

**March 2011**
**Olga Pogarska, Edilberto L. Segura**

- Industrial production growth accelerated to 10.5% yoy in February 2011.
- Despite a later spring sowing campaign and smaller area sown under winter crops, Ukraine's grain harvest is forecast to be slightly better than last year.
- The State budget reported a UAH 4.1 billion surplus over January-February 2011 amid spectacular growth in tax revenues and moderate spending.
- Weaker reform implementation led to a delay in March's IMF tranche release. However, the impact of the current delay is likely to be neutral.
- Annual consumer price growth accelerated to 7.7% in March 2011.
- The government decided on state-intervened bank resolution plans.
- The current account balance switched to a large deficit in February 2011, but the financial account was in surplus mainly thanks to a successful sovereign Eurobonds placement in February 2011.
- Ukraine has intensified trade negotiations with its main trading partners – Russia and the EU – raising confusion over its current foreign policy.

### Executive Summary

In February 2011, the Ukrainian economy maintained a good pace of growth. Most of the sectors improved their performance compared to the previous month thanks to high world prices on steel, robust growth in Ukraine's main trade partner countries and strengthening domestic demand. Industrial production growth accelerated to 10.5% yoy in February as stronger increases in metallurgy, machine-building and production of utilities compensated for some deceleration in the chemical industry and stagnation in food processing. Retail trade turnover, typically used to gauge private consumption patterns, picked up by a solid 12.7% yoy. Due to colder weather during February-March 2011, Ukraine started the spring sowing campaign later than projected. While the delay may negatively affect yields, better conditions than last year for winter crops allowed the government to project a slightly higher grain harvest at about 41-42 million tons in 2011. Despite better-than-forecast growth momentum in the first two months of 2011, we maintain our real GDP growth forecast at 4% yoy in 2011.

Robust real sector growth, higher tax rates, the improving financial stance of Ukrainian corporate enterprises and banks as well as abolishment of the 11-month reporting period for corporate profit tax (EPT) helped raise budget revenues by an impressive 44.5% yoy for the first two months of the year. Larger VAT refunds in March and a vanishing EPT base effect were likely the main reasons of more moderate but still impressive growth in budget revenues over the first quarter. As government spending grew quite moderately over January-February, the state budget was in a large surplus over the period. Budget performance could weaken in the coming periods. Revenue growth may continue decelerating due to enforcement of EPT rate reduction and small business privileges on April 1st and government plans to reduce excises in order to soften inflation pressures. Expenditures, on the other hand, may increase amid postponement of reform measures and initiatives to relax budget spending.

Weaker reform implementation led to a delay in disbursement of

the IMF tranche. The delay is likely to have a neutral impact on the Ukrainian economy as there is a good degree of confidence that co-operation with the IMF will continue. Favorable budget performance over the first quarter of 2011 may be a strong argument for the IMF to tolerate more gradual reform implementation.

During February-March 2011, Ukraine intensified trade negotiations with its main trading partners – Russia and the EU. Ukraine began the final stage in talks on the creation of a free trade area with the EU, which has already existed for four years. Simultaneously, Ukraine was urged to deepen cooperation with members of the Customs Union (Russia, Belarus and Kazakhstan). The lack of details over the likely design of an agreement with the Customs Union raised confusion over Ukraine's foreign policy among both Western officials and Ukrainian citizens. So far, Ukraine has stood firm in its willingness to increase engagement with the European Union with the utmost goal of becoming a member of the EU. The road, however, has turned out to be much longer than expected. In contrast, close trade relations with Russia and high dependence on natural gas imports hold near-term benefits for Ukraine as participation in the Customs Union is likely to bring a notable reduction in the price of imported natural gas, abolishment of Russia's export duties on crude oil and gasoline products and improved opportunities for Ukraine's heavy machinery industry. This may be a strong argument for Ukraine, as its trade and current account balances started to worsen in 2011, following notable improvements in 2009-2010. At the same time, membership in the Customs Union will automatically complicate Ukraine's relations with the WTO and its members as tariffs in the Union are higher than those agreed with WTO members. Furthermore, the benefits from joining the Union may turn out to be short-lived as by receiving cheaper energy resources, the country will have less incentive to modernize its outdated and energy-consuming technologies. So far, the Ukrainian authorities have assured that Ukraine's FTA agreement with the EU remains a priority for the country.

