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Ukrainian Economy 2012 Outlook

External turbulence takes a toll

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Capitalizing on gains from a strong 2011, we believe the Ukrainian economy is well prepared to withstand global turbulence this year. Economic growth will slow but remain positive (+1.9%), supported by continued strength in private domestic demand. The growing external financing gap poses the biggest threat, but in our view the NBU has sufficient reserves to cover it and keep the hryvnya broadly stable, even without a price discount on imported gas from Russia or the resumption of cooperation with the IMF. Also we think external debt servicing by the government and private sector will be smooth; the experience of 2009 suggests debt rollover should be manageable even in tough markets.

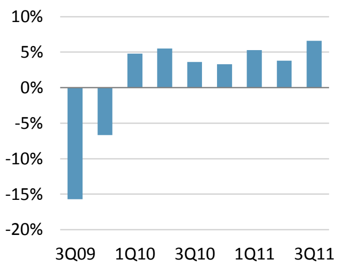
- After a resilient 2011 (GDP growth rose hefty 4.9% and inflation was kept in check at just 4.6%), Ukraine's economy faces a difficult 2012 as external demand wanes. We downgrade our projection for Ukraine's GDP in 2012 from our previous forecast of 4.6% yoy to 1.9%. Private consumer demand will remain a bright spot this year supported by double-digit growth in social payments and public sector salaries against the backdrop of decelerating inflation.
- The greatest economic threat in 2012, in our view, is the sizable external financing gap, which we project at USD 7.1 bln (3.8% of GDP). The government has two options to help cope with the shortfall: secure a discount on natural gas imports from Russia and/or unfreeze its USD 15.5 bln IMF standby loan. With uncertainty on both fronts, we are conservative and assume no price discount and no IMF loan in 2012 in our base scenario.
- We believe the NBU will try to keep the hryvnya stable in 2012 in order to support leveraged Ukrainian households. However, this will come at a high cost – namely the USD 7.1 bln needed to cover the external financing gap from NBU reserves, which should be enough keep depreciation to just 2-3% to UAH 8.2/USD by yearend.
- We think the government will keep the fiscal gap in check as raising debt remains a challenge. We project the 2012 general budget deficit (adjusted for Naftogaz' shortfall) to shrink from 4.2% of GDP in 2011E to 2.8% in 2012.
- Smooth debt servicing by Ukraine is solely an issue of liquidity not of solvency as implied by the economy's modest debt burden (end-2011E public debt at 36% of GDP). However, we believe access to international debt markets in 2H12 is necessary for smooth budget execution and debt rollover.

Key economic data and forecasts

	2008	*2009*	*2010*	*2011E*	*2012E*
GDP growth, yoy	2.3%	-14.8%	4.2%	4.9%	1.9%
Household consumption, yoy	11.8%	-14.1%	7.0%	14.1%	8.1%
CPI, eop	22.3%	12.3%	9.1%	4.6%	9.1%
C/A balance, % of GDP	-7.1%	-1.4%	-2.1%	-6.1%	-6.3%
General budget balance, % of GDP*	n/a	-8.1%	-7.3%	-4.2%	-2.8%

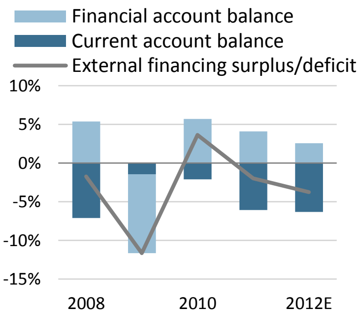
** Includes central budget (excluding costs of capitalizing banks), local budgets, social funds and Naftogaz*
Source: Concorde Capital

Quarterly GDP, yoy



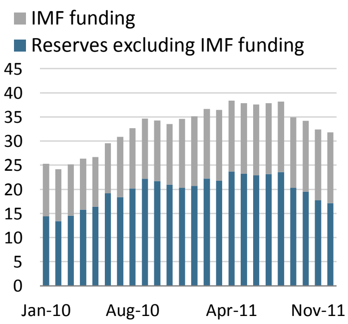
Source: UkrStat

External financing needs, % of GDP



Source: NBU

NBU gross reserves, USD bln



Source: NBU

Mostly better off than in 2008-2009

We believe that in many respects the Ukrainian economy is in better shape to withstand global turbulence than it was before the 2008-2009 crisis.

Debt markets tough but not as bad for Ukraine as in 2009
We think that if necessary Ukraine could raise new external debt in 2012 that though expensive, would be manageable, unlike in 2009 when foreign debt markets were completely closed. Investor perception of Ukraine is still better than at the height of the 2008-2009 crisis: 5-year CDS is now at 900 bps, well below the peak of over 5,000 bps in 1Q09, even though cooperation with the IMF has been suspended.

Political power is consolidated, can quickly and unilaterally adopt reforms
The consolidation by one political party of the key levers of the Ukrainian government is unprecedented. This is in sharp contrast to the perennial political paralysis of 2007-2010, which undermined consistency in economic policy. The president, Cabinet of Ministers and parliament have the ability to unilaterally push through unpopular but critical reforms (as they did with pension and tax code makeovers previously), though they have been cautious of late due to upcoming parliamentary elections (October 2012).

Stronger ability to raise local funds to cover the fiscal gap
The Finance Ministry introduced new instruments to raise funds locally – USD-linked local bonds in October and USD-denominated local bonds in mid-December. The latter should help channel households' FX cash savings through banks to the state and support the government's liquidity (we expect the government to raise net USD 2.5 bln via such bonds in 2012). While these new papers might substantially ease funding pressure on the government, we believe access to international debt markets in 2H12 is necessary for smooth budget execution and debt rollover.

The NBU has learned some lessons from the 2008-09 crisis
The National Bank of Ukraine's approach after the last crisis hit was to flood the banking sector with liquidity via refinancing loans, which eventually fuelled large-scale FX market speculation. In contrast, of late, the central bank has been overly cautious with the provision of liquidity. We hold that this approach will cost around 0.5 pp in economic growth in 2012 and could further undermine banks' already weak earning capacity. Yet, we deem this stance justified, at least for a while – funds for FX speculation are limited and expensive, which is supportive of hryvnya stability.

