflationary effort. Hence, we would not expect severe increases in policy rates in the next few months. Currently, the key interest rate stands at 10%. The central bank will instead try to limit excess liquidity, increase reserve requirements and continue issuing Depo Certificates.

... via draining liquidity from market...

Indeed, the times of cheap hryvnia funds, when 1-month (ask) rates were at 3.0-3.5% and the Ukrainian interbank market enjoyed excess liquidity at the level of UAH 15-17bn, are already in the past. In the first quarter, the 1-month rates reached on average 6.4%. Since the fourth quarter of 2007, the National Bank of Ukraine started gradually reducing the liquidity via deposit certificates, treating this as one of the tools to curb credit growth and inflation.

... increasing minimum reserves

The extension of the minimum reserve requirements to funds obtained from banks and foreign financial institutions introduced in November 2007 has substantially raised the amount of minimum reserves by 75% to UAH 9.7bn in December 2007. The volume of excess liquidity has been shrinking, from UAH 8-10bn in January 2008 to UAH 3-5bn in March 2008, as the government has been very efficient in tax collection, draining liquidity from the market. This has impacted the price of resources and the money market rates have returned to their historical maximum levels (1M at 15.55% on March 18, 2008, and 3M at 13.0% on March 18, 2008), while the yield curve has become inverted.

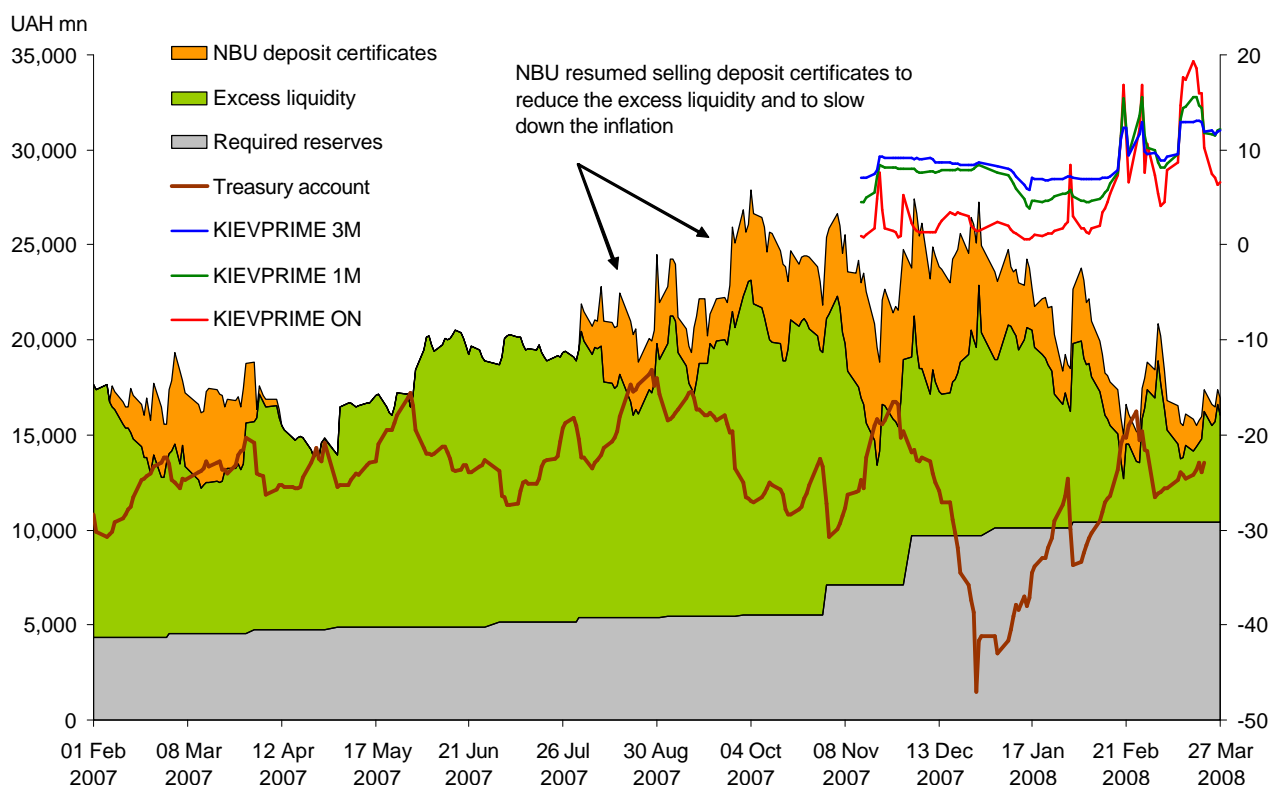
Drained liquidity increased demand for hryvnia

During the period of low liquidity, banks had to sell their dollar resources to increase their hryvnia liquidity. This pushed the USD/UAH exchange rate during the third week of February and second week of March to the stronger end of the band (4.95-5.00 USDUAH). The central bank has even resumed overnight refinancing on a large scale to calm the market, which was not the case last year. Given the clear intention of the central bank to reduce excess liquidity, we expect money market rates to remain elevated in 2008.

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Liquidity monitor



Source: NBU, State Treasury, Bloomberg, Erste Bank Ukraine

Fiscal policy

State budget deficit should be maintained at 2% of GDP

The government expects the state budget deficit for 2008 to reach 2.0% of GDP or USD 3.4bn. Parliament has approved a preliminary state budget for 2008 with amendments. In the spring of 2008, the government is expected to come up with the amended and final version of the state budget for 2008. This was part of the deal between the government and Parliament that stipulated the approval of the state budget for 2008 in a short period of time (to pass a deadline for 2008).

Government likely to borrow mostly on domestic market

According to the preliminary version, revenues are expected to reach UAH 215.4bn (USD 42.65bn) and expenditures to net UAH 232.4bn (USD 46.02bn). The government plans to borrow UAH 15.9bn (USD 3.14), both on the domestic primary bond market (USD 1.54bn) and externally (USD 1.6bn). However, taking into consideration the global liquidity crisis, investors' aversion to risky EM bonds and the central bank's aim to drain liquidity from the market, the government will likely focus mostly on domestic issues. It will be a challenging task, as the current yields of 7.6-8% did not attract a significant number of buyers (USD 75.8mn sold in Jan-Feb 08), even though the Ministry of Finance increased the yield by 110bp in a recent auction of 2Y bonds.

Social expenditures mean risk to proposed budget deficit

Social spending plays an important role in the state budget of PM Tymoshenko. On average, social spending will increase by 30% in 2008. The government plans to increase the minimum salary by 32% y/y and pensions by 37% y/y, as well as implement other social programs. Approximately 50% of the workforce was employed in the public sector. In 2007, more than USD 6bn was paid as salaries to the public sector. This category of employees gets salary indexation based on the minimum wage level set by the government. That is why the increase in minimum wages means a non-

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negligible pro-inflationary impulse, although the share of people receiving the minimum wage is not so big. In 2007, overall social spending amounted to UAH 53.2bn (USD 10.54bn).

Compensation for Oschadbank savers not likely to be fully paid this year

Another big government bill is related to compensation for savers at Oschadbank, who suffered from devaluation of the currency after the collapse of communism, for which the government earmarked UAH 20bn (USD 3.96bn) in the 2008 budget. However, this is the estimated maximum amount and it is contingent on the privatization results for the year. In the 2008 budget, UAH 6bn (USD 1.19bn) is assigned to payments in cash through the Oschadbank branches to former clients (USD 200 per person). An additional UAH 2bn (USD 0.4bn) is to be paid in non-cash form with depositors able to claim offsets on utility bills. This part of the package has been misinterpreted by some savers (pensioners), which caused a delay in utility payments at the beginning of the year. We estimate that finally only about UAH 8bn (0.9% of GDP) will be paid out as compensation in 2008.

So far, tax collection has improved in 2008

Revenue collection has shown a positive dynamic for the first two months of 2008. Revenue collection exceeded the target by UAH 1.8bn (8% y/y) in the first two months of the year. The government has called for a serious effort to fight corruption in the state customs. As a result, custom collections have increased by an impressive 70% y/y (as of March 14, 2008) to UAH 15.2bn. There is also a positive dynamic of VAT collection as well as refunds, a main source of Ukraine's budget (36% of the 2007 budget or USD 11.8bn). Tymoshenko's government has announced that it would work on eliminating VAT corruption schemes, in which some exporters with government ties were given preferential VAT treatment.

