

Quick Stats

	Change from	
	H1 '09	H2 '08
GDP	↓	↓
Unemployment	↑	↑

Hot Topics

- Economic recovery has surfaced towards the end of 2009, but remains feeble and primarily driven by base-period effects
- Election-induced political uncertainties are expected to remain in place for an extended period of time, as even in case of smooth transition of power, the next president will be tempted to call for early Parliamentary elections to consolidate his position

POLITICS AT A GLANCE

As expected, the second half of 2009 was characterized by quite disgraceful maneuverings on the part of main political forces, as they sought to undermine each others' position in the run-up to the Presidential elections. The relations between the President, the Government and the alleged opposition have been as fractious as ever, with all three engaging in detrimental populism in an attempt to win short-term political capital. Thus the negotiations with the International Monetary Fund (IMF) over the fourth \$3.8 billion tranche of assistance were effectively blocked after the President signed the controversial social standards law, in spite of resistance from the Government and IMF. Likewise, the opposition's threats to call for a no-confidence vote over Government's ostensibly unsatisfied response to flu epidemic and its siding with the President over social standards bill, did nothing to improve country's poor business image. Serious and coordinated efforts to reform, alas, were absent in H2 2009. Arguably, the only truly welcoming event came towards the end of the year when UEFA, Europe's administrative body for football, approved of Donetsk, Kharkiv and Lviv to host European championship matches in 2012 and confirmed Kyiv as the venue for Euro 2012 final. This decision is a huge boost to country's long-term economic and investment position and should result in an improved regulatory environment and infrastructure.

Victor Yanukovich, the leader of the opposition, has won the second round of Ukraine's 5th Presidential elections, beating Yulia Tymoshenko, the acting prime-minister, by a narrow margin. It has always been the case, however, that irrespective of who becomes the next president, country's social and economic woes will remain the number one challenge for policy-makers. In the murky world of Ukrainian politics, it was unclear who of the two main contenders would be more successful in dealing with the country's most pressing issues – i.e., repairing ineffective institutions, amending flawed constitution, taming excessive regulation, and improving mediocre competitiveness. On the one hand, both candidates ought to be free-marketeters, as their parties draw support from prominent business elites, yet when judged by their rhetoric or campaign slogans, both can just as easily be sent to the left of the political spectrum. Similarly, both are not much different in their foreign policy objectives – conciliatory towards Russia, open towards Europe and cautious with NATO. As a result, the win for either of the candidates carried neither inherent risks nor clear rewards. Yanukovich's victory therefore will not brink strategic political shift. The real danger for Ukraine at this juncture will be a prolonged period of systematic instability provoked by too close a result in the second round (as is already the case) and subsequent fierce contention in courts. Once the new president has sworn in, the most intense uncertainties should ease, yet further sources of instability will remain, such as that the President will seek to dissolve the Parliament in case of inability to form a working cabinet.

Ukraine Fact Sheet

Annual data	2009*	Historical Averages (%)	2004-2008
Population (million)	45.9**	Population growth	-0.6
GDP (US\$ billion; market exchange rate)	111.7	Real GDP growth	6.4
GDP (US\$ billion; purchasing power parity - PPP)	290.5	Real domestic demand growth	11.9
GDP per head (US\$; PPP)	6,350	Inflation	13.8
Exchange rate (av) UAH:USD	7.81**	FDI inflows (% of GDP)	6.0

Source: Economist Intelligence Unit (EIU), State Statistic Committee (SSC)
* - EIU estimates; ** - actual data

ECONOMIC OVERVIEW

Executive summary

The worst economic crisis Ukraine has experienced in more than a decade appears to be over. After plunging by 20.3% y-o-y in Q1 2009, GDP growth moderated to an estimated -15% for the year as a whole. Improved external balance on the demand side and sustained agricultural output on the supply side were the main factors behind economic revival. However, production was always bound to improve in y-o-y terms towards the end of the year, if only thanks to flattering statistical base, given that global financial turmoil affected Ukraine most drastically in final quarter of 2008. A more substantial recovery and one which is supported by domestic demand is unlikely to commence at least before H2 2010.

