

## Rating report cisUKRN 001-001 on a credit rating's assignment

State:	Ukraine
Credit rating's type:	Long-term credit rating according to the Regional Rating Scale
Rating action:	<b>Assignment</b>
Assignment date:	March 23, 2010
Credit rating's level:	<b>cisA</b>
Credit rating's outlook:	<b>Stable</b>

Credit ratings are assigned according to the Regional Rating Scale in the course of a rating analysis and indicated by the letters **cis** in the credit rating index. The Regional Rating Scale allows for the evaluation of the distribution of a credit risk of a sovereign's economy and is designed to be used by issuers of securities, obligors, financial institutions, mediators and investors in the regional financial markets.

## Rating Agency's Conclusion on a Credit Rating

A credit rating is based on economic and financial indexes, demographic and labor statistics, market conditions, information on debt obligations over 2005-2009 as well as social and economic development of the country in the long term. Besides, the information on management system, political situation and relations of different governmental authorities is analyzed in the course rating assignment.

The credit rating of Ukraine is based on the official information<sup>1</sup> that was available to the rating agency and considered reliable.

## Credit Rating's History

Date	23.03 2010
Rating's level	cisA
Outlook	Stable
Rating action	Assignment

An obligor or a debt liability with **cisA** credit rating is characterized with the strong creditworthiness as compared to other CIS obligors or debt liabilities. This level of creditworthiness is susceptible to adverse changes in commercial, financial and economic conditions.

A “**Stable**” outlook indicates that there are no anticipated reasons to change the rating in the course of the year.

<sup>1</sup> Public information, given by the national statistical services of the CIS states, Intergovernmental statistical committee of CIS, Central banks, Ministries of Finance and other official bodies of the CIS states

### Factors Maintaining a Credit Rating of Ukraine:

- high natural-resources potential and capacity of the national market, which provide for investment attractiveness for the most branches of Ukrainian economy;
- high level of the country's social and economic indices compared to other CIS states;
- geographical location and function of a transit state, which provide for the special geopolitical importance of the country inside the region.

### Factors Constraining a Credit Rating of Ukraine:

- high sensitivity of the economy and governmental finance system to changes of the world market prices in the raw material markets due high share of raw products in the total volume of exported goods;
- political instability over the past years that prevented from conduction of the structural reforms and making operative decisions under the crisis events.

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## Summary

Ukraine is located in Eastern Europe. The country's territory is 603 700 sq.m. The state borders on the Russian Federation, Republic of Belarus, Republic of Poland, Republic of Hungary, Slovak Republic, Republic of Moldova and Rumania. Ukraine is bounded by the Black Sea and Azov Sea that provides an access to the states of the Mediterranean basin. Ukraine's capital is the city of Kiev. Due to its geographic location, Ukraine has many traffic arteries, which connect Western Europe with the Russian Federation, states of the Trans-Caucasian region and Central Asia. Ukraine is one the state-founders of the CIS.

The fields of coal, manganese ore, iron ore and uranium ore have been explored and extracted in the territory of Ukraine.

According to the state's constitution, Ukraine is a unitary, democratic, social, constitutional state. Taking into account the form of political management, Ukraine is a president and parliamentary republic. Taking into account the form of state (political) regime, Ukraine is a democratic state.

Ukraine consists of territorial autonomy — Autonomous Republic of Crimea, 24 Oblasts and 2 cities with a special status: Kiev and Sevastopol. The largest cities with population over 500 000 persons are: Kiev, Kharkov, Dnepropetrovsk, Odessa, Donetsk, Zaporozhye, Lvov, Krivoy Rog and Nikolaev.

As of January 01, 2010, Ukraine's population size amounted to 46m people according to the preliminary data. From 1994, Ukraine's population size decreased annually mainly due to natural depopulation. At the end of 2009, the population density amounted to 76 persons per 1 sq. km.

Over the past years Ukraine's labor market has been influenced by population processes and labor migration that led to gradual decrease in the quantity of employees. According to the results of 2008, the largest volume of employment in Ukraine belonged to the industry – 25,7% of the total volume of employees excluding small businesses, education – 12,1% and trade 11,2%. Over the past years, evolution of the nominal wages in Ukraine has shown a trend to growth, but in 2009 the level of average monthly salary decreased by 30.9% to USD 238.7 in dollar equivalent due to devaluation of the national currency.

Industry is the most important sector of Ukraine's economic complex. Share of the industry's value added in the GDP structure according to the results of 2009 was 26.6%. The key branches of Ukraine's industry are still metallurgy, mechanical engineering and food industry. It is important to notice that transformation processes in the 90-th of the previous century led to establishment of the monopolized sectors of the economy, particular in the industrial complex, and did not provide the structural modernization of the national economy. Existing system disproportions restrict the developments perspectives of the industry and create substantial risks and restrictions for strengthening of the competitiveness of the national economy.

Beginning in 2000, Ukraine's GDP showed the growth within the limits of 2,1-12,1% that was supported by the export potential of metallurgy industry and chemical industry as

well as due to increase in the domestic demands. At the same time, beginning in 2005 growth rates of Ukraine's GDP were lower than mean value of the CIS states.

Non-fulfilled reforms and imperfection of the market mechanisms in certain sectors of the economy, particular in agribusiness industry, energy sector, housing and utilities infrastructure, increase the economy's vulnerability in the face of the world financial and economic crunch.

Over the last year, according to the preliminary calculations of the National Bank of Ukraine (hereinafter – the NBU) and in contrast to 2000-2008, the state's GDP decreased by 15% under the influence of circumstances of the world economic crunch. Reduction of the GDP volumes occurred due to downturn of Ukraine's industrial complex (due to foreign market disruption) and loss of a part of the foreign market by Ukrainian exporters. According to the results of 9M2009, Ukraine's external imbalance had a negative value and amounted to USD 12,2 bn. Besides, the necessity to repay the significant amounts of foreign debts by governmental and private sectors of Ukraine as well as decrease in the inflow of direct foreign investments caused the negative balance of the financial account amounting to USD 13,7 bn. According to the results of 2009, the deficit of Ukraine's balance of payments was completely financed at the expense of cash received from the IMF as well as reserve assets.