We think that the state budget deficit of 2% of GDP will be met in 2008. It is important to note that most of the social spending was implemented in the first month of the year. As of March 25, 2008, USD 725mn was paid to Oschadbank savers, or 61% of cash payments planned for 2008. The positive dynamic of the state revenue collection looks encouraging and the prospects of strong privatization results make us optimistic about the state budget for 2008. We are less optimistic on the government borrowing plan, as the government yields would have to be increased in order to attract investors. However, given the low level of public debt (12.5% of GDP), higher costs of debt service should not burden the state budget too much.

Financial market overview

Tough liquidity situation causes low investor interest

The local fixed income market has not avoided the impact of the recent global credit crunch impact and local liquidity squeeze (as a result of anti-inflation measures). Companies have reoriented themselves towards issuing debt on the local market, but the demand side remains weak. This has increased yields for domestic bonds; domestic corporate bond yields have increased on average from 13% in September 2007 to 15% in March 2008. Similar trends have been observed in the banking, municipal and government segments. Banks, being major local buyers of domestic bonds, have cut demand during the recent liquidity shortage on the local money market after the central bank substantially dried up the excessive liquidity in the market.

Better tax collection has compensated for unsuccessful auctions

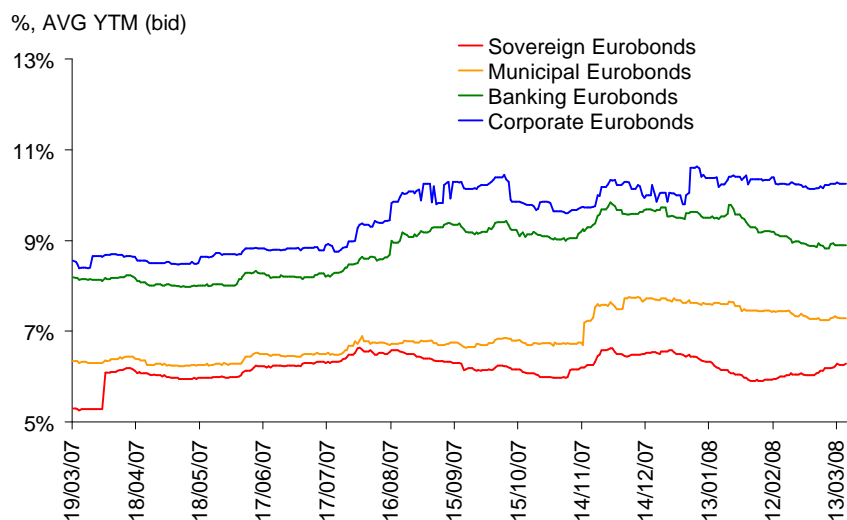
Under such challenging market conditions, the government was able to borrow USD 76.9mn (or 5% of the planned volume for 2008) by selling treasury bonds on the domestic market since January. Such lower than scheduled inflow of borrowings had no great impact on the state budget, as it was filled from other sources (more effective tax collection and customs duties). A large part of this amount was borrowed in January, as sovereign bonds were offered at higher yields (approx. 110bps more than in previous auctions). However, during the following months, the Ministry of Finance faced a series

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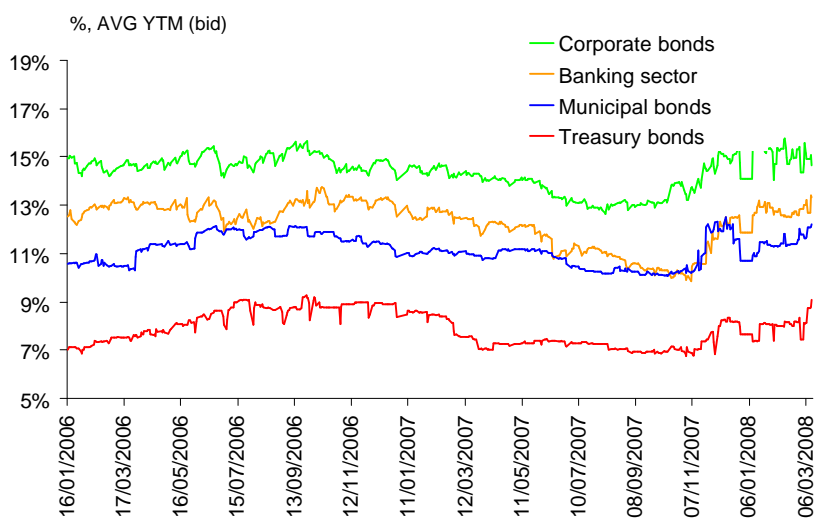
of unsuccessful auctions, as investors were not interested in buying treasuries and waited for higher yields. Since the beginning of 2008, there have been no new corporate Eurobond issues. Borrowers are obviously waiting for more favorable conditions.

Ukrainian Eurobonds average yields



Source: Bloomberg, Erste Bank Ukraine

Ukrainian domestic bonds average yields

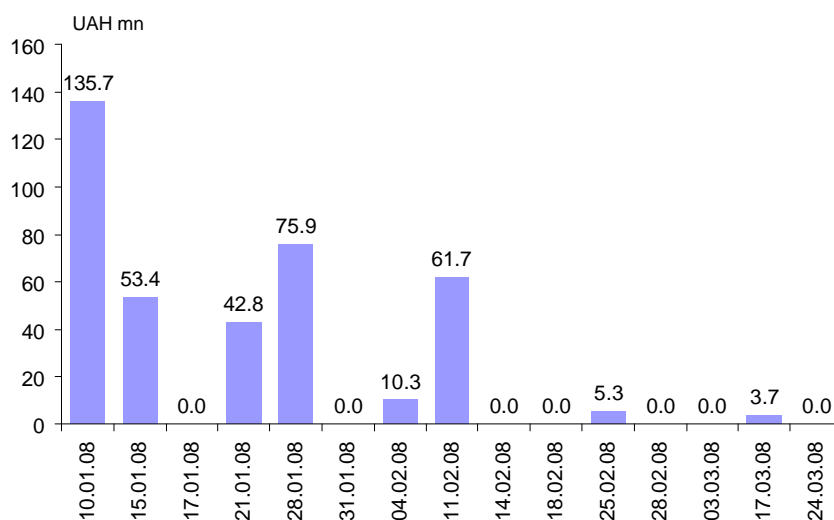


Source: Cbonds, Bloomberg, Erste Bank Ukraine

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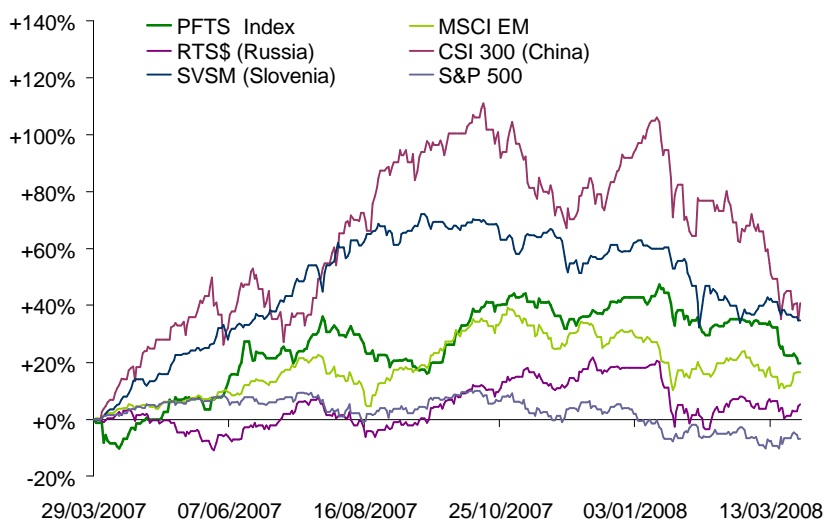
Treasury Bonds auction volume



Source: MinFin, Erste Bank Ukraine

Equity market performance

Performance



Source: PFTS, Bloomberg, Erste Bank Ukraine

Stock market saw strong rally in 2007

The Ukrainian stock market showed an incredible performance of 135.4% for the PFTS Index, a 142.5% increase of the market capitalization to USD 111.8bn in 2007, and was not strongly affected by fluctuations on international markets (as it has low liquidity). Ukrainian companies became more transparent in 2007, which led to greater interest among foreign investors. Metallurgical companies, machine builders and distributors/generators of electricity were the top-performing sectors. Kyivenergo (KIEN UZ) was a top-performing Tier-1 stock, returning a 429% gain for the year.