	2006	2007	2008	2009	2010	2011 <sup>f</sup>
GDP growth, % yoy	7.3	7.9	2.3	-14.8	4.2	4.5
GDP per capita, \$	2 300	3 070	3 880	2 540	3 030	3 500
Industrial production, % yoy	6.2	10.2	-3.1	-21.9	11.0	
Retail sales, % yoy	24.8	28.8	18.6	-16.6	7.6	
Budget deficit, % GDP	-0.7	-1.7	-2.0	-8.8	-6.5	-3.5
Government external debt, % GDP	11.0	8.7	9.3	20.5	23.8	25.3
Inflation, eop	11.6	16.6	16.6	12.3	9.1	12.0
Gross international reserves, \$ billion	22.4	32.5	32.5	26.5	34.5	32.0
Current account balance, % GDP	-1.5	-3.7	-7.0	-1.7	-1.9	-2.8
Gross external debt, % GDP	50.6	56.0	56.4	88.6	88.1	78.0
Exchange rate, Hryvnia/US Dollar, eop	5.1	5.1	7.7	7.99	7.96	8.2-8.5

Including implicit pension fund deficit in 2007-2009, and including Naftogaz and pension fund deficits since 2009 (not including bank recapitalization expenditures and VAT bonds)  
Sources: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2011 Budget Law, The Bleyzer Foundation

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### Economic Growth

Following a good start in January, the Ukrainian economy continued to increase in February, supported by a favorable external environment. Industrial production accelerated to 10.5% yoy in February 2011, up from 9.7% yoy in the previous month. The acceleration was prompted by faster growth in metallurgy, machine-building and utilities, which more than compensated for some deceleration in chemicals and mining and continuing depression in food processing.

As world steel prices kept rallying on international commodity markets, Ukraine's production of metallurgical products went up by 17.4% yoy in February, up from 13.3% yoy a month before. Robust growth in Russia, one of the main destination markets for Ukraine's export of heavy machinery, underpinned a 30.1% yoy increase in machine-building in February (further up from about 28% yoy in January 2011). Production of electricity, gas and water grew by about 6% yoy in February (compared to a 3% yoy decline a month ago) amid cold weather that month and resumption of electricity exports to Belarus.<sup>1</sup> Although in monthly terms Ukraine's oil refineries kept cutting production in February 2011, the industry reported a 1% growth in annual terms (after an almost 20% yoy decline in January) thanks to a favorable statistical base effect. Underpinned by strong growth in metallurgy, production of coke and iron ore grew by 9.2% yoy and 3.7% yoy in February, respectively.

Some moderation of world fertilizer prices may explain growth deceleration in the chemical industry in February to 17.4% yoy compared with a 28.5% yoy increase a month before. In addition, food processing production was down by 3.6% yoy as the industry continued to experience supply shortages of flour and milk. While the situation with the former started improving in February thanks to state intervention, milk production kept declining, reflecting shrinking livestock in Ukraine. Coupled with slightly weaker egg production in February 2011, this resulted in an agricultural output growth slowdown to 5% yoy in January-February 2011.

A lower sowed area under winter crops, a delay in the 2011 spring sowing campaign due to colder weather, surging costs (for seeds, gasoline, etc.), tight funds and uncertainty related to government agricultural policy<sup>2</sup> are likely to constrain the growth in agriculture this year. At the end of March 2011, Ukraine's sown area under spring grains (excluding corn) was 14% yoy lower. Though sowing is likely to catch up in April, the later start may result in lower crop yields. On a positive note, winter crops are in better condition than last year, which may compensate for the 8% decline in the sown area under winter crops. In addition, Ukraine plans to increase production of corn and some other cereals (buckwheat, millet) and legumes. Overall, the Ukrainian government forecasts this year's harvest at 41-42 million tons, slightly up from 39.3 million in 2010, which may be realistic in the absence of extreme weather conditions.