Lower steel prices and more expensive gas
On this front, Ukraine seems to be in a less advantageous position than in 2008-2009. Prices for steel, Ukraine's key export commodity, have corrected 14% from their 2011 highs and we expect them to remain on average 5-10% yoy lower in 2012. We do not expect this to be counterbalanced by cheaper imported gas, as the latter's price lags global energy prices by roughly nine months, as stipulated by Naftogaz' contract with Gazprom.

Watch list for 2012

The Ukrainian government has two options to substantially soften the effect of turbulence in external commodity and capital markets on the domestic economy:

1. **Secure a discount on natural gas imports from Russia**

   Bilateral negotiations, which have been underway behind closed doors for months, appear difficult and could drag on until at least March, after the presidential election in Russia. Taking the Russian-Belarusian gas arrangement as a guide, we estimate Ukraine could realistically get a USD 105/tcm gas price break in 2012. This implies a total discount of USD 4 bln in 2012 and USD 2-3 bln likely to be paid in 2012 as a cash consideration for acquisition of a 50% stake in Ukraine's gas transportation system. See our report "Ukraine-Russia gas deal" dated Dec. 22, 2011.

   A cut in gas import volumes is the only way for Ukraine to avoid a sharp deterioration in external accounts if the government fails to negotiate for a substantial gas price break from Russia. In line with government plans, we assume Ukraine will import 33.7 bcm of gas in 2012 (including 27.4 bcm by Naftogaz and 6.3 bcm by Ostchem Holding) vs. 44.6 bcm (including 40 bcm by Naftogaz and 4.6 bcm by Ostchem Holding) in 2011E, which implies the country's gas bill will remain largely unchanged in 2012 at USD 14.0-14.5 bln. We note that Naftogaz still has to agree with Gazprom on a decrease in contracted gas volumes, but despite politically-charged rhetoric on both sides, we believe this (unlike the price discount) to be a technical issue.

2. **Unfreeze USD 15.5 bln IMF standby loan**

   Officially, the IMF took a pause in negotiations in November 2011 for "additional technical work", but the major stumbling block is rather Ukraine's unwillingness to raise household gas tariffs as the IMF has requested. We think the government is waiting until after it concludes talks with Russia on a gas price discount before determining the necessity and magnitude of any tariff hike. If Ukraine secures a significant price break, we think it will compromise with the IMF on a moderate 15-20% tariff increase.

   Resumption of Ukraine's IMF program would support central bank reserves and boost investor confidence – we think Ukraine's sovereign yield curve could move 50-100 pp downward on the news, all other things equal.

With uncertainty on both fronts, we remain conservative and assume no price discount and no IMF loan in 2012 in our base scenario.

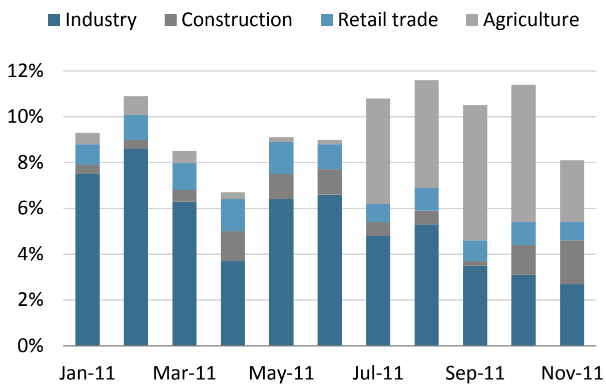
GDP growth to slow to 1.9% in 2012

We turn more pessimistic on Ukraine's economic growth outlook in 2012 and now project GDP to increase 1.9% yoy, a substantial downgrade from our previous forecast of 4.6% and following 4.9% in 2011E.

Industries turn negative year-on-year in December

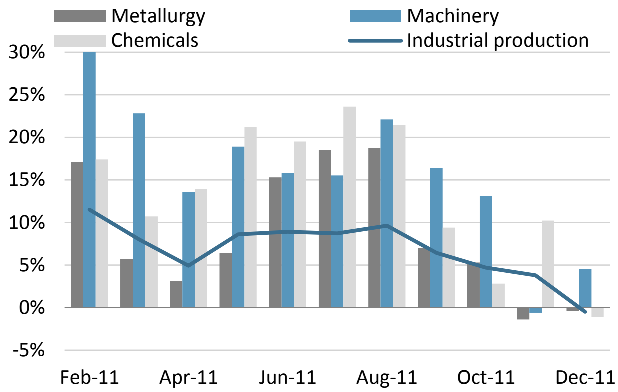
2H11's GDP growth of above 5% yoy is not sustainable, in our opinion, as it rests mainly on a bumper harvest, whose positive effects on economy (direct and secondary via food industry) will fade already in 1H12. Chances of a repetition of last year's harvest are low given the poor condition of winter crops, implying a high base effect for the sector this year. The industrial backbone of the economy is already showing signs of a slowdown: output expanded a mere 3.8% yoy in November and slipped further to negative 0.5% yoy in December (though 2011 growth was still strong at 7.3% yoy).