Development of the economy, based on positive foreign economic market conditions and expansion of the national consumer market, favored the increase of revenues of Ukraine's consolidated budget over 1999-2008. Totally, beginning in 2003 Ukraine's consolidated budget was implemented with a deficit, the index of which was at moderate level – within 0,2-3,2% of the GDP.

Implementation of Ukraine's state budget in 2009 was characterized by the decrease in amounts of receipts to the revenue item of the budget by 2.7% compared to previous year mainly due to decrease in tax receipts. At the same time, level of performance of the annual plan by revenues was 91,9%, but expenditures of the state budget increased insignificantly over the analyzed period compared to the year 2008. All the abovementioned led to increase of the state budget's deficit in 1.5 times compared to previous budget.

In 2010, burden on the expenditure item of the state budget will increase due to the necessity to extend the anti-crisis measures, particularly to support the banking sector. Besides, pressure on the expenditure item will be provided by the increase in social standards and expenditures for financing the budget sector and payment of the Pension Fund's deficiency as well as due to increased expenditures for governmental debt servicing.

Ukrainian government's creditworthiness is significantly limited by the high level of contingent liabilities, connected with the necessity to support the financial sector, as well weakness of the banking system and population's distrust to it. To support the financial system, the Government and National Bank of Ukraine allocated the funds the total amount of which was more than US\$ 170bn or 19% of GDP over 2008-2009.

As of January 01, 2010 ratio of Ukraine's national government debt to the gross domestic product was 33,0% and located within tolerable limits. At the same time, volume of

Ukraine's joint foreign debt exceeded the threshold values that together with a high share of the short-term debts in the general structure of foreign debts pointed out the substantial risks limiting the creditworthiness level of Ukrainian borrowers, including the national government. Besides, the situation of foreign debt servicing is worsened due to significant decrease in the volumes of foreign economic activities, particularly there is the increase in ratio of payment volume for foreign debt servicing to the volumes of export of goods and services. Over 2009, this index increased up to 36,3% under the threshold value of 20%.

The key risks, which will determine Ukraine's creditworthiness in the short term and medium term, are the following: balance of payments deficit problems; reduction of the revenue item of the State budget with simultaneous increase of the governmental debt; high energy dependence of the economy.

## 1. Location of the State, administrative arrangement, natural and climatic conditions, resource potential and infrastructure

Ukraine is located in Eastern Europe. The state borders on the Russian Federation, Republic of Belarus, Republic of Poland, Republic of Hungary, Slovak Republic, Republic of Moldova and Rumania. Ukraine is bounded by the Black Sea and Azov Sea, which provide the access to the states of the Mediterranean basin. Ukraine's capital is the city of Kiev. Due to its geographic location, Ukraine has many traffic arteries, which connect Western Europe with the Russian Federation, states of the Trans-Caucasian region and Central Asia. Ukraine is one the state-founders of the CIS.



Picture 1.1. Ukraine's map

Ukraine consists of territorial autonomy — Autonomous Republic of Crimea, 24 Oblasts and 2 cities with a special status: Kiev and Sevastopol. There are 459 cities, 885 urban settlements, 28 471 villages in Ukraine. The largest cities with population over 500 000 persons are: Kiev, Kharkov, Dnepropetrovsk, Odessa, Donetsk, Zaporozhye, Lvov, Krivoy Rog and Nikolayev.

According to the UN classification, Ukraine is a mononational state. According to the population census performed in 2001 the key nationalities are – Ukrainian (77,8%) and Russian (17,3%). As of January 01, 2009, 45 962 900 persons were permanent residents of the state, among which the urban population was 68,6%. It is important to say that over



the past years there was a trend to reduction of the total population size due to negative balance of the natural population increase.

The population density amounted to 76 persons per 1 sq. km. Manhood amounts to 46,1% of the total population, but female population – 53,9%. Among general population, the persons under active working age make 14,1%, persons of active working age – 70,0%, and persons over active working age – 15,9%. Due to negative natural increase, there is a disposition towards population aging process that leads to the increase in burden on social security system.

Land resources of Ukraine amounts to 60,4m ha, including agricultural lands – 71,0%, forests and other wooden lands – 17,5%, built-over land – 4,1%. Besides, extremely high level of living space reclamation is attributable to Ukraine. About 92% of the country's territory is under the economic control. Ukraine has many reserves of water resources. There are 63 100 rivers with overall length of 206 400 km in Ukraine. At the same time, water resources are located irregularly in Ukraine and their quantity is not sufficient.

Today, more than 8 600 fields of 97 types of mineral products have been explored in Ukraine. Taking into account the volumes, the largest reserves are the reserves of coal, iron ore, manganese ore and titan and zirconia ore, graphite, kaolin, potassium salt, sulfur and apyrous clay. At the same time due to depletion of many fields and absence of their appropriate increase, there is a trend to decrease in thr mineral raw material base. It is necessary to notice that Ukraine does not have enough raw hydrocarbon deposits to supply the population and economic branches that increases the dependency of Ukraine's economy on situation in the international markets of energy resources.

In 2009, freight turnover amounted to 380 003,5m. tons/km, including 51,6% of the turnover applied to rail transportation, but 37,3% – to pipeline transportation. Length of the public road network is almost 170K km, among which 165,8K km have hard surface. Ukraine's transportation sector consists of 6 railways, 32 airports, 20 governmental commercial seaports and 10 river ports.