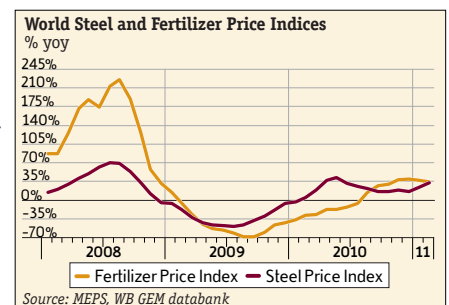
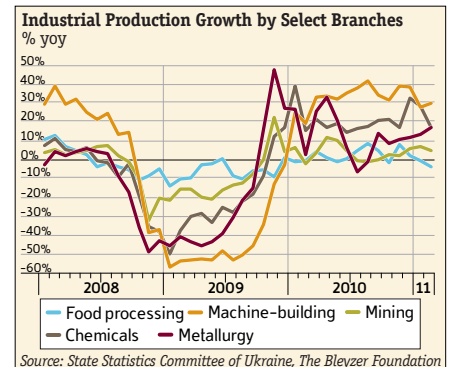
Thanks to realization of infrastructure projects related to Ukraine's co-hosting of the Euro 2012 football championship, the construction sector maintained the growth of construction works at a real 6.1% yoy in January-February 2011. Continuing real monthly wage growth (up by 11% yoy for the first two months of 2011) as well as a tentative increase in consumer credit<sup>3</sup> underpinned an almost 13% yoy increase in retail trade turnover during the period. Thanks to buoyant industry and trade growth, cargo transportation turnover and wholesale trade grew by 12.7% yoy and 7.3% yoy respectively. Overall, due strong momentum in the first two months of the year, we have revised our real GDP forecast to 4.5% yoy in 2011. Surging commodity prices, gradually restoring bank credit and robust real wage growth will be supportive of real GDP growth. However, their impact may be softened by surging energy prices and imports, inflation pressures, high external debt financing needs and continuing turbulence in the MENA region.<sup>4</sup>

<sup>1</sup>During January, Ukraine and Belarus were negotiating the price for Ukraine's electricity exports. During that month, exports of electricity fell by 56% yoy.

<sup>2</sup>At the end of March 2011, the government extended grain export quotas until the end of June 2011, though a few days earlier representatives of the Presidential administration signaled the quotas would be abolished at the beginning of April 2011, likely replacing them with tariff regulation measures. The quota volumes on most crops except corn were left unchanged. Mixed signals from top Ukrainian officials on quota issues, a non-transparent quota distribution system as well as government plans to create a state-run grain export monopoly (draft laws #8053 and #8163 were registered in the parliament during February 2011), a state-owned agrarian insurance company (the draft resolution was released at the end of March 2011), etc. have raised uncertainty among agricultural producers and traders, constraining investments in and development of the sector.

<sup>3</sup>The aggregate figures show consumer lending is still declining in 2011. However, available research shows that consumer demand growth is more dependent on the flow of credit (new borrowings) rather than the stock of credit. According to NBU data, 12-month cumulative consumer credit grew by 4.1% yoy in February 2011.

<sup>4</sup>MENA countries (WB definition) accounted for about 14% of Ukraine's total export of goods in 2010.



Real Sector Performance of Ukraine					
	Jan-Feb 2011		2010	2009	2008
Agricultural output	5	5.2	-1	-1.8	17.1
Industrial output	10.5	8.8	11	-21.9	-3.1
Construction works	6.1	-21.3	-5.4	-48.2	-15.8
Domestic trade turnover					
Wholesale trade	7.3	3.3	0.4	-19.3	-6
Retail trade	12.7	-4.7	7.6	-17.4	18.1
Restaurants	6.8	-4.1	3.5	-15.6	4.6
Transportation turnover					
Cargo	12.7	15.3	6.4	-22.5	-0.2
Passenger	4.6	-7.3	-0.2	-11.5	4.5
Services, non-financial	13.5	-5	2.9	-16.8	15.8