Contribution to NBU economic growth index, yoy



Source: NBU

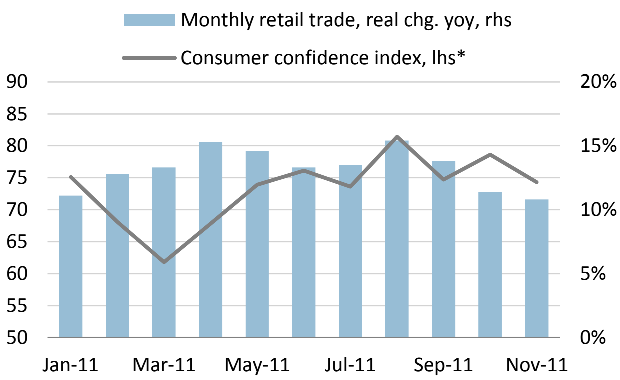
Monthly industrial output, yoy



Source: UkrStat

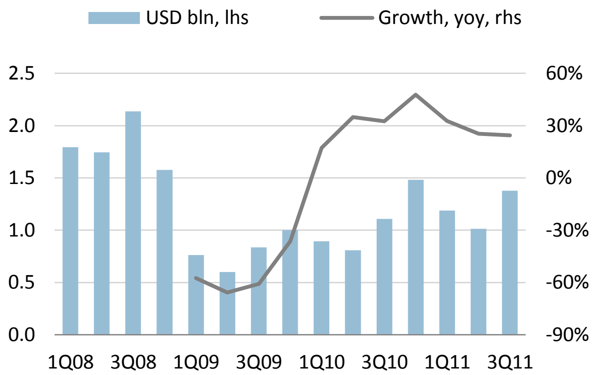
Retail trade remains a bright spot, adding 10.8% yoy in November (+13.6 yoy in 11M11), pointing to continued strength in private consumer demand. This is also illustrated by strong home appliance & electronics sales (+27% yoy in nominal terms in 9M11, according to GfK Temax).

Monthly retail trade, yoy



** Numbers below 100 imply negative assessments exceed positive ones*
Source: UkrStat, GfK

Home appliance and electronics sales in Ukraine



Source: GfK Temax Ukraine

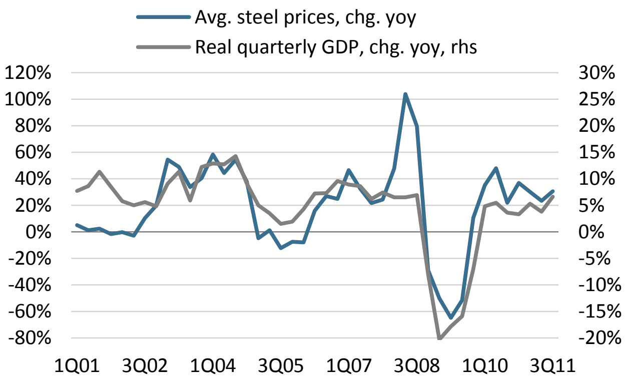
2012 GDP growth to rest on domestic demand

Ukraine's economy remains highly dependent on external commodity markets, especially steel. Historically, the correlation between changes in steel prices and Ukraine's real economic growth is above 0.7 – which indicates the economy's inherent vulnerability to external shocks. Steel prices are now 14% off their 2011 highs and we see average prices 5-10% yoy lower in 2012 – a sign that Ukraine has no reason to count on exports as a key driver of economic growth this year.

Fortunately, robust domestic demand should partly offset the weakness in exports. We see two key drivers of internal consumption in 2012:

1. Strong real income growth supported by increases in public sector nominal wages and social outlays (according to 2012 state budget) against the backdrop of decelerating inflation
2. Sizable spending on infrastructure projects connected to Euro-2012 in 1H12

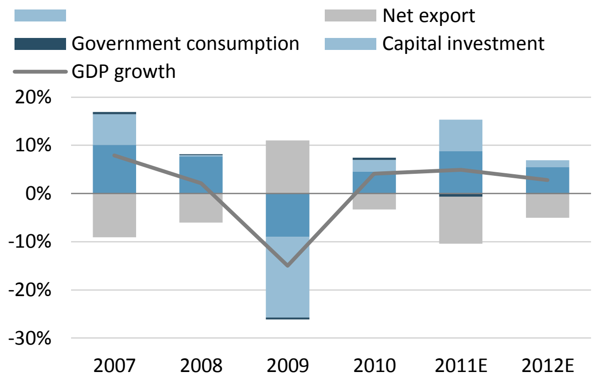
Steel prices vs. Ukraine's real GDP*



Steel CIS Export Billet, Black Sea

Source: Bloomberg, UkrStat, Concorde Capital

Ukraine's GDP growth breakdown



Source: UkrStat, Concorde Capital

GDP component breakdown

GDP component	*2010*	*2011E*	*2012E*	*Our view*
Household consumption	7.0%	14.1%	8.1%	Household consumption remains steady, supported by real salary growth (+8.5% yoy in 11M11). With consumer loans up just 2.0% in 11M11, bank lending has an only marginal effect on private consumption. Real household income should continue growing firmly in 2012, especially against notable deceleration in consumer inflation. Nominal growth will be supported by increases in the salaries of public employees and social payments ahead of the October parliamentary election. At the same time, growth in private sector salaries should slow this year.
Government consumption	2.7%	-3.1%	-0.5%	We see the contribution of government consumption to GDP growth at zero to negative in 2012 – the government is likely to channel increases in budget revenues into social payments rather than into the provision of public goods. Historically, government consumption has never made material contributions to economic growth.
Fixed capital investment	4.9%	10.9%	7.0%	Sizable outlays for Euro-2012 projects contributed to fixed capital investments in 2011, with financing coming from both local banks and external debt markets. There is unlikely to be a comparable upsurge this year, but work on infrastructure projects should continue at least in 1H12. At the same time, the effect of private companies intensifying investments in 2011 is likely to spill into 2012.
Exports	4.5%	3.2%	0.5%	Exports grew 3% yoy in 2011E – robust demand for metallurgy, machinery and chemicals supported strong growth in 1H11 before real exports slipped into the red since 3Q11. In 2012, we expect exports to cool as the economies of Ukraine's key trading partners decelerate.
Imports	11.1%	21.5%	6.4%	The increase in imports in 2011 was due to solid investment demand and private consumption. Energy imports, on a low 2010 base effect, were also a big contributor. Imports are likely to remain strong in 2012, erasing much of the benefit of strong domestic demand.
GDP	**4.2%**	**4.9%**	**1.9%**	

Sources: UkrStat, Concorde Capital

Inflation at record low but monetary loosening unlikely

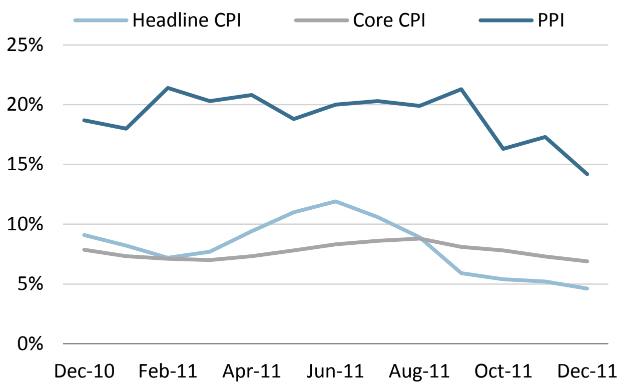
Ukraine's CPI continued to decelerate in December, ending 2011 at 4.6% yoy (down from 5.2% in November), the slowest pace since early 2003. Growth in food prices (the largest consumer basket component with a share of 51%) moderated to 0.7% yoy last month, supported by 2011's abundant harvest.