In early 2008, PFTS faces correction, in line with global markets

The recent global instability caused by the credit crunch has dragged the local stock market into a bearish trend in the first months of 2008. As of March 20, 2008, the PFTS Index had lost 12.7% YTD and entered a second wave of sell-offs. Such a situation is explained by the high share (up to 80-90%) of foreign capital operating on the local stock market, as well as the global risk aversion. However, there is no panic, as these sell-

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offs usually happen on average daily turnover of USD 10-15mn. Buyers are largely represented by short-term speculators buying back the shares they sold earlier. The market is mostly supported by foreign institutional investors with an investment horizon of more than one year, who expect their investments to grow no less than 20-30% per year.

Last year successful for IPOs, this year looks more moderate

2007 was a record year for Ukrainian IPOs. The total volume of IPOs with additional share issuance amounted to USD 1.89bn. Ukrainian companies preferred foreign exchanges for their IPOs - the London SE, Frankfurt SE and Warsaw SE. The Ferrexpo (the leading Ukrainian iron producer) IPO raised USD 420mn on the London SE (the first listing of the Ukrainian company on this exchange). Real estate and food processing companies were also active on the international exchanges. The sub-prime mortgage turmoil had a negative impact on IPOs of Ukrainian companies. As a recent example, developer Davento Limited was able to place only USD 77.8mn (an 11% stake), instead of the planned USD 150-165mn (a 20% stake), in a private placement. Thus, many companies that had planned an IPO for 2008 have postponed it until later this year or next year.

What should we expect in 2008?

What should we expect in 2008? Global sentiment will play a major role in the performance of the PFTS. Among positive factors that could help the market to rebound could be the upcoming privatization and auctioning of state-owned company stakes (some of them will be auctioned directly on the PFTS), improved transparency of the companies and better financial results. It is positive that internal demand has been on the rise, as asset managers have increased the share of internal capital in their portfolios. Moreover, the large government pension funds, such as the state post office and state railway company, have hired asset management companies to manage their funds. If the global markets calm down in 1H08, the PFTS Index has a good chance to gain back the lost positions and show moderate double-digit growth in 2008.

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Press conference

April 3, 2008, Kiev

Ukraine shows strong growth, but has yet to find a way to battle inflation

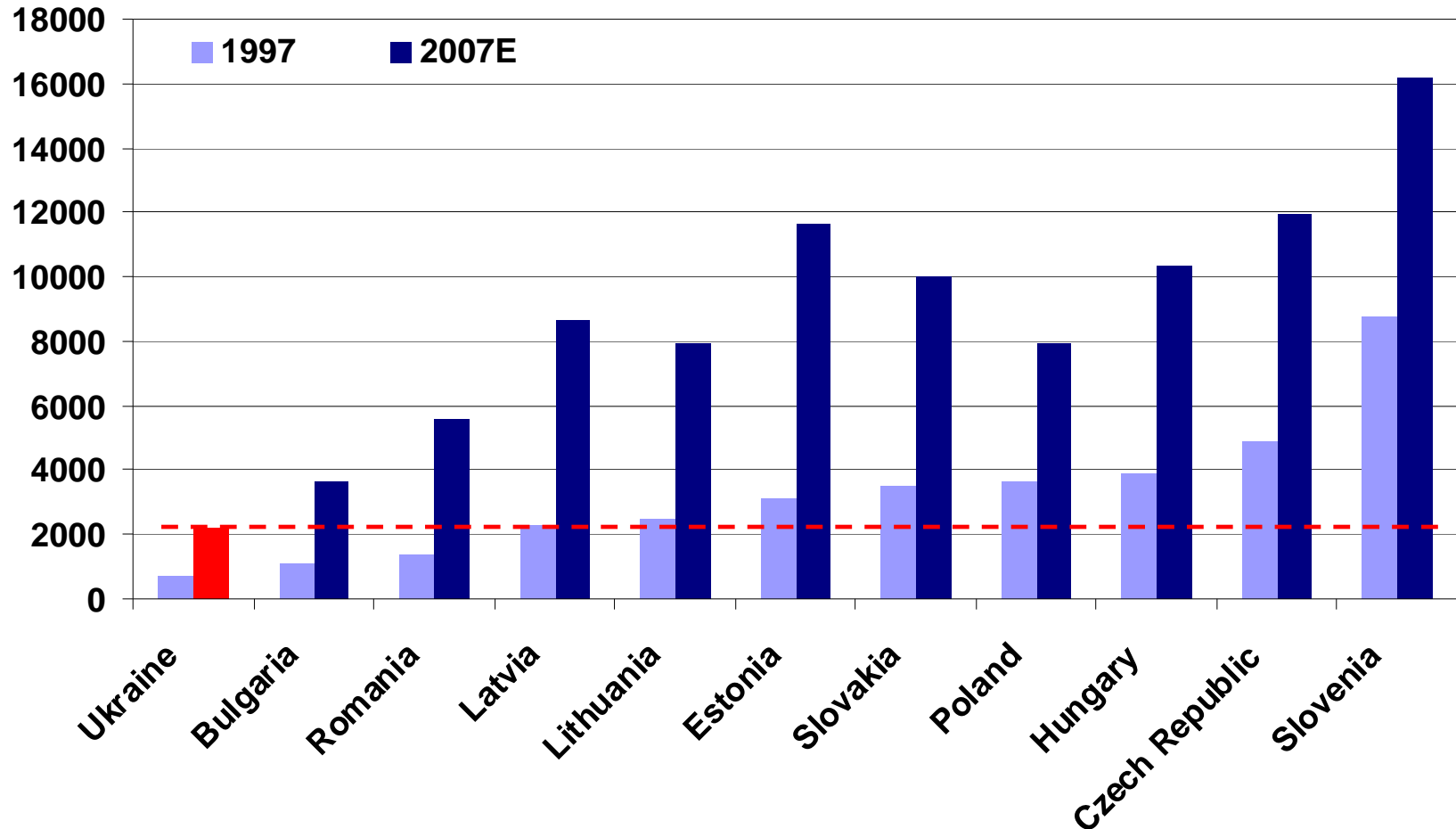
Juraj Kotian, Co-Head CEE Macro and Fixed Income Research, Erste Group

Viktor Stefanyshyn, Analyst of Erste Bank Ukraine

Roman Oliynyk, Analyst of Erste Bank Ukraine

Ukraine will follow convergence of incomes experienced by CEE countries in the last decade