National pipeline network includes gas pipelines and oil pipelines with branches, which connect Ukraine with Russia, Belorussia on the one side and with Poland, Slovakia, Hungary, Romania and Moldova from the other side. Ukraine's gas transportation system consists of the gas pipelines with the length of 37 100 km, including 14 000 km – pipelines of the largest diameter (1020-1420mm), 72 compression stations and 13 underground storages with active gas volume of more than 32bn cubic meters or 21,3 % of the pan-European active capacity. Ukraine's oil transportation system consists of 19 oil trunk pipelines with overall length of 4 766,1 km, 51 oil pumping stations and yank batteries with overall capacity of 1 085K cubic meters. Substantial risks of operation of Ukrainian gas and oil transportation systems are dependency on one energy supplier – the Russian Federation enjoys a monopoly for oil and gas supply and their transit.

## 2. Political Order

According to the state's Constitution, Ukraine is a unitary, democratic, social, constitutional state. Taking into account the form of political management, Ukraine is a president and parliamentary republic, but taking into account the form of state (political) regime, Ukraine is a democratic state. Governmental authorities in Ukraine are divided into legislative authority, executive authority and judicial authority. The President of Ukraine is a head of the state, guarantor of the state sovereignty, territorial integrity of Ukraine, execution of the Constitution, rights and liberties of men and citizens. After the 2004 constitutional reform, the mandates of the President of Ukraine were limited by their distribution between the Cabinet of Ministers and Government. Today, the President has the following powers:

- representation of the state in foreign affairs, control over foreign policy activities of the state, negotiation and conclusion of international contracts of Ukraine;
- termination of the authorities of the Verkhovna Rada of Ukraine, suspension of the documents of the Cabinet of Ministers of Ukraine, cancellation of the documents of the Council of Ministers of the Autonomous Republic of Crimea, a veto power as to the laws, accepted by the Verkhovna Rada of Ukraine;
- submission for appointment of the Prime-Minister of Ukraine, Minister of Defense of Ukraine, Minister of Foreign Affairs of Ukraine, Chairman of the National Bank of Ukraine, assignment of the Prosecutor-General of Ukraine, chairmen of local governmental administrations, half of the composition of the National Bank of Ukraine, a third of the composition of the Constitutional Court of Ukraine.

The President of Ukraine is Viktor F. Yanukovich, who holds the office since February 2010, when he received 48.9% of votes of electors during the regular election of the President of Ukraine.

The Verkhovna Rada of Ukraine is the only legislative authority of the country. The government of Ukraine consists of 450 deputies, who are elected from party lists. The latest special election in the Verkhovna Rada of Ukraine was held on September 2007 and according to the results the Party of Regions had 34.4% of the votes, block of Yulia Timoshenko – 30,7%, Block “Nasha Ukraina – Narodna Samooborona” – 14,2%, Communist Party of Ukraine – 5,4% and “Block of Litvin” – 3,9%.

The Verkhovna Rada of Ukraine has the following powers:

- adoption of laws, approval of the State budget of Ukraine, control over its performance and decision making concerning the report on its performance;

- determination of the fundamentals of domestic policy and foreign policy, examination and decision making concerning the approval of the Program of the Cabinet of Ministers of Ukraine, adoption of the national development programs;
- calling of the election of the President of Ukraine, removal of the President of Ukraine from his office in accordance with a special procedure (impeachment);
- assignment and removal from the offices of the Prime-Minister of Ukraine, Minister of Defense of Ukraine, Minister of Foreign Affairs of Ukraine, other members of the Cabinet of Ministers of Ukraine, Chairman of the Antimonopoly Committee of Ukraine, Chairman of the State Property Fund of Ukraine, performance of the control over activities of the Cabinet of Ministers of Ukraine;
- approval of the decisions on lending and economic assistance to foreign countries and international organization by Ukraine as well as receipt of economic assistance from foreign states, banks and international financial organization by Ukraine, control over their use;
- assignment and removal from the offices of the chairman and other members of the Accounts chamber, chairman of the National Bank of Ukraine, half of the composition of the Council of the National Bank of Ukraine, assignment of a third of the composition of the Constitutional Court of Ukraine, election of judges.

In accordance with the Constitution of Ukraine, the highest body of the executive authority is the Cabinet of Ministers of Ukraine, which, in turn, is subordinated to the Verkhovna Rada of Ukraine. Political confrontation caused by the election of the President of Ukraine in 2004 and as a result the constitutional reform promoted the decrease in the level of concentration of the power authorization in the President's hands and its transfer to the Verkhovna Rada of Ukraine and Cabinet of Ministers of Ukraine. At the same time, it is important to notice that unstable political situation in the country over 2005-2009 did not permit to develop the coordinated state policy in economic sphere.

Results of the latest election of the President of Ukraine and the subsequent reformatting of the majority in the Verkhovna Rada of Ukraine laid down the foundations of the political stability in the country. The abovementioned enables to carry out domestic economic reforms as well as favor the mobilization of resources to fulfill the governmental debt obligations, if needed.

In accordance with the Constitution of Ukraine (article 140), there is a local government system in Ukraine, which includes the local Councils of Deputies and their executive authorities, population self-organization entities as well as local referendums, meetings and local initiatives. Material and financial capability of the local government in Ukraine is movable and immovable property, revenues of the local budgets and other cash funds, land, natural resources owned by the territorial communities of villages, small towns, cities, districts in the cities as well as community properties controlled by the district and regional councils.

Territorial communities or local government bodies established by such communities shall provide the following:

- manage the communal property;
- adopt the programs of social and economic development as well as control their performance;
- adopt the budget of respective administrative and territorial units and control their performance; determine local taxes and charges;
- establish, reorganize and liquidate communal enterprises, organizations and institutions as well as control their activities.

Local government bodies shall implement the fundamentals of the national policy in the respective territory through the cooperation with local governmental administrations.

