

EM SOVEREIGN / EASTERN EUROPE

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Ukraine — Political Outlook: Parliamentary Elections Are the Linchpin

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COUNTRY — CASH DEBT ISSUES AND CDS LEVELS

Coupon/Description	Ratings Mdy's/S&P/Fi	Maturity	Amount				YTW	Sprd (bps)
			Outstanding (US\$ in MM)	Next Call Date	Bid Price	Bid Price		
6.875% Rep. of Ukraine Notes	Ba3/BB-	03/04/11	\$600.0	N/a	N/a	101.00	6.63	188
7.650% Rep. of Ukraine Notes	Ba3/BB-	06/11/13	\$1,000.0	N/a	N/a	105.75	6.63	187
8.125% Naftogaz Notes	Ba2/BB-	09/30/09	\$500.0	N/a	N/a	97.75	8.88	409
5-Year Ukraine CDS								180

Prices as of March 8, 2006. Source: BSIL.

Recommendations

Sector:	Marketperform
Cash:	Underperform
CDS:	Underperform

Ukraine Update

We visited Ukraine last month, meeting with officials from the NBU, the ministries of economy and finance, the IMF and the World Bank, along with various local financial-sector institutions, NaftoGas, KyivStar, and members of the diplomatic community. This report describes our observations from the trip.

Summary view: Market concern over the turn-of-the-year Russia-Ukraine gas pricing dispute appears to have eased back, as the emerging consensus is that a relatively Moscow-friendly administration (a coalition of Our Ukraine and Regions of Ukraine) will assume power after the March 26 parliamentary elections. We have long argued that the normalization of the relationship with Russia is key to putting Ukraine's credit fundamentals back on track, after the marked deterioration across a range of macroeconomic indicators seen over the past year. In particular, real GDP growth has slowed to a virtual standstill, and the trade and current accounts are thought to have moved into the red as export growth has been hit by combination of a shadow trade war with Russia and a broader deterioration in the terms of trade. Key credit strengths remain the relatively modest external and public sector debt burden, resilience of the fiscal performance despite the slowdown in economic activity, and improving prospects for foreign direct investment, particularly in the banking sector. Credit risks remain Ukraine's political stability, or rather the lack of it, and its effect on the relationship with Russia. The gas pricing agreement reached with Russia on January 4, 2006, appears to be only an interim arrangement, and leaves Russia with the option of hiking prices from July 2006. Emergence of another "Orange" coalition government, which fails to adequately assure Russia as to its intentions, could easily provoke another stand-off with perhaps more serious impacts second time around.

Political Outlook/Risk

Domestic Politics: Parliamentary Elections are Linchpin

The political backdrop appears complex and unstable at first glance.

The "Orange" coalition, which secured victory in the December 2004 presidential elections, and which forms the backbone of the current government, struggled to maintain a united front during its first year in office. The coalition has been rocked by recurrent in-fighting, allegations of corruption and an intermittent but damaging trade war with Russia. These factors contributed to the ouster of the first

The analyst certification is located on the last page of this report.

Orange administration, which had been led by Yulia Tymoshenko, in September 2005. President Victor Yushchenko nominated a technocrat, Yuri Yekhanurov, as prime minister in her place. The gas price war with Russia over the New Year resulted in the signing of a gas price agreement between RosUkrEnergo (RUE, a 50-50 joint venture between Gazprom and a number of private investors) and NaftoGas Ukrainy on January 4, 2006. On January 10, Tymoshenko managed to rally the opposition and allied with Regions of Ukraine and the Litvin Block to vote Yekhanurov's administration out. President Yushchenko refused to accept that this vote was constitutional, and the Yekhanurov administration has, so far, continued in office in an "acting" capacity.

The January 10 vote has hamstrung the government. Given the proximity of parliamentary elections (due on March 26, 2006), no one in the opposition has been willing to try to form a new government; policymaking has effectively been held in limbo until the elections. While the hope is that elections will clear the way for the formation of a strong, stable government, opinion polls suggest that none of the leading parties will secure an outright victory and Ukraine appears set for another coalition government.

The Hope is That Elections Will Clear the Air

Forty-six parties have registered with the Central Electoral Commission to participate in the parliamentary elections, although only six or seven parties are expected to cross the 3% constitutional threshold required to secure parliamentary representation. Herein is a review of the main political parties and their platforms.

Our Ukraine bloc (OU). The party, is a reform coalition centered around the Our Ukraine faction which backed Viktor Yushchenko's presidential election campaign, and also includes a range of smaller parties, including Narodnyi Rukh, the Party of the Industrialists and Entrepreneurs (Kinakh), the Congress of Ukrainian Nationalists, the Christian Democratic Union, and the Ukrainian Republican Party Sober (Matvienko). Current opinion polls suggest that the party will secure 15%–20% of the vote. The party includes Oleksandr Omelchenko, the incumbent mayor of Kiev; Petro Poroshenko, the former head of the national security council and an ardent foe of Yulia Tymoshenko; and Yuri Yekhanurov, the prime minister. The party is pro-European (supporting Ukraine's membership in EU, the WTO and NATO) and is in favor of market reform, and, perhaps as a consequence of these positions, is viewed by Moscow as being anti-Russian. This view partially reflects the fact that prominent party members, including the foreign minister Boris Tarasyuk, hail from the nationalist "Rukh" (peoples') movement. Tarasyuk is viewed with considerable suspicion by Moscow. These suspicions were hardly eased by his recent comments to the effect that Ukraine could secure NATO membership as early as 2008 and that Ukraine could seek to renegotiate the lease for the Sebastopol naval base with Russia.

Regions of Ukraine (RU). RU is led by Viktor Yanukovich, the former prime minister and runner-up in the December 2004 presidential elections. The party emerged as the "party of power" during the Kuchma era, and represents the interests of big business, predominantly in Eastern Ukraine. The party is also seen as mostly representing the interests of the ethnic-Russian community in Ukraine. The party has campaigned on a platform that promises to improve relations with Moscow and to put an end to the energy pricing spat with Russia, going so far as to say that if voters want cheap gas prices they should vote for RU. Ukraine's richest man and leading oligarch, Rinat Akhmetov, is hoping to enter parliament on the party's list (he is currently number 3.) Akhmetov's System Capital Management (SCM) has launched an aggressive campaign to improve the image of SCM internationally and rebalance its business interests more to the EU, while trying to retain historically close ties to Russia. Running for parliament is perhaps part of Akhmetov's approach to cleaning up his image—securing a seat in parliament would also secure him immunity from prosecution. Akhmetov has indicated that he would push to assume the position of prime minister in an RU-led cabinet, but we believe that this is unlikely to occur. RU consistently tops the opinion polls with ratings of 25%–30%, but has struggled to increase its support beyond that achieved by Yanukovich in the presidential elections. Its support appears to be capped at current levels.

Bloc Yulia Tymoshenko (BYT). BYT is led by the charismatic and increasingly iconic Yulia Tymoshenko. Its key strength is the dynamism of Tymoshenko, the former prime minister, and its key weakness is the fact that Tymoshenko overshadows other politicians within the bloc and draws antipathy from other party leaders and politicians. The party is seen as a one-woman show. Tymoshenko is populist and interventionist in outlook, and forceful and direct. Many have questioned her commitment to market economics, citing her stint as head of the government between January and September 2005. Tymoshenko is also criticized for not being a team player, a reason given by President Yushchenko for

his decision to dismiss her from office in 2005. It is unclear whether Tymoshenko has learned from her past mistakes and if she is willing to compromise, particularly on her demand that she serve as prime minister in any future coalition that includes the BYT. The BYT has been polling in the 12%–15% range.