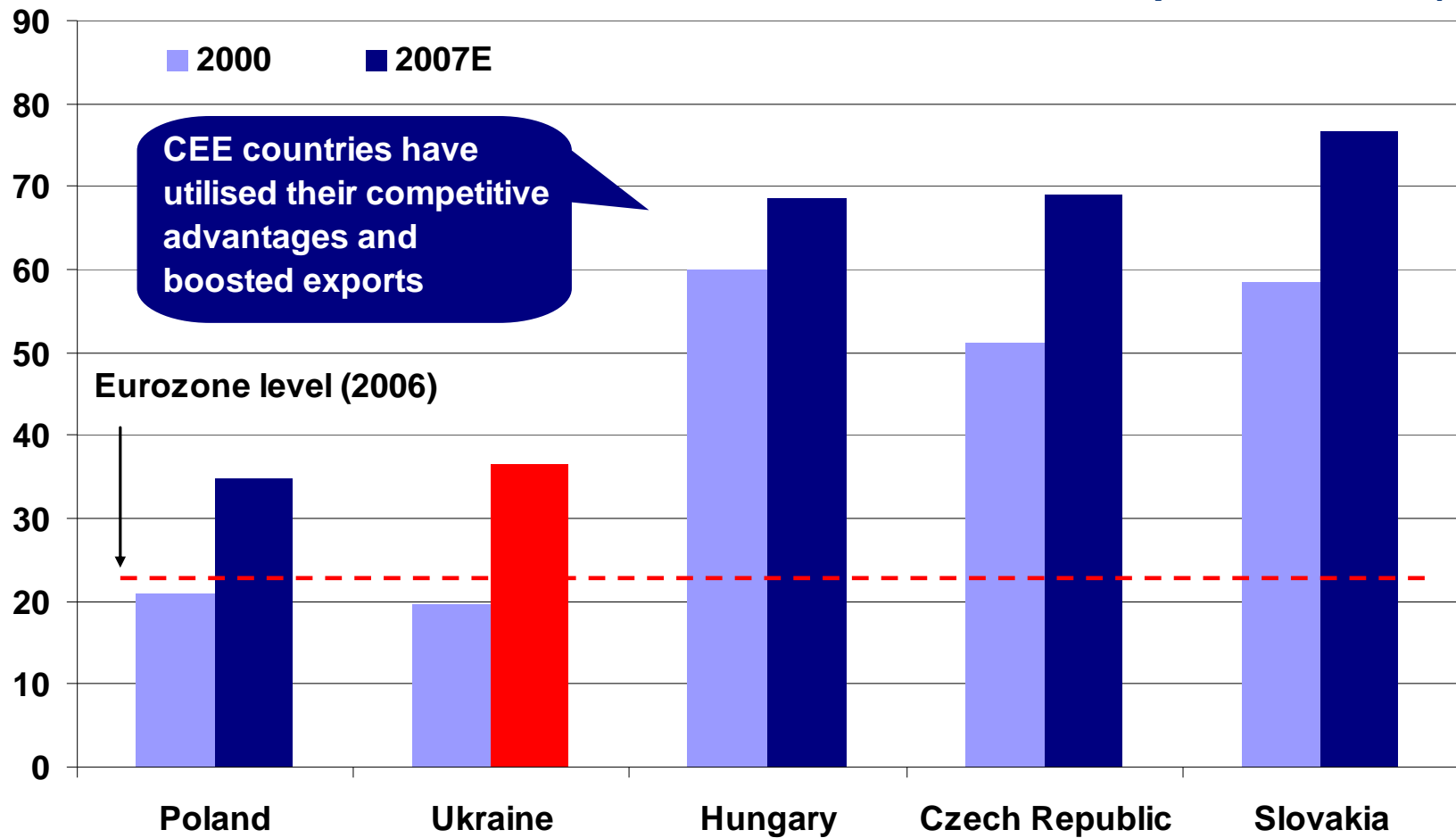
GDP per capita (in EUR)



Source: Eurostat, IMF, Erste Group Research

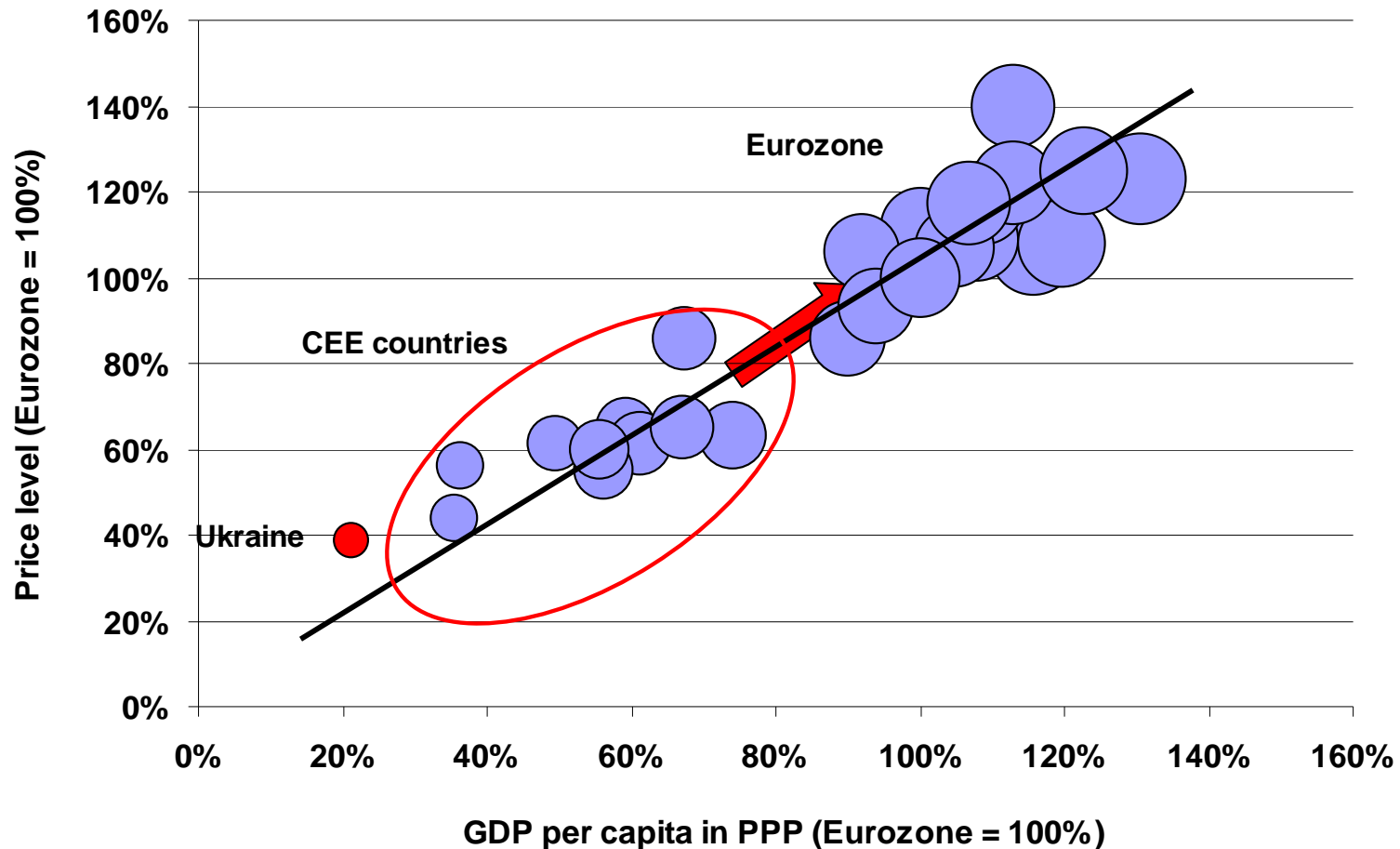
Entering the WTO will increase trade opportunities and speed up the catching up process

Exports to GDP (%)



Source: Erste Group Research

Inflation will remain a relatively high as income convergence induces also price convergence



Source: Eurostat, OECD, IMF, Erste Group Research

Introduction of inflation targeting would require a binding schedule of adjustment of energy prices

- Ukraine faces the same exogenous price shocks (increasing food and oil prices) like the rest of the world

Local specifics:

- High weight of food prices in consumer basket
- Peg to the weakening US dollar
- Fiscal expenditures boost consumption

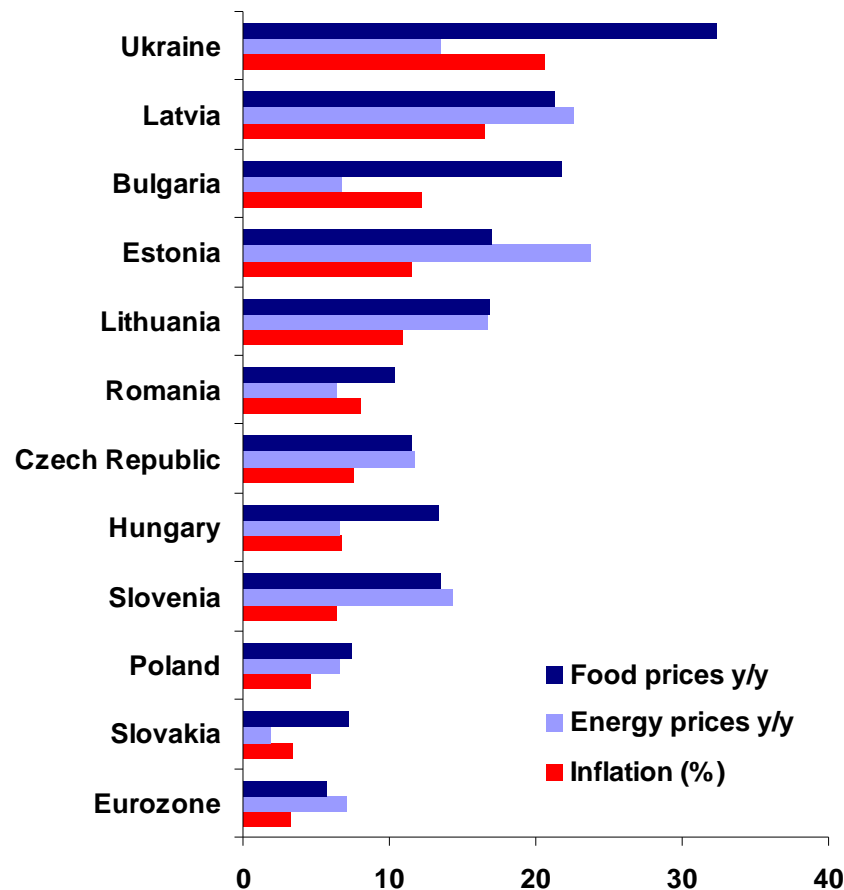
Anti-inflationary package

- focus on anti-cyclical policy

Inflation targeting & free float currency

- the most efficient disinflation policy in CEE

Inflation as of February 2008 (%)