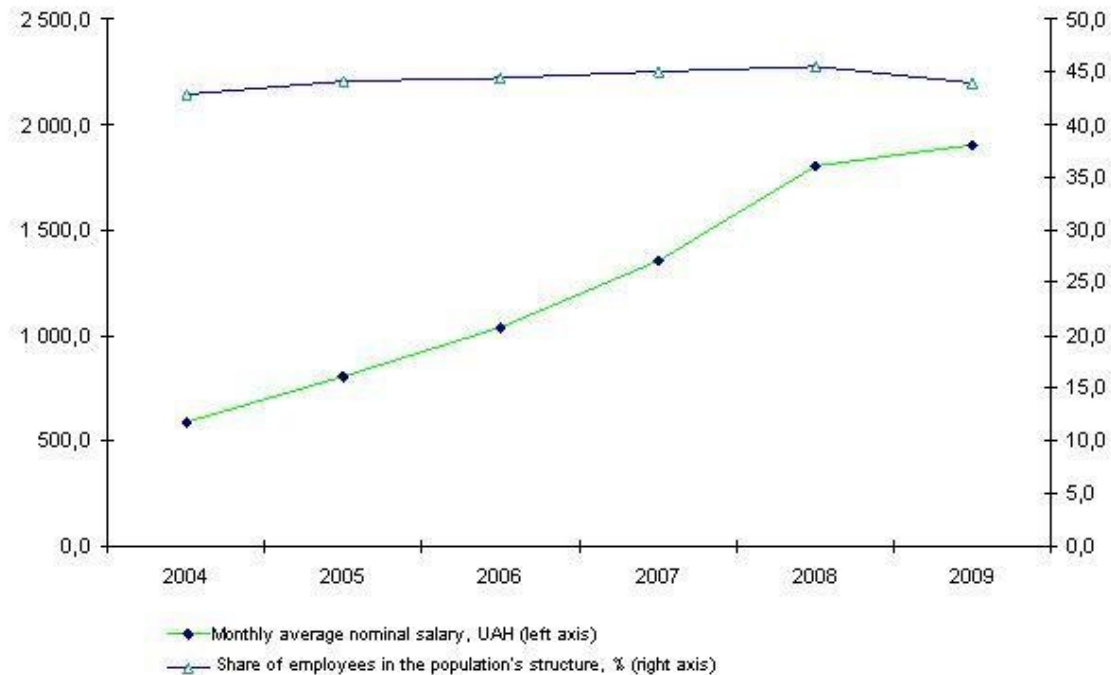
Today, the legislative and executive authorities of Ukraine demonstrate high level of the political consolidation that positively affects the national government's capability to mobilize the resource required for fulfillment of the debt obligations. After the 2004 constitutional reform, the power authorization in Ukraine is divided between the President, Verkhovnaya Rada and Cabinet of Ministers. Such state administration structures significantly reduces the risks attributable to the majority of the CIS states and connected with dependency of the system on one person and his ability to react to domestic and foreign risks operatively and sufficiently.

At the same time, there is a threat of decrease in the interaction efficiency of different governmental branches in the case of appearance of conflicts relating to the domestic policy. High level of the authority decentralization hides the risks relating to the impossibility to make operative decisions under crisis circumstances as well as to carry out the system national structural reforms in the course of political instability.

### 3. Country's Social and Economic Development

#### 3.1. Labour Market and Personal Incomes

During 2004-2008 the Ukraine's labour market was dominated by positive trends, reflecting in rising number of employees and growing incomes (Exhibit 3.1)



**Exhibit 3.1 Key Indicators of Ukraine's Labor Market in 2004-2009**

Source: State Committee for Statistics of Ukraine

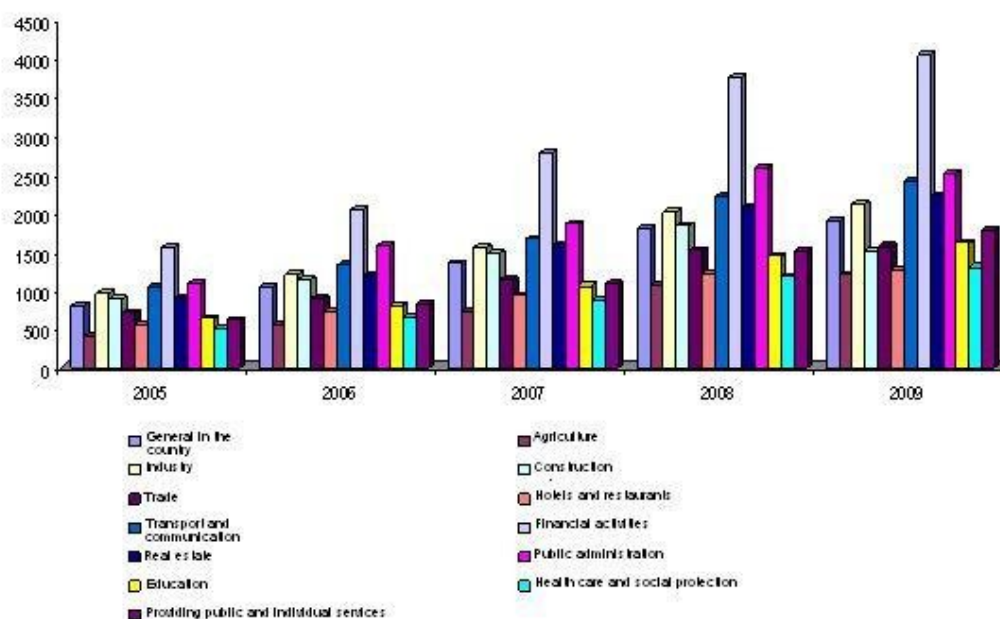
It should be noted that the ratio of employees to the number of population is average in CIS region (Table 3.1)

**Table 3.1 The Ratio of Number of Employees to the Number of Population in Certain CIS Countries**

Country	Share of employees in the population, %	
	2008	2009
Russia	48,3	48,9
Ukraine	45,3	44,3
Belarus	47,4	48,6
Azerbaijan	46,6	48,3
Armenia	34,5	34,0
Kazakhstan	49,7	49,4

Source: Central banks and statistical services of CIS countries

The amount of monthly average nominal salary in Ukraine was recorded in 2009 at UAH1 906. The level of salaries in USD equivalent is on average level comparing to other CIS countries. The highest amounts of salaries in Ukraine were recorded during 2005-2009 in the sectors 'financial activities', 'transport and communication', and 'industry' (Exhibit 3.2)