Economic policy

Over H2 2009 the authorities achieved only limited progress in meeting their policy commitments under \$16.4 billion, 24-month stand-by arrangement agreed with the IMF in October 2008. Although the exchange rate has steadied and risks to the banking sector have lessened (owing to successful nationalization of some of the most troubled institutions), progress on other policy measures was limited. In particular, the authorities have failed to raise household gas prices and lower the size of the deficit in the 2010 budget. Most importantly, the adoption of the Social Standards Law, which the IMF thinks "cannot be financed without higher inflation or unemployment", resulted in the delay of the release of the fourth tranche of assistance.

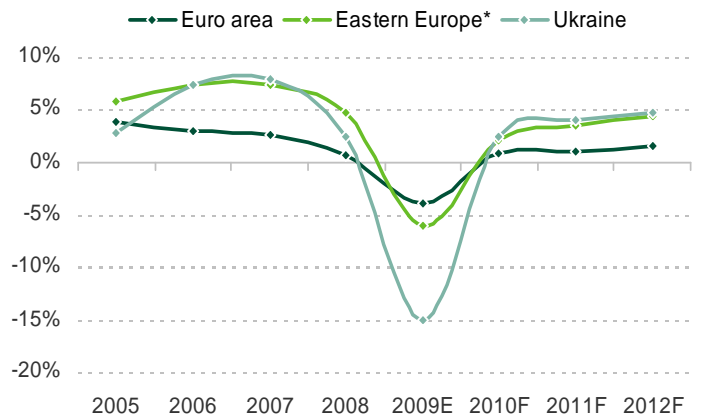
The freeze in IMF lending has increased already acute fiscal pressures. The Fund has also turned down Ukraine's urgent appeal to provide an additional \$2 billion emergency loan in late December. It did, however, allow the country to lower its minimum international reserve requirement, which enabled tapping into extra \$2 billion from the National Bank (NBU), thus helping to pay for Russian gas as well as ensure timely payment of salaries and pensions. A broader compromise with the IMF to unblock lending will be possible only until after the elections. Much, however, will depend on how soon the new government is formed.

ECONOMIC GROWTH

After 15 months of negative y-o-y growth, industrial output picked up in the last two months of the year, albeit from a very depressed level, and was still down 21.9% for the year overall. The recovery has primarily been driven by low-base effects, but also by substantial improvements in export-oriented industries. Metals sector in particular has leaped 27.3% y-o-y in December on the back of rising external demand and prices. Overall, industry and services estimated to have contracted 25% and 14% respectively for year as a whole, with agriculture remaining the only sector to support GDP on the supply side.

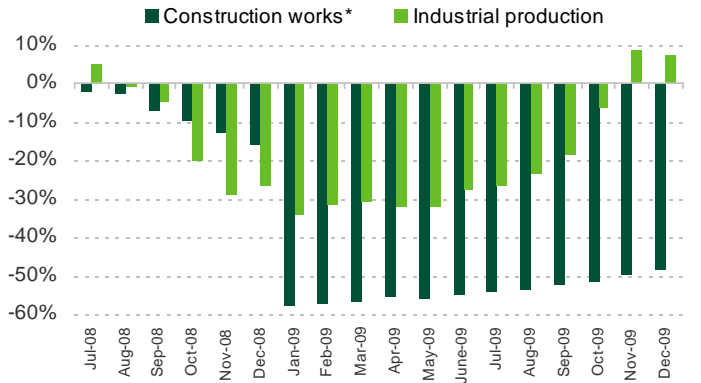
The situation on the demand side remains less upbeat. The trends in retail sales¹ indicate that the bottom in terms of domestic consumption is yet to be reached notwithstanding a recent improvement in consumer sentiment. By the end of 2009 the rate of real decline in retail sales reached 16.6% from 15.2% witnessed over H1 2009, as falling wages and weaker currency continued to depress purchasing power (see Kyiv Retail MV for more details).