The People's Bloc of Litvin (LB). Led by Volodymyr Litvin, the wily speaker of parliament and former head of Kuchma's presidential administration. Litvin was a swing-player in the Orange revolution, rallying behind Yushchenko when it appeared that the Orange team was gaining momentum during the street protests of December 2004. He has reasonable contacts with both the Yushchenko and Yanukovych camps, hence arguably is a go-between. Litvin has struggled to fend off allegations (as yet to be proven) that he was complicit in the plot to murder the investigative journalist Georgi Gongadze, but he has a loyal voter base in the centre ground of the political spectrum and is seen a political survivor. Litvin's centrist political faction polls in the 5%–6% range.

The Socialists. Led by Oleksandr Moroz. Like Litvin, Moroz is a hardened political operator, having headed his party for more than a decade. The socialists entered government following the Orange Revolution and held some key portfolios including industrial policy and agriculture, with Valentina Semenyuk heading the sensitive State Property Fund. Reformers have criticized the Socialists for stalling key market reforms over the past year, even though Semenyuk failed to prevent the landmark sale of Kryvorizhstal in 2005; Soviet-style, Semenyuk was taken ill just prior to the sale. The Socialists poll in the 6%–8% range and are thought to be willing to work with OU and BYT, but are unlikely to be willing to work in any coalition including the LB and RU. Moroz and Litvin have traded accusations over the Gongadze case, and Moroz always stood aloof from the Kuchma administration, remaining in opposition during the 1990s.

The Communist Party of Ukraine (CPU). The CPU polls in the 5%–6% range. The party is pro-Russian and seen as anti-Western and anti-reform generally, although specific business interests have tended to drive the party's agenda on a case-by-case basis. The party is only likely to serve in a government led by RU, but excluding OU, BYT et al.

Pora-ROP. Pora is a new political party, formed from the student movements which underpinned the Orange revolution and which were themselves modeled on the Serbian "Pora" civic students' movement, which helped topple Slobodan Milosevic from power in 2000. Pora has attracted high profile candidates, including Vitaly Klitchko, the former World Boxing Champion, who is running on a Pora platform as mayor of Kiev. Pora has formed an electoral block with the Reforms and Order Party (ROP) of the incumbent minister of finance, Viktor Pynzenyk. Pynzenyk has subsequently announced that he is taking leave from his ministerial position in order to campaign for the elections. Pora-ROP is thought to be popular in the city of Kiev, but has struggled to make an impact nationwide and might struggle to pass through the 3% electoral threshold. Pora-ROP is expected to ally with Our Ukraine in any post-election coalition, although Klitchko will go head-to-head against Omelchenko of OU in Kiev, pitting the two "Orange" parties against each other. It is doubtful that Pora-ROP would be willing to join a broader coalition, for example with RU. Pora-ROP might serve as a rallying point for the reform opposition in parliament (perhaps including Tarasyuk and Rukh) should OU form a coalition government with RU in a post-election scenario.

Progressive Socialists. Led by the vitriolic Natalia Vitrenko. The Progressive Socialists are made up of old-style Communists opposing market and business reform. The party is likely to remain in opposition if they manage to pass the 3% threshold. The party typically polls in the 2%–4% range.

Ne-Tak: New political movement formed out of the ashes of the Social Democratic Party of Ukraine (SDPu) and led by Viktor Medvedchuk, the former head of the presidential administration under Leonid Kuchma. Ne-Tak's platform is pro-Russian, and its platform is closer to that of RU, which would be its natural coalition partner should it pass the 3% threshold to secure parliamentary representation. The party is currently polling around the 3% mark. Various allegations of misconduct/corruption have been laid against Medvedchuk but election to parliament would usefully give him parliamentary immunity from prosecution.

Coalition Building Could be a Painful Process

The only clear conclusion that can be drawn from the opinion polls is that the next government will be a coalition. Various coalition scenarios are possible, but we see only three realistic scenarios. We attempt to sketch these out below.

1. ***OU-RU (45% probability)***. It might seem incredible that these two bitter rivals in the 2004 presidential election campaign could put the past behind them and form a coalition. However, the two sides are known to have held talks in recent weeks about forming an Orange-Blue coalition. From OU's perspective, the willingness to join RU would be driven by fears that a pure-Orange coalition would be unstable, and subject to the same strains and fissures that have undermined policy-making over the past year. RU, by contrast, has missed the patronage of power, and might be willing to form a coalition in exchange for a seat (or seats) at the front table. It is rumored that the RU leadership has offered to allow incumbent prime minister (acting) Viktor Yekhanurov to remain in office, perhaps taking the key position of speaker of parliament in exchange. RU is also thought to have moved towards OU on the reform front, even moderating its opposition to WTO membership for Ukraine; even though this would likely be scheduled to coincide with Russian WTO accession. The inclusion of RU in government would offer the prospect of an improvement in relations with Russia. A two-party coalition with a majority in parliament would also offer the prospect of a relatively strong and decisive government. Critics on the right, though, argue that RU, simply by the weight of its likely parliamentary representation, would risk dominating OU. This could be countered by bringing the Socialists and the Litvin Bloc, or Pora, in to any such coalition, although it is difficult to imagine the Socialists or Pora working with RU given their past strained relations. Broadening the coalition risks fractures if the past year is anything to go by. A further argument against an OU-RU coalition is that opinion polls consistently indicate that this is the least-favored option on the part of the population, with backing for such a coalition standing at only around 5%. OU itself could also splinter as prominent leaders such as Tarasyuk defect in opposition to RU's pro-Russian agenda and opposition to NATO membership. Many hard-core supporters of the Orange Revolution would regard such a coalition as a sell-out of the principles of the movement. (A prominent writer on Ukrainian affairs, Professor Taras Kuzio, recently quipped that under an RU-OU coalition the Orange Revolution's catch phrase of "Bandits to Prison" could well be replaced by "Bandits in Government.") Such a coalition could prove damaging personally to Yushchenko, undermining his ambitions to secure a second term as president in 2009.
2. ***A pure-Orange coalition (35% probability)***. This would be formed to keep RU out of power, and include OU, BYT, LB, the Socialists and Pora. This might appeal to romantics (opinion polls show it is the most favored coalition, with 35-40% backing), but the experience of the past year is that the Orange coalition is simply unable to function as a team. The risk of resumed in-fighting is not insignificant, particularly between Tymoshenko and rivals in OU (especially Poroshenko, and Bezmyrtny) and Pora-ROP (Tymoshenko has called for Pynzenyk to be sacked as minister of finance.) Choosing a prime minister under such a coalition formulation could also likely be difficult. Tymoshenko is ambitious and it is doubtful whether, having served as prime minister once already, she would be willing to serve in a lesser role in government second time around. Should BYT beat OU in the elections, it seems unlikely that Tymoshenko would accept anything less than the top job. Given the criticism of her last stint in the job, it also seems unlikely that Yushchenko would countenance her return to the office of prime minister. It has, however, been suggested that Tymoshenko still might be tempted to take a high profile role such as head of the national security council, speaker of parliament, or minister of energy. The role of speaker of parliament might just appeal, given the new prominence of parliament under the constitutional set-up agreed in December 2004 and introduced in January 2006. Nevertheless, it seems unlikely that the formation of an Orange coalition would result in the normalization of relations with Russia. Rather, we would expect that Russia would continue to pull economic levers behind the scenes to destabilize such a strongly pro-Western administration. Under this scenario, the economy would likely continue to struggle. Investment inflows would be slow, while the intermittent disruption of trade relations with Russia would cut real GDP growth even further, perhaps pushing the economy into recession. The external financing position would continue to weaken, although not critically—Ukraine still has favorable debt ratios and UAH8 billion in revenues from the Kryvorizhstal remaining in the National Bank of Ukraine.
3. ***Early elections (20% probability)***. Arguably the worst-case scenario. Under the new constitutional set up, the Central Electoral Commission has 14 days to validate the election results. Political parties then have 30 days to try to form a parliamentary majority and a further 30 days to secure parliamentary approval for the cabinet. Thus, it might be as long as 10 weeks before Ukraine has a functioning government. Failure to secure parliamentary backing might leave the president with little choice but to call fresh parliamentary elections. He might even be tempted to combine this with a

constitutional referendum seeking to reverse the constitutional reforms introduced on January 1, 2006, which reduced the powers of the president in favor of parliament. (Note that the constitutionality of such a referendum would be open to question, as the result of any such vote would then have to be approved by parliament.) Under this scenario, Ukraine would be subject to further months of political instability, with the risk of sapping confidence across debt and foreign exchange markets. Faced by this prospect, the NBU might decide to refrain from its current strategy of defending the UAH, opting to simply let the currency find its own level. This would presumably be significantly weaker than current levels, which would produce higher inflation and also put upward pressure on debt ratios.