**Exhibit 3.2 Salaries in Ukraine by Types of Economic Activities in 2005-2009, UAH**

*Source: State Committee for Statistics of Ukraine*

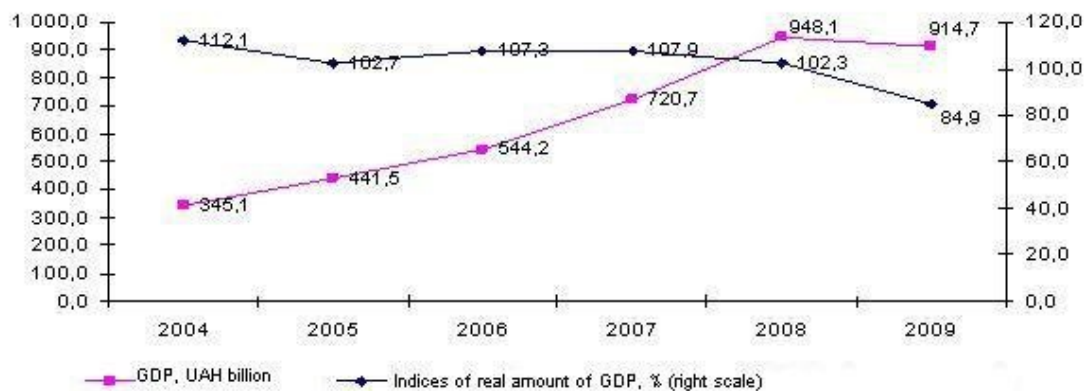
The labour market has retained rather considerable salary discrepancies among sectors during the past few years. In fact, the amount of salaries in the sectors 'agriculture', 'health care and social protection', 'education' and 'trade', which employ major part of the national labour resources, still remain low.

The consequences of the global crisis had a significant impact on the pace of development of Ukraine's labour market. The decline in demand for labour resources prompted decrease in the number of employees by 0.8 million in 2009. A sharp decline in the number of employees occurred in such sectors as construction, trade, industry, including car manufacturing, metallurgy, and machine-building. In order to diminish expenses many employers in Ukraine used such practices as cutting working hours and coercive vacations.

The situation with compensations also aggravated in 2009. Despite the fact that nominal salary rose in 2009 by 5.5%, its real amount decreased by 9.2%.

### 3.2. Economy Structure (Gross Domestic Product – growth, structure, fundamental sectors of economy, and discrepancies in economic development)

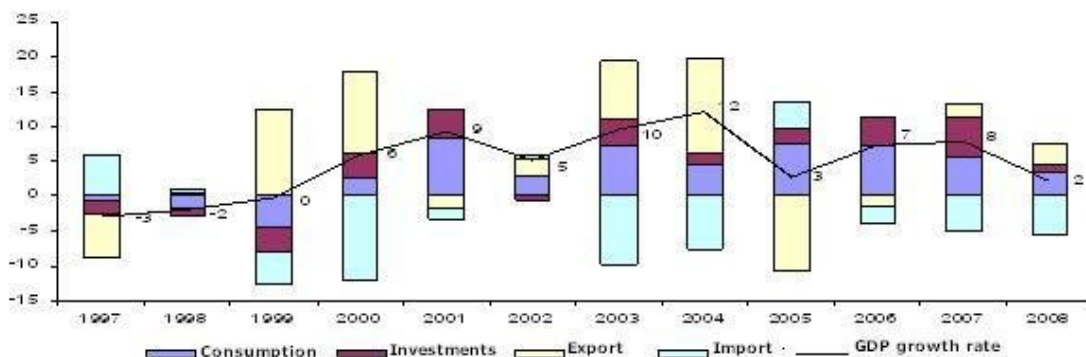
During 2004-2007 and 1H2008 the Ukraine's economy demonstrated high pace of development. Except for 2005, the year-over-year rates of GDP growth were recorded at not less than 7%. The Ukraine's GDP rose 2.7 times in absolute figures during 2004-2008 (Exhibit 3.3).



**Exhibit 3.3 Pace of Ukraine's GDP in 2004-2009**

Source: State Committee for Statistics of Ukraine

The structure of the GDP by categories of end consumption was dominated by 2005 by exports, at that starting from 2005 the boosters of economic growth became domestic consumption and investments (Exhibit 3.4)



**Exhibit 3.4 Ukraine's GDP Growth Rate (%) and Its Components (In Percentage Points)**

Source: State Committee for Statistics of Ukraine, UNO; Calculations: Credit-Rating

Key factors for positive trend in the GDP in 2005-2008 were sectors ‘industry’ and ‘trade’ by forming gross added value (Table 3.2)

**Table 3.2 Structure of Gross Added Value in Ukraine in 2005-2008, UAH million**

Types of Economic Activities	2005 год	2006 год	2007 год	2008 год
Agriculture	40 542,0	41 006,0	47 417,0	65 148,0
Extracting industry	17 939,0	22 064,0	31 695,0	54 337,0
Processing industry	86 863,0	109 416,0	143 428,0	164 735,0
Production and distribution of electric energy, gas and water	15 169,0	18 610,0	23 245,0	28 800,0
Construction	16 370,0	21 168,0	30 456,0	29 185,0
Trade and repair of cars	56 041,0	68 573,0	95 220,0	131 261,0
Transport and communication	47 435,0	56 053,0	70 063,0	87 078,0
Education	20 882,0	26 243,0	32 905,0	43 520,0
Health care and social protection	13 965,0	17 722,0	22 542,0	29 209,0
Other types of economic activities	80 797,0	106 277,0	159 921,0	227 441,0
<b>Gross Added Value (in main prices), total</b>	<b>388 601,0</b>	<b>474 123,0</b>	<b>634 794,0</b>	<b>824 176,0</b>
<b>GDP (in market prices), total</b>	<b>441 452,0</b>	<b>544 153,0</b>	<b>720 731,0</b>	<b>948 056,0</b>