We see a high chance of CPI slowing further in 1Q12 against a high comparison base, but expect the trend to reverse as of April as the positive effects of 2011's bumper crop fade. End-December core CPI was 6.9% yoy (down from 7.3% yoy in November), well above headline inflation, with the gap clearly indicating temporary drivers of deceleration. Assuming a household gas and heating tariffs increase of 15-20% in 2012, we project inflation at 9.1% at end-2012.

Slowing inflation has few monetary policy implications in the current environment, in our view, as the NBU is unlikely to loosen monetary conditions. We expect the NBU to continue keeping banking sector liquidity constrained to prevent large-scale FX speculation, even though tough funding conditions might cost up to 0.5 pp of economic growth in 2012, according to our estimates.

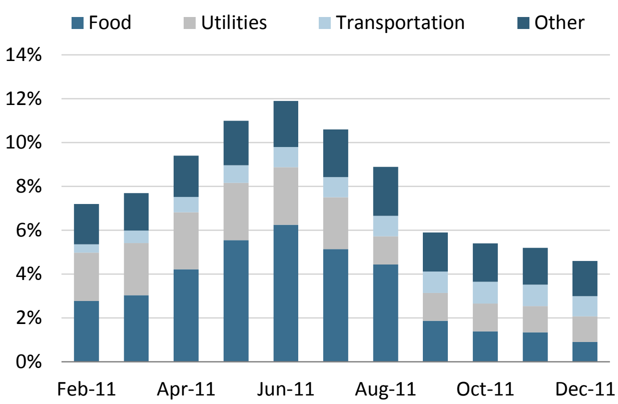
One of the key benefits of low inflation is that a raise in household utility tariffs (required by the IMF to restart its loan program) would be much less painful. Deceleration in consumer prices should also support household real incomes and bodes well for private domestic consumption.

CPI and PPI, y-o-y



Source: UkrStat

Headline CPI breakdown



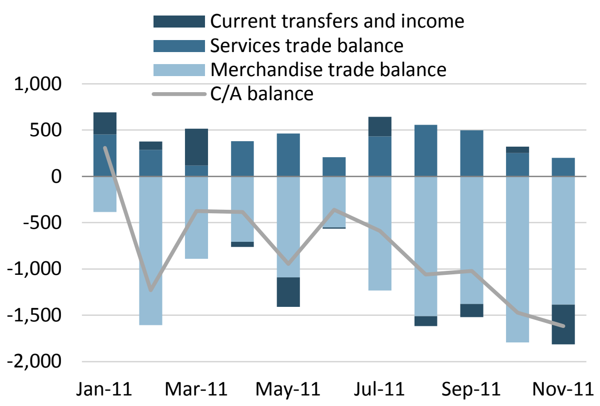
Source: UkrStat, Concorde Capital

Balance of payments: Coping with external financing risks

Ukraine's major macro risks in 2012 will be on the side of external accounts. After C/A deficit narrowed to 1.4% of GDP in 2009 (mainly due to a slump in domestic demand and hryvnya depreciation), the trend reversed sharply, with the gap expanding to 2.1% of GDP in 2010 and an estimated 6.1% in 2011, beating even the most pessimistic forecasts.

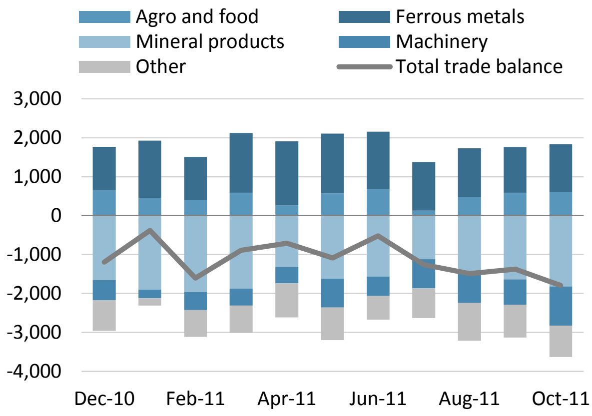
The merchandise trade deficit is the key driver of the C/A gap, as imports continue to grow faster than exports (+40% yoy vs. +35% yoy respectively in 11M11). Energy and machinery/equipment remain the largest imported items and they also remain the fastest growing, driven respectively by gas price hikes and surging demand for investment goods ahead of Euro-2012. Meanwhile, on the export side, steel sales abroad decelerated from 42% yoy in August to just 11% yoy in November, with 11M11 growth remaining strong at +32% yoy.

Monthly current account balance, USD mln



Source: NBU

Monthly merchandise trade balance, USD mln



Source: NBU

Given weakness in external commodity markets and continued slowdown in the economies of Ukraine's key trading partners, we project merchandise export volumes to increase by a mere 5% yoy in 2012. At the same time, we expect imports to grow slightly faster at 7-8%, bringing the merchandise trade balance to negative USD 15.8 bln (vs. -USD 13.3 bln in 2011E).

The sharp growth in the merchandise trade deficit is partly due to Ukraine facing a major terms of trade shock – prices for steel (Ukraine's key export commodity) are expected to decrease 5-10% yoy on average in 2012, while the price of gas (the single largest import item) is set to remain at all-time highs in the next couple of months (assuming no gas price discount from Russia) as it lags global energy prices by roughly nine months, as stipulated by Naftogaz' contract with Gazprom.