International Relations

EU accession. The Yushchenko administration has set EU accession as a cornerstone of its policy program, with Boris Tarasyuk, the foreign minister, setting 2016 as a target date for EU accession. Progress towards this goal has been somewhat mixed. On one hand the EU/EC appears eager to encourage economic and political reform in Ukraine. On the other, there appears a reluctance to formally offer Ukraine a clear perspective to EU accession. This reluctance to commit to Ukraine reflects a number of factors. First, there is recognition that the debate over enlargement within the EU is ongoing, with concern in some quarters that the EU has already over-expanded, reflected in the bitter debate last year over Turkish EU accession. Second, there is concern over the impact that Ukrainian EU accession could have on the European economy, particularly the impact on the Common Agricultural Policy (CAP), as Ukraine's agricultural sector has enormous potential given its famous "black earth" soils. Third, there is recognition that accepting Ukraine as an EU candidate member state could jeopardize the strategically important EU-Russia relationship. EU strategy towards Ukraine has thus been to try to boost cooperation while falling short of offering a clear perspective or timetable to EU accession. The EU has rewarded Ukraine by awarding it "market economy" status as of December 1, 2005, and is working towards easing visa restrictions for Ukrainians visiting the EU. Ukraine has already lifted visa restrictions on EU citizens visiting Ukraine. Discussion is also underway over a possible EU-Ukraine free-trade agreement. Nevertheless, the lack of a clear EU perspective is a major negative for this credit, as unlike other EU candidate member states (Bulgaria, Romania, and Turkey) Ukraine lacks a clear anchor for reform going forward.

NATO membership. Membership in NATO has also been set as a policy priority by the Yushchenko administration, with the ministry of foreign affairs suggesting that entry into the organization is possible by 2008. With this in mind, cooperation with NATO has been stepped up a notch. Interestingly, though, opinion polls have consistently shown a majority of the Ukrainian population opposed to NATO membership, which contrasts with a majority generally favoring EU accession. Arguably this reflects concern that accession into NATO could antagonize Moscow and hence undermine, rather than improve, Ukraine's security. Nevertheless, any move to enter NATO would require parliamentary approval, which is by no means assured given the likely opposition from RU, the LB, the Socialists and the Communists. Moscow has made it clear that it would view NATO membership by Ukraine as a serious provocation by Kiev. Matters are complicated by the fact that air defense facilities located in Ukraine provide a key link in Russia's own air defense system, while Russia's Black Sea Fleet is based in the Ukrainian port of Sebastopol, leased to Russia. However, in contrast to the lack of commitment from EU members to push Ukraine's EU accession bid, NATO appears much more amenable to Ukrainian membership. To an extent this reflects support from the U.S., which has valued recent Ukrainian participation in coalition activities in Iraq and also sees NATO membership for Ukraine as providing a reward for progress on democratization in Ukraine. Also, as NATO's recent enlargement to the Baltic states and former Warsaw Pact states in Central Europe has demonstrated, Washington appears much more willing than the EU to tough it out with Moscow. Arguably this reflects the fact that the US is not so reliant on Russia for energy supplies as is Europe.

Membership in the WTO. Hopes for Ukraine's early entry into the WTO in 2005 were dashed by parliament's failure to pass key WTO-compliant legislation in the fall. However, hopes are building that the new parliament will finally get the required legislation on the statute book in time to allow WTO membership by September 2006. Bilateral negotiations with existing WTO members are proceeding well, with a recent trade agreement signed with the U.S. that also finally awarded Ukraine market-economy status. Bilateral agreements still need to be concluded with Australia, Colombia and the Kyrgyz Republic, but these are expected to be completed over the next few months. The assumption is that Ukraine and Russia will join the WTO in parallel.

Policy Environment/Risk

While the formation of the Yekhanurov administration in September 2005 reduced in-fighting (as the new regime is seen as being loyal to Yushchenko and OU), its lack of a strong power base in parliament and successive parliamentary votes in January 2006, first removing the entire cabinet and then re-voting to remove the ministers of energy and justice, have given it little more than an interim/acting role. The Yekhanurov administration failed to push key WTO-compliant legislation through parliament, but was more successful in pushing through the privatization of Kryvorizhstal and in capping the growth of the budget deficit (although the emphasis was on revenue generation than on reforming the expenditure side), despite pressure from the parliamentary deputies to pork barrel ahead of the election.

Looking beyond the parliamentary elections, our assumption is that a pure-Orange coalition government would, in theory, be most likely to pursue a radical reform agenda. However, in practice, it would likely be hampered by tensions in terms of its relationship with Moscow and internal fissures, for example, between the Socialists, Pora-ROP and the BYT. The upshot is that the economic outlook under such a scenario would likely be for a continuation of 'crisis management', which has been perhaps the key characteristic of government in the months since the Orange revolution. By contrast, an OU-RU administration, while being more stable, would be far less ambitious in terms of reform. Indeed, in many respects, economic policy would likely resemble that of the previous Kuchma administrations, i.e. fitful reform and somewhat opaque governance. The normalization of the relationship with Russia, however, could well see a return to higher growth, with a likely improvement in external balances.

Fiscal policy. Despite the economic slowdown over the past year, budget performance has remained surprisingly robust. Largely, this reflects conscious government efforts to simplify the tax regime and reduce the prevalence of preferential tax schemes, tax offsets and tax breaks.

According to data supplied by the Ministry of Finance, the consolidated budget posted a deficit of UAH7.5 billion for the full year in 2005, equivalent to just short of 2% of GDP. IMF estimates, however, put the general government deficit, including various quasi-budget deficits and arrears accumulation, nearer to 3% of GDP. The share of general budget spending in GDP actually increased in 2005, to more than 40%, from 35% in 2004. Driving this increase were substantial hikes in pensions and public sector wages, agreed by both the previous Yanukovich administration and its successor. The fact that the deficit was contained to 3% of GDP reflected the authorities' success in broadening the tax base and reducing tax avoidance. Customs receipts, probably reflecting the boom in import demand and corporation tax came in well above plan.