GDP Growth – Ukraine vs. the Region



Source: EIU
 E – EIU estimates; F – EIU forecasts.
 * - Azerbaijan, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia and Ukraine

Construction Works and Industrial Production (% change, y-o-y)



Source: State Statistics Committee (SSC)
 * - monthly data are cumulative

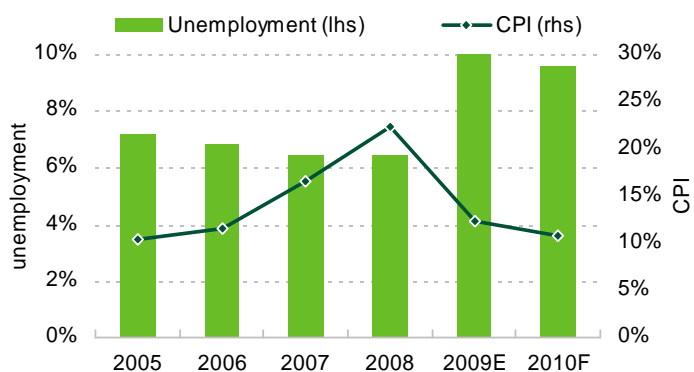
Exchange Rate on the Interbank Currency Market (weighted average)



Source: NBU

¹Including estimated sales at marketplaces and by small business owners

Unemployment and Inflation



Source: SSC
 E – IMF estimate for unemployment; inflation – actual
 F – poll of forecasts (see Table 2 on the next page)

Overall, with gross fixed investment equally nose diving (by an estimated 45% for the year as a whole) amid a much worsened business environment, external balance was the only component of GDP to offset economic decline on the demand side.

The weak state of domestic economy is partly attributable to the challenges still faced by the Ukrainian banking sector. In particular, rising non-performing loans (NPLs) dissuade banks from lending to both firms and households. According to NBU, the share of bad loans more than tripled in 2009, to ca. UAH 65 billion or some 8.5% of the total loan portfolio. Many experts, however, including Fitch, a rating agency, estimated that the share of NPLs is much greater, possibly reaching 20-30%. All in all the credit remains mostly unavailable especially for households, as banks are prepared to lend only short-term and mostly to large enterprises.

PRICES AND UNEMPLOYMENT

Annual inflation rate continued to slow over H2 2009. Consumer Price Index (CPI) rose 12.3% – a relatively mild level in historical terms – but still uncomfortably high. Large contraction in domestic demand is the main factor behind disinflation, but lower global prices for food and commodities have also eased price pressures. Although the CPI is forecast to rise slower in 2010 and 2011, there are risks that inflation will remain high, particularly if the Social Standards Law gets implemented and possibly the government chooses to finance the budget deficit through monetary emission from the NBU.

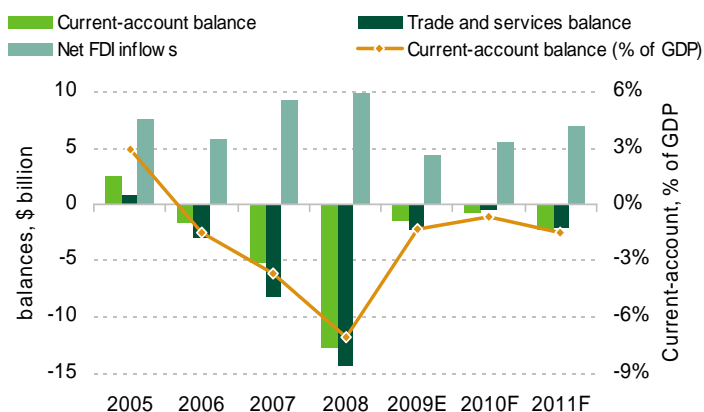
Against all odds, official unemployment rate consistently fell in almost every month of the year. Less surprising was the growing rate of joblessness, calculated using the methodologies of International Labor Organization (ILO). The number of people out of work is estimated to have reached 2.2 million in Q4 – a figure which is expected to fall to only 1.9 million by the end of 2010.