With little clarity on the terms of a potential gas deal between Ukraine and Russia, we assume no price discount (implying 2012 USD 416/bcm, up 34% yoy) in our base case scenario. We expect Ukraine to counterbalance the hike in gas prices by slashing import volumes from 45 bcm in 2011 to 34 bcm in 2012, which would leave its total gas bill virtually flat yoy. In view of that, we project the C/A deficit to widen to 6.3% of GDP in 2012 or USD 11.9 bln (vs. 6.1% of GDP in 2011, according to our estimates).

We note that a new gas deal with Gazprom might have a significantly positive effect on Ukraine's economy, with a price discount improving the C/A balance by about USD 4.0 bln. The deal could also bring in USD 2-3 bln in FDI via a cash contribution from Gazprom into a new gas transportation JV.

FDI and debt inflow to fall short of the C/A gap

Ukraine's financial account ran a monthly average surplus of USD 0.8 bln in 1H11 before narrowing sharply to just USD 0.3 bln in 2H11 as external debt rollover became a challenge. The financial account finished 2011 with an estimated surplus of USD 6.9 bln, but would have been close to zero if not for strong FDI.

This year is going to be even more difficult. An estimated USD 53 bln (28% of 2012E GDP or 167% of the NBU's end-2011 reserves) in public and private sector external obligations are due this year. In our base scenario, we assume global debt markets improve in 2H12, with government and private borrowers tapping it for new funding. We expect the government to place USD 2-3 bln in Eurobonds next year and refinance its USD 2 bln loan from Russia's VTB Bank, bringing its foreign debt rollover ratio to above 100%. As for the banking sector, we expect local subsidiaries of EU-based banks to continue repaying wholesale funding to their parents. The non-financial corporate sector is likely to remain a net recipient of external debt, with funding coming mainly from related foreign entities in the form of trade credits and short-term loans. We see 2012 external debt rollover ratios of close to 80% for the banking sector and above 100% for the corporate sector, broadly in line with the pattern from previous years.

External debt rollover

	2008	*2009*	*2010*	*2011E*	*2012E*
Government					
Debt due, USD bln	1.0	1.9	0.9	5.3	3.9
Change in debt, net, USD bln	0.1	5.8	7.2	1.3	0.6
Rollover rate (%)	107%	412%	862%	123%	114%
Banking sector					
Debt due, USD bln	16.7	20.6	12.3	12.6	11.8
Change in debt, net, USD bln	8.5	-8.6	-2.7	-2.4	-2.4
Rollover rate (%)	151%	58%	78%	81%	80%
Corporate sector					
Debt due, USD bln	18.4	22.2	24.6	29.6	31.8
Change in debt, net, USD bln	7.7	2.2	7.4	5.1	2.3
Rollover rate (%)	142%	110%	130%	117%	107%

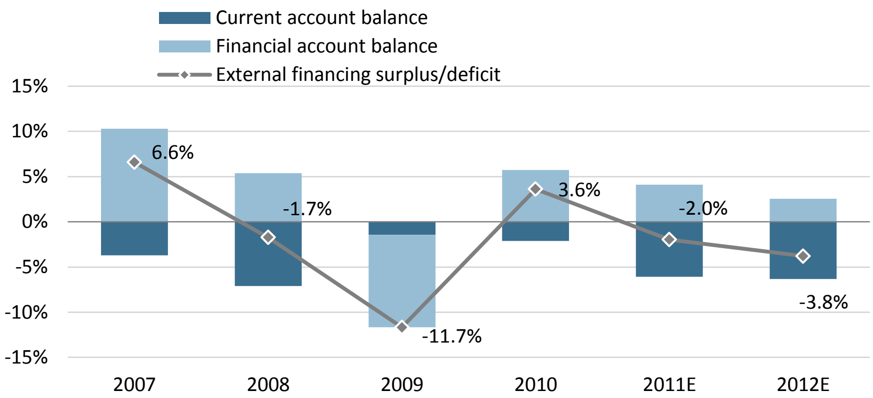
Source: NBU, Concorde Capital

We see Ukraine's gross external debt increasing 1% yoy to USD 123 bln in 2012, but decreasing in relation to GDP by 7 pp to 66%.

FDI substantially abated by end-2011. Net inflows in 11M11 were still strong at USD 5.8 bln (+19% yoy), though USD 1.3 bln is a one-off inflow related to the privatization of Ukrtelecom. We expect FDI of USD 5.5 bln next year, with roughly a quarter flowing to the banking sector.

In 2012, we estimate Ukraine's financial account surplus at USD 4.8 bln (-31% yoy), falling substantially short of the C/A gap, implying the economy's external financing needs (combined C/A and financial account balances) will reach USD 7.1 bln.

External financing gap, % of GDP

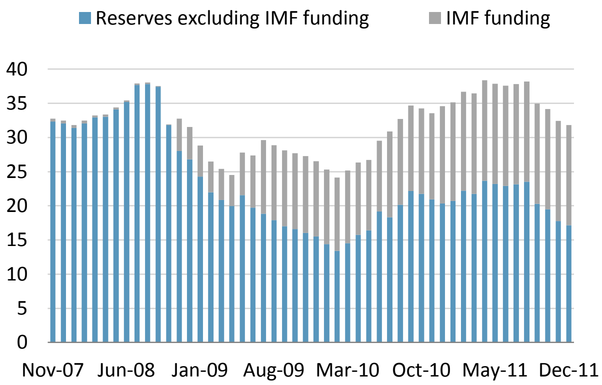


Source: NBU, Concorde Capital

External financing gap to be covered by NBU reserves

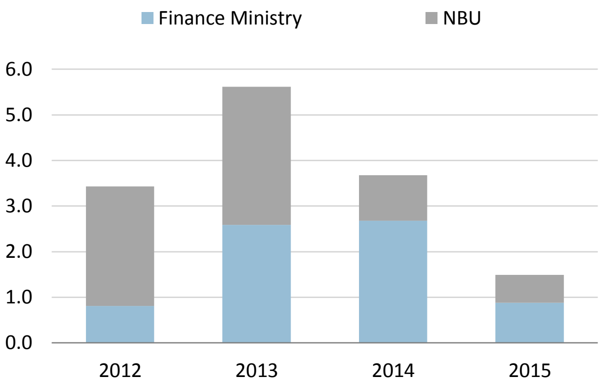
The NBU's gross international reserves declined from an all-time high in May of USD 37.8 bln to USD 31.8 bln at end-2011. We expect the NBU to fully cover the external financing gap (up to USD 7.1 bln, by our estimates) by selling its reserves as exchange rate stability will remain a policy priority. On top of that, next year the NBU will start repaying Ukraine's IMF loan attracted in 2008; USD 2.6 bln is due in 2012 (in addition to USD 0.8 bln to be repaid by the Finance Ministry). We see central bank reserves falling 31% yoy to USD 22.1 bln by end-2012, implying coverage of 3.0 months of imports (vs. 4.6 months as of end-2011).