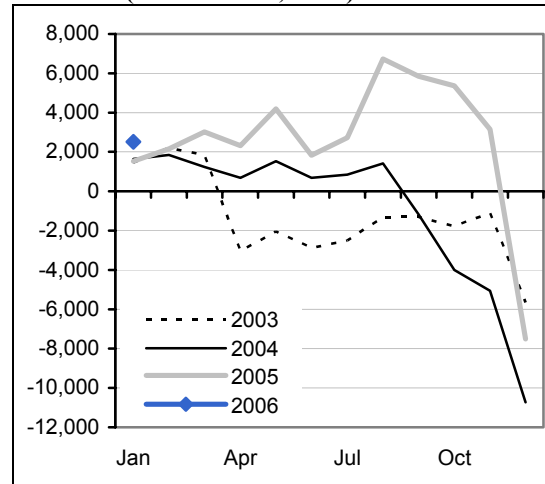
As expected, the state budget for 2006 was significantly revised during its passage through parliament in the fall, as a result of extensive pork-barreling. The original budget draft assumed revenues of UAH118.7 billion, and spending of UAH127.4 billion, implying a deficit of UAH8.7 billion or just under 2% of GDP. The final budget approved by parliament and signed off by President Yushchenko on December 20, 2005, raised budget revenues to UAH127.4 billion and spending to UAH137.1 billion, boosting the deficit to UAH9.7 billion. Compared to the 2005 outturn, this implies an increase in spending of 21.5%, on the back of the assumption that revenues will rise by a similar amount. The consolidated budget deficit in 2006 is targeted at UAH12.9 billion (equivalent to around 2.6% of GDP). The budget includes significant increases in current spending, including big increases in public sector salaries and pensions. Obviously this creates potential problems for the future, although a more thorough restructuring of the fiscal accounts, to improve the "quality" of spending, will need to await the formation of the next government. Likewise, a program to overhaul the country's tax system has also been sidelined pending the outcome of parliamentary elections.¹

Given that real GDP growth appears set to remain depressed in 2006, the budget targets detailed above could be difficult to attain, especially given that the budget was based on the assumption that real GDP growth would reach 7% in 2006. Above-plan inflation (the official 8.7% inflation target appears to be on the low side) should help on the revenue side, though, and the MOF will obviously hope to continue to bear down on tax avoidance.

Early reports on budget performance to date in 2006 suggest continued strong fiscal performance. According to the MOF, the consolidated budget managed to run a surplus of UAH2.5 billion in January, an increase of UAH1 billion from the year-earlier period. Budget revenues were reportedly up by 36% year over year, outpacing spending growth, which was 27.6% higher year over year.

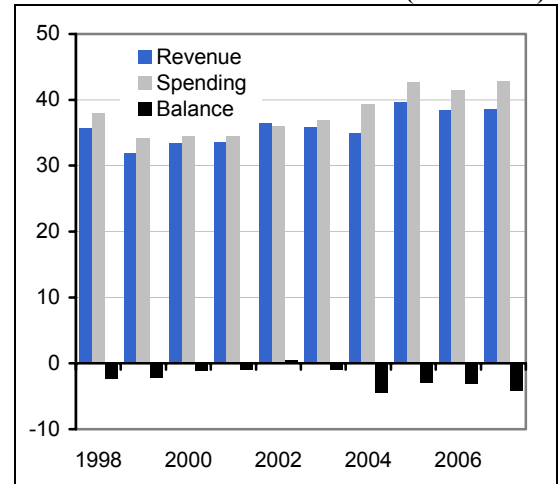
¹ *Draft Concept for Reforming Ukraine's Tax System*, see www.business-rada.kmu.org.ua

CUMULATIVE CONSOLIDATED BUDGET BALANCE (UAH IN MM, YTD)



Sources: BSIL; Ministry of Finance.

GENERAL BUDGET PERFORMANCE (% OF GDP)



Sources: BSIL; Ministry of Finance; IMF.

From a financing perspective, the MOF appears well placed to cover an enlarged budget deficit in 2006. Given the planned UAH12.9-billion budget deficit, assuming UAH3 billion in increased energy subsidies resulting from the recent gas pricing deal (see below) and UAH10.2 billion in debt amortizations falling due in 2006, this implies a total financing requirement of around UAH26 billion. Reviewing possible funding sources, the MOF is thought to have around UAH8 billion remaining in the fiscal reserve from the record Kryvorizhstal privatization in 2005. In addition, the MOF has around US\$500 million (UAH2.5 billion) in loans in the pipeline from the World Bank/IBRD, and is expected to tap the Eurobond market in the second half of 2006, for at least a benchmark US\$500 million (5–7 year maturity). Assuming domestic debt issuance on par with 2005, i.e. UAH6.9 billion, this yields funding sources of UAH20 billion. We do not believe that it would be difficult for the Treasury to fill the gap by increasing eurobond issuance to US\$1 billion and raising the balance in funding from the domestic debt market. The budget for 2006 allows the Treasury to increase the stock of domestic state debt to UAH24.2 billion, from UAH19.2 billion at the end of 2005, suggesting net issuance of UAH5 billion. Even by boosting the stock of domestic debt to UAH24.2 billion, the ratio of public sector debt/GDP would remain very low by international standards, at around 27%.

Monetary and exchange rate policy. For much of the year following the Orange Revolution, the National Bank of Ukraine (NBU) was fighting off strong upside pressure on the exchange rate. Arguably this was a reflection of the fact that the current account continued to post a sizeable surplus, and Ukraine benefited from sizeable capital inflows. Initially the NBU tried to hold the currency at its previous target rate of UAH5.34:US\$1, but in April 2005, it allowed the currency to strengthen to UAH5:US\$1. The NBU continued intervening in defense of the dollar over the course of 2005, with interventions totaling around US\$10 billion. This resulted in the doubling of reserves over the course of 2005 to US\$19.5 billion. Given that most of these interventions went un-sterilized, the NBU's activities provided a significant boost to domestic liquidity and hence inflation. Interest rate policy has, meanwhile, proven relatively ineffective given that inter-bank rates are very low (at around 2%); hence the transmission mechanism is weak. Unlike Russia, where the ministry of finance has run large surpluses, mopping up domestic liquidity and helping the CBR sterilize inflows, in Ukraine the maintenance of budget deficits has left the NBU on its own in terms of sterilizing inflows.

Uncertainty over energy pricing in late 2005 combined with a sharp deterioration in the current account position reversed the trend on the exchange rate in early 2006. The NBU was forced to intervene to defend the UAH, spending US\$1 billion in January, and US\$313 million in February in interventions. Intervention has continued in the first few days of March, but with reserves amounting to US\$18.3 billion as of the end of February and total market turnover of only around US\$30–50 million daily, the NBU has sufficient reserves to defend the UAH at least until the elections. NBU governor Volodymyr Stelmakh issued a statement on February 28 affirming the central bank's determination to hold the currency in the corridor of UAH5–UAH5.06:US\$1 at least until the elections.

Beyond the elections, the NBU appears likely to adopt a pragmatic approach. Given the relative weakness of the transmission mechanism for interest rates, the NBU still appears to favor holding the

currency relatively fixed (arguably it is the only anchor against inflation): it seems to have spurned IMF calls for the adoption of a more flexible exchange rate regime. However, should political instability extend beyond the elections and result in sustained pressure on the UAH, and if this came in conjunction with a further deterioration in the external balance, we believe that the NBU would allow the currency to weaken more aggressively, rather than waste resources on intervention. The NBU might widen the bands within which it allows the currency to float, rather than moving to a fully floating exchange rate.

Privatization. Privatization revenues reached UAH20.7 billion (5% of GDP) in 2005, which compares with the original target, which was to have generated UAH7 billion in privatization receipts. The key sale in 2005 was the re-privatization of Kryvorizhstal for UAH24.2 billion (UAH4.26 billion returned to the former owners). The sale was notable not only for the cash revenues generated, but also for the fact that it was sold despite determined opposition from the former owners, parliament, and members of the government (including the head of the State Property Fund, Semenyuk).