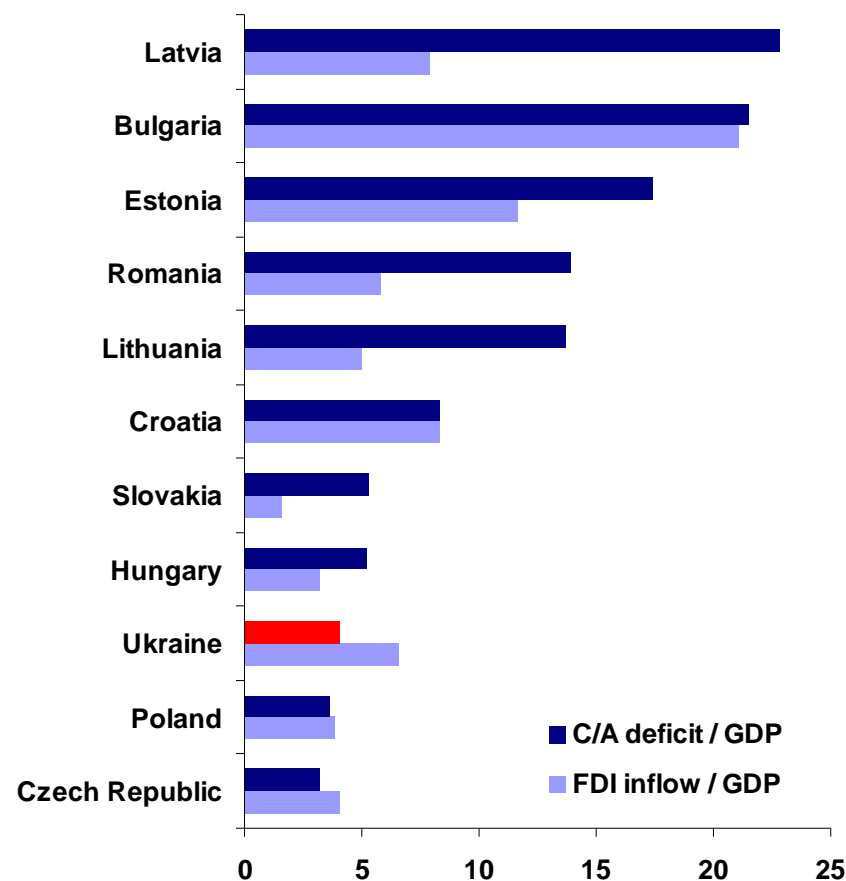


Source: Eurostat, Erste Group Research

Ukraine is cushioned against risks related to financing C/A deficit thanks to strong FDIs

- The risk premium for countries with high external imbalances has increased under the global turmoil on financial markets
- Ukrainian current account deficit is to deteriorate due to strong growth of consumption and investments
- FDIs have been sufficiently high to cover C/A deficit
- Privatisation is to keep FDI inflow on high level in next couple of years

Current account deficit / GDP (%)

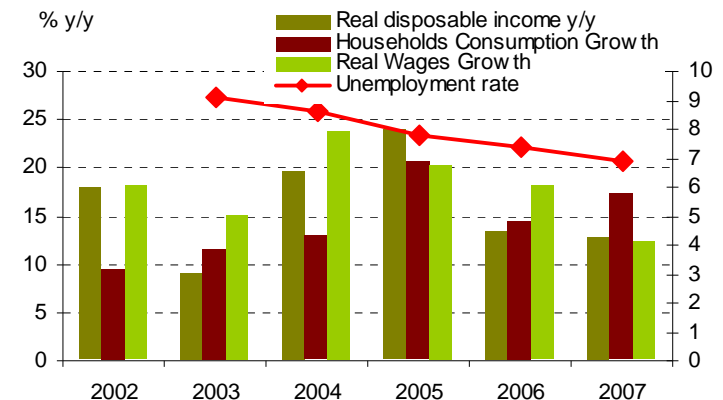
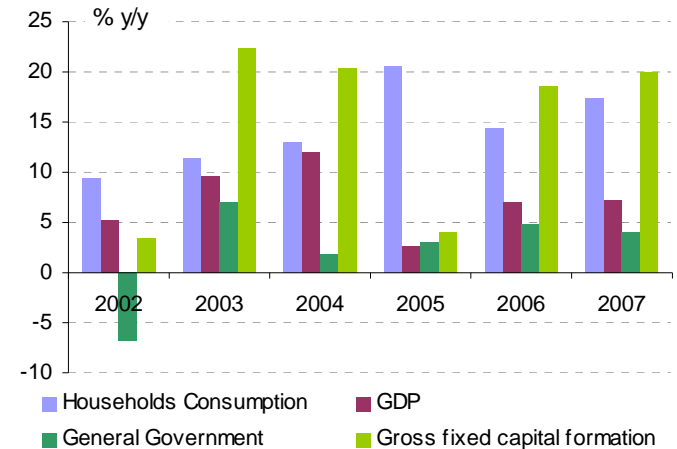


Source: Eurostat, Erste Group Research

GDP growth will slow in 2008 to 6.6%

- GDP will drop marginally to 6.6% in 2008
- There is a gap in GDP growth and household consumption
- GDP will continue to be fuelled by strong consumption
- Gross fixed investment, especially in manufacturing is expected to be strong in 2008 (2007 companies profits increased by a huge 60% in 2007)

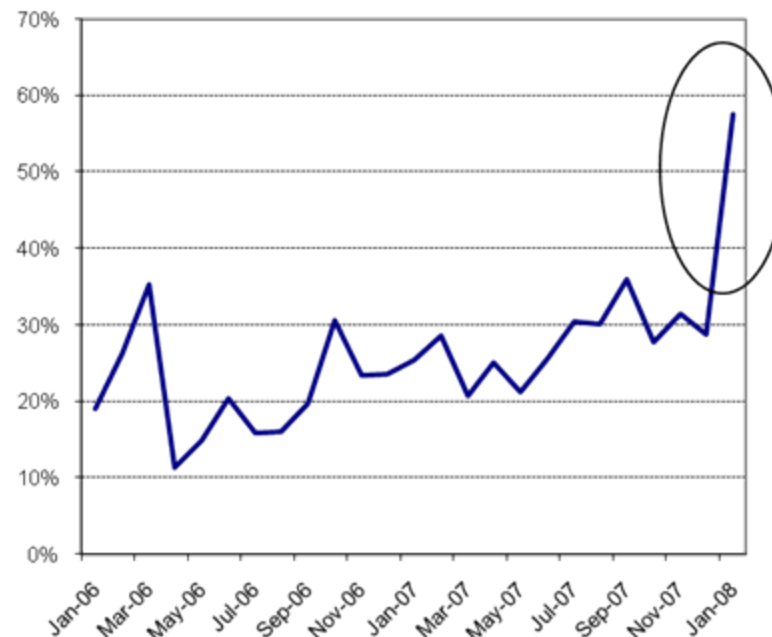
GDP/household/wages/growth



Source: Ukrstat, Erste Group Ukraine

- Increase in social benefits, on average by 30% should support spending
- Growth of social benefits as a pro-cyclical measure pose additional risk to inflation
- We expect the nominal wage to increase by 33%
- Retail sales (the highest in CIS) will be have a double-digit growth in 2008 as well