NBU gross international reserves, USD bln



Source: NBU, Concorde Capital

IMF debt redemption schedule, USD bln



Source: IMF, Concorde Capital

Hryvnya likely to remain stable, but at a high cost

We believe exchange rate stability will remain the NBU's top priority through 2012, particularly with parliamentary elections coming in October. The key concern for the central bank and the government being the impact of a sharp hryvnya decline on the nation's highly leveraged households (59% of retail loans are FX-denominated). We think the NBU has a good chance of succeeding in keeping the UAH/USD rate broadly flat though end-2012, but the cost might be high.

In our base scenario (with no new gas deal with Russia and the IMF loan remaining frozen), we see the NBU spending about USD 7.1 bln of its reserves to support the hryvnya, albeit allowing it to depreciate by 2-3% to UAH 8.2/USD by end-2012. However, we note that under our base case scenario, the economy will remain extremely vulnerable to external or domestic shocks and there is a possibility the NBU will lose its tight control of the local currency market. In the event of a major shock in 2012 (i.e. a buildup in hryvnya depreciation expectations), we do not rule that the NBU will be forced to let the hryvnya fall to UAH 9.0-9.5/USD.

We think resuming cooperation with the IMF is critically important in terms of supporting market confidence and facilitating the country's access to international debt markets. The NBU governor has said on several occasions that the central bank is interested in unfreezing Ukraine's IMF loan, but the government has yet to follow suit and move ahead with IMF-required reforms. We put the chances of Ukraine unfreezing its IMF loan at 50/50 and think the government will have no choice but to implement unpopular IMF-mandated actions if the external situation deteriorates and hryvnya depreciation pressure starts to mount.

Implications of gas discount & IMF scenarios on the Ukrainian hryvnya in 2012

Scenarios	*Comment*	*C/A gap, USD bln*	*NBU reserves as of end-2012*
No gas deal with Russia/ no IMF program	Our base scenario. The NBU keeps the hryvnya broadly stable through end-2012, but a shock (domestic or external) could trigger a surge in currency demand, resulting in an sizable drain of NBU reserves and the hryvnya falling to UAH 9.0-9.5/USD.	11.9	21.1
Gas deal with Russia/ no IMF program	Very positive short-term effect on C/A, which would considerably ease exchange rate pressure and enable the NBU to keep the hryvnya stable at a reasonable cost.	7.9	27.2
No gas deal with Russia/ IMF program resumes	With no gas discount, Ukraine's external financing gap should remain substantial, but the IMF program should enable the NBU to support the hryvnya while keeping gross reserves reasonably high. The IMF program would boost investor confidence and weaken hryvnya depreciation expectations.	11.9	24.5
Gas deal with Russia/ IMF program resumes	The most favorable outcome for Ukraine's economy in 2012. The C/A gap narrows sharply vs. our base scenario and the external financing gap is almost fully covered with new money from the IMF. NBU reserves remain broadly stable yoy.	7.9	30.6

Source: Concorde Capital

Financing constraints force tougher expenditure control

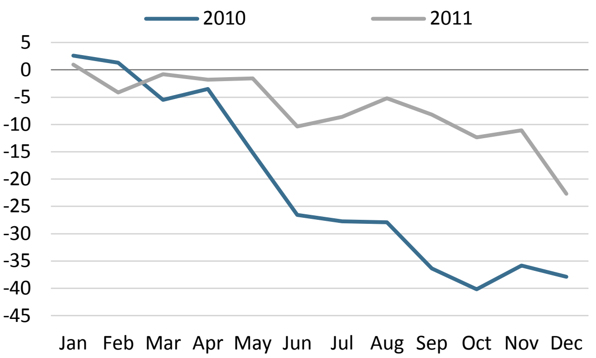
General budget deficit curtailed at 4.2% of GDP in 2011

Ukraine is making visible progress toward fiscal consolidation. Ukraine's central budget deficit stood at UAH 11 bln in 11M11 (0.9% of 2011E GDP), a noticeable improvement from a UAH 36 bln gap in 11M10 (net of UAH 16.4 in VAT-bonds issued in 2010). Revenues remained strong at 23% yoy in 11M11 (net of VAT-bond effect), with tax proceeds growing even faster at 44% yoy. Recently, the government estimated the full-year 2011 central budget gap at 1.7% of GDP, well below the initial target of 2.5%, as failure to meet the full year borrowing plan likely forced the government to keep expenditures constrained.

The Finance Ministry reported the general government deficit (the consolidated budget deficit adjusted for the shortfalls of Naftogaz and social funds but excluding the costs of capitalizing banks) at 4.2% of GDP last year, above the IMF's ceiling of 3.5%, but a substantial improvement from an estimated 7.3% shortfall in 2010.

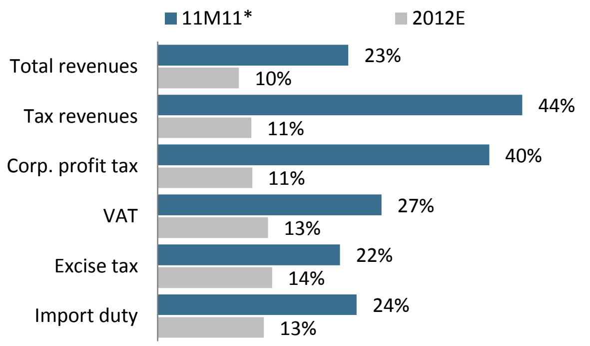
The 2012 budget continues the fiscal consolidation path, with the government setting the central budget deficit at UAH 38 bln or 2.5% of 2012E GDP (including Naftogaz' capitalization costs), which is broadly in line with IMF requirements. The state budget conservatively assumes revenues (+10% yoy) and expenditures (+5% yoy) considerably lag nominal GDP growth (+13% yoy, according to our projections).