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

#### Headquarters

123 N. Post Oak Ln., Suite 410  
 Houston, TX 77024 USA  
 Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666  
 Email: sbleyzer@sigmableyzer.com

#### Kyiv Office, Ukraine

4A, Baseyna Street, «Mandarin Plaza», 8th floor  
 Kyiv 01004, Ukraine  
 Tel: +38 (044) 284-1289 Fax: +38 (044) 284-1283  
 Email: kiev.office@sigmableyzer.com.ua

#### Kharkiv Office, Ukraine

Meytin House, 49 Sumska Street, Office 4  
 Kharkiv 61022, Ukraine  
 Tel: +38 (057) 714-1180 Fax: +38 (057) 714-1188  
 Email: kharkov.office@sigmableyzer.com.ua

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### Fiscal Policy

Over the first quarter of 2011, Ukraine's fiscal revenue growth has surprised on the upside. However, a deeper data reading, the introduction of the corporate profit tax rate reduction and other tax privileges and the government response to growing social tensions (related to rising prices and increasing income gaps, growing frustration with the reform progress and resistance to government reform initiatives) suggest that successful fiscal execution will remain challenging this year.

Over the first two months of 2011, state budget revenues grew by 44.5% yoy mainly on account of a 67% growth in tax proceeds. Such a spectacular increase in the latter was achieved thanks to higher excise taxes and import duties (receipts grew by 32% yoy and 48% yoy respectively) and buoyant domestic demand (which explains a 46% yoy increase in VAT proceeds). At the same time, collections from the corporate profit tax (EPT) picked up by an impressive 74.5% yoy over January-February. While such an increase is partially attributed to the improving financial stance of Ukrainian enterprises, its main reason lies in a change in the corporate tax reporting period for profits received in the last quarter of the previous year.<sup>5</sup> As this was a one-off event, the growth in EPT proceeds is likely to decelerate thereafter.

	UAH billion	% yoy	Annual target, %
<b>Total Revenues</b>	<b>44.7</b>	<b>44.5</b>	<b>15.9</b>
Total taxes	39.2	66.9	16.7
PIT	0.8	-	11.7
EPT	9.7	74.5	21.9
VAT	19	45.9	17.5
Excise total	4.4	32	10.6
Duties	1.2	47.7	12.5
Non-tax revenues	5	-16.5	11.7
<b>Total Expenditures</b>	<b>40.5</b>	<b>12.9</b>	<b>12.6</b>
Consumer expenditures	39.8	12.6	-
Capital expenditures	0.7	38.7	-
<b>Balance, UAH billion</b>	<b>4.1</b>	<b>-4.8</b>	<b>-38.8</b>
Public debt borrowings	18.8	279.2	20.6
Public debt principal payments	6.8	198.6	11.0
Privatization receipts	0.0	-44.5	0.4

Except for budget balance  
Source: Ministry of Finance, 2011 Budget Law,  
The Bleyzer Foundation

Favorable budget revenue figures for the first two months of the year, however, were overshadowed by VAT claims. According to the State Tax Administration, VAT refunds amounted to about UAH 5.2 billion for January-February 2011. At the same time, developments with the stock of VAT claims as well as VAT refund arrears were not reported. In mid-March, the government introduced an automatic VAT refund system. However, only a small number of enterprises, whose total claims amounted to about 15% of average monthly VAT refunds, were eligible to participate in the system in March. The government committed to phase out all VAT arrears by the end of March 2011 and increase the share of VAT refunded through the automatic system to about 60% by the middle of the year. Due to likely larger amounts of VAT refunds, the growth of VAT proceeds may decline. Already in March 2011, VAT refunds grew to UAH 3.7 billion, which was more than 40% higher than the average monthly amount for the first two months of the year.

Furthermore, starting on April 1<sup>st</sup>, a corporate tax rate reduction by 2 percentage points to 23% as well as a number of tax holidays for small business came into effect. In addition, anxious to contain rising prices (e.g. on gasoline products, which affect the prices of other goods and services and are particularly painful in the run up to spring sowing campaign), the government announced plans to reduce excises on gasoline products. All of the above signal that budget revenue growth is likely to moderate through the rest of the year. According to preliminary data, state budget revenue growth eased to 28.4% yoy over January-March.