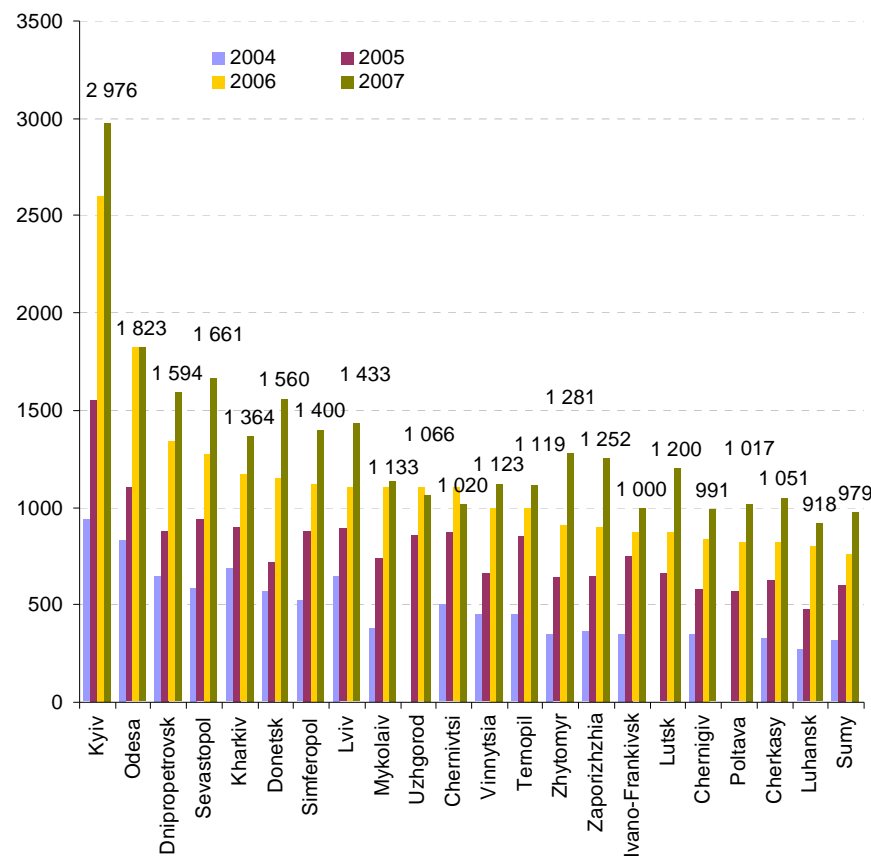
Social Benefits increase in 2008



Source: Ukrstat, social benefits and other current transfers, annual Growth rate

- We expect a moderate growth in housing in 2008 (in 2007 housing went up by 18% y/y)
- Mortgages increased by more than 60% in 2007 to USD 11.2bn (8.2 % GDP). We expect a healthy mortgage growth in 2008
- We see a strong potential in commercial real estate because of misbalances in supply-demand: retail (Ukraine offers the highest yields in CEE region), offices (2% vacancy rate), and warehousing (shortage of supply)

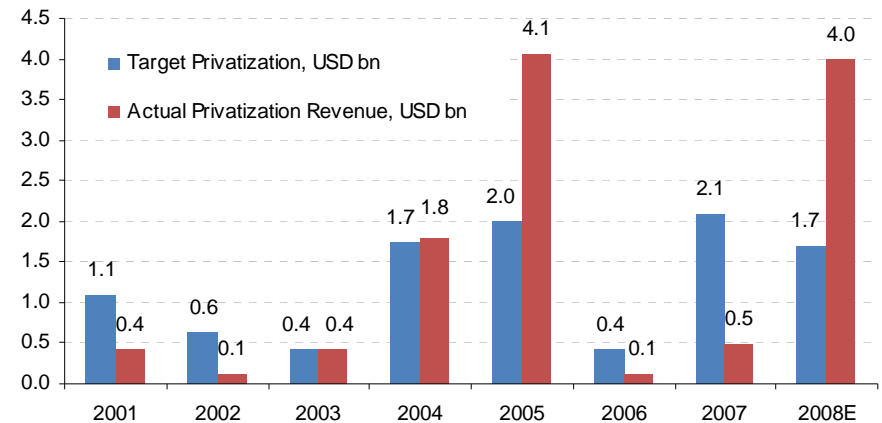
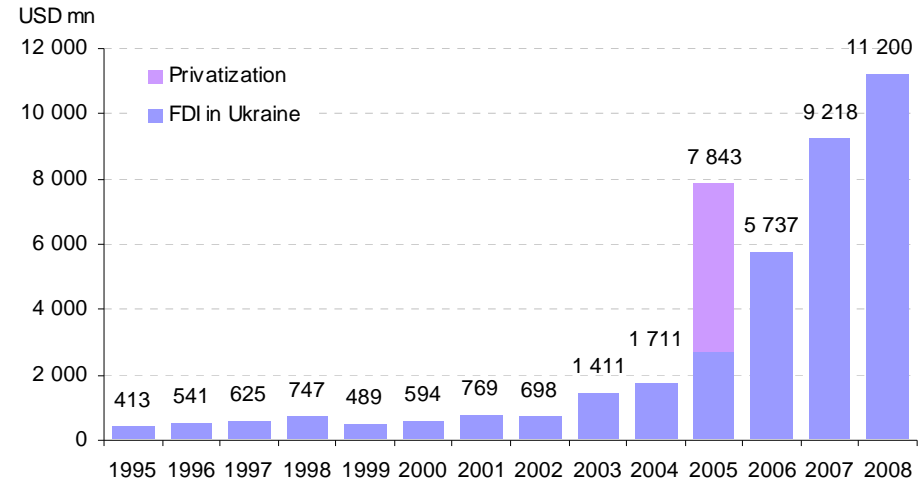
Average housing prices for major cities, USD per sqm



Source: Ukrainian Association of Realtors

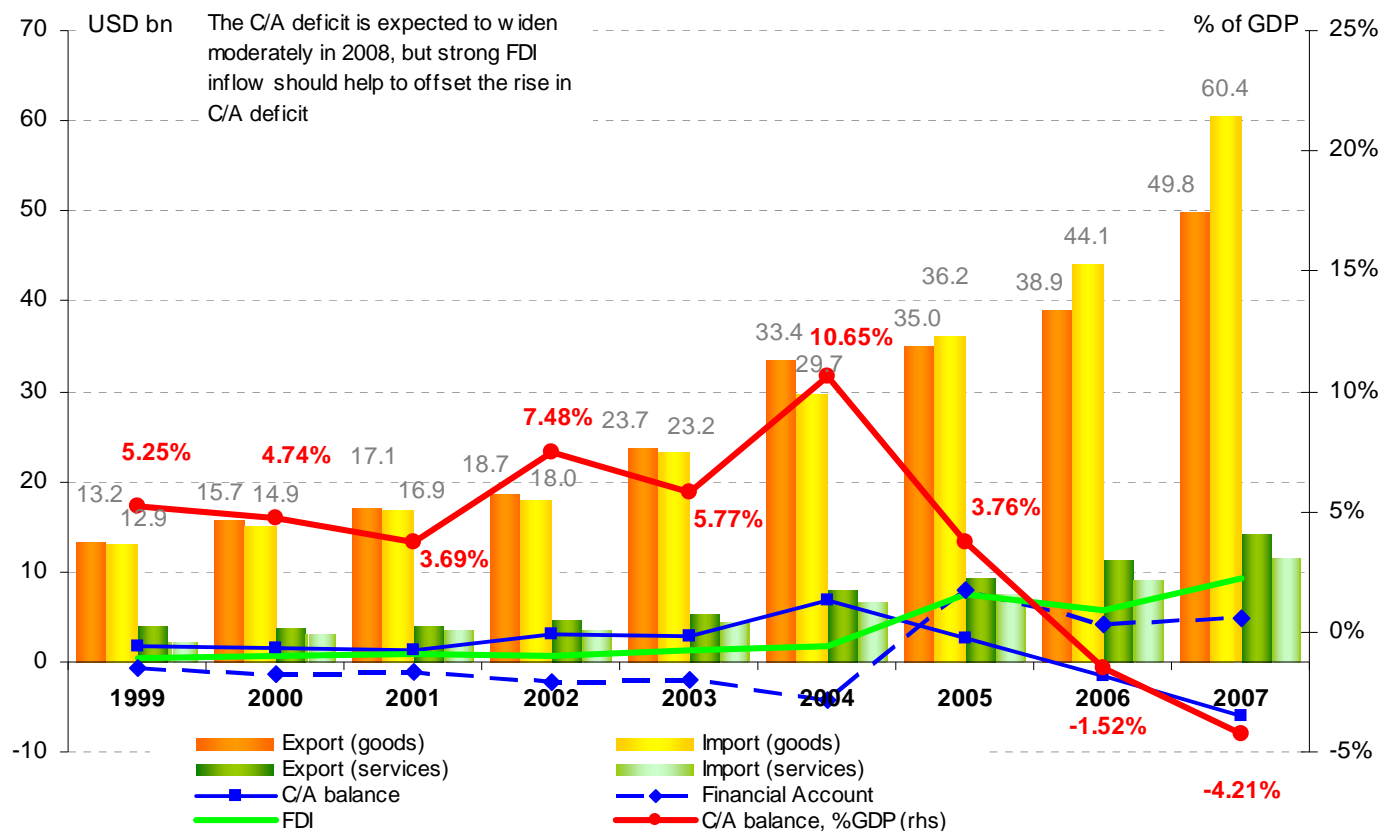
- FDI was driven by strong M&A in banking (38% of 2007 FDI) and real estate and construction (21% of GDP)
- We expect FDI to beat a record 2007 (USD 9.2bn) and reach USD 11bn in 2008 driven by strong M&A and privatization revenues
- The government plans to sell 13 strategic companies (more than 300 companies). We expect that a conservative privatization target of USD 1.7bn will be beat (we project around USD 4bn revenues received)