Central budget balance, cumulative, UAH bln



** 2010 data without the effect of UAH 16.4 bln in VAT-bonds issued in 2010, Dec. 2011 is preliminary*
Source: Finance Ministry, Concorde Capital

Central budget revenue growth, yoy



** 11M11 data without the effect of UAH 16.4 bln in VAT-bonds issued in 2010*
Source: Finance Ministry, Concorde Capital

Expenditures look understated

While the budget's revenue targets look conservative, in our opinion, we have several concerns on the expense side. We believe the government underestimated Naftogaz' financing needs, putting them at UAH 12 bln (vs. our estimate of UAH 16 bln in 2011) given the rise in the import gas price by 34% yoy to USD 416/tcm for 2012. The government also plans a minimum wage increase of 13% yoy, just slightly above our 2012 CPI forecast of 9.0% eop. We do not rule out that the government will raise salaries more ahead of the October parliamentary election.

We project a 2012 general budget deficit close to 2.8% of GDP (including Naftogaz), but note that if the government does not meet its borrowing target, it might be forced to rein in expenditures and keep the deficit below the initial ceiling.

Debt rollover will remain difficult both domestically and externally

The government plans to borrow UAH 61 bln (USD 7.6 bln) on the domestic market and UAH 38 bln (USD 4.7 bln) on the external market in 2012. Key external debt repayments this year include USD 2.0 bln to Russia's VTB, USD 0.8 bln to the IMF and USD 0.5 bln in Eurobonds.

Raising and rolling over debt, both domestically and externally, is going to be a challenge this year. The government only achieved about two-thirds of its 2011 borrowing target.

In terms of foreign obligations, we believe the government is almost certain to once again rollover its VTB loan, but raising the other USD 2.7 bln is dependent on international debt markets. As for local borrowing, FX-denominated government bonds, introduced in mid-December, might be key. The Finance Ministry sold USD 0.4 bln in these bonds in December at yields broadly in line with the sovereign Eurobond curve. We see the potential to attract another net USD 2.5 bln via these instruments this year. Demand for standard UAH bonds will remain muted as hryvnya liquidity in the banking sector should stay tight through 2012.

Central budget deficit financing

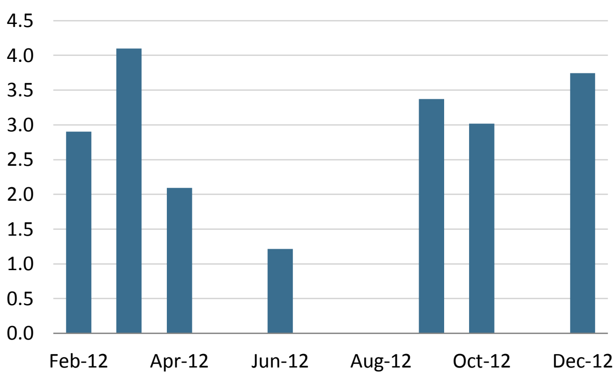
	USD bln	*% of GDP*
Cash leftover from 2011	0.0	0.0%
External borrowing	*4.7*	2.5%
External redemptions	*-3.9*	-2.1%
incl. VTB loan	-2.0	-0.6%
incl. IMF debt	-0.8	-0.3%
incl. Eurobond	-0.5	-1.1%
Net external borrowing	0.8	0.4%
Domestic borrowing	*7.6*	4.1%
Domestic redemptions	*-4.3*	-2.3%
Net domestic borrowing	3.3	1.7%
Privatization revenues	1.3	0.7%
Total financing	5.3	2.8%
Total needs	4.7	2.5%
incl. Naftogaz capitalization	*1.6*	0.8%
Cash leftover for 2013	0.6	0.3%

Source: 2012 budget, Concorde Capital

Public debt looks reasonable by international standards

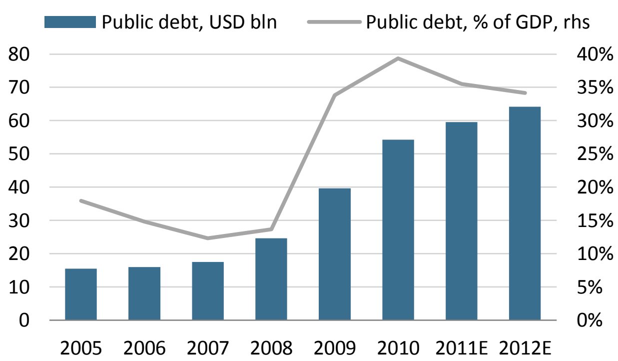
Ukraine's public debt increased 10% over 11M11 to USD 59.4 bln or 35.5% of 2011E GDP. We see public debt growing 8% yoy in 2012 to USD 64 bln, but declining 1.3 pp yoy in relation to GDP to 34%. Ukraine's moderate debt burden implies its ability to service maturing debt is an issue of liquidity not of solvency.

Government local debt maturity profile in 2012, UAH bln



Source: Finance Ministry, Concorde Capital

Public debt



Source: Finance Ministry, Concorde Capital

Appendix 1: Concorde Capital 2012 forecasts vs. consensus

	Concorde Capital	*Consensus**
Real GDP, chg yoy	1.9%	3.2%
Household consumption, chg yoy	8.1%	5.4%
Gross fixed investment, chg yoy	7.0%	7.0%
Industrial production, chg yoy	2.9%	7.0%
Consumer prices, avg chg	5.2%	7.0%
Merchandise trade balance, USD bln	-15.8	-16.5
Current account balance, USD bln	-11.9	-9.5

**Eastern Europe Consensus Forecasts, December 2011*

Source: Consensus Economics Inc.