Unlike revenues, budget expenditures grew at a moderate 13% yoy over the first two months of the year. As a result, the state budget reported a UAH 4.1 billion surplus for the period. Despite the uncertainty over the future pace of revenue growth, current strong budget performance inspired the government to consider plans to relax budget spending and to postpone implementation of previously announced painful reform measures. Thus, the government is likely to allow faster increases in wages in education and health care sectors as growing prices and income inequality<sup>6</sup> already prompted teachers' protests in March. There have been a series of protests in Ukraine since November 2010 (street traders, small businesses, miners, students, etc.), indicating growing frustration with government policies and resistance to reform initiatives. Hence, the government postponed implementation of the most painful measures. The government negotiated with the IMF for a more gradual increase in natural gas tariffs for the population. Details of compensatory measures to sustain Naftogaz's financial position are still not available. In mid-March 2011, Ukrainian authorities again postponed the start of pension reform. The approval of necessary legislation, planned for March 2011, was delayed until May/June of this year.

Weaker reform implementation (particularly in the areas of pension reform and sustaining Naftogaz's finances) was likely the main reason for a delay of March's release of IMF funds. Given strong budget results over the first quarter of 2011, the government expects the IMF to be more tolerable to Ukraine's reform progress. However, negotiations may be tough on government plans to increase spending and projected weaker growth in budget revenues over the coming months. The next IMF mission visit is scheduled for May

<sup>5</sup>According to current legislation, corporate profit tax returns are filed on a quarterly basis. The tax payments are due within 40 calendar days following the last day of the reporting quarter and must be paid within the next 10 calendar days. However, in previous years, there was an additional reporting period of 11 months due within 20 calendar days following the end of November. This rule was abolished in 2010. This means that tax returns for corporate profits received in 4Q 2010 should have been fully paid during February 9-19th, 2011. At the same time, in February 2010, corporate enterprises paid taxes only on profits received in December 2009. This created an abnormally low base for comparison for February 2011.

<sup>6</sup>Average monthly wages in education and health care sectors are among the lowest, representing about 80% and 68% of the average monthly wage across all economic sectors of Ukraine respectively in February 2011, down from 84% and 72% respectively in February 2010 (SSC Wage reports for February 2011 and 2010).

#### Headquarters

123 N. Post Oak Ln., Suite 410  
Houston, TX 77024 USA  
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666  
Email: sbleyzer@sigmableyzer.com

#### Kyiv Office, Ukraine

4A, Baseyna Street, «Mandarin Plaza», 8th floor  
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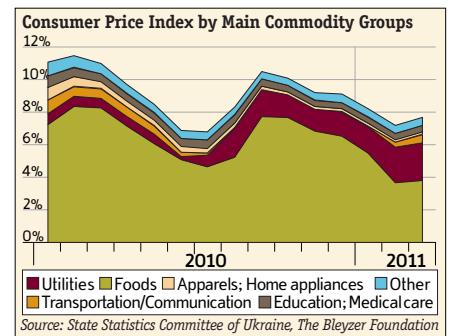
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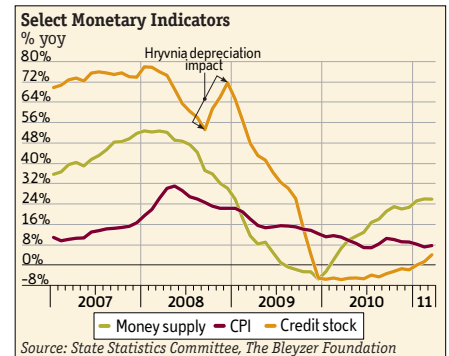
2011, indicating that the next tranche release in case of favorable review may be only in June-July. The short-lived delays with the IMF program were anticipated by the market at the beginning of the year. Hence, until there is a sufficient degree of confidence that cooperation with the IMF will continue, in the short-term the consequences of the tranche delay are likely to be neutral for the Ukrainian public finances and the economy as a whole.