FDI Inflow/Privatization



Source: Ukrstat, MinFin, SPF, Erste Bank Ukraine

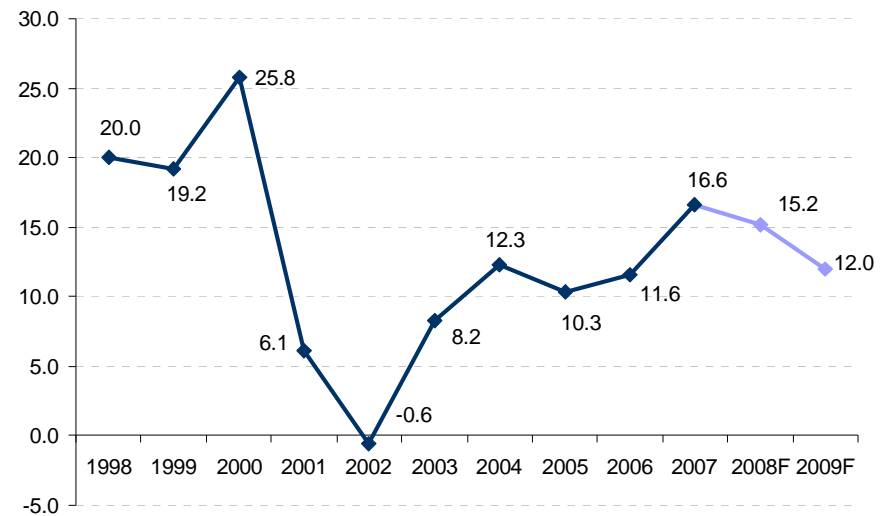
Current Account Balance: 1999-2007



Source: NBU, Erste Bank Ukraine

- We expect CPI to be elevated for the year and subside in the second half of 2008 to finish the year at 15.2%
- Ukrainian specific of inflation: food basket accounts for 55% of weight (three times higher than in CEE countries); peg to USD (dollar depreciation leads to imported inflation)
- The government anti-inflationary measures in conjunction with NBU: short and mid-term measures

CPI Data with forecast: 1998-2009F



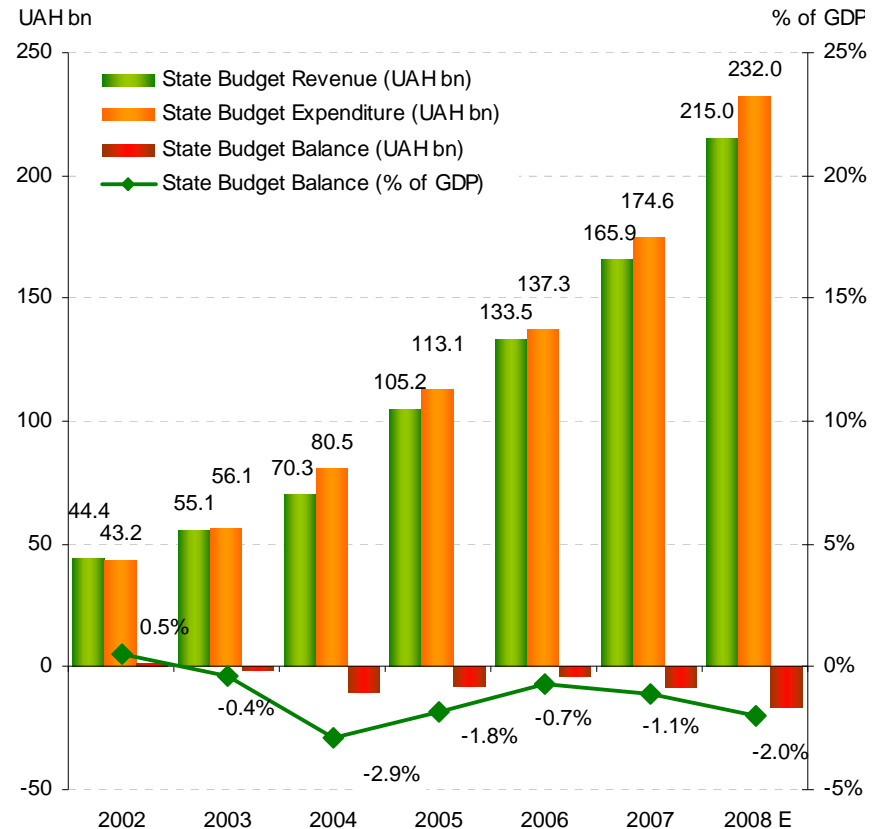
Source: Ukrstat, Erste Bank Ukraine

– We expect Budget Deficit to widen to 2% of GDP in 2008

– Increased expenditure (minimum salary, pensions)

– Positive dynamics of tax collection would help to offset the deficit. The government has been orienting more on domestic borrowing

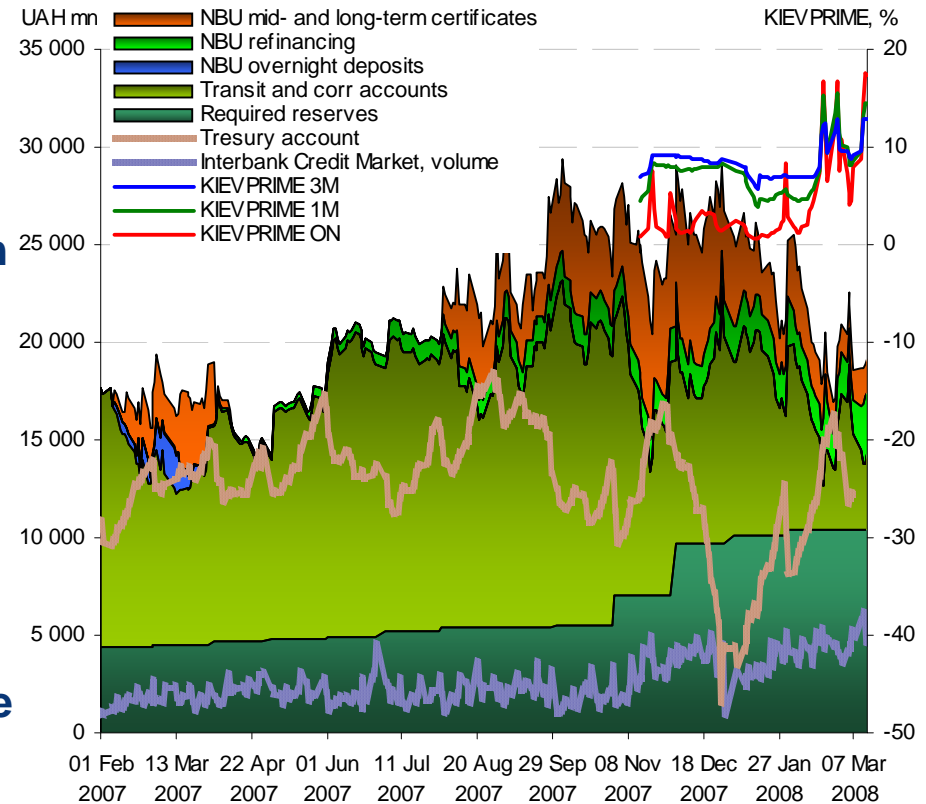
Budget 2002-2008F



Source: MinFin, Erste Bank Group

- NBU became more active in reducing liquidity to curb credit growth (+74% in 2007)
- Time of cheap hryvnia is over, MM rates are hovering around 10%. We expect 3m KIEVPRIME to be at 11% in 2008
- Draining of liquidity through deposit certificates, increased reserve requirements, and accumulating resources on Treasury accounts
- Demand for hryvnia has increased in the time of lower liquidity and global dollar depreciation