The success of the Kryvorizhstal privatization has boosted support for further state asset sales within both the presidential administration and the incumbent (Yekhanurov) government. President Yushchenko has indicated that the re-privatization of the Nikopol Ferroalloy (NZF) will proceed in the near future. To recap, NZF was originally sold in 2003 for UAH400 million to a group controlled, as was Kryvorizhstal, by former President Kuchma's son-in-law, Viktor Pinchuk. However, as with Kryvorizhstal, the original privatization of NZF was challenged by the Yushchenko regime and this move was upheld by a Supreme Court ruling in January. Parliament subsequently voted to prevent the re-privatization of NZF, only for President Yushchenko to veto parliament's move to block the sale in February 2006. The company is now expected to go under the hammer after the parliamentary elections, although this will depend on the shape of the next government; RU will likely seek to block the sale. Other assets slated for sale after the elections include Ukrtelekom, the Odessa Fertilizer Plant and the Port of Odessa. All three assets could generate significant revenues (several billion U.S. dollars) for the state, although the make up of the next government could still affect the sale plans.

Energy policy/strategy. The January 4 gas supply/pricing agreement reached between RosUkrEnergo (RUE) and Naftogaz Ukrainy has emerged as perhaps the central issue in the parliamentary election campaign.² The presidential administration has defended the deal as the best that could be negotiated under the circumstances. BYT, the LB and even members of the government, including the minister of finance, Pynzenyck, have argued that the deal runs against the national interest, is non-transparent and promotes corruption. They have joined calls for the deal to be re-negotiated. The lack of transparency with respect to the ownership structure of RUE has been particularly embarrassing for the Yushchenko administration. The obvious question has been asked as to why a middle man, such as RUE, is being used when a simpler direct agreement between Gazprom and Naftogaz Ukrainy would appear more logical. RUE is reported to have revenues of over US\$3bn, but only employs a dozen or so people, raising issues as to what added value it is providing. RU has campaigned on a platform that only they can assure good relations with Russia and ensure the supply of cheap energy.

During the course of our visit to Kiev, a number of additional documents were published which provided more detail on the agreement. To summarize the deal as per this latest documentation:

- Naftogaz Ukrainy will sell 40 billion cu meters (bcm) of gas to RUE at the Turkmen-Uzbek border for US\$50 per 1,000 cu meters (this gas was contracted to be supplied to Naftogaz Ukrainy as per an earlier agreement with Turkmenistan). RUE will then sell 25 bcm of gas to Naftogaz Ukrainy for US\$80 per 1,000 cu meters at the Russian-Ukrainian border. RUE will therefore take 15 bcm of gas for transit to Ukraine.
- RUE will sell an additional 2 bcm of gas to Naftogaz Ukrainy at the Russian-Ukrainian border for US\$95 per 1,000 cu meters. The average price paid by Naftogaz will rise to US\$95 in H1 2006, from an average of around US\$44 in 2005.
- In 2006 Naftogaz Ukrainy will transport 127.8bn of natural gas for a transit fee of US\$1.6 per 1,000 cu meters over 100 km. However, given an existing debt of US\$1.25 billion owed to Gazprom by Naftogaz, over the period 2006–2009, the fee will actually remain at US\$1.09 per 1,000 cu meters,

² For a review of the agreement please see Bear Stearns Sovereign EM Research, *Ukraine: Gazprom Update*, December 28, 2005, and also Bear Stearns Sovereign EM Research, *Ukraine: The Gas Dispute Revisited*, January 18, 2006.

implying a total gas transit fee of only US\$2.05 billion. Transit fees are fixed for 5 years. Note that market transit fees in Western Europe are closer to US\$2.5–3 per 1,000 cu meters over 100 km.

- Naftogaz Ukrainy will store up to 15 bcm of gas for Gazprom, for an aggregate payment of US\$866 million, implying a fee of US\$2.25 per 1,000 cu meters per year. This fee is fixed for 25 years. Market rates for gas storage in Europe, currently range from US\$8–17 per 1,000 cu meters per annum. Transit fees for gas supplied into storage for RUE in Ukraine are also fixed at US\$1.6 per 1,000 cu meters over 100km for the period 2005–2030.
- RUE will also offer 7 bcm of Uzbek gas and 8 bcm of Kazak gas at a price of US\$230 per 1,000 cu meters. This gas can either be consumed in Ukraine or exported.³

The deal appears complex. However, given that Turkmenistan only has a production capacity of around 41 bcm, and has already agreed to supply 6 bcm of gas for export to Gasexport Ltd, it seems that Naftogaz Ukrainy will only actually be able to secure 22 bcm of gas (35 minus 13 for transit). Taken together with 20 bcm domestic production, Naftogaz Ukrainy will have around 42 bcm to supply to households (20 bcm), municipal heating companies (9 bcm), budget organizations (2.1 bcm), regional distributors (1.7 bcm) with around 8 bcm used to fuel the pipeline system. Demand by industrial users (32 bcm) will now be met with gas supplied by RUE to a 50:50 joint venture with Naftogaz Ukrainy (see below). Under the terms of the agreement, Naftogaz Ukrainy also loses the right to export gas. In 2004 the company is thought to have exported in excess of 5 bcm, with 3 bcm exported in 2005, earning a “profit” of US\$500–700 million per annum.

Naftogaz Ukrainy officials we met were eager to dispel concerns expressed in the media and the market that the January 4 agreement has threatened the liquidity of the company. The officials clarified that the new 50:50 joint venture between Naftogaz Ukrainy and RUE, Ukrgazenergo (UGE), would be responsible for supplying gas to industrial users. Under the terms of the January 4 agreement, RUE would supply gas at US\$95 per 1,000 cu meters to UGE, which would then sell it to industrial users. According to the Naftogaz Ukraine officials, as of writing the price paid by these industrial users was around US\$120 per 1,000 cu meters, implying a profit for UGE. Naftogaz Ukrainy would remain responsible for supplying the needs of household consumers, which would be met from domestic production from Naftogaz subsidiaries (Ukrghasdobycha and Chernomornaftagazprom). Production costs in Ukraine are currently above the retail price paid by domestic consumers in Ukraine (around US\$32 per 1,000 cu meters) and hence the implication is that Naftogaz Ukrainy would bear the loss on this part of its operations. When asked whether this loss would be covered by resort to increased foreign borrowing or transfers from the budget, the reply was that this was a “political decision” and would be decided in due course.

Given the increased strain on the finances of Naftogaz Ukrainy resulting from the January 4 agreement, market focus has been on whether the government would bail out the company in order to stave off insolvency. The company is state-owned but does not have an explicit state guarantee with respect to its debt. Officials from Naftogaz Ukrainy confirmed that the company does not own the gas pipelines in Ukraine but leases these (for an undisclosed but presumably nominal fee) from the state. Creditors would therefore appear to have limited assets to attach should the company become insolvent.

In a report to parliament on February 14, the minister of finance, Pynzenyck, indicated that the cost of the January 4 agreement would be US\$660 million in terms of losses incurred by the utilities. Pynzenyck argued that if this sum was not met from the budget, then Naftogaz Ukrainy would have trouble meeting its investment program and servicing its debt. No clarification was given as to whether budget transfers would be made to Naftogaz Ukrainy. Recent loans secured by Naftogaz Ukrainy appear to suggest that, at least until the parliamentary elections, the losses would be borne by the company. Presumably the hope is that, beyond the elections, domestic prices will be hiked and the company could perhaps recoup early-year losses. It remains unclear what would happen if the price charged by RUE is further hiked, as seems possible given the 6-month duration of the pricing structure for gas deliveries as per the January 4 agreement and recent statements by Turkmenistan to the effect that it will look to hike the US\$60 per 1,000 cu meters price agreed previously with Gazprom.

In terms of recent press reports that a number of foreign banks were pulling credit lines previously extended to Naftogaz Ukrainy, the official line from the company seemed to be that they still had a

³ See “New Gas Revelations: Is Ukraine in for total property redistribution”, by Yulia Mostovaya and Alla Yeremenko, *Zerkalo Nedeli*, No.4 (583), February 4–10, 2006.

number of foreign institutions willing to extend credit and they did not anticipate any problems meeting their obligations.