EXTERNAL SECTOR

The factors that contributed to high current-account deficits in the past have shifted dramatically into reverse in the last months of 2008 and the first months of 2009. Close to positive current account balance this year is primarily due to a dramatic fall in imports, which were down 45% for goods and 28% for services. Export fell too, but to a lesser degree, and if calculated net of gas purchases, total annual trade balance has been posting small surpluses in virtually every month of 2009.

Total capital account ran a deficit of \$11.8 billion in 2009 (against some \$9 billion surplus posted in 2008). The combination of rising debt repayments (especially in private sector), weakening inflows of foreign direct investment (FDI), as well as growing accumulation of hard currency outside of the banking system (estimated at ca. \$8 billion) ensured that capital account was deep in the negative territory. Total net FDI inflows came to only ca. \$4.4 billion versus \$9.9 billion invested in 2008. The banking sector remained the principal beneficiary of FDI inflows, as foreign banks supplied capital in an attempt to recapitalize their local subsidiaries.

External Sector



Source: EIU
 E – EIU estimates; F – EIU forecasts.

2010 & 2011 Forecasts*

	2010	2011
Real GDP Growth (% y-o-y)	2.41	4.20
Private Consumption (% y-o-y)	0.98	3.65
Consumer Price Inflation (% y-o-y)	10.71	9.0
Unemployment (ILO, %)	9.56	8.60
Consolidated Budget Balance (% of GDP)	-4.01	-3.0
Current-Account Balance (% of GDP)	-0.19	-1.54
Exchange Rate UAH:USD (av)	8.21	7.65

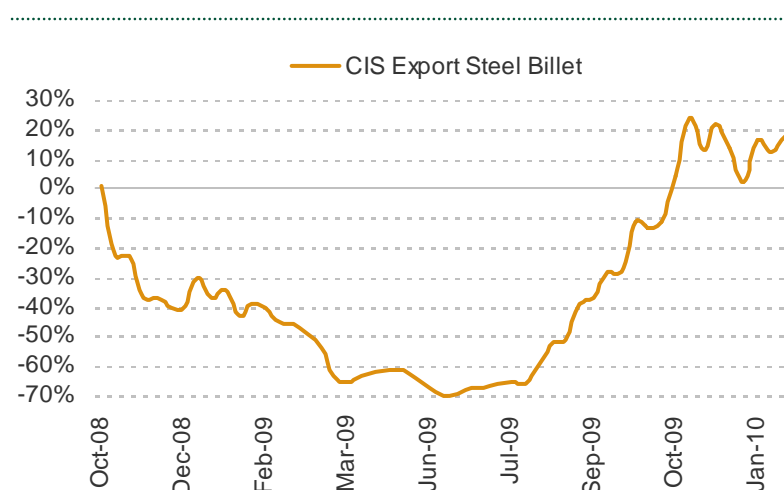
* simple averages derived from the latest available forecasts provided by the following organizations: Bank of America Merrill Lynch, Dragon Capital, DT-Global Business Consulting, Economist Intelligence Unit, Erstebank, International Monetary Fund, Renaissance Capital, Troika Dialog, UniCredit Bank and World Bank.

OUTLOOK

Perhaps the sole most important gauge for Ukraine's economic prospects is the price of steel. Helped by a resurgent demand in Asia and excessively lax monetary policies in the developed world, commodity prices in general and the price of CIS Steel Billet in particular has been rising since August 2009. It is still far below its historical peak, but the production in export-oriented industries is already returning to normal. Nevertheless, after the economically disastrous 2009, Ukraine will recover only slowly.

Lack of credit and high unemployment will put off any significant rebound in consumer spending until at least H2 2010, so exporting its way out of the crisis remains the only realistic solution for Ukraine presently. GDP is expected to grow between 2% and 4% in 2010 before expanding at a more solid rate of ca. 5% in 2011. Local currency should remain broadly stable, especially once the elections-related turmoil fully subsides in H2 2010 and donor support provides addition cushion. The main threats to Ukraine's stability come from within. Political in-fighting has too often been the main cause of poor policymaking and economic mismanagement, and now that fiscal risks are so high, what is lacking the most is political consensus.

Steel Prices (% change, y-o-y)



Source: Dragon Capital

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