Source: State Committee for Statistics of Ukraine

The consolidated specific gravity of industrial sector in the structure of gross added value in Ukraine during 2005-2008 was recorded at over 30%. The fundamental segments of Ukraine’s industrial sector are mining operations, catering industry, production of coke and oil products, metallurgy and machine building. The majority of given items form core of Ukrainian export of goods. We should also mention rather significant Ukraine’s involvement into cross-border transportation of goods as one of large exporters and importers, which is mirrored by indicators of external commercial and export goods quota (Exhibit 3.1)

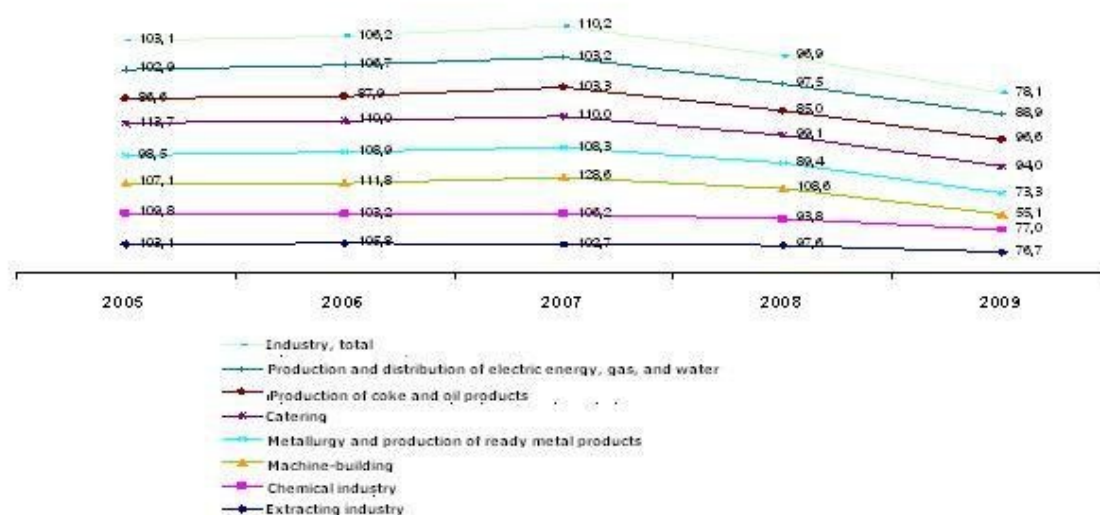




**Exhibit 3.5 Indicators of External Commercial and Export Quota of Goods in 2005-2009**

Source: calculated by data provided by State Committee for Statistics of Ukraine and by National Bank of Ukraine

The trends of development in the majority of Ukraine's fundamental sectors were positive during 2005-2007 (Exhibit 3.6). These were driven by both market growth which reflected in rising prices and soaring demand in the global commodities markets for main Ukraine's export items – primarily metals, chemicals, and products of transport machine building, and by rapidly growing domestic demand fueled by rising personal incomes and vigorous growth of bank lending.



**Exhibit 3.6 Production Indices of Fundamental Sectors of Ukraine's Economy in 2005-2009**

Source: State Committee for Statistics of Ukraine

It is worth mentioning that rather high pace of Ukraine's economic growth in the past few years was accompanied by accumulation and aggravation of macroeconomic disproportions. Extreme dependency upon global commodities prices due to imperfect production structure and high energy duty of production, which became especially severe after rise in gas prices; distorted culture of household consumption prompted by outpacing personal incomes over productivity of labour – these are to name a few of disproportions in Ukraine's economy structure. These and other discrepancies formed extensive nature of Ukraine's economic growth contributing to accumulation of macroeconomic risks – of monetary, currency and credit kinds, which sooner or later would affect national economy.

Starting from August 2008 the business environment of Ukraine's exporting companies has worsened severely. The global financial and industrial stagnation entailed deep decline in demand for Ukraine-made products, primarily of metallurgy sector. Under impact of 'freezing' construction projects around the world, and of decreased consumption of machine-building sector, the volumes of metal export to the CIS plunged by 20.2%, specifically to Russia – by 22.9%, to European countries – by 4.1%, to North America – by 21.4%. A decline in external demand prompted fall in global metal prices, which had significant impact on performance of leading national metallurgical companies, considering their high energy consumption and dependency upon energy prices.

The toughened terms of lending following erosion in liquidity of banking institutions has prompted decline in domestic demand for products of machine-building sector, primarily of car manufacturing. Specifically, in comparison with the similar periods of 2007, the volume of production of vehicles and equipment decreased in October 2008 by 17.9%, in November – by 51.6%, in December – by 54.5%. A sharp decline in output rates in 2H2008 was also recorded in machine-building companies involved in manufacturing of equipment for mining and smelting sector, ferrous and non-ferrous metallurgical companies, and construction companies, which are affected by risks intrinsic to their customers.

The output rates in machine-building sector were weighed by decelerating economic growth in Russia, which is the domicile for the biggest customers of Ukrainian machine-building companies.

The worsened external economic environment had little impact on pace of Ukraine's foreign sector (Table 3.3)

**Table 3.3. Key Figures of Ukraine's Foreign Sector in 2008-2009**

Indicators	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009
Balance of the current account, USD million	-3 662,0	-3 313,0	-2 078,0	-3 710,0	-654,0	-181,0	-68,0	-898,0
Balance of the financial account, USD million	3 527,0	5 724,0	6 053,0	-5 609,0	-4 677,0	-2 273,0	-4 854,0	-716,0
Balance of payments, USD million	-135,0	2 410,0	3 980,0	-9 318,0	-5 225,0	-2 046,0	-4 902,0	-1 553,0
Gross international provisions (as at period-end), USD billion	33,2	35,5	37,5	31,5	25,4	27,3	28,2	26,5

*Source: National Bank of Ukraine*

Besides a decline in the current account of balance of payments, the financial account also worsened in 4Q2008. This was mainly prompted by necessity in repayment of short-term loans by Ukraine's banking sector – the negative balance by this item amounted to UAH2.8 billion in this period. Moreover, in 4Q2008 considerable repayments of long-term loans of the banking and of the real sectors were performed. In this period, a negative balance by transactions with Eurobonds emerged first time in five years – the amount of Eurobonds repayments was recorded at USD0.4 billion under no new issues.