Summarizing our impressions from the trip, what appears clear now is that the January 4, 2006, agreement was essentially a stopgap with a shelf life of only 6 months, sufficient to get beyond the parliamentary elections. Once the composition of parliament and the next government is clear, both sides are expected to return to the negotiating table. The deal gives Russia a significant degree of leverage over any future Ukrainian government.

Over the longer term, there was an acceptance from the officials we met that Ukraine should expect to pay market prices for energy, and that this would be good both in terms of cementing its sovereignty and independence from Russia, and in terms of bringing much needed improvements in energy efficiency. The key problem was the timing of any price "liberalization", i.e. the length of the transition period to market prices. A near-universal view was that the country's chemical industry was already struggling to remain competitive at current energy pricing levels, while the metals sector could survive with energy costs as high as US\$160 per 1,000 cubic meters. Note that our own estimates suggest that the impact on the economy of a hike to US\$230 per 1,000 cu meters for gas, close to West European market levels, would be huge, at the equivalent of 8%–9% of GDP. Of particular significance, this would be a long-term structural hit to the economy rather than a one-off effect.

Banking sector Risk

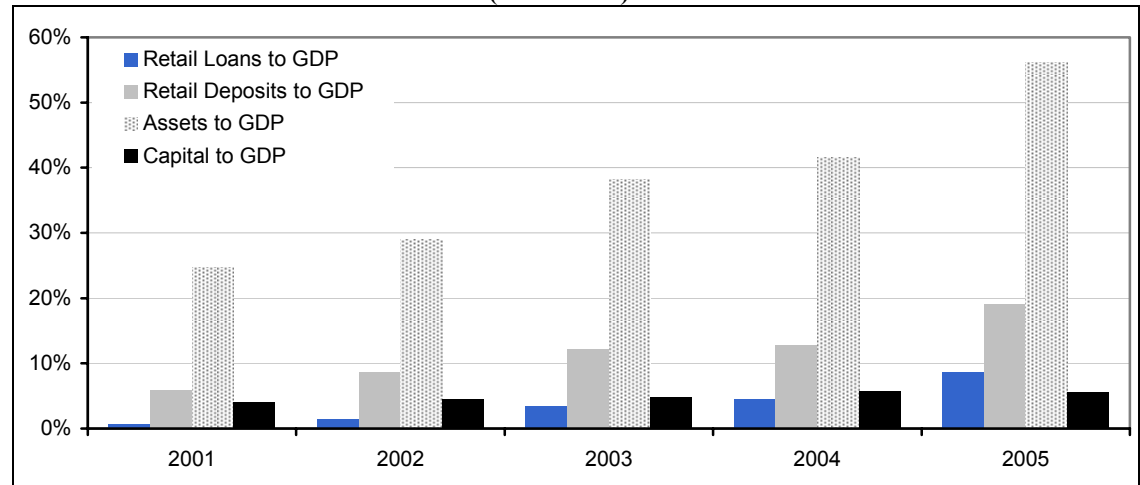
The 2004 presidential elections provided perhaps the single biggest test of the strength of the Ukrainian banking sector since the 1998 crisis. During the election campaign and subsequent Orange Revolution, around 15% of UAH deposits were withdrawn and switched into foreign currency accounts. This put a serious strain on the viability of the system. It appears that a systemic meltdown was only prevented by the active intervention of the NBU through stabilization loans extended to 17 banks in order to replace the liquidity withdrawn from the system. With the stabilization of the political situation in early 2005, confidence in the system recovered and retail deposits have roughly doubled in size.

After initially being formed to serve the industrial groups from which many of them were founded, Ukrainian banks appear to be on the verge of a major transformation. Two fundamental changes in the system are of particular note. First, foreign banks are assuming an increasingly important role as a result of acquisitions. Second, a massive expansion in branch networks is underway as banks aim to take advantage of rapid retail and SME banking growth.

Given that there are 163 banks in operation, the largest one accounting for less than 10% of total assets, the banking system is quite fragmented. The banking system is dominated by privately owned banks, with the share of state-owned banks standing at only 7%. Herein the contrast with Russia is quite marked, as Sberbank still accounts for around 60% of retail deposits in Russia. In Ukraine, the strong potential for banking sector growth coupled with the relative fragmentation of the sector and the success of European bank operations in other Eastern European countries, has created a perfect environment for foreign interest in Ukrainian banks. Already, the largest FDI inflow, besides the Kryvorizhstal privatization, has been into the banking sector, where the second, fourth and fifth largest banks have now been acquired by major European banks generating around US\$2.5 billion of FDI. (This figure includes USD1.1 billion from the yet-to-be-completed sale of 85% of Ukrsootsbank to Banca Intesa, where the minority shareholders secured an injunction against the increase in share capital required for the deal to be finalized.) Given the limited availability of capital to support growth, we expect this trend to continue. The share of foreign banks is expected to increase to more than 50% of total banking assets, up from 13% at present.

Rates of banking penetration are relatively low by European standards, at around 56% of the GDP as of the end of 2005. The banking system still mainly serves large corporates, which continue to dominate the economy. However, retail banking has been growing rapidly in the last three years, albeit from a low base where retail loans reached 9% of the GDP and retail deposits reached 19% of the GDP at the end of 2005.

UKRAINE RETAIL BANKING PENETRATION (% OF GDP)



Source: BSIL; NBU.

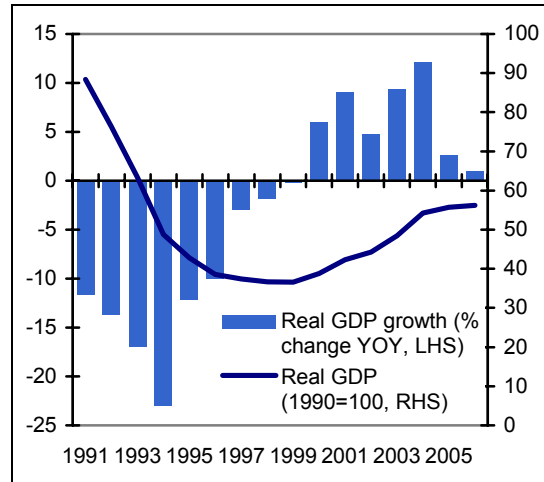
With a total equity of US\$4.2 billion as of August 2005, the banking sector has quite weak capitalization, which has been further strained by the high costs involved with the expansion of banks' networks. As the leverage ratio has fallen to 10%, from 17% in 2001, the ability of the banking sector to withstand an economic shock relative to the size of the economy has declined. This situation is further exacerbated by the high levels of loan concentrations, due to fact that the banks are part of large industrial groups which are mainly active in cyclical sectors. Increasing foreign involvement in the sector is a positive factor for the Ukrainian economy as a means of improving capitalization, thus solving the problems of related party exposure, risk management and improved efficiency of the financial system overall.

Economic outlook/risk

Growth. Real GDP growth slowed markedly over the course of 2005, which reflected a combination of factors including: political uncertainty during and after the 2004 presidential election campaign; uncertainty over the re-privatization process which appears to have stalled investment; deteriorating terms of trade for key industries such as steel and chemicals; disruptions to energy supplies (fuel and gas), disputes with Russia over energy pricing and over trade in general (fuel, metals and food/agricultural products); and the nominal and real appreciation of the UAH. Thus, according to data produced by the State Statistical Committee of Ukraine, real GDP growth slowed to just 2.6% for the full year in 2005, a remarkable slowdown from the 12.1% year-over-year growth reported for the full year in 2004, and the 8.3% year-over-year average growth rate reported over the previous 5-year period (2000–2004).

