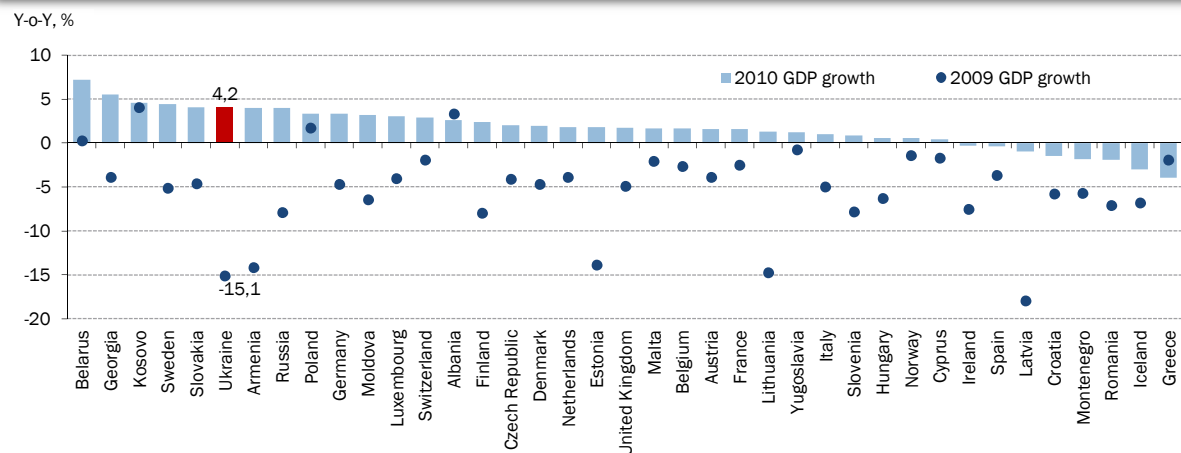


Post-crisis economic growth profile

The growth path of the Ukrainian economy over the post-“orange revolution“ period had been erratic and volatile, mostly subject to flows of hot money, instability in the external commodities market and squeezed domestic consumption in 2008. The pattern was especially unstable in 2008-2010, with the achievement of V-shaped recovery in 2010 (+4.2% in real GDP). Meanwhile, economic activity has been supported by external demand and higher steel prices mostly, with domestic sectors to be on a sluggish path to recovery. Consumption remains restrained by slow real income growth and the still -damaged credit channel. Thus, we see above-average likelihood of a reverse back to the 2000-2004 growth pattern, with dependence on the export sector highly possible. This may consequently lead to economic underperformance in the medium term, as long as likely rent-seeking and underinvestment under the “Status quo” scenario (the most probable scenario, as of July 2011) will prevail in basic sectors – metallurgy, engineering etc. Moreover, production of high-quality consumer goods will suffer again (which may lead to C/A deficit widening and related economic imbalances).

After the crisis fallout and a 15.1% contraction in GDP in 2009, 2010 economic growth rate stood at 4.2%. That places Ukraine among the Top-6 European real GDP performers (IMF projections).

Estimated real GDP growth in European countries



Source: IMF estimation of 2010 GDP growth, Econstat, CMU

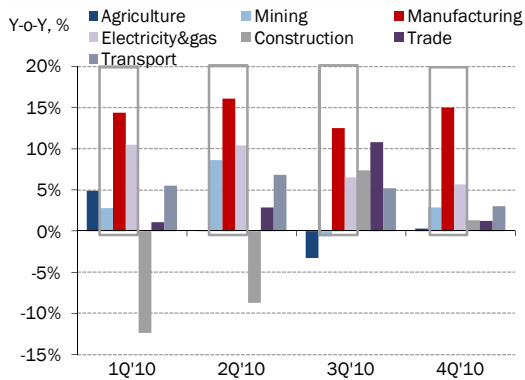
In the group of Former Soviet Union countries (F.S.U.), Ukraine stands out as an average-growth country: Seven F.S.U. countries had a higher estimated growth in 2010, while for the other seven F.S.U., growth was lower than Ukraine's. As a consequence, Ukraine's relative position vis-a-vis the rest of the F.S.U. is within the median. As for the relative growth of CIS states, the economic performance of Ukraine is lagging somewhat vs. the region's 2010 GDP growth (+4.34% is expected by IMF).

2010 recovery was driven by external demand, driven largely by the international commodities market. A demand-led 2010 recovery sparked by the initial increase in merchandise exports (+29.6% Y-o-Y for 2010), rather than by gradual expansion of consumer spending. As base metals make up almost an 35% share of total exports, we still see a high dependence of Ukraine's growth on the world commodities market. Here are some features of the sectoral growth pattern for 2010 recovery, following the 2008-2009 crisis:

- Top GDP growth-contributing sectors in the recovery period are different from those of the pre-crisis period. The recovery shows higher growth rates for the goods-producing sectors, mainly machine-building, while in 2007-2008, the metallurgical sector outpaced the overall growth;
- dynamic sectors during the recovery were relatively more labor-intensive.

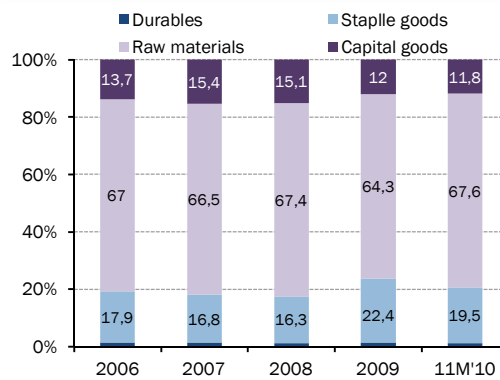
Notably, manufacturing led 2010 growth, with a 14.5% Y-o-Y increase. Higher public confidence and reviving lending fueled a gradual lift in the trade sector (+4.0% Y-o-Y). Construction is still lagging in the overall pace: with a slump deceleration last year (up to -1.7% Y-o-Y from -42.5% Y-o-Y in 2009). As the manufacturing sector leads here, the shape of economic growth is quite promising. Still, there is potential for trouble. In particular, industrial production is still oriented on semi-finished goods, the share of raw materials in the total production volume is increasing (64.3% in 2009 vs 67.6% in 11m'10), whereas the share of capital goods is steadily decreasing (15.1% in 2008 vs 11.8% in 11m'10). The latter is due to lagging performance in low-tech and energy-intensive industries, especially metallurgy.

Manufacturing leads the growth...



Source: GDP components growth - State Statistics Committee

... but industrial production is still raw oriented



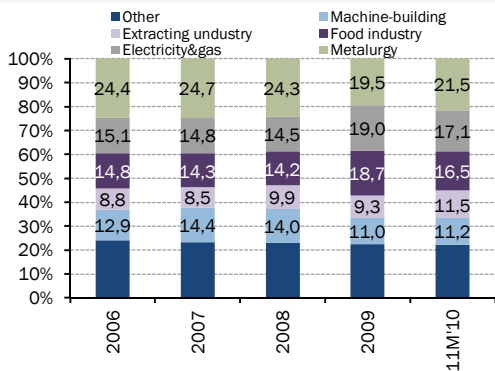
Source: structure of industrial production sold by category - NBU, State Statistics Committee

Still high raw materials' share in total production volume

The share of base metals in the breakdown of the industrial production sold between 2009 and 2010 grew from 19.5% in 2009 to 21.5% in 11m'10. The 13% rise in global steel consumption raised production of Ukrainian steel by 10%. Moreover, foreign demand primarily fueled domestic production, generating ~61% of the total growth and absorbing 81% of total Ukrainian output. Accordingly, the share of base metals in the Ukrainian merchandize export pattern accounted for 34.2% over 11m'10 (vs 32.3% in 2009), obviously demonstrating the high dependency of the country's economic position in the world commodities market. Furthermore, the figure below shows a high correlation between Ukrainian export proceeds, industrial production growth and world steel prices. Thus, we assume that the condition of the world steel market will play a prevailing role in 2011 GDP growth again.

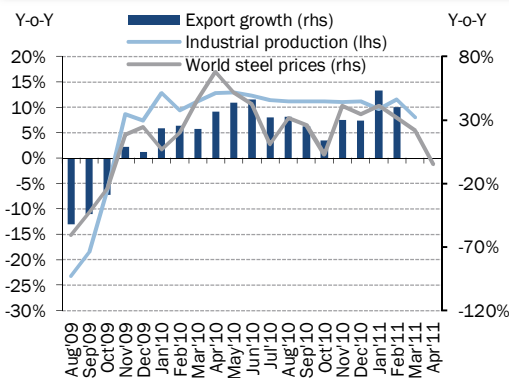
Base metals accounted for 34.2% of merchandize export volume

Metallurgy forms the bulk of industrial production...



Source: structure of industrial production sold by industry- NBU, State Statistics Committee

... constituting the dependence on world steel markets

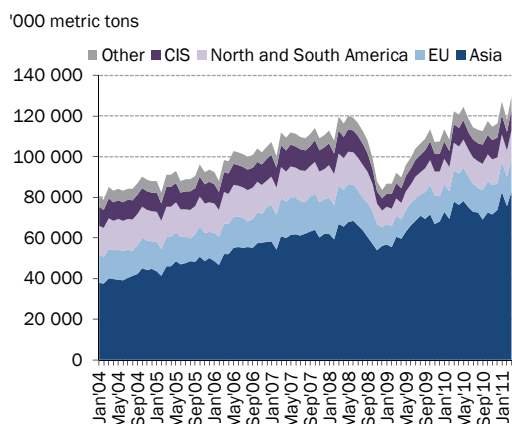


Source: State Statistics Committee, Bloomberg, AYA estimations and calculations
Note: steel prices growth figures are 1 month back and based on LME Steel Billet Spot prices

The surge in the global steel sector capacity expected in 2011 supports our view that the Ukrainian steel market is going to be quite tough. Turkey, the second-largest importer of Ukrainian steel, might arise as a flat steel exporter in 2011, after significant development of its steel-making facilities. In addition, it is expected that in 2011, the Arab markets will also see more integration between steel leaders in Muslim countries, due to the efforts exerted by the Arab Iron and Steel Union (AISU) to achieve integration. Furthermore, domestic steel demand remains sluggish; we expect the soft patch to persist at least through 1H'11, given gradual progress in the government-lead infrastructure programs for Euro-2012 and demand from railcar producers.

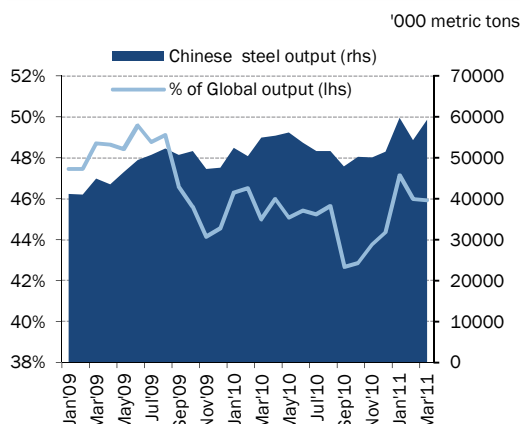
We are conservative in regard to steel market prospects

Global steel output structure



Source: Bloomberg, International Iron and Steel Institute, AYA calculations

Chinese steel output



Source: Bloomberg, International Iron and Steel Institute, AYA calculations

Chinese influence on the global steel market will remain substantial. After the 10.5% estimated Chinese real GDP increase in 2010, the IMF forecasts 9.6% growth in 2011. Despite such growth deceleration, China continues to dominate in the global steel and raw materials industries. For example, the estimate for the Chinese 2010 steel production is 626.5 MM tons (45% of global crude steel output, +10.5% Y-o-Y). Yet the degree of such influence may decline slightly within 2011. 2H 2010 demonstrated a drop in Chinese steel production, due to the government's policy of closing inefficient steel-making facilities (currently, the Chinese government is liquidating outdated ironworks.) Moreover, there is a moratorium on construction of new steel plants, up to the end of 2011.

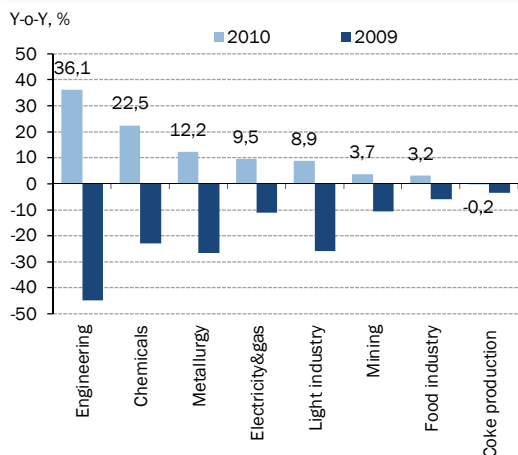
Despite the continuing "steel addiction", some sectoral shifts are on the edge. In contrast to the low increase in the share of engineering in total industrial products sold (11.2% over 11m'10 vs 11.1% over 2009), machine-building had the highest growth last year (+36.1% Y-o-Y). In February 2011, that share was already 11.6%. High investment demand from CIS (particularly from Russia) was the main factor fueling this improvement. The major growth manifested itself in transport engineering, due to:

1. higher railcar market pull from Russia (due to the considerable upturn in transportation of internal oil products and rail transport re-equipment programs). Russian railcar production grew threefold.
2. 47.3% rise in bus and trolleybus production by Bogdan Corporation, in a joint project with the Czech Republic;
3. uptick in domestic demand for public service vehicles while municipalities are preparing for Euro-2012.

Even with abovementioned shifts, we assume that the economic growth is not yet on a sustainable road. With revived export sectors and sluggishly recovering domestic sectors, consumption remains restrained by slow real income growth and the still-damaged credit channel. Thus, **we see an above-average likelihood of a reverse, back to 2000-2004 growth pattern, with continuing dependence on export sector within the next years.** Consequently, that may lead to economic underperformance in the medium term, as long as under the "Status quo" scenario (the most probable political scenario as of July 2011) likely rent-seeking and underinvestment will prevail in basic sectors – metallurgy, engineering, etc. Moreover, we assume production of high-quality consumer goods to stay flaccid again. That may lead to C/A deficit widening and related economic imbalances.

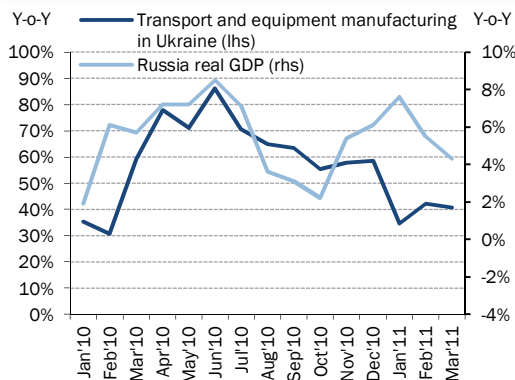
Machine-building had the highest growth last year (+36.1% Y-o-Y)

Machine-building demonstrated the highest growth rate in 2010...



Source: industrial branches growth, State Statistics Committee

... fueled by external demand from Russia mostly



Source: State Statistics Committee, Federal State Statistics of Russia, AYA calculations
Notes: Russia GDP growth is presented with a lag of +1 month on the basis of Index of basic industries, calculated by Federal State Statistics of Russia

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