Appendix 2: Macro data and forecasts

	2005	*2006*	*2007*	*2008*	*2009*	*2010*	*2011E*	*2012E*
Business cycle indicators								
Real GDP, % chg yoy	3.0	7.4	7.6	2.3	-14.8	4.2	4.9	1.9
Household consumption, % chg yoy	20.1	15.9	17.1	11.8	-14.1	7.0	14.1	8.1
Investments in fixed capital, % chg yoy	3.9	20.9	23.9	1.6	-50.5	4.9	10.9	7.0
Nominal GDP, UAH bln	441	544	721	948	915	1,095	1,338	1,516
Nominal GDP, USD bln	86	108	143	180	117	138	168	188
GDP per capita, USD	1,836	2,312	3,078	3,891	2,554	3,016	3,684	4,129
Industrial output, % chg yoy	3.1	6.2	7.6	-5.2	-21.9	11.2	7.3	2.9
CPI (eop), %	10.3	11.6	16.6	22.3	12.3	9.1	4.6	9.1
CPI average, %	13.5	9.1	12.8	25.2	15.9	9.4	8.0	5.2
PPI (eop), %	9.5	14.1	23.3	23.0	14.3	18.7	14.2	11.9
External accounts								
Current account balance, USD bln	2.5	-1.6	-5.3	-12.8	-1.7	-2.9	-10.2	-11.9
% GDP	*2.9%*	*-1.5%*	*-3.7%*	*-7.1%*	*-1.4%*	*-2.1%*	*-6.1%*	*-6.3%*
Merchandise trade balance, USD bln	-1.1	-5.2	-10.6	-16.1	-4.3	-8.7	-13.9	-15.8
% of GDP	*-1.3%*	*-4.8%*	*-7.4%*	*-8.9%*	*-3.7%*	*-6.3%*	*-8.3%*	*-8.4%*
Service trade balance, USD bln	1.8	2.1	2.4	1.7	2.4	4.7	4.0	3.8
% of GDP	*2.1%*	*1.9%*	*1.7%*	*0.9%*	*2.0%*	*3.4%*	*2.4%*	*2.0%*
Financial account balance, USD bln	8.2	4.0	14.7	9.7	-12.0	7.9	6.9	4.8
% GDP	*9.5%*	*3.7%*	*10.3%*	*5.4%*	*-10.2%*	*5.7%*	*4.1%*	*2.6%*
FDI net, USD bln	7.5	5.7	9.2	9.9	4.7	5.8	6.1	5.5
% of GDP	*8.7%*	*5.3%*	*6.5%*	*5.5%*	*4.0%*	*4.2%*	*3.6%*	*2.9%*
Gross NBU reserves (eop), USD bln	19.4	22.4	32.5	31.5	26.5	34.6	31.8	22.1
Debt								
Public debt, USD bln	15.5	15.9	17.6	24.6	39.7	54.3	59.6	64.2
% GDP	*18%*	*15%*	*12%*	*14%*	*34%*	*39%*	*36%*	*34%*
Public external debt, USD bln	11.6	12.7	13.8	18.5	26.6	34.1	37.7	37.4
% GDP	*13%*	*12%*	*10%*	*10%*	*23%*	*25%*	*22%*	*20%*
Gross external debt, USD bln	39.6	54.5	80.0	101.7	103.4	117.3	121.9	123.4
% GDP	*46%*	*51%*	*56%*	*56%*	*88%*	*85%*	*73%*	*66%*
Monetary and banking sector indicators								
Monetary base, UAH bln	83	97	142	187	195	226	231	244
Monetary base, % chg yoy	54%	17%	46%	32%	4%	16%	3%	5%
Money supply (M3), UAH bln	194	261	396	515	487	598	654	685
Money supply, % chg yoy	54%	35%	52%	30%	-5%	23%	9%	5%
Monetary multiplier (eop M3/MB)	2.3	2.7	2.8	2.8	2.5	2.6	2.8	2.8
Monetization (avg M3/GDP), %	37%	42%	46%	48%	55%	50%	47%	44%
Bank loans, % chg yoy	62%	71%	74%	72%	-2%	1%	10%	5%
Bank deposits, % chg % yoy	60%	39%	52%	28%	-8%	26%	13%	11%
Loan-to-deposit ratio	1.08	1.33	1.52	2.05	2.19	1.75	1.71	1.62
Exchange rate								
Official UAH/USD (eop)	5.05	5.05	5.05	7.70	7.99	7.96	7.99	8.20
Official UAH/USD (avg)	5.12	5.05	5.05	5.27	7.79	7.94	7.97	8.07
Fiscal indicators								
Consolidated budget revenues, USD bln	26.2	34.0	43.6	56.4	35.0	39.6	49.2	54.3
% of GDP	*30%*	*32%*	*31%*	*31%*	30%	29%	29%	29%
Consolidated budget expenditures, USD bln	27.7	34.7	45.1	59.1	39.8	47.6	52.1	57.2
% of GDP	*32%*	*32%*	*32%*	*33%*	34%	35%	31%	30%
Consolidated budget balance, USD bln	-1.6	-0.7	-1.5	-2.7	-4.8	-8.0	-2.9	-2.9
% of GDP	*-1.8%*	*-0.7%*	*-1.1%*	*-1.5%*	-4.1%	-5.8%	-1.7%	-1.5%
General budget balance, USD bln*	n/a	n/a	n/a	n/a	-9.5	-10.1	-7.0	-5.2
% of GDP	*n/a*	*n/a*	*n/a*	*n/a*	-8.1%	-7.3%	-4.2%	-2.8%
Social indicators								
Population, mln (eop)	46.9	46.6	46.4	46.3	46.0	45.8	45.6	45.5
Unemployment (ILO methodology, avg.), %	7.8%	7.4%	6.9%	6.9%	9.6%	8.8%	8.3%	8.1%
Average monthly salary, USD	160	206	268	235	239	281	326	366
Real disposable income, % chg yoy	23.9%	11.8%	14.8%	7.6%	-10.0%	17.1%	7.7%	6.8%

** Combined balance of the central budget (excluding costs of capitalizing state banks), local budgets, social funds and Naftogaz*
Source: UkrStat, NBU, Finance Ministry, Concorde Capital

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