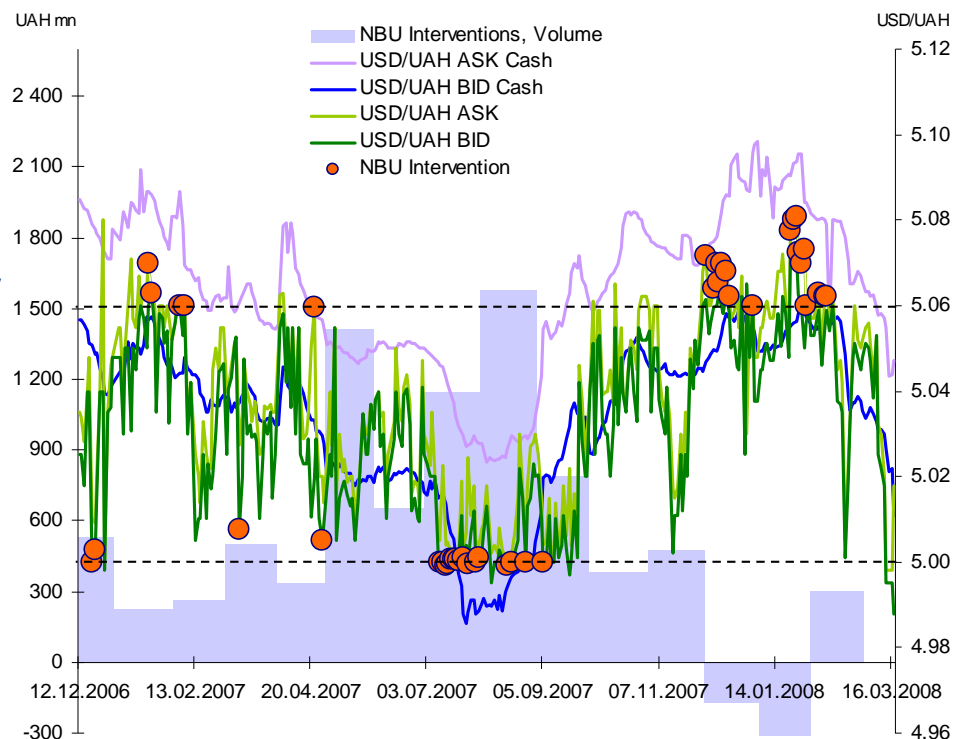
Liquidity Chart



Source: NBU, Bloomberg, Erste Bank Ukraine

- Currency appreciation helped to fight inflation in CEE countries
- Widening of the fluctuation band is feasible in 2008. We expect the shift to the stronger band by the end of the year
- Stronger UAH in 2008

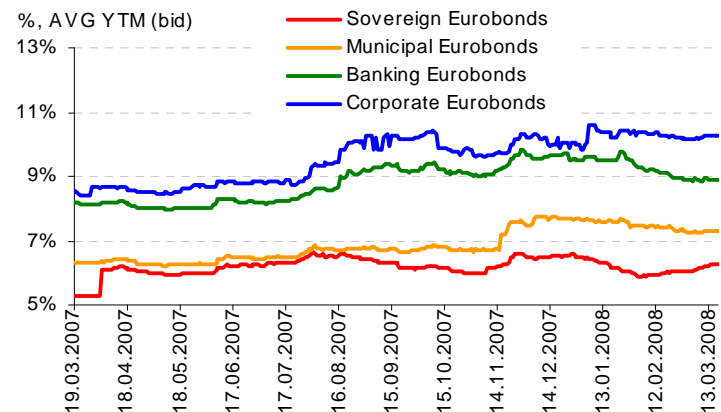
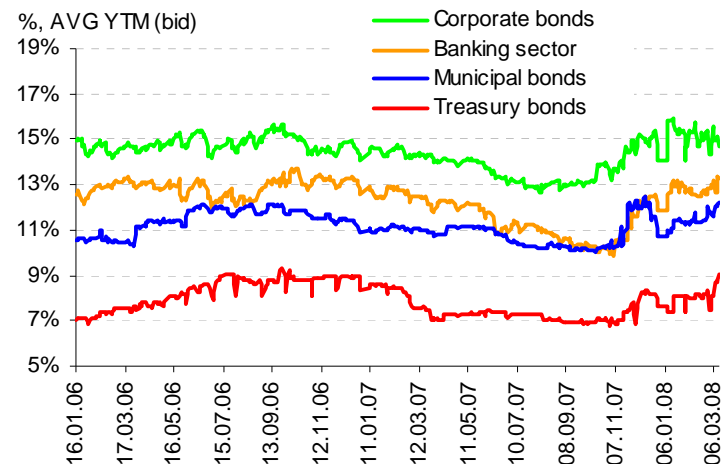
FX Chart



Source: NBU, Bloomberg, Erste Bank Ukraine

- Lower investors interests to bonds on domestic markets and Eurobonds (global aversion to EM bonds)
- Yields will be elevated and may come down in the second half of the year
- Government raised UAH 368 mn (target UAH 1bn). Yields increased by 110 bp for mid-term treasuries

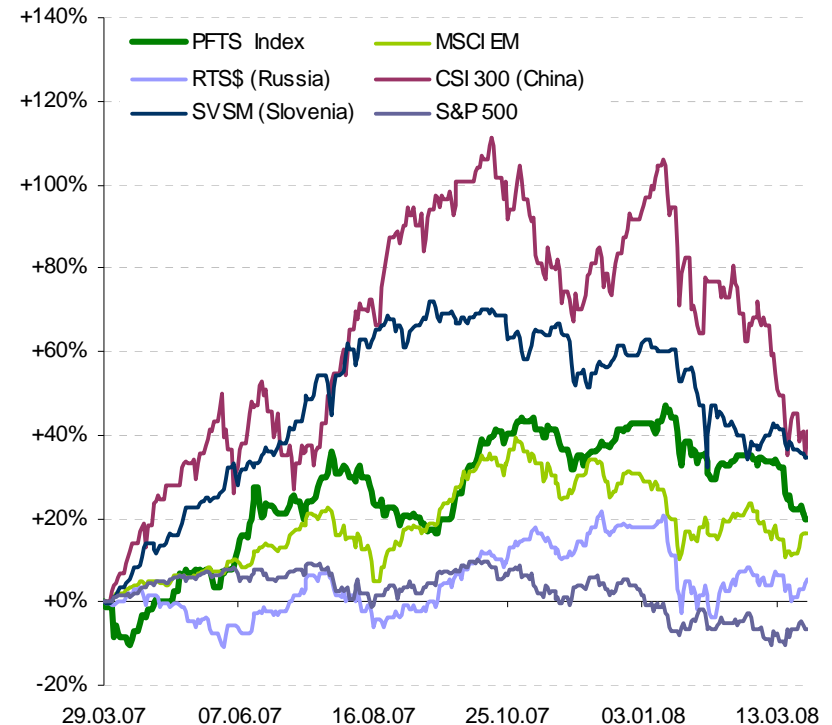
UA Bond Yields



Source: Bloomberg, Cbonds, Erste Bank Ukraine

- PFTS strong rally in 2007 turned into a bear mood in the IQ 2008
- Record IPO volume in 2007 (USD 1.9bn) will see a slow down in 2008 due to global volatility on financial markets
- Positive for 2008: sales of state's stakes in oblenergos on PFTS; improving transparency and financial results of the companies; state pension funds and local investors would become more active

Equity Indices Performance



Source: Bloomberg, Erste Bank Ukraine

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