Similar trends by the financial account of the balance of payments retained in 2009 too – a poor inflow of foreign direct investments, exceeding payments on foreign currency-denominated obligations (public, banking and corporate sectors) over inflow of borrowed funds, accumulation of foreign currency beyond banking sector – all these factors contributed to evolvment of negative balance of payments in the financial account amounting to USD11.8 billion.

The decreasing global liquidity and shrinking volume of export and import transactions weighed heavily on Ukraine's balance of payments and prompted sharp decline (in 3Q-4Q2008 and 1Q2009) in gross international reserves of the National Bank of Ukraine. In these circumstances Ukraine resumed contacts with International Monetary Fund by 'Stand-by' program. In October 2008 and in January-September 2009 Ukraine raised three tranches from the IMF totaling USD10.6 billion.

Starting from 2Q2009, in Ukraine, like in the majority of CIS countries, the export transactions started to demonstrate certain revival, driven by some improvements in foreign markets. The growth in prices for energy in global commodities markets was mainly driven by revision of sentiments by market players regarding scale and consequences of the global economic crisis. A certain positive role also played enhanced outlooks for economic growth in certain Asian countries, which are exporters of energy, namely in China. The rising prices in global metal markets, which started from deceleration in fall or prices in 1Q2009 and followed by their growth, was prompted by rising industrial demand, primarily in China.

Generally the consequences of the global financial crisis to a great extent materialized risks of Ukraine's creditworthiness, associated with high dependency of the budget revenues upon environment in foreign markets, debt burden of the government, and

volatility of investment preferences relating to investment activities in developing countries.

A certain change in pace of development of the global economy exhibits deceleration of recession rather than recovery. Consequently, considering rather high Ukraine's dependency upon trends in international trade and cross-border capital flows, it is too early to talk about improvements in macroeconomic environment in the country. The downturn in Ukraine's economy was one of the deepest among CIS countries. Although Ukraine managed with the challenges faced by the national economy in late 2008, the resources, which enabled to succeed in this have almost run out. Significant challenges in funding deficiency of balance of payments under shrinking reserves and opacity with regard to their refilling with funds from international financial institutions, shrinking revenues of the state budget accompanied by rising state debt – all those factors will affect Ukraine's short-term and medium-term creditworthiness.

During the past few years the Ukraine's economy demonstrated high pace of growth. The growth in industrial production, rising volume of residential and commercial construction, increased business activities in almost all economy sectors – all of these positive trends were underpinned by both increasing export and rapidly growing domestic consumption. However, all these were accompanied by accumulation and aggravation of macroeconomic discrepancies, major of which were high dependency upon global commodities prices, high energy duty of the production, and distorted culture of household consumption.

The structure of Ukraine's GDP by types of economic activities was dominated during 2005-2009 by industry, which consolidated share in gross added value in Ukraine amounted to over 30%. The fundamental segments of Ukraine's industrial sector are mining operations, catering industry, production of coke and oil products, metallurgy and machine building. The majority of given items form core of Ukrainian export of goods.

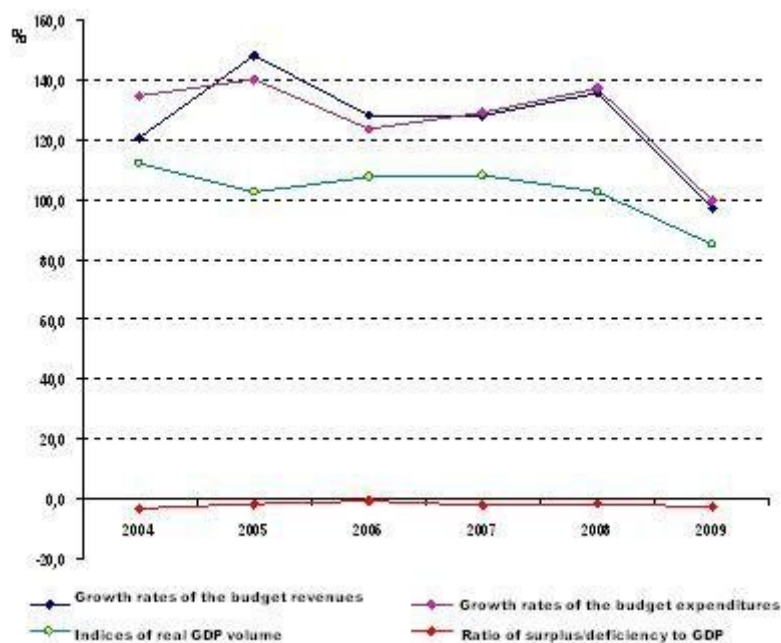
Starting from August 2008 the business environment of Ukraine's exporting companies has worsened severely. At that the decreasing volumes of export of goods was accompanied by significant difficulties associated with raising borrowed funds due to erosion in the global financial system, and outflow of foreign capital driven by negative sentiments. These factors weighed heavily on the general national balance of payments, which in its turn prompted shrinkage of reserves of National Bank of Ukraine and significant rise in the debt burden of the central government. Although Ukraine managed with the challenges faced by the national economy in late 2008, the resources, which enabled to succeed in this have almost run out. Significant challenges in funding deficiency of balance of payments under shrinking reserves and opacity with regard to their refilling with funds from international financial institutions, shrinking revenues of the state budget accompanied by rising state debt – all those factors will affect Ukraine's short-term and medium-term creditworthiness.

## 4. Financial and Credit System

### 4.1. Budget and Tax Policy

The Ukraine's budget and tax policy was formed during 2004-2008 from one side under stable economic growth and from the other side under certain political conflicts. Insufficient coordination of different branches of power and absence of external incentives for structural reformation of the national economy and public finances prevented from taking necessary measures aimed at reforms in tax and budget systems in the period of stable receipts to the country's consolidated budget. This resulted in higher than in other post-Soviet countries impact of the financial and economic crisis on Ukraine's economy and its budget system.

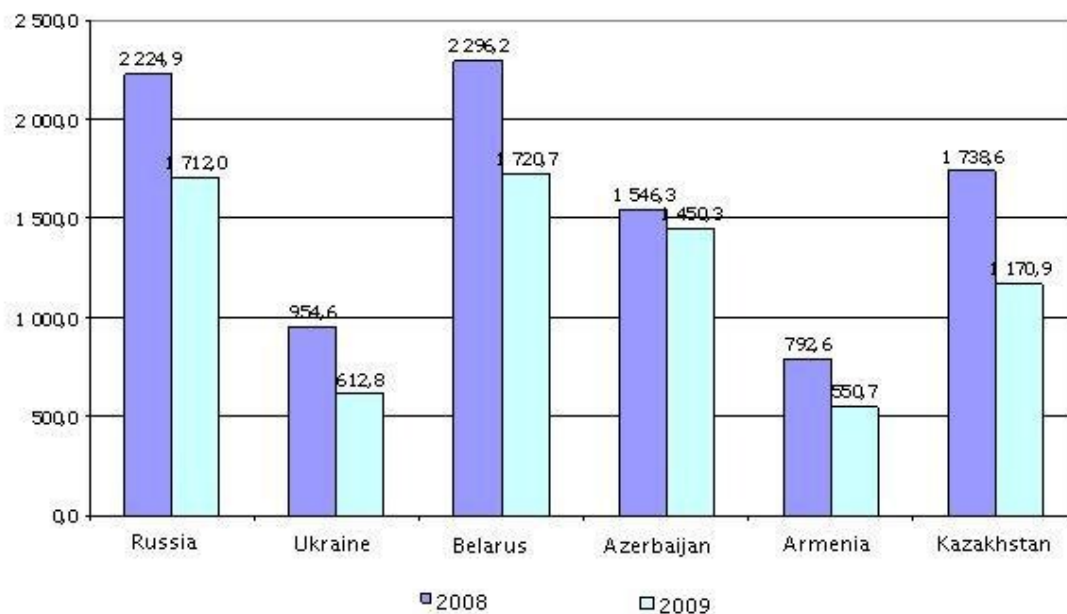
The deceleration in pace of social and economic development, specifically decline in industrial output and construction works performed (by 21.9% and 48.2% respectively), and 1.8 times shrinking external trade turnover and retail turnover of goods by 5.8% had negative impact on tax receipts. According to figures recorded in 2009 the revenues to the national consolidated budget decreased by 3.1% versus similar year-earlier period (Exhibit 4.1).



**Exhibit 4.1 Key Figures of Ukraine's Consolidated Budget in 2003-2009**

Source: Ministry of Finance of Ukraine

Despite of the fact that Ukraine's budget revenues calculated per capita are in excess of the figures recorded in the majority of CIS countries, except for Russia, Belarus, Kazakhstan, and Azerbaijan (Exhibit 4.2), major expenditure objectives remain current expenses for funding public sector and administration.



**Exhibit 4.2 Comparative Indicators of Budget Expenditures Per Capita in Certain CIS Countries, USD**

Source: Credit-Rating

Over the entire period of its existence the budget policy of Ukraine was aimed at maintaining budget balance and social sector, whereas the function of creating incentives for long-term economic growth and economy development has not been realized in full.

In order to enhance efficiency of the budget policy and reinforce budget's function in creation and implementation of the national economic policy, improvement of regions' competitiveness and stimulating their development – by raising labour productivity and employment – there have been several attempts to bring budget-relating legislation in accordance with modern requirements. In order to provide the budget process with legislative basis Ukraine has adopted Budget Code. Before the Budget Code of Ukraine became effective <sup>2</sup> the budget relations were regulated by Law of Ukraine 'On Budget System in Ukraine' and a number of regulations, which provisions often contradicted, which prevented from its efficient implementation. The adoption of Budget Code in 2001 allowed for adjusting budget-affecting legislation, assign powers for performing expenditures and delimiting revenue sources between different levels of the budget system, unifying budget classification, enhancing and formalizing budget process in all stages, strengthen control over use of budget funds. Further stages of the budget reformation included introduction of program and objective method in the budget process, implementation of medium-term planning of budget indicators, and reforming in local budgets and improvement in relations between budget.

Specifically in 2007 the resolution of the Cabinet of Ministers of Ukraine approved Conception for reforming local budgets aimed at carrying out reforms in local budgets by 2011. However, the proposed measures aimed at changes in budget-relating legislation

<sup>2</sup> The Budget Code of Ukraine was adopted on June 21, 2001; effective since Jul. 25, 2001

with simultaneous carrying out of tax and administrative and territorial reforms were not performed.

The financial and economic crisis sharpened cumulated problems and to certain extent stimulated reformations in the budget and tax systems. Under shrinking revenues in both local budgets and the state budget it was decided to boost reformations of the tax-related legislation and enhance efficiency of the budget system (primarily in terms of execution of inter-budget relations), but then existing political conflicts prevented from fulfillment of reformations.

In 2009 the work over development of the Tax Code draft proceeded. Today Ukrainian tax-affecting legislation is a set of regulations of different levels affecting tax issues in the country. At that despite of inconsistency of legislation, generally the tax system corresponds with global practice. In the course of enhancements in the system the so-called 'anti-market' taxes and duties (namely tax on gains from sale of goods and services) were substituted by profit tax and value added tax, which together with individual income tax, excise duty and customs duty form foundation of the tax system. Today the mentioned taxes contribute to around 70% of receