

## Quick Stats

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

## Hot Topics

- Marking his 100th day in power, Victor Yanukovich, Ukraine's newly elected president, unveiled a comprehensive 5-year reform agenda, which included some long overdue, but essential proposals to improve business climate and put country's economic growth on a more sustainable footing
- Statisticians are expected to confirm an official end to a recession in Q2 2010: GDP in Q1 declined by a seasonally adjusted 0.3% compared with the previous three-month period, but was 4.9% higher than a year ago

## POLITICS AT A GLANCE

The period following the election of Victor Yanukovich as Ukraine's new president was unexpectedly mild. The decision by Ms. Tymoshenko, the former prime-minister and main rival of the current president, to abandon a challenge to the result and withdraw her complaint from the Supreme Court has helped remove some of the uncertainties about prolonged power transition. Other sources of instability, such as possible dissolution of Parliament were also removed given that Mr. Yanukovich has been very quick in forming a new coalition and appointing the prime-minister. Although the legality of the ruling coalition was doubtful, the Constitutional Court later confirmed its legitimate status.

Negotiations with the International Monetary Fund (IMF) entered a new phase with a broad agreement to replace the initial \$16.6 billion stand-by program (of which Ukraine received almost \$11 billion) with a new \$14.9 billion 2.5-year facility. New lending program could be approved in late July, since Ukraine appears on track in making the required policy adjustments in fiscal and monetary areas (see Economic policy section for details).

In the international sphere the focus has been on the ongoing negotiations with the European Union on the creation of a free-trade zone and liberalization of visa procedures. While the latter issue may drag for some time, a free-trade deal could be formalized in 2011. Also of note was the reconfirmation by UEFA, Europe's administrative body for football, of four Ukrainian cities as venues for Euro 2012 football championship.

## Ukraine Fact Sheet

Annual data	2009	Historical Averages (%)	2005-2009
Population (million)	45.8	Population growth	-0.6
GDP (US\$ billion; market exchange rate)	117.4	Real GDP growth	0.6
GDP (US\$ billion; purchasing power parity - PPP)	290.1*	Real domestic demand growth	4.2
GDP per head (US\$; PPP)	6,337*	Inflation	15.2
Exchange rate (av) UAH:USD	7.79**	FDI inflows (% of GDP)	6.3

Source: Economist Intelligence Unit (EIU)  
\* - EIU estimates

## ECONOMIC OVERVIEW

## Executive summary

The worst economic crisis Ukraine has experienced in more than a decade has ended. After contracting 15.1% in 2009, the economy expanded by an estimated 6.3% y-o-y in six months to the end of June. Apart from improved external balance on the demand side and sustained agricultural and industrial output on the supply side, GDP was propped up by reactivated domestic consumer demand. Currently, the economic growth is forecast to average 4.3% over 2010-2014, which is slower than previously (5.9% over 1999-2003 and 6.4% over 2004-2008), but still faster than elsewhere in Europe. Should the authorities succeed in implementing their reform agenda, the growth could potentially accelerate to 6-7% per annum.

**Economic policy**

The current administration has put forward a five-year reform plan, which among its key proposals included the following:

- **Cut Corporate Income Tax** to 20% in 2011 (from current 25%) with further stepped reduction to 17% in 2014;
- **Cut VAT** to 17% (from current 20%);
- **Introduce real estate tax;**
- **Stabilize public finances** by improving tax administration and expanding taxation base, introducing anti-corruption laws and adopting a law on state debt;
- **Improve business climate** by reducing the list of licensed economic activities (by 30% till 2011), simplifying business entry and exit procedures, privatizing state assets, bringing legislation and procedures in line with EU standards.

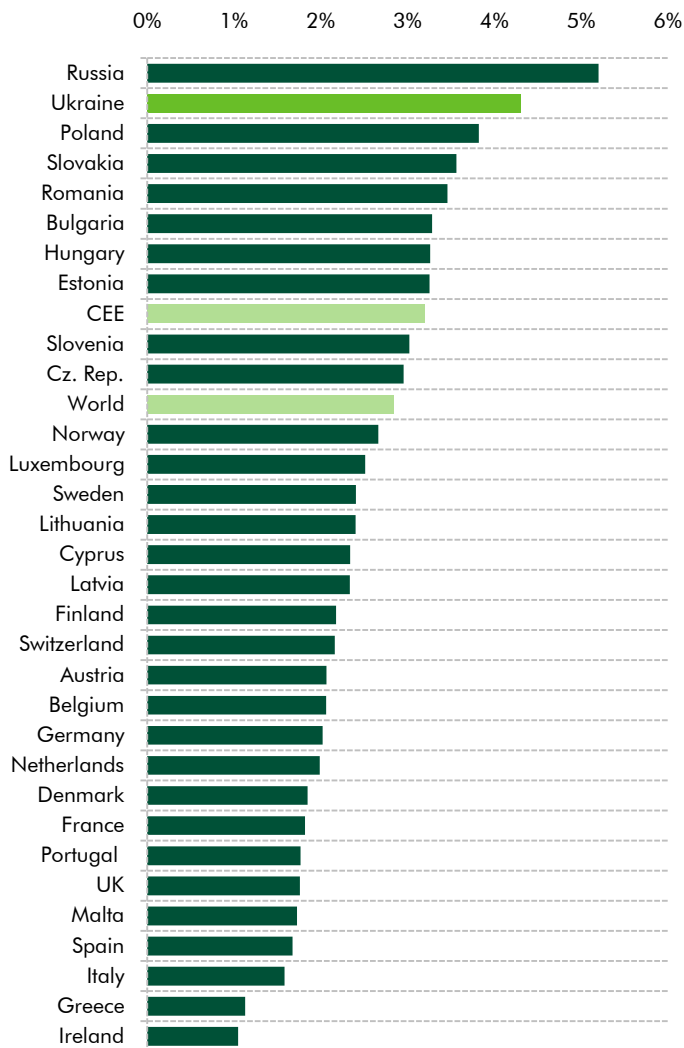
Although the authorities stopped short of setting too many deadlines for the proposed reforms, the direction they chose could have hardly been more sensible. The political calendar also favors resolute action, since the next parliamentary elections are scheduled for 2012, creating some breathing space after years of political turmoil. Still, we believe the pace of reforms is likely to be slow due to strong vested interests and highly conservative population.

Ukraine’s challenging fiscal situation and IMF’s firm stance on reforms (which became firmer in the face of debt troubles in Europe) has galvanized the authorities into action. In mid-July some of the most important measures were finally approved – i.e., the increase in gas prices, budget cuts and the adoption of a law that would strengthen National Bank’s (NBU) independence. Additionally, new gas deal with Russia, which cut base prices by 30%, has significantly improved Ukraine’s chances of trimming budget deficit, as demanded by the IMF.

**ECONOMIC GROWTH**

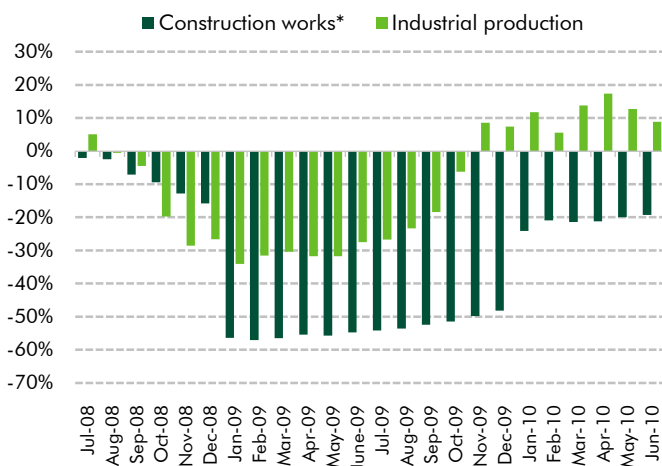
GDP is supported almost entirely by external demand, with industry and agriculture remaining the main drivers of the economy. Consumer demand has only recently started to pick up, while construction sector remains in negative territory despite extremely low base (construction works declined 48% in 2009). Lack of affordable financing and weak domestic demand, especially on the part of corporate sector (capital investment fell 12.5% y-o-y in Q1), are the main reasons behind the still struggling construction sector.

**Average Annual GDP Growth over 2010-2014 (% change, y-o-y)**



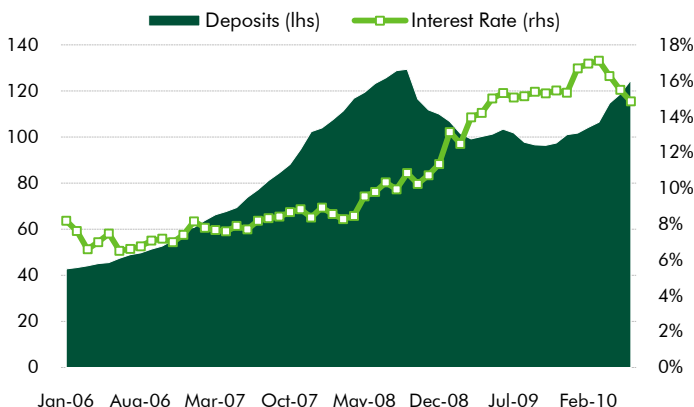
Source: Economist Intelligence Unit, Experian Business Strategies, Goldman Sachs

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



Source: State Statistics Committee  
\* - monthly data are cumulative

**Stock of Household Deposits (UAH, billion) and Weighted Average Deposit Rates (% per annum)**



Source: National Bank of Ukraine

The weak state of domestic economy is partly attributable to the challenges still faced by the Ukrainian banking sector. In particular, rising volume of non-performing loans (NPLs) continues to dissuade banks from lending to both firms and households. According to the NBU, outstanding NPLs reached ca. HRN77.6 billion (\$9.8 billion) or 10.8% of total loans in June. That being said, issuing loans is becoming more profitable given that deposit rates are falling and the stock of deposits is moving closer to pre-crisis levels.

Growing public confidence in banks was matched by improving consumer mood. Indeed, for the first time in four years, the majority of Ukrainians remained optimistic about their country's economic prospects for three consecutive months, according to GfK, a research firm. After contracting in y-o-y terms for 14 straight months, retail sales inched upwards in March and were already 9.2% higher in June than a year ago.

**PRICES AND UNEMPLOYMENT**

Consumer prices index (CPI) fell in every month since March, bringing 6-month inflation rate to only 3.3%, a rather low figure in historical terms. A large contraction in domestic demand is the main factor behind disinflation, but seasonal factors also eased price pressures. CPI is forecast to average 10-11% in 2010 and stay in high one-digits throughout 2011. Were it not for the proposed 50% hike in gas prices (to become effective from August 1), y-o-y inflation rate this year could have been some 2.8pp lower, according to Goldman Sachs, an investment bank.

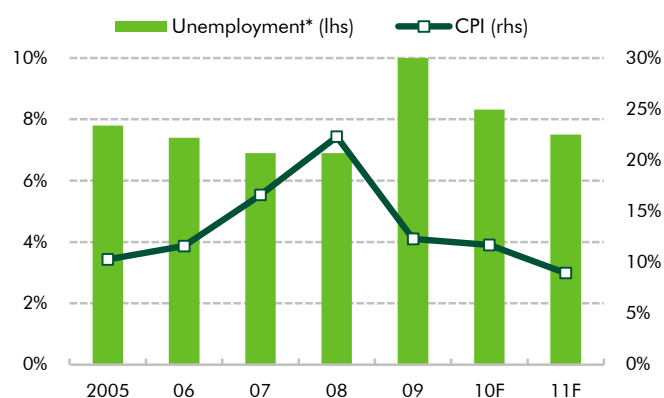
The rate of joblessness inched upwards by 0.2 pp (to 9.8%) in Q1 2010 compared with previous three months, but was 0.5 pp below the level recorded a year ago. Unemployment is forecast to decline by around 1 pp in 2010 and 2011.

**EXTERNAL SECTOR**

Strong global commodity prices and seasonal drop in imports helped to shrink merchandise trade balance to an estimated -\$0.152 billion in May (from almost -\$0.347 billion in April). Even as service trade balance weakened on account of lower revenues from transportation, it remained in much bigger surplus than a year ago, improving 5-month trade and services gap to -\$0.166 billion (from almost -0.5 billion in Q1). Due to softer steel prices and recovering internal demand, trade and services balance is set to worsen over the coming months, resulting in a negative current-account of about 1% of GDP.

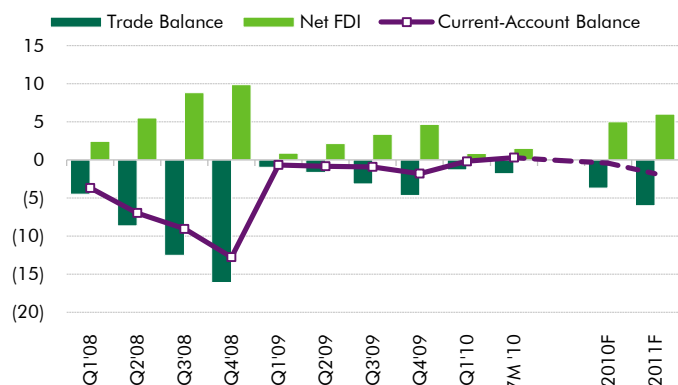
Total capital account ran a surplus of \$1.3 billion in five months to the end of May, complete turnaround from the \$5.7 billion deficit recorded over the same period a year ago. The improvement came on the back of bigger inflows of borrowed capital in both private and public sectors as well as the reversal of household-induced hard currency flight from banks. Furthermore, even as net foreign direct investment (FDI) weakened in y-o-y terms (from already low base), they became healthier in structure, as no recapitalization funds from foreign banks were recorded.

**Unemployment and Inflation**



Source: State Statistics Committee  
 \* - International Labor Organization methodology (% of workforce)  
 F - poll of forecasts (see Table below)

**Balance of Payments, cumulative (USD, billions)**



Source: Economist Intelligence Unit  
 F - Troika Dialog forecast

## OUTLOOK

Luckily the weakening of external demand for Ukrainian exports is being balanced by a strengthening domestic demand. However, no significant upturn in private spending should be expected this year given that bank lending is still declining, unemployment remains high and wages are growing only sluggishly. The economy is nevertheless heading in the right direction.

GDP is expected to grow between 2% and 4% in 2010 before expanding at a more solid rate of ca. 5% over 2011. The economy growth over 2011-2014 is forecast to average ca. 4.5%, but could accelerate to 6-7% especially towards EURO2012 and in case government succeeds in pushing through structural reforms aimed at improving regulatory environment and investment climate. Mr. Yanukovich may not be the most enlightened figure in Ukrainian politics, but his government does feature some reform-minded individuals and we believe that at least some of the necessary social and energy reforms stand a good chance of being implemented.

### 2010 & 2011 Forecasts\*

Measure	2010	2011
Real GDP Growth (% , y-o-y)	3.33	4.25
Private Consumption (% , y-o-y)	2.75	3.75
Consumer Price Inflation (% , y-o-y)	11.70	8.96
Unemployment (ILO, %)	8.32	7.50
Consolidated Budget Balance (% of GDP)	-6.02	-4.62
Current-Account Balance (% of GDP)	-0.19	-0.63
Exchange Rate UAH:USD (av)	7.93	7.68

\* - simple average derived from the latest forecasts provided by the following organizations: Dragon Capital, Erste Bank, Economist Intelligence Unit, International Center for Policy Studies, International Monetary Fund, Renaissance Capital, Troika Dialog, UniCredit Bank and World Bank.

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