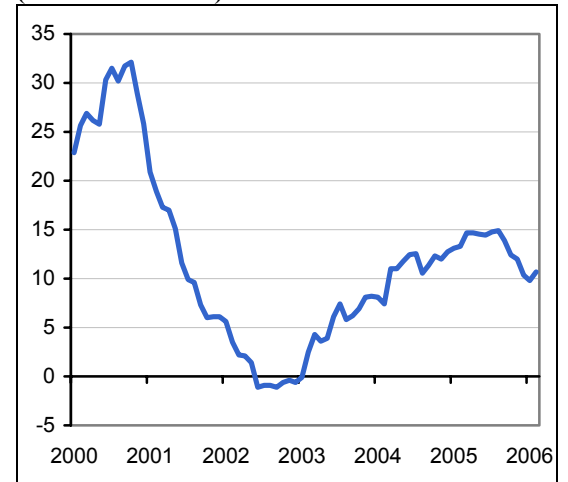
Against this backdrop, official budget projections for a rebound in real GDP growth in 2006 of 7% year over year appear optimistic. The Ministry of Economy recently revised its own forecasts down to assume a more sedate 2.4%–2.5% growth rate for the full year in 2006. However, even this target might be difficult to achieve, given the subdued 0.9% year-over-year real GDP growth rate recorded in January 2006. Industrial output declined by 5.7% year over year in January, following a 2.9% year-over-year decline in December, and reflects a combination of factors, including inclement weather conditions and energy supply disruptions. Reviewing the recent Naftogaz Ukrainy-RUE gas pricing deal, the World Bank recently estimated that real GDP growth would likely range in the 1.5%–3.5% range in 2006. Obviously, with this latter estimate, much depends on whether the gas price agreement survives the elections, and whether Ukraine is not subjected to further substantial hikes in energy prices over the short to medium term. Given the slowdown already apparent before the latest price hikes for energy, BSIL assumes that full year growth will struggle to extend much beyond 1%.

TRENDS IN REAL GDP



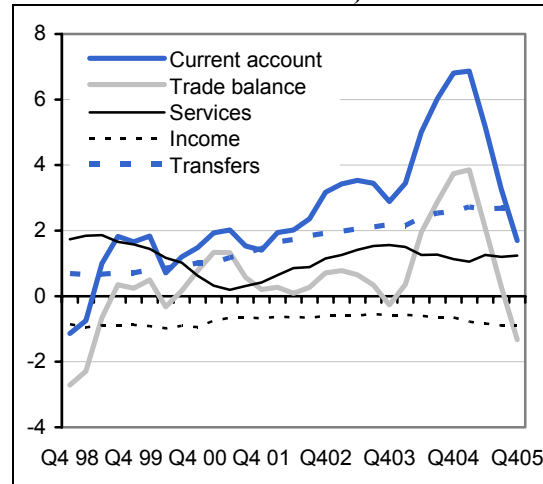
Sources: BSIL; IMF; Ministry of Economy.

TRENDS IN CONSUMER PRICE INFLATION (% CHANGE YOY)

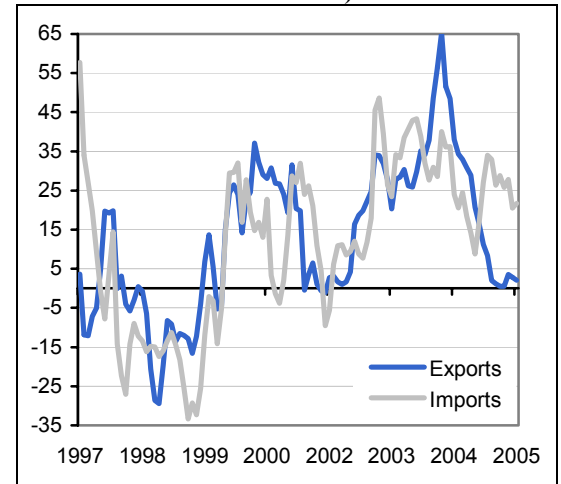


Inflation. Inflation, which had accelerated in mid-2005, largely on the back of supply disruptions (fuel shortages) and largely un-sterilized intervention by the NBU on the foreign exchange market, eased back over the second half, and the year-over-year CPI pushed back into single digits by January 2006, at 9.8% year over year. This slowdown appears related to the overall weakening in economic activity, hikes in reserve requirements on banks imposed by the NBU, and the impact of the UAH revaluation in April 2005. Inflation then re-accelerated in February, as the CPI rose by 1.8% month over month (10.7% year over year), and within this food prices, which make up a large weight (63%) in the basket, rose by 2.6% month over month, as sugar prices rose by 25.5%, potatoes by 22.2% and vegetables by 14.9%. Bad weather appears to have disrupted food supplies over the course of the month. Encouragingly, the price of non-food products increased by just 0.2% month over month in February, while the price of services increased by 0.6% month over month. We expect pressure from food and agricultural prices to ease over the course of the year, and, with reports of an on-going trade war over food and agricultural products with Russia, the likelihood is that domestic markets will be swamped by products that were meant for export, thereby creating strong dis-inflationary pressures. It is more difficult to predict the impact of exchange rate movements and utility price increases given the impact of politics. We assume that after the elections the government will be forced to hike domestic energy prices, increasing these two- or even three-fold. Obviously this will have a notable upward impact on inflation

Balance of Payments. Ukraine's trade and current account performance had been on a sharply deteriorating trend, even prior to the gas-pricing dispute with Russia. As with the broader economic slowdown, this reflected weakening terms of trade in key export industries, such as metals and chemicals, and disruption to traditional trade ties with Russia. The merchandise trade account has, for example, been rapidly deteriorating since February 2005. At that point, on a 12-month annualized basis the merchandise trade account was running a surplus of more than US\$4 billion. However, by year-end, the merchandise account was in deficit to the tune of US\$1.9 billion, a quite remarkable deterioration over the course of the year. The downturn reflected a dwindling of export growth (by dollar value) from 43% year over year in 2004, to just 4.7% year over year in 2005; exports actually posted year over year declines in the final few months of the year. Merchandise imports by contrast rose by 26% year over year in 2004 and by 24.6% year over year in 2005, fuelled by still-healthy growth in disposable income, and double-digit growth in household credit.

UKRAINE — CURRENT ACCOUNT (US\$ IN MM, 12-MONTH MOVING AVERAGE)


Sources: BSIL; NBU. Note data for Q4 2005 = BSIL estimate.

GROWTH IN MERCHANDISE TRADE (% CHANGE, 3-MONTH MOVING AVERAGE)


Sources: BSIL; NBU.

The NBU has yet to release balance of payments data for the final quarter of 2005. However, data for the first three quarters of the year reveal a deterioration from the first quarter of 2005 similar to that observed on the merchandise trade account. Hence, on a 12-month moving average basis, the surplus on the current account declined from US\$6.9 billion (approximately 10% of GDP) in Q105, to just US\$3.3 billion in Q305. Given reported trends on the merchandise trade account, we estimate that the full-year surplus on the current account declined to US\$1.7 billion (1.9% of GDP) in 2005. Again this represents a remarkable deterioration over the course of just one year.

Looking at prospects for 2006, it seems unlikely that export growth rates will pick up quickly given continued weakness in global metals prices (expected to remain flat) and continued problems in terms of the trading relationship with Russia. Imports, meanwhile, will likely be further buoyed by the increased energy import costs resulting from the RUE-Naftogaz Ukrainy deal. Indeed, we estimate the net loss to the balance of payments from the January 4 agreement at between US\$1 billion and US\$2 billion (albeit dependent on Ukraine's ability to re-export gas), assuming 5% growth in exports by dollar value, and 15% growth in imports yields a merchandise trade deficit of US\$5.6 billion and a current account deficit of around US\$3.5 billion or 3.7% of GDP.

A current account deficit of 3.7% of GDP is neither large by regional standards, nor when set against the returns achieved from net FDI in 2005 (5% of GDP). Alongside privatizations in the pipeline (but dependent on the outlook of the new government after the March 2006, elections), foreign M&A activity appears to have picked up steam over recent months, with particular interest in the domestic banking sector (see above). Whether this interest will continue in the face of continued political instability and/or problems in terms of the relationship with Russia is open to question.

It should also be mentioned that the relatively benign outlook above is built on the assumption that Ukraine manages to secure a transitional arrangement for the introduction of market prices for energy. A more aggressive timetable in terms of energy-price liberalization (say with gas priced at US\$230 per 1,000 cu meters), would likely impose a much harsher shock on the Ukrainian economy, with first-round effects perhaps as high 8-9% of GDP. Under this worst-case scenario, a large part of Ukrainian industry would be rendered uncompetitive, making a very large structural hit on the balance of payments. (Note that industrialists have warned that much of Ukraine's chemical industry would be uncompetitive should the gas price be hiked to US\$130 per 1,000 cu meters, whereas the break-even point for many enterprises in the metals sector is around US\$160 per 1,000 cu meters.) Under such a scenario, it is difficult to imagine Ukraine avoiding a sharp downward correction in the UAH, with serious negative impacts in terms of growth and inflation.

UKRAINE — MACROECONOMIC PERFORMANCE

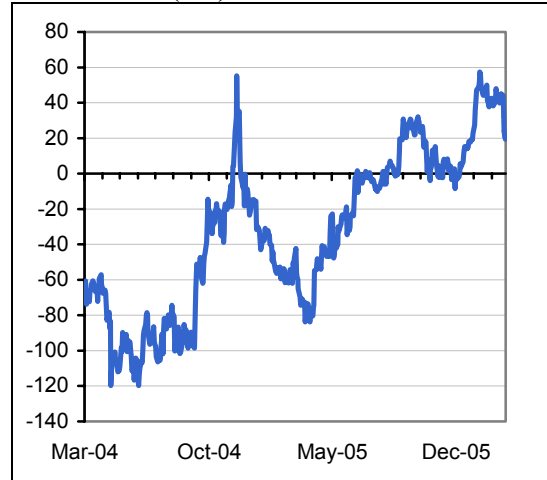
	97—00 Average	2001	2002	2003	2004	2005	2006F
Real GDP (% change)	0.2%	9.1%	4.8%	9.3%	12.1%	2.6%	1.0%
GDP (\$ per capita)	705	742	847	1,024	1,371	1,781	1,997
CPI (ave)	19.4%	12.2%	0.8%	5.5%	9.1%	13.6%	10.0%
Unemployment (% labor force)	10.9%	11.1%	10.1%	8.5%	7.7%	7.0%	7.0%
Fiscal and Debt Indicators							
Total External Debt							
Total External Debt (% XGS)	100.0%	96.7%	92.7%	82.1%	75.6%	77.8%	86.0%
Total External Debt (% GDP)	60.0%	56.8%	52.4%	47.4%	44.8%	41.8%	46.0%
Debt service ratio (% XGS)	13.7%	5.4%	8.0%	8.0%	8.4%	9.1%	9.1%
Public Sector							
Fiscal Balance (% GDP)	-3.0%	-1.6%	0.5%	-0.5%	-4.4%	-3.0%	-3.1%
External Debt (% GDP)	40.8%	26.6%	24.6%	21.3%	19.9%	16.6%	20.0%
Internal Debt (% GDP)		10.7%	10.1%	8.0%	6.4%	6.5%	7.0%
Country External Liquidity							
XGS (National Accounts) % Growth	-3.0%	3.5%	9.2%	4.6%	10.0%	-0.5%	5.0%
Current Account Balance (% GDP)	0.8%	3.8%	7.7%	7.3%	9.6%	1.9%	-3.7%
Trade Balance (% GDP)	-3.4%	0.6%	1.7%	0.1%	5.7%	-2.2%	-6.0%
FDI (% GDP)	1.8%	2.1%	1.2%	1.5%	1.5%	6.0%	1.5%
Gross Financing (% Reserves)*	198.0%	283.0%	197.0%	136.0%	76.0%	70.2%	123.1%
Import cover (months)	0.8	1.7	2.3	3.0	3.4	5.6	5.0
Domestic Liquidity							
M1/FX reserves (%)	267.0%	187.0%	180.0%	147.0%	133.0%	108.0%	101.2%
M2/FX reserves (%)	399.0%	284.0%	287.0%	261.0%	249.0%	203.0%	189.0%

Sources: BSIL; ICPS; Fitch Ratings; IMF; NBU. * Gross financing = Current account balance + debt amortizations + short term debt

Conclusions and Strategy

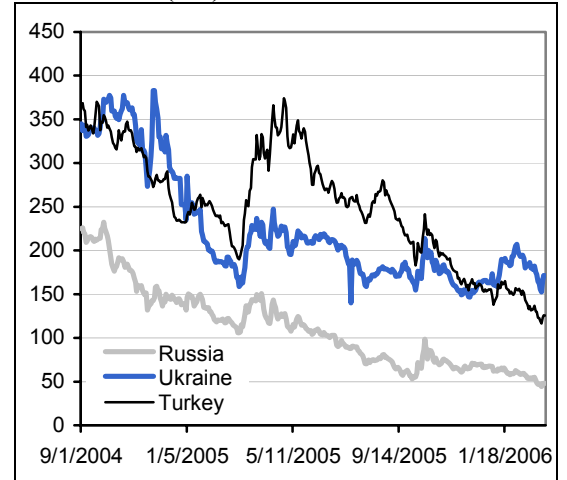
The market has recouped most of the early-year losses stemming from the Ukraine-Russia gas-pricing dispute. Thus, the spread (asset swap) between Ukraine 7.650% notes 06/13 and Gazprom 9.625% 03/13, which widened to around 60 bps in early January, had tightened to around 20 bps in early March. Arguably, though, a sizeable proportion of the latter spread compression reflects widening in Gazprom amid broader concerns over an Emerging Market sell-off. 5-year Ukraine CDS has followed cash, widening to just over 200 bps in mid-January before rallying in to about 150 bps at the end of February, before pushing back to around 180 bps in early March on the back of broader EM concerns. Generally, the rally on Ukraine cash and CDS has been driven by an assumption that the March 26 parliamentary elections will yield a relatively market-friendly coalition between OU and RU and will see a normalization in terms of the relationship with Russia. There is an underlying acceptance that Ukraine has relatively favorable debt ratios, has performed reasonably well from a budget perspective over past year and has a number of budget and external financing options, particularly in regard to privatization and FDI. Nevertheless, and while we still think that an OU-RU government is the most likely outcome of the parliamentary elections, there has been a noticeable deterioration in the country's credit ratios over the past year (particularly the current account), which suggests that spreads should not return to pre-crisis levels. 5-year Ukraine CDS at 180 bps seems expensive to us, given some continuing uncertainty over the election result and a relationship with Russia that is still somewhat strained. In the short term, we believe that spreads will likely widen, as the coalition-building exercise could prove protracted and divisive. Ultimately these may well provide cheaper entry levels, but we would still advise investors to wait at the sidelines a little longer to see how the political situation pans out.

**UKRAINE 7.650% 06/13-GAZPROM 9.625% 03/13
ASW SPREAD (BPS)**



Sources: BSIL; Bloomberg

5-YEAR CDS (BPS)



Sources: BSIL; Bloomberg

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