### Monetary Policy

Following unexpectedly low inflation during the first two months of 2011, price growth accelerated to 1.4% month-over-month (mom) in March. The growth in the consumer price index was led by higher food prices, utility and gasoline costs. Soaring world food prices, domestic shortages and seasonal factors caused domestic prices of foodstuffs to rise by 1.8% mom in March. Within the group, the highest price increases were registered for vegetables (+9.5% mom), fruit (+4.6% mom) and bread and bakery (+2.7% mom). Despite faster monthly growth that month, in annual terms food prices were only 5.7% lower than in March 2010. Relatively moderate domestic food inflation over the last six months (less than 10%) sharply differs from world food trends (according to FAO, world food prices grew by about 26% over the period) and may be explained by tight administrative price controls as well as export restrictions (grain export quotas were extended until the end of June 2011).



Continuing adjustment of utility tariffs to cost-covering levels was another source of consumer price inflation. Advancing by 1.2% mom, utility services were 21.5% more expensive in March 2011 than a year ago. High world crude oil prices and excise taxes kept spurring the growth of domestic gasoline prices and road transportation costs, which grew by 9.3% mom and 2.1% mom respectively. Scheduled increases in electricity tariffs (up by 15% since April 1st 2011), natural gas and heating (up by 20% and 26% respectively since April 15th), telecommunication tariffs (a 10-35% increase in the monthly fee for landline phone services) and high world commodity prices will continue to pressure consumer prices upwards in the coming months. At the same time, the recent government decision to reduce excise taxes on gasoline products may bring some relief to consumers. However, we maintain our inflation forecast at 12% for 2011.



Faster money supply growth amid gradually resuming bank credit activity will also contribute to price growth this year. Over the first three months of 2011, money supply rose by 26% yoy. The growth was underpinned by a 30% yoy increase in the stock of deposits and an almost 7% yoy rise in credit. Monetary base growth decelerated to 13.7% yoy in March as sizable NBU sterilization compensated for Hryvnia injections related to net NBU purchases of foreign currency on the interbank forex market, large principal payments on domestic debt and a reduction in cash balances on government accounts with the NBU (by about 20% mom). In February 2011, NBU sales and purchases of foreign currency were virtually balanced, while in March NBU purchases exceeded sales by \$250 million. In addition, March 2011 was a local pick for public debt principal payments, which led to notable improvement in banking sector liquidity. To absorb excess liquidity from the market, the NBU extracted about UAH 14.5 billion from the market in March.

The growing stock of credit suggests that the banking system is on the way to restoring its financial health. While the level of non-performing loans remains high, it's being addressed by both commercial banks and the regulator. Commercial banks are injecting additional capital, while the NBU and the government have been working on strengthening regulations, modernization of accounting and improvement of banking legislation. Facilitating resolution of NPLs is among the priority areas of these efforts. In particular, at the beginning of March 2011, amendments to the Law on Enforcement Proceedings became effective, which should improve security of collateral. In March, the government decided on state-intervened banks resolution plans, which should further increase the population's confidence in the banking system. In particular, the government announced that all of Rodovid Bank's obligations to depositors will be transferred to the state-run Oschadbank. To meet new obligations, Oschadbank will be recapitalized with UAH 604 million of public funds allocated through the issuance of domestic debt securities. Rodovid Bank will be transformed into a 'toxic assets' bank, which will accumulate the bad assets of all three state-intervened banks (Rodovid, Ukrgazbank, and Kyiv). The bank is planned to be recapitalized with UAH 3.95 billion (\$0.5 billion). The share capital of the most troubled Nadra Bank will be raised 10 times to UAH 3.9 billion (\$0.5 billion) by issuing new shares. At the same time, as all these initiatives will take time, the Ukrainian banking sector's return to health will be gradual as will be credit growth.

#### Headquarters

123 N. Post Oak Ln., Suite 410  
Houston, TX 77024 USA  
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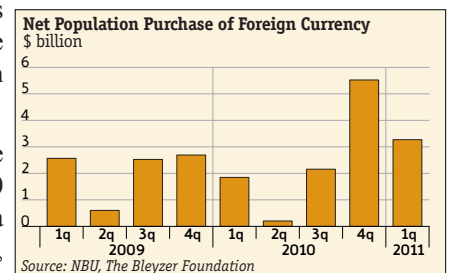
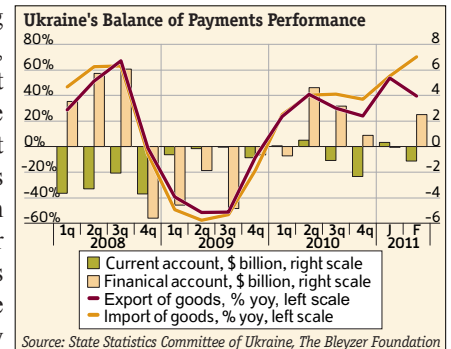
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### International Trade and Capital

During February 2011, high world commodity prices and solid growth in the main trading partner countries kept supporting Ukraine's exports. However, tensions in the MENA region, an outlet for about 14% of Ukraine's merchandise exports, may explain moderation of export growth to 39.5% yoy in February compared to 53.6% yoy a month before. Traditionally, the growth was led by exports of metallurgical products (+45% yoy), machinery and transport equipment (+32% yoy) and chemicals (+67% yoy). On the import side, high energy prices and larger volumes of natural gas imports led to import growth acceleration to 70% yoy in February (up from 55% yoy a month before). A surge in natural gas imports (2.4 times higher in January-February 2011 compared to the respective period last year) is related to large gas deliveries to RosUkrEnergo, expropriated from the gas trader at the beginning of 2009. As the Ukrainian authorities plan to return all gas due to RosUkrEnergy by the end of April, energy import growth is likely to lose momentum in May. At the same time, non-energy imports also reported buoyant growth. In particular, imports of machinery and transport vehicles rose by 90% yoy in February 2011, though a low statistical base effect partially explains such an impressive growth rate in the group.

With imports growth notably exceeding exports, Ukraine's foreign trade in goods balance notably widened to \$1.5 billion in February 2011, bringing the cumulative balance to -\$2.0 billion. Widening of the foreign trade deficit caused the current account to switch from a \$0.3 billion surplus in January 2011 to a \$1.1 billion deficit in February. As was anticipated, the financial account balance improved in February, reporting a \$2.5 billion surplus. The improvement was achieved mainly on account of \$1.5 billion sovereign Eurobonds issuance and a high trade credit positive balance. The stock of private sector external debt (both banking and corporate) declined in January-February (not including trade credits) as external debt redemption payments were larger than new borrowings.

Ukraine's high external debt financing needs are among the main depreciation pressures on the Hryvnia exchange rate. High population demand for foreign currency is another factor. Over the first quarter of 2011, net population purchases of foreign currency amounted to \$3.3 billion, according to NBU data. High population demand for foreign currency during 4Q 2010 and 1Q 2011, particularly in a relatively calm political period, may be an indicator of a growing shadow economy and a reflection of uncertainties related to the implementation of government reform measures (i.e., business adjustment to new tax administration rules, government initiatives to introduce indicative wages, etc.). So far, the NBU has sufficient resources (gross international reserves amounted to \$36.4 billion as of end-March 2011) to smooth Hryvnia exchange fluctuations. However, continuation with the IMF program remains a key to maintaining foreign investors' confidence and allowing Ukraine to serve its foreign debts.



#### Headquarters

123 N. Post Oak Ln., Suite 410  
 Houston, TX 77024 USA  
 Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666  
 Email: sbleyzer@sigmableyzer.com

#### Kyiv Office, Ukraine

4A, Baseyna Street, «Mandarin Plaza», 8th floor  
 Kyiv 01004, Ukraine  
 Tel: +38 (044) 284-1289 Fax: +38 (044) 284-1283  
 Email: kiev.office@sigmableyzer.com.ua

#### Kharkiv Office, Ukraine

Meytin House, 49 Sumska Street, Office 4  
 Kharkiv 61022, Ukraine  
 Tel: +38 (057) 714-1180 Fax: +38 (057) 714-1188  
 Email: kharkov.office@sigmableyzer.com.ua