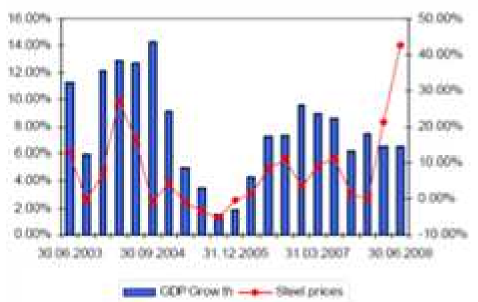
Ukraine faces challenging times yet sees economic recovery on the horizon

25.11.2008

- Ukraine to enter 2009 in recession, yet economic growth expected to rebound in the second half of the year
- Economy is more resilient to cyclical shocks, while fiscal and monetary policies remain vulnerable points
- IMF loan to secure overall banking system stability
- Positive long-term outlook envisions GDP growth of 5-6% in 2010 and single-digit inflation

Recession projected for H1 of 2009, yet economic growth expected to rebound in the second half of the year

Short-term outlook for Ukrainian economy has dramatically changed in recent months and the country is now most likely heading into the recession next year. On the one side, external factors such as the global financial crisis, weakened global demand and especially falling commodity prices have adversely hit the Ukrainian economy. On the other side, Ukraine also had to face problems which have had a local origin. The Ukrainian central bank had to prevent banking sector from run on banks through implementation of some administrative measures. The main aim of these measures has been to stabilise the market, but in the long run would have had adverse effect on Ukrainian economy. That is why technical support provided by IMF, which goes along side the financial, will very likely moderate those initial measures and help to set up structural reforms, which would be beneficial for the financial sector and economy. "*Ultimately, Ukraine might come from the crisis much healthier than it jumped in, but in the meantime the situation will be more challenging",* assessed Juraj Kotian, Co-Head Macro/Fixed Income CEE at Erste Group.



The decline in GDP will be strongly dependent on steel prices and demand. Erste Group analysts project a recession of 2.5% of GDP in 2009, with economic growth returning in 2H09. The current account is likely to shrink to just 3% of GDP in 2009, as slowing demand, the credit freeze and dropping commodity prices will hurt imports. The introduction of a floating exchange rate will result in local currency devaluation, which is supposed to support the real sector of the economy. The optimal level of the UAH/USD will depend on steel prices. At current metal price levels, Erste Group analysts project the optimum level to be around 7 UAH per USD, with the hryvnia gradually moving towards this level. During the next several months, the hryvnia rate will depend on NBU actions – imposing the floating rate and administrative market regulation. Also, much will depend on liquidity in the banking system, with the tense situation in the sector keeping money market rates rising.

Economy is more resilient to cyclical shocks (compared to just several years ago), yet fiscal and monetary policies remain vulnerable points

"By many measures, Ukraine is currently much more immune to cyclical shocks: FX reserves have increased substantially, foreign capital increased its share on the local financial market (which is now well capitalized and profitable), the fiscal system has a strong budget code (with defined roles and responsibilities in the budget process) and the WTO has liberalized external trade", Maryan Zablotskyy, macroeconomist at Erste Bank Ukraine, points out.

The weak points in Ukraine's economic policy are its fiscal and monetary policy. On the one hand, the state budget has had a good balancing influence on fiscal policy - since 2000, the average budget deficit has stood at just 0.75% of GDP. However, budget planning was only conducted for one year, which meant that the government has tended to increase spending in nominal terms during times when steel prices and growth were increasing. Such a budget spending policy tends to amplify the economic cycle and the impact of steel price volatility on the economy.

NBU propels the implementation of floating exchange rate

For the last seven years, the local currency has been relatively unchanged vs. the USD, the currency to which the hryvnia is officially tied. In practice, this means that the hryvnia exchange rate has been administratively regulated, with the NBU having to make heavy use of its FX reserves. 2008 brought a break from the past, once the NBU started accelerating the shift towards a flexible currency rate. The main advantage entailed by this move is that floating rate regimes are thought to be more efficient in offsetting effects of term-of-trade shocks than fixed rate regimes. Thus, a depreciating local currency caused by a floating exchange rate will not lead to a decline in nominal wages, nor will it offset negative effects on exporters.

Low budget deficit has preserved safe level of public debt

The gross external debt of Ukraine stands at USD 100bn (as of 1H08). Short-term debt and inter-company lending together amount to USD 32bn, which is fully covered by FX reserves. The government policy of keeping low budget deficits has led to one of the lowest public debt levels in the CEE region. Prior to the IMF loan, public debt stood at 8-9% of 2008 projected GDP. In addition, Ukraine has one of the highest levels of GDP distribution through the consolidated state budget, which now stands at 38% of GDP. According to Erste Group analysts, this indicates that *"public debt is well within the safety zone and that the government has a lot of space to cut spending and issue guarantees for corporate debt."*

IMF loan to secure overall banking system stability

On November 5, the IMF approved a USD 16.4bn two-year stand-by loan. As part of its agreement with the IMF, the Parliament adopted a law on "Countering the effects of the global financial crisis" that touches on fiscal, monetary and inflation policies and banking regulation.

Regarding fiscal policy, Ukraine is to cut spending to meet declining incomes in 2009. Ukraine will keep its inflation rate at 17% by end-2009, while nominal wages and social benefits are to increase only to cover the inflation rate. On the point of monetary policy, Ukraine is to impose a floating currency exchange rate regime, which will ultimately result in devaluation, at least during 1H09.

One substantial impact of the IMF agreement will be borne upon the banking system. Since the credit crunch can deepen the cyclical economic downturn, providing support to the banking sector became a stringent matter. Thus, one measure entailed by the IMF agreement is the creation of a UAH 40bn stabilization fund, which will be used for issuing loans and conducting bailouts of banks. The government also received the right to borrow money in foreign currency on the local market and use government bonds to buy troubled banks. These, alongside the increase in the state fund guarantee for deposits from UAH 50,000 to UAH 150,000 (covering 99% of individual accounts) and the increase in refinancing activities by the NBU are meant to secure overall banking system stability, which is likely to go through a period of large-scale evolutionary changes. The IMF and Ukraine have effectively agreed on driving further consolidation in the banking sector. Even with minimum capital requirements twice those in Europe, Ukraine has some 170 banks, a number that could fall by as much as 30% in 2009 and 2010.

Positive long-term outlook envisions GDP growth of 5-6% in 2010 and single-digit inflation

The current cyclical shock does not present any significant difficulties for the Ukrainian government in terms of meeting its foreign financial obligations, due to the low public debt ratio. *"Ukraine will keep up with payments on its public debt, which will improve the country's image and investor confidence. The anti-crisis measures taken by the government (to get the IMF loan) will cause changes in the financial system that will make the Ukrainian economy more resilient to cyclical effects in steel demand and prices in the future",* envisions Maryan Zablotskyy.

The steel industry will continue to invest heavily in production efficiency programs. The local steel industry has great potential for cutting production costs, as Ukraine has one of the world's biggest layers of iron ore and large layers of coal. The recent introduction of steel price futures on the London Metals Exchange (and plans to introduce them on the New York Mercantile Exchange) will bring new hedging possibilities for steel producers. The banking system will also strengthen after a period of consolidation and an increase in the share of foreign capital. In the future, Ukraine will remain influenced by cyclical downtrends in steel demand, but will be much more resilient to them, than it is now (compared to just several years ago). *"GDP growth will return to its potential growth of 5-6% in 2010, while inflation is likely to come down to a single-digit figure"*, conclude Erste Group analysts.

ERSTE GROUP

November 18, 2008

Going through the Crisis: Ukrainian Way

Special Report

Ukraine to enter 2009 in recession

Strong impact on almost all sectors

Long-term recovery expected

“When written in Chinese, the word "crisis" is composed of two characters – one represents danger, and the other represents opportunity.”

John Fitzgerald Kennedy

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Introduction

Short-term outlook for Ukrainian economy has dramatically changed in recent months and the country is now most likely heading into the recession next year. We can partially blame external factors like global financial crises for that, which has trimmed Emerging Markets from external funding and elevated risk premiums paid for debt to abnormal levels. In October, CDS spreads (insurance against default) on sovereign debt of Ukraine exceeded 2000bps, the level which was a far above regional peers, despite much lower level of external debt to GDP and relatively high FX reserves in Ukraine. But compared to these countries, Ukraine had to pay a risk premium for being solitaire between two universes – EU/NATO and Russia, while convergence towards the former one has become “not so easy” after Russian intervention in Georgia. Besides global financial crises, weakened global demand and especially falling commodity prices have been another external factor which adversely hit Ukrainian economy. In reaction to falling demand for steel products, some producers have already completely halted production for a couple of weeks. Recent depreciation of Ukrainian hryvnia has provided a partial relief from pressure which is coming on steel industry from every side.

Ukrainian economy had to face also to problems which have had a local origin. Ukrainian central bank had to prevent banking sector from run on banks through implementation of some administrative measures. The main aim of these measures has been to stabilise the market, but in the long run would have had adverse effect on Ukrainian economy. That is why technical support provided by IMF, which goes along side the financial, will very likely moderate those initial measures and help to set up structural reforms, which would be beneficial for the financial sector and economy. The government by accepting technical and financial assistance will be committed to much closer cooperate with IMF and adopt at least some of pro-market measures prescribed by IMF. These should be reasonable alternative to populist ad-hoc measures which are so favourite among Ukrainian politicians (because of high political vulnerability and short political cycles in Ukraine). Finally, Ukraine might come from the crises much healthier than jumped in, but in the meantime the situation will be more challenging.

Politics

Internal politics

Ukraine remains in political uncertainty.

Since the Orange Revolution of 2004, Ukraine has remained in political turmoil. The next parliamentary elections can be ordered by the president at any time and held during the next 60 days, as there is not a coalition in Parliament that holds a majority of seats, as demanded by the Constitution. Preliminary parliamentary elections were already ordered and then called off by the president, as urgent measures have to be adopted by Parliament to meet IMF demands associated with the USD 16.4bn loan. The next parliamentary elections could be the third in the last three years. There are several political parties that have chances of passing the 3% barrier to enter Parliament:

	Popular rating*, %
Party of Regions	28.4
Block of Yulia Tymoshenko	27.6
Our Ukraine	8.2
Communist party of Ukraine	7.9
Block of Lytvyn	6.7

* - according to Razumkov social sciences centre as of 10 October 2008

Foreign policy issues prevail in politics.

There is a tendency of smaller parties gaining more support. The current turmoil is likely to continue, especially with the approaching presidential election in early 2010. The intense political confrontations are mainly due to strong lobbying from large corporate businesses with political parties and foreign influence on the external policy of Ukraine. Ukraine, due to its unique geopolitical position, is crucial in schemes created by the European Union, Russia and the US for transportation corridors for energy resources to Europe from Central Asia. Thus, there are always attempts to influence Ukraine's main foreign policy priorities.

Foreign policy issues

Public opinion in both Ukraine and EU favor Ukraine joining the EU.

European Union

In a constantly increasing majority, Ukrainians favor Ukraine's integration into the EU. As of May 2008, 56% support EU integration, with 25% against and 19% undecided.

As for the EU, 45% of EU citizens support Ukraine entering the union. The greatest support comes from countries that recently joined the EU (66%), while support among 'old members' stands at 41%.

The greatest support comes from Poland (76%), Lithuania (70%) and Cyprus (63%). Austria, with 69% against, alongside Germany (64% against) and Luxemburg (54% against), are the countries that are most opposed to Ukraine's EU integration efforts.

Perspective of NATO membership for Ukraine looks dim.

NATO

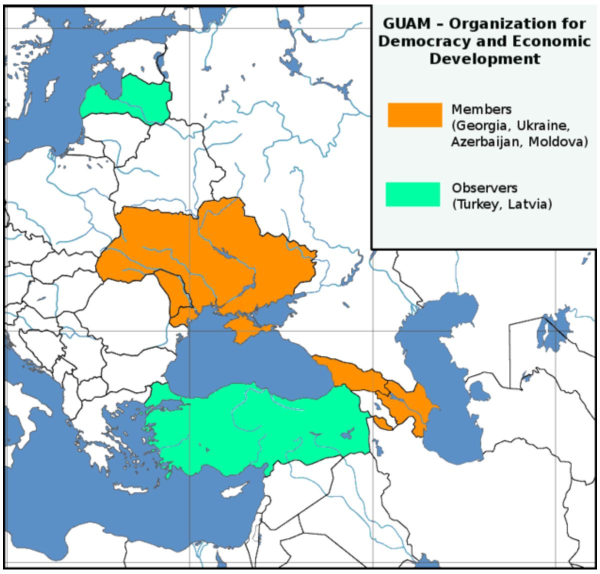
In contrast to vast EU membership support, NATO membership has only 32% popular support in Ukraine, with 53% opposed to such a move. Ukraine may not receive an invitation to join NATO, as Russia is putting heavy pressure on European politicians. Nicolas Sarkozy and Angela Merkel have both issued similar negative comments regarding Ukraine's possible NATO membership.

Recently, NATO Secretary General Jaap de Hoop Scheffer said that Ukraine will not receive an invitation at the next NATO summit in December 2008: "NATO needs Russia and Russia needs NATO. We don't want another cold war."

GUAM

Ukraine is a regional leader in GUAM which is a democratic alternative to CIS.

GUAM is an international organization formed by Georgia, Ukraine, Azerbaijan and Moldova. Turkey and Latvia have observer status. GUAM was created in 1997 as an alternative for further development of nations of the former Soviet Union. Ukrainian President Viktor Yushchenko stated that GUAM members "don't see themselves any more as wrecks of the Soviet Union" and are willing to become a locomotive of a "third wave of democratic revolutions" in the CIS region. GUAM is a democratic alternative to the CIS (Commonwealth of Independent States). GUAM is heavily supported by the US and Eastern European countries that are seeking independence from Russia's monopoly on the supply of oil and gas. **Ukraine has the status of regional leader in the GUAM project.**



GUAM is supported by USA and Eastern European countries in a competition to better link Europe to energy rich middle Asia.

GUAM is part of the competition between the two proposed transportation corridors to better link Europe with Asia. Russia, Azerbaijan and Iran have already been through rounds of negotiation on their plan, the North-South Transportation Corridor (INSTC); neighboring countries (formerly, but no longer with the understandable exception of Armenia) have expressed enthusiasm as well. This corridor would travel along the border between Russia and the Baltic states of the EU, then continue south through Ukraine. The US would prefer that this critical transportation corridor bypass both Russia and Iran. The plan proposed to GUAM by the US crosses both the Black Sea and the Caspian Sea.

Germany and France are opposed to Ukraine's EU and NATO perspectives as part of non-formal agreements with Russia

Russia is trying to block Ukraine's integration into the EU and NATO in order not to allow Ukraine any influence in energy policy among European countries. France, Germany and Italy will remain opposed to Ukraine's EU and NATO prospects as parts of non-formal agreements with Russia. Russia has also been successful in influencing Ukrainian politicians, given the constant political turmoil. Poland, the Baltic countries and Sweden remain key advocates for Ukraine in the EU.

Ukraine needs at least 3 years to enter talks for possible EU membership.

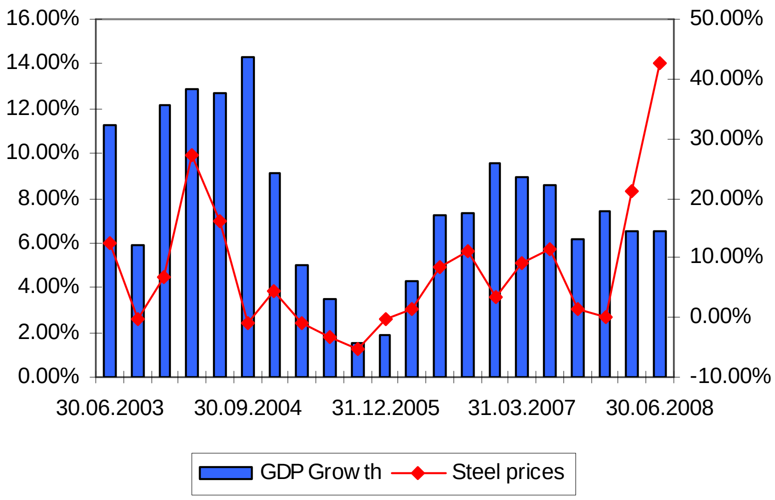
Realistically, Ukraine is not ready to join the EU, as it needs three years to reach the GDP per capita level Romania had when it joined the EU. Ukraine is likely to pursue a free trade agreement with the EU, which has high chances of being implemented within 2-3 years. It is likely that, in the next several years, Russia will have a strong position in protecting its foreign interests. Thus, Ukraine will not enter into any confrontations with Russia. In the next several years, public opinion in both the EU and Ukraine regarding Ukraine's EU integration is likely to become more positive. Issues surrounding joining the EU or NATO are likely to become more prominent within three years, with a realistic background for defined dates for integration.

Economy

Current outlook

Ukrainian economy is constantly under effect of cyclical changes in steel prices and demand,

Ukraine has experienced average real GDP growth of 7.5% since 2000. This economic growth was resilient against rising energy prices and the uncertain political climate. However, GDP growth has strong cyclical effects, which arise from volatility in metal prices. Metallurgy accounts for 35% of exports and 25% of GDP and state budget income. In 2004, GDP growth accelerated to 12.1%, then fell to 2.7% in 2005 and rose by 7.6% in 2006 and 2007. Price volatility is typical for global steel prices. A downward price correction of 30-40% took place during 1996-99 and 2000-01. In 2005, steel prices fell by over 30% in the CIS region during a five-month period, but quickly recovered. After enjoying record gains, steel prices are currently collapsing amid the global economic slowdown. Thus, Ukraine is likely to witness another economic shock in 2009.



but is more resilient to cyclical shocks than just several years ago.

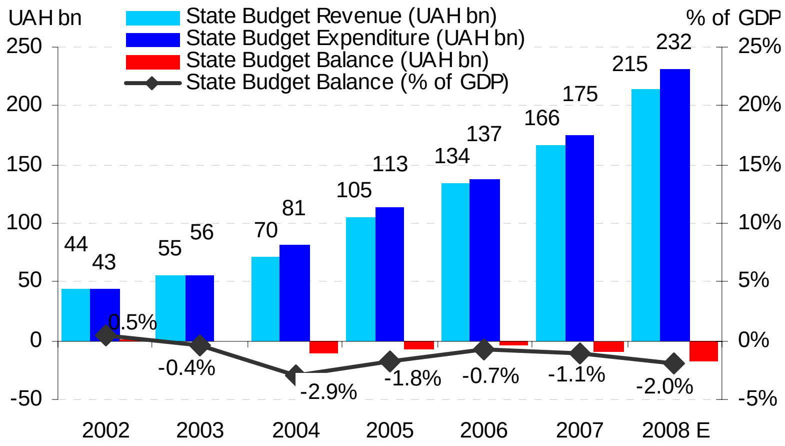
Unlike Russia, which introduced a stabilization fund using income from its largely state-owned oil and gas exporters, Ukraine, which has privately-owned steel production, must seek economic reforms. By many measures, Ukraine is now much more immune to cyclical shocks (compared to just several years ago): FX reserves have increased substantially, foreign capital increased its share on the local financial market (which is now well capitalized and profitable), the fiscal system has a strong budget code (with defined roles and responsibilities in the budget process) and the WTO has liberalized external trade. The weak points in Ukraine's economic policy that can increase steel prices' cyclical effect on the economy are fiscal and monetary policy.

Fiscal policy of the recent years is likely to amplify current economic downtrend.

Fiscal policy

The state budget has had a good balancing influence on fiscal policy - since 2000, the average budget deficit has stood at just 0.75% of GDP. However, with budget planning only conducted for one year, the government has tended to increase spending in nominal terms during times when steel prices and growth were increasing. Such a budget spending policy tends to amplify the economic cycle and the impact of steel price volatility on the economy.

Going through the Crisis: Ukrainian Way



NBU is imposing impose floating exchange rate regime.

Monetary policy

For the last seven years, the local currency has been relatively unchanged vs. the USD, the currency to which the hryvnia is officially tied. Since 2008, the NBU has accelerated the shift to a flexible currency rate, which has not yet been achieved. Floating exchange rate regimes are thought to be better at offsetting effects of term-of-trade shocks than fixed rate regimes. Under a fixed exchange rate regime, negative effects from deteriorating export output must be adjusted by domestic prices and wages, which can be a slow process. In addition, the national bank must step in with interventions, buying foreign currency and reducing the money supply and overall financial system liquidity, which is harmful for economic growth. In contrast to the fixed exchange rate, a depreciating local currency caused by a floating exchange rate will not lead to a decline in nominal wages, nor will it offset negative effects on exporters.

Both currency exchange regimes and budget expenditures are among the most sensitive political issues. Governments, which change nearly every year, tend to increase expenses and praise local currency stability in order to gain in popularity. As introducing more long-term budget planning may still be a long-term process, the introduction of a floating exchange rate regime has already been implemented.

Banking system generated large gross external debt.

Banking system

Steel price fluctuations can also affect the banking system. Strong economic growth and trade booms have been followed by sharp increases in deposits, which fueled the lending boom. Sharp decreases in deposits may destabilize the banking system. Even more significant impact on credit growth may have the decline in foreign capital inflows. As economy weakens and banks radically decrease the volume of new loans, threat of rising defaults is rising. However, the growing presence of foreign-owned banks (which now account for 35% of banking system capital) has strengthened the sector. Foreign banks are largely responsible for the strong growth of foreign currency-denominated loans. Assets at Ukrainian banks have been growing remarkably strongly in the last several years. In 2007, banking assets grew by more than 70% y/y. Half of the loans were provided in foreign currency, which generated a substantial amount of gross external debt.

Short-tem debt and public debt at favourable levels.

Public debt and external debt

The gross external debt of Ukraine stands at USD 100bn (as of 1H08). Short-term debt and inter-company lending together amount to USD 32bn, which is fully covered by FX reserves. The government policy of keeping low budget deficits has led to one of the lowest public debt level in the CEE region. Prior to the IMF loan public debt stood at 8-9% of 2008 projected GDP. In addition, Ukraine has one of the highest levels of GDP distribution through the consolidated state budget, which now stands at 38% of GDP. This is not a positive indicator for the economy, but it indicates that public debt is well within the safety zone and that the government has a lot of space to cut spending and issue guarantees for corporate debt.

During the next year, it is the gross external debt of the economy that carries the greatest risk, especially for the banking sector. It is important to support the banking system, as the credit crunch can deepen the cyclical economic downturn. It is estimated by the government and IMF specialists that the total deficit in foreign financing of the economy will amount to USD 17bn during the next year. The IMF has agreed to help cover the deficit of foreign financing for the Ukrainian economy, issuing a USD 16.4bn loan.

IMF loan

Ukraine and IMF agreed on USD 16.4bn loan.

On November 5, the IMF approved a USD 16.4bn two-year stand-by loan. The first transfer of USD 4.5bn has been available since November 6. On November 4, Parliament adopted a law on "Countering the effects of the global financial crisis" as part of its agreement with the IMF. The IMF stated that "Ukraine has developed a comprehensive policy package designed to help the country meet the balance of payment needs… The strength of the program justifies the high level of access, equivalent to 800 percent of Ukraine's quota in the Fund." The program touches on fiscal, monetary and inflation policies and banking regulation.

Regarding fiscal policy, Ukraine is to cut spending to meet declining incomes in 2009. Ukraine will keep its inflation rate at 17% by end-2009. Nominal wages and social benefits are to increase only to cover the inflation process. Ukraine is to impose inflation targeting, based on the core inflation. The indicator is based on the exclusions of fresh fruit, housing services, administratively regulated food products and transportation services. Core CPI includes 45% of the CPI basket. Its implementation is likely in 2010, as it is not well known to the public, which is vital for the inflation targeting policy.

Ukraine imposed preemptive measures to secure banking system stability.

Regarding monetary policy, Ukraine is to impose a floating currency exchange rate regime, which will ultimately result in devaluation, at least during 1H09. Currently, the NBU is imposing measures to keep the official exchange rate in line with the market price. For the time being, the hryvnia exchange rate is administratively regulated, with the NBU having to make heavy use of its FX reserves. The UAH has gone though some depreciation, which is still below potential.

The IMF and the Ukrainian government agreed on the following measures for the banking sector:

- increase in the state fund guarantee for deposits from UAH 50,000 to UAH 150,000 (covering 99% of individual accounts)
- Ukraine and international experts will jointly monitor the biggest banks, which account for 60% of the market, and decide which should receive refinancing
- increase in refinancing activities by the NBU
- increase in transparency of publicly disclosed information from commercial banks

Additional measures by the government include the creation of a UAH 40bn stabilization fund, which will be used for issuing loans and conducting bailouts of banks. The government received the right to borrow money in foreign currency on the local market and use government bonds to buy troubled banks.

Banking system is likely go through a period of consolidation.

These measures are enough to secure overall banking system stability, which is likely to go though a period of large-scale evolutionary changes. The IMF and Ukraine have effectively agreed on forcing further consolidation in the banking sector. Even with minimum capital requirements twice those in Europe, Ukraine has some 170 banks, a number that could fall sharply in 2009.

Glance into 2009

Ukraine will experience recession in 2009.

Real economy
The economy is likely to enter 2009 in recession. The decline in GDP will be strongly dependent on steel prices and demand. In light of historical precedent, it is estimated that a 10% steel price drop results in a 1.5% annualized drop of GDP in the quarter when the drop occurred. The effect disappears quickly during the following quarters and leaves a 0.75% GDP decline over a full year. The same 10% decline in steel prices leads to a 2% decline in inflation. We project a recession of 2.5% of GDP in 2009, with economic growth returning in 2H09. The current account is likely to shrink to just 3% of GDP in 2009, as slowing demand, the credit freeze and dropping commodity prices will hurt imports. The government and IMF have projected a strong inflation figure of 17%, which suggests strong local currency devaluation.

Hryvnia will decline gradually as NBU will move towards floating currency exchange rate regime.

UAH rate
The introduction of a floating exchange rate will result in local currency devaluation, which is supposed to support the real sector of the economy. The optimal level of the UAH/USD will depend on steel prices. At current metal price levels, we project the optimum level to be around 7 UAH per USD, with the hryvnia gradually moving towards this level. During the next several months, the hryvnia rate will depend on NBU actions – imposing the floating rate and administrative market regulation. Also, much will depend on liquidity in the banking system.

Banking sector to expedience turmoil, but will come out of crisis strengthened.

Banking sector
Banks will go through a period of consolidation in 2009 which will continue in 2010. The total number of banks is likely to decline by as much as 30%, while foreign banks will increase their share in total capital to more than 60% during the next two years. The tense situation in the banking sector will keep money market rates rising. The KIEVPRIME (the money market rate indicator among the biggest banks) rate will move further from KIBOR (the general banking system money market rate indicator).

Long-term outlook

Ukrainian economy will become more resilient to cyclical shocks in steel prices and demand in future.

In 2010 economy will return to its potential real GDP annual growth rate of 5-6%.

The current cyclical shock does not present any significant difficulties for the Ukrainian government in terms of meeting its foreign financial obligations, due to the low public debt ratio. Ukraine will keep up with payments on its public debt, which will improve the country's image and investor confidence. The anti-crisis measures taken by the government (to get the IMF loan) will cause changes in the financial system that will make the Ukrainian economy more resilient to cyclical effects in steel demand and prices in the future. The steel industry will continue to invest heavily in production efficiency programs. The local steel industry has great potential for cutting production costs, as Ukraine has one of the world's biggest layers of iron ore and large layers of coal. The recent introduction of steel price futures on the London Metals Exchange (and plans to introduce them on the New York Mercantile Exchange) will bring new hedging possibilities for steel producers. The banking system will also strengthen after a period of consolidation and an increase in the share of foreign capital. In the future, Ukraine will remain influenced by cyclical downtrends in steel demand, but will be much more resilient to them, as it is now (compared to just several years ago). GDP growth will return to its potential growth of 5-6% in 2010, while inflation is likely to come down to a single-digit figure.

Macro Summary

Indicator	unit	2004	2005	2006	2007	2008f	2009f	2010f
Real economy								
Real GDP	% y/y	12.1	2.6	7.1	7.6	4.8	-2.5	5.5
Nominal GDP	UAH bn	345	441	538	713	1046	1193	1455
GDP per capita	UAH	7 299	9 407	11 527	15 301	22 709	26 299	31 782
Household consumption (real)	% y/y	13.1	20.6	14.4	17.1	9.0	-3.0	7.6
Gross investments (real)	% y/y	20.5	3.9	18.7	24.8	3.0	-3.0	10.0
Industrial output	% y/y	12.5	3.1	6.2	10.2	0.0	-4.0	7.0
External balance								
Export	USD mn	32 672	34 287	38 368	49 248	63 500	70 485	83 979
Import	USD mn	28 996	36 141	45 034	60 669	78 050	82 733	96 797
C/A	% of GDP	10.5	2.9	-2.9	-4.2	-6.7	-2.5	-4.0
Prices								
CPI inflation	% y/y, Dec	12.3	10.3	11.6	16.6	20.0	16.0	9.0
	% y/y, avg	9.0	13.5	9.2	12.8	22.8	18.0	9.4
Labour market								
Unemployment rate (ILO methodology)	%	9.2	7.8	7.4	6.9	6.5	8.6	7.1
Average wage	UAH	591	806	1 043	1 353	1 879	2 199	2 605
Public sector								
Fiscal balance	% of GDP	-3.2	-1.8	-0.7	-1.1	-2.0	-2.5	-1.5
Foreign debt	% of GDP	47.3	46.6	51.0	60.0	60.2	64.2	51.6
Public debt	% of GDP	25.5	17.7	14.8	13.0	10.9	12.0	10.6
Interest rates								
Central Bank Interventions Rate	avg	7.60	9.20	9.00	8.20	12.00	12.00	10.00
	Dec	9.00	9.50	8.50	8.00	12.00	12.00	9.00
Short-term Interest Rates (3M)	avg	17.60	12.70	13.50	9.60	18.00	13.50	8.00
	Dec	28.00	16.00	15.00	8.70	9.80	12.80	8.80
Exchange rates								
USDUAH	avg	5.32	5.12	5.05	5.03	5.02	6.70	6.30
	Dec	5.31	5.05	5.05	5.05	6.20	6.50	6.20
EURUAH	avg	6.61	6.39	6.34	6.89	7.45	8.00	8.15
	Dec	7.22	5.97	6.65	7.42	7.44	8.45	8.06

Sector-by-sector overview

Global financial crisis timeline & Ukraine

World

2H2007 "First signs":

- Credit crunch affected portfolios of banks and hedge funds around the world, from BNP Paribas to Bank of China. UBS announces $0.6bn 3Q loss
- FED, ECB & BoJ inject liquidity. FED cuts discount rate
- Northern Rock has liquidity problems. Merril Lynch announces US$5.4 billion loss

1H2008 "Downturn begins":

- January 2008 stock market downturn. Bear Stearns acquired for $2/share by JPMorgan Chase. Merrill Lynch sold to BoA. Lehman Brothers files for bankruptcy
- FED loans $85 billion to American International Group (AIG) to avoid bankruptcy
- US, EU enter recession, production cut in almost all industries

2H2008 "Recession fears":

- U.S. Senate passes $700 billion bailout bill. The financial crisis is spreading to Europe. Icelandic financial crisis. The IMF sees major global downturn
- Coordinated rate cut. FED makes emergency move to lend around $1.3 trillion directly to companies. UK government injects £37bn in the nation's three largest banks
- ECB attempts to revive credit market by weekly injections of unlimited Euro funds at 3.75%. Germany approves a plan to inject €500bn into credit markets

Ukraine

2H2007 "No major impact":

- NBU targets the decrease of foreign borrowings due to growing inflation risk: increases required reserves and issues deposit certificates
- Local companies have attracted abroad USD 1.7bn via Eurobonds and USD 4.5bn via syndicated loans in 2H2007

1H2008 "Impact begins":

- Local money market experiences liquidity squeeze, due to anti-inflation measures of NBU and keeping the money on the treasury account
- Banks stop issuing new loans and increase rates for deposits and loans
- Real estate reports decreased demand
- Problems with refinancing abroad for local industries and banks as the distrust deepens
- Non resident investors begin to leave market

2H2008 "Slowdown in Ukraine":

- Local banking system saved from panic by NBU measures
- Real estate is down, residential market in stagnation
- Metallurgy reports storehouses overfilled with unsold products while the price of steel products decreases more than 50%
- Cost cutting has started, projects are frozen, some companies think about being sold
- Non resident investors continue to leave Ukraine
- Huge corporate debts at the risk of default

Future Outlook (1-2 years ahead)

- Problems with refinancing abroad
- Retail credit growth will be slowed down to single digit growth level
- Companies trying to move over to less aggressive expansion plans
- Projects freezing which will result into moderate industrial growth
- Cost-cutting strategies in all sectors
- IPO plans will be frozen for the next five years
- Decline and stagnation of steel, real estate, retail trade sectors, which were driven by loans
- Agriculture and food sectors will be less impacted
- Further devaluation of hryvnia to help exporters
- Exports and imports growth will slow down
- More M&A and consolidation deals are expected, as healthy companies will take over the weaker ones

Sectors

Banks

Ukrainian banking sector has showed strong growth results,

The local banking was one of the most attractive and quickly growing sector. Actually what at the first glance looked as the very strong growth on the unsaturated market was only the cause and the effect of the typical "bubble" or the "overheating" effect.

being overheated by cheap capital from abroad,

Due to rapid growth of the amount of outstanding loans which has reached 70-80% y/y in the early 2008, and which were financed by abundant and cheap resources from abroad, the local economy has shown strong growth results. The foreign "mother" banks have pumped capital into their Ukrainian "daughters" which has led towards record FDI inflow into Ukraine in the 1H2008, even as the global markets were already experiencing difficulties.

which has urged the NBU to implement the tightening measures.

Sadly, the rapid expansion of monetary aggregates and a couple of other external factors have brought the inflation to very high levels, CPI has even broken through 30% y/y level in early 2008. Thus, the National Bank decided to reduce the excess liquidity in the banking system to cool down the growth of loans. This has caused a short-term liquidity squeeze in March-May 2008, following which many local banks have stopped to issue new loans and increased the rates. The cool down of the economy began.

Heavy times on the global markets

Global markets have entered the stage of "trust crisis" in 2H2008 as the situation abroad became worse. At the same time local fixed income, FX and money markets were going through heavy times as well. Stagnation in the real estate sector, which lasted already since 2H2007, and the newly reported problems from the metallurgical sectors, both of which were the key clients of the banks, caused hard times for banks.

and massive withdrawal of the deposits locally, forced NBU to action.

Additionally to the above events, the October raid on the Prominvestbank has caused the panic and massive withdrawal of deposits by private persons in the amount of UAH16-18bn during the first two weeks of October. This has endangered the whole banking system. Thus the NBU had to act quickly to bring stability back. On October 13th, the National Bank of Ukraine has issued a Decree Nr.319, which intended to stabilize the banking system by temporarily freezing the growth of banks' assets, prohibiting loans to entities which don't have an income in foreign currency, which meant no loans in FX to individuals, and prohibiting early withdraw of the deposits. Right after that, the NBU has injected enough liquidity via long-term refinancing into the banking system.

New limits for loans issuing

These temporary limits literally have stopped the loan issuing "business" for banks, as most of loans are issued in FX. This has caused further problems for the local real estate, metallurgy, machine building and retail sectors, where the demand for products is heavily dependant on financing.

forced banks to revise their plans.

Under these circumstances, local banks began to revise their strategic plans, change their growth outlook to more moderate, turn to the cost cutting strategies. Difficult times began for the banks that had very aggressive expansion plans and non-diversified loan portfolios. We expect that banks will begin to report large losses soon, as already now we see a delay in credit payments and this tendency is increasing. The local banking system will see takeovers and mergers as banks will go through hard times. The stability of the sector will depend on the prompt actions of the NBU, which currently has sufficient resources to act as a crisis manager.

Real Estate

a) Residential and commercial

A decrease in demand, both speculative and non-speculative,

One of the first victims of financial crisis was real estate sector. Speculative real estate investors began to leave the overheated sector right after the crisis has hit the US market in 2H2007. And for non-speculative buyers, it was more and more difficult to make a purchase as the prices were increasing at a higher rate than the nominal income during recent years. The traditional summer decrease of the new deals lasted well from summer 2007 into 2008.

together with limitations on financing

The situation became worse after the NBU used the liquidity squeezing as the anti-inflationary measure, earlier in 2008. This step has left local banks almost out of excess liquidity and forced them to reduce their loan portfolio growth. All banks increased rates for loans and deposits, some have even stopped issuing new loans at all.

have put the highly leveraged sector on the recession path.

70-80% of local real estate market has been fueled by loans both for individual buyers and for construction companies. Thus, as banks began to limit credit growth, real estate sector felt an unprecedented decrease in demand for new apartments. The grim outlook and the panic mood on the global markets, has made all speculative capital to leave the local real estate sector. Both residential and commercial real estate segment went into stagnation

Companies applied cost-cutting

Local real estate market operators have publicly acknowledged that they have problems only in September-October 2008. News about no demand and massive cost cutting began to spread on the market. Smaller construction companies were sold, projects were frozen

while the government offered its help as well,

The government has recently adopted anti-crisis measures, according to which real estate companies and construction materials producers are obliged to cut net margin to 15%. The government might help local construction companies in terms of financing in urgent cases. Although the procedure has not been specified yet.

but this won't solve the key problem: the demand issue

As of now, the Ukrainian residential and commercial real estate segment faces huge demand problems as the local economy cools down. The price for residential real estate has fallen by up to 30%. The possible risk might come if the hryvnia will strongly devalue, which will make almost impossible for local borrowers to repay their mortgage loans. Though currently NBU keeps the exchange rate strong.

b) Roads and infrastructure

Road construction sector in a better shape

On the other hand, the infrastructure and roads construction segment feel themselves better. Some companies still have contracts and working projects. Recently, Mostobud won four tenders in Romania for the expansion of a 4-lane section of the 'South Bucharest' bypass and for the rehabilitation of national roads at the 'Vyrfule – Stey' site. The total value of the projects is more than EUR 95mn.

due to a different client base,

Mostobud also has investment plans for the local bridge-building market for the next few years, which are focused on two bridges in the Kyiv Region and one in the city of Kremenchug. Company plans to invest more than US 5.2 bln in Kremenchug bridge building.

and expected EURO 2012 projects.

The local construction market during the following years will be driven by the projects connected to Euro 2012. Despite certain delays, the preparation moves on. Sergiy Taruta, who controls the industrial group ISD, has announced that he is ready to build stadium in Lviv, which will cost more than $85mn. Besides stadiums, Ukraine plans to improve hotels, roads and other infrastructure. This means huge investments and growth in construction and building industries.

Metallurgy

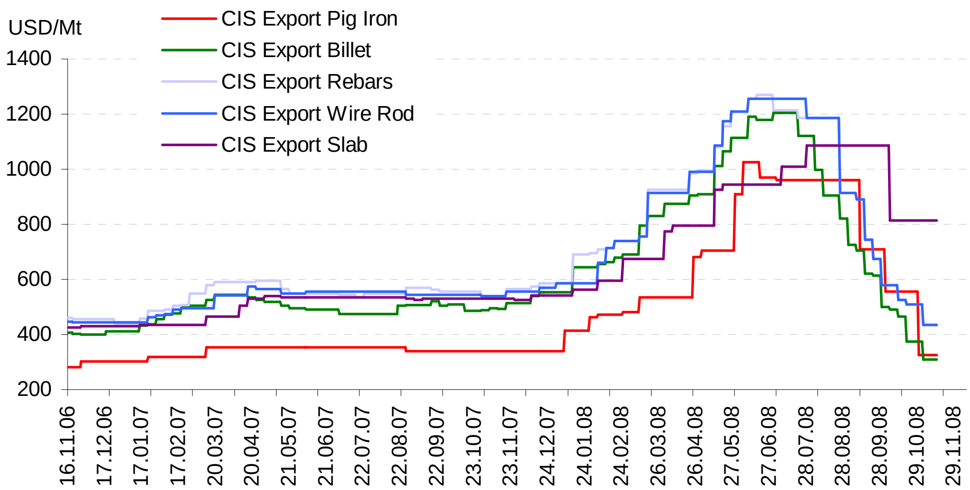
Being not ready for the crisis

Frankly speaking, the local metallurgy industry was not prepared for the crisis – companies were enjoying a period of good profitability, implementing heavy CAPEX programs and taking on more debt. On the other side, large Ukrainian metallurgy holdings are better positioned than other local companies, as they are owned by oligarchs, who have well diversified business portfolios. Almost all local metal and mining companies belong to a couple of financial-industrial groups. This means that most of them have closed production cycle and they are not so dependent on supplies.

the steel makers have run into liquidity shortage

Local metallurgy industry began to experience first liquidity problems already in the 1H2008, but then it was partially compensated due to rapid price growth. CIS steel export prices have hit their peak in July at 1200 USD/mt. Later on, they have fallen sharply to the levels below 400 USD/mt. The price increase and decrease has been driven mostly by fluctuations in the demand from Asian countries, which have reduced their construction activity in the 2H2008 due to the global downturn.

Chart 1. Development of CIS steel export prices



Source: BLOOMBERG

facing reduced demand and refinancing difficulties.

This added on top of the recent refinancing problems and caused serious liquidity problems for Ukrainian metallurgical companies. During the recent months, these companies have suffered a liquidity shortage, forcing some of their owners to think about selling off their companies. The demand-supply gap increased further into the negative territory, and metal traders have reported unusually high stocks of metal products. Local steel companies began halting their production lines and downsizing.

Key companies have halted their production,

For example, on the 26th of October, the second largest after Kryvorizhstal steel company MMK Ilyicha has been stopped and 60 thousands of its employees will temporarily receive reduced wages. Since the 1st of November, Zaporizhia Aluminum Plant, major local producer of aluminum is halting production due to debts. On the 6th of October, 20.8% stake of Ferrexpo was sold to RPGI due to margin call on the loan from JPMorgan Chase. Later on, Ferrexpo has revised its development outlook to more moderate.

although some companies still think

On the other hand, Metinvest, the largest Ukrainian metallurgy holding, tries to finalize the purchase of the US coal company United Coal to increase own supply of

about expansion.

coking coal from 50% to 100% and to have a closed production cycle. According to our point of view, Metinvest is trying to decrease the price of the deal, using the current recession as the argument.

The government showed readiness to help the sector

To help local steel and chemical industries, the government has approved a moratorium on increasing of prices for cargo transportation for these sectors, the reimbursement of VAT taxes within three days and zero taxes for natural gas in the period from October 1 until end-2008. Additionally, the government has asked ministries to halt any price increases for electricity and coking coal until the end of this year. This should ease the pressure on our local steel and chemical sectors. These measures will only partially help the industry, as the major factor of this crisis, decreased global steel demand, will slowly begin to revive only in the 2H2009.

to save jobs.

On the 10th November, the government has signed a memorandum with steelmakers. The memorandum consists of a set of obligations for both parties. The steelmakers promised to keep the minimum output and the workforce intact. The government has promised cheap financing of the development of the steel industry, to sell gas at the cost of import plus the transit charge, and to reimburse VAT to exporters within five days.

Long-term plans are optimistic

As reported by the Ukrainian steel plants, they are planning in the long-term to reach 20mn tons of annual steel production before 2018. Azovstal should increase capacity by 21%, Makeevsky steel plant by 44%, Enakievskiy steel plant by 29%. Investment in Azovstal will compose $5 bln, in Makeevsky steel plant at least $6 bln, in Enakievsky steel plant around $2 bln. Overall, Ukrainian steel producers plan to increase annual capacity from 42-43mn tons to 55-58mn tons before 2015.

but in the short-term we expect reduced output.

It is estimated that the global steel demand will fall 30% in 4Q08, prompting companies from ArselorMittal, the biggest steelmaker, to Russian Severstal to cut output and review investment plans. Ukrainian steel mills have cut their steel output by 25% m/m in October 2008, which resulted in 33.5Mt output or a decrease of 6% y/y for 10M2008. The domestic steel output will decrease by ca 15% y/y in 2008, with local steel companies trying to unload their record high inventories well into 1H2009.

Case study: Metallurgical exports to Africa

Removed customs duties to Africa

It is worth to mention, on a positive note, that Ukraine might widen its metallurgy exports to Africa and increase its share from current 9-10% of metallurgy exports to this territory. This summer, North African countries have removed all custom duties on metal and raw materials import. This might be a good chance for increase of Ukrainian metallurgy exports, as North African real estate markets still remain strong.

as a chance to increase exports to a strong market

Prospective for Ukrainian export could be Algeria which has more than 3mn tons demand. 70% of consumption is imported production. Realization real estate projects due to 2011 should help to increase import volume to 2mn tons annually. Other countries in region also increase real estate sector all the time despite crisis. Among them are Morocco, Tunis, Egypt. Building growth in Tunis should provide metal consumption of up to 4mn t. Sudan has imported around 1mn tons of rolled metal. So, a possible expansion of Ukrainian rolled metal export to the East and North Africa direction could give new opportunities for domestic steel producers.

facing healthy competition.

Industrialization in emerging markets like China, India, Iran, Brasilia and Middle East will help to increase demand for steel products. But China and India are our main competitors and to receive competitive advantage, Ukrainian steel producers should invest considerable amount of money into production line modernization.

Machine Building

a) Automobile sector

Another strongly leveraged sector

Global financial crisis and decline of production activity across the world has impacted Ukrainian machine builders as well. The local automobile building sector is highly dependant on loans, as in early 2008 almost 60% of all new car purchases have been financed by banks. It is clear that in the times of tight liquidity and no FX loans to individuals (NBU Decree Nr. 319), the demand for new cars will strongly decrease.

was forced to revise sales figures on the back of reduced demand

Earlier this year it was expected that the new car sales will reach 700-750 thsd, but as of beginning of November the number has been reviewed down to 600 thsd cars in 2008. The sales of new cars will decrease by estimated 37% to 380 thsd cars in 2009. It is expected that in 2009 from 0% to 10% of all new car purchases will be financed by loans, while in the early 2008 this figure was 60-70%.

and began to implement cost-cutting strategies.

Facing such market outlook, automobile producers move on to more moderate growth plans and reduce their costs. In October, Eurocar reduced the output by 50% and has sent into vacations 1000 out of 1300 workers, due to strong fall in demand. Bogdan Corporation, a major Ukrainian automotive corporation, is cutting its production plan for 2009 by 40% because of the souring automotive market.

Demand still present

Local automobile producers try to diversify their demand base. Recently, Bohdan Corporation won a tender to supply the municipality of Batumi, Georgia with 83 class-A 092 mini buses, a deal that is reportedly worth $3.4mn EBRD is financing the supply contract.

although the market will be reformatted.

We expect that the local new car market will be “reformatted” due to current unfavorable macro conditions, with the strongest demand found in the cheap car and premium segments.

b) Rail car

Sector in a consolidation mood,

Rail car building and ship building might help the metal sector to go through the crisis, maintaining the domestic demand for metal. In early summer a couple of large companies have announced about their plans to create rail car holdings.

lead by Azovmash, F&C Group, Smart Holding, and TAS Group.

Azovmash’s holding will include Azovobschemash and Mariupol Wheel plants. Finance and Credit Group’s holding will include Stakhaniv Rail Car and Konotop Rail Car plants. Mr. Novinskiy, the owner of Smart Holding, announced as well about his plans to enter the rail car segment. Dnipropress plant, which is controlled by Smart Holding, began the modernization program aiming to launch rail car production. TAS Group decided to join Kremenchuk Wheel, Kryukiv Rail Car and Dniprovagonmash in one holding.

Robust demand outlook from the state-owned clients

As the sector has a different client base, it still enjoys healthy demand for its products. Recently, the largest rail car producer Kryukiv Rail Car signed contracts with Ukrainian state-owned railway company Ukrzaliznytsya and Belarus Railways for 130 passenger wagons in 2008. Additionally, Ukrzaliznytsia plans to buy 200 passenger cars from Kryukiv Rail Car in 2009, which Ukrzaliznytsya will be able to finance via recently received $125mn loan from EBRD for new railcars purchase.

and ongoing CAPEX

The largest rail car producer continues its CAPEX activities. Recently, Kryukiv Rail Car has completed construction of a USD 5.9mn assembly welding shop. With this new facility, Kryukiv's annual capacity for passenger railroad cars will grow from 100 to 300 cars. Kryukiv's product portfolio will now include both Ukraine railroad cars and subway wagons.

ensure low impact by the crisis.

As we see, the rail car segment, mostly passenger rail cars, will not be impacted to a great deal by the crisis, as the demand from the state-owned clients remains robust and was not affected greatly by the crisis.

c) Shipyards

Benefits of overseas transportation

In such a difficult market situation, when the transportation sector is also feeling the impact of the crisis, overseas transportation has certain benefits. First of all, overseas transportation is the cheapest and the price of transportation has no connection to product capacity. Thus, the demand for overseas transportation will be less affected by the crisis, especially for tankers and container trucks.

turned shipyards into an attractive investment asset.

The key role in the overseas transportation is provided by shipyards, which derive their main profits from shipbuilding, ship maintenance and fees for demurrage and shipping. A few months before the crisis hit Ukraine, some of the key Ukrainian financial-industrial groups bought dockyards or announced plans to invest in deep-sea dockyards. Among them is ISD.

ISD Group controls strategic dockyard in Poland

In our opinion, ISD might sell all non-core assets and consolidate its dockyard and certain steel assets. Meanwhile, Poland's Treasury Ministry plans to come to an agreement with ISD to restructure the Gdansk dockyard by December 2008. ISD, which owns the dockyards, expects the government of Poland to provide about USD 50-65mn for restructuring the Gdansk dockyard, which the concern owns.

and plans to buy another one.

The joint plan for restructuring the Gdansk and Gdynia shipyards sent to the European Commission in September provided for investments totaling EUR 110mn by 2020, out of which EUR 90mn is to be invested in the development of the Gdansk dockyards. ISD would like to win the Polish tender and add Gdynia to its shipyard assets.

At the same time Ukrainian shipyards enjoy long-term contracts,

Usually Ukrainian shipyards build only the hulls of ships. But there exists one shipyard, which delivers complete ships. It is Zaliv Shipyard, which is controlled by the Finance & Credit Group. Currently, it is building two container carriers according to an order from the Netherlands' Damen Shipyards (at this moment, they have suspended manufacturing of two vessel hulls) and a natural gas vessel for Norwegian company Ulstane.

cost and synergy benefits.

Overall, the shipyards industry was not heavily impacted by the recent crisis, as they enjoy the strong price competitive advantage, log-term ship building contracts and good synergy effects if owned by industrial group.

d) Aircraft

Strategically important aircraft industry enjoys current long-term contracts,

It is obvious that the demand for the aircrafts will remain on its current levels, due to long-term projects and due to Ukraine's specialization in the strategic airlifters. The state-owned company Antonov produces airplanes in the range from the small aircrafts to the massive An-124 Ruslan and An-225 Mriya strategic airlifters (the latter being the world's biggest aircraft in service but just one of it has been built).

and upcoming projects with Iran (An-148)

Iran is interested in setting up mass production of the new An-148 regional jets at its factories with the participation of Ukraine and Russia. From the Ukrainian side, the largest aircraft plant, Antonov, is discussing a USD 1bn agreement with Iranian aircraft company HESA. Fixed orders have already been placed for more than 50 aircraft to be made until 2012, with the first one expected to appear on the market as early as 2008. An additional point is the possibility of such agreements with Russia and China. The assumed term of project realization is 2012.

and Lybia (helicopters).

Ukraine and Libya are to launch new projects in the military and technical fields. An official Libyan source confirmed that President Yushchenko said priority should also be given to bilateral economic projects, as well as to the establishment of a common industrial base. The Ukrainian leader recalled the rapid establishment of a base for the maintenance of Antonov planes, while Libya participated in the activities of the Ukraine Helicopters company, with an eye to the establishment of a firm by Libya and Ukraine.

Agriculture

a) Grain

Favorable price & IPO conditions in 1H2008

Agricultural business was less impacted than real estate or metallurgy. Enjoying good harvest and record prices in the 1H2008, a couple of local companies from the agriculture and food sector even managed to carry out successful IPOs and placements abroad. Among them were MCB Agricole Holding, Landkom International PLC, Myronivskiy Hlibprodukt (MHP), Kernel Group, Mriya Agro Holding Plc and Sintal Agriculture Ltd. Although the "happy times" have ended as the agriculture prices began to subside in the 2H2008 and the financing for winter sowing campaign became less accessible.

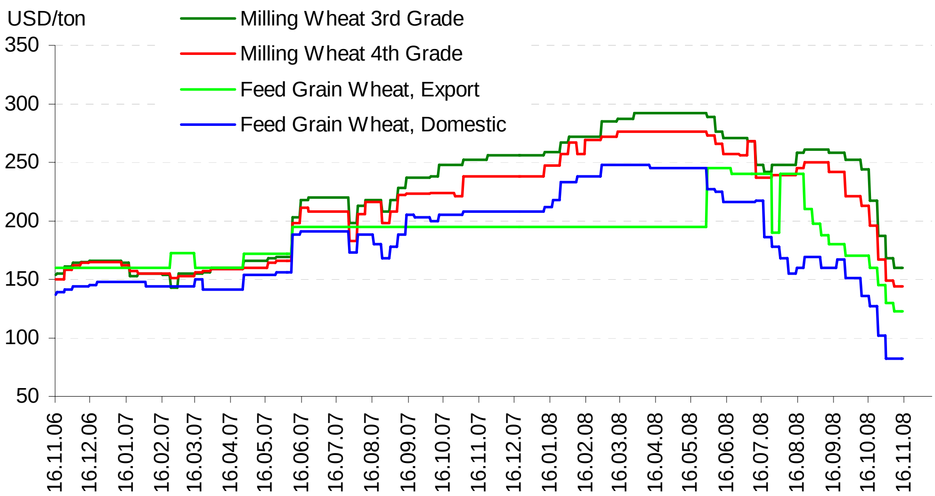
and a record harvest

To begin with, as of Oct08 local farmers have harvested 44.8mn tons of grain, and it is expected that this year's harvest will reach 51mn tons of grain, which is the highest amount since the Ukraine's independence. The grain exports have intensified as well, but it is clear that the grain exports will subside in the following months, as the demand on the global markets for agricultural commodities cools down. Anyway, the record harvest in 2008 has helped Ukraine to partially offset the recent decline of the exports of metal products.

have been replaced by decrease in price and in demand in the 2H2008.

The increased supply has pushed the price of wheat, corn and barley down, both on the local and global markets. According to Ukragroconsult, the price of the milling wheat of 3rd grade has decreased from 292 USD/ton in Apr08 to 160 USD/ton in Nov08. Similar price trends were observed in barley and corn export prices. The Ukrainian Agrarian Fund has performed regular interventions on the local market, but these were stopped since 23rd of October, as the financial resources were not transferred from the State Budget. This has made the situation worse. This price decrease forced farmers to withhold selling their harvest, and wait for better times.

Chart 2. Development of Ukrainian Wheat and Feed Grain prices



Source: BLOOMBERG

Agricultural companies met financing difficulties during the winter sowing season

As the agricultural companies are going through the sowing season, most of them are being negatively impacted by the cost of loans and difficulty to receive financing, caused by recent liquidity problems in the local banking system. Good news for agricultural market is the recent agreement between companies and banks to extend the repayment of loans until June 2009. This measure should maintain agricultural producers afloat during sowing campaign.

which will result in lower harvest in 2009.

Nevertheless, we expects that next year's harvest in Ukraine will be smaller than in 2008, due to financing problems for local agricultural companies. This means higher prices for grain next year.

b) Sugar

Least effective companies to perish,

In 2007/2008 marketing year there were 110 sugar plants in Ukraine. Next year this amount will decrease to 70. The main reason of such situation is out of date equipment, which results in higher cost of sugar halt production.

while the sugar demand remains healthy

Now the most effective sugar producers are Ukrros, Dakor and Astarta-Kyiv. Recently, Astarta-Kyiv signed a contract to supply sugar to Coca-Cola Beverages Ukraine until 2011. Sugar supplies to Coca-Cola will be increased by 10% annually compared to the contracted amount for 2008.

and the land areas have been increased.

Gross harvest in 2008 would be less then last year and will total more then 5mn tons. To improve the situation, main sugar processors decided to increase the land areas for sugar beet to achieve higher harvest next year.

Retail

Another high leveraged sector endangered by decreased demand

Local retailers were among the highly leveraged sectors in Ukraine. Loans propelled their rapid expansion and have fueled the demand for the products sold in their supermarkets. As it became more difficult to receive good financing, and people's income is affected by the cost-cutting in almost all sectors of economy, the retailers see decrease of sales, both in food, household appliances (in October by 20% m/m) and electronics segments. Thus, any new loans to the retail companies are bound with an increased risk, as they might not be repaid.

and is forced to cut costs and do M&A.

The situation will be difficult especially for the local retailers with high debt ratios, as they won't be able to refinance themselves easily, which might result in defaults. It is clear that cost-cutting strategies will be implemented, investment and expansion plans will be put aside. We expect a lot of M&A deals, as bigger companies will take over the weaker ones. Already, Nash Kray, Pakko, Agrokontract, Amstor and Unitrade Group have announced their desire to be purchased. On the other hand, better position have companies with foreign investments. For example, Metro Cash&Carry has opened 5 hypermarkets this year in Ukraine with total value EUR 120mn. IFC will lend $75mn to Eurotek for retail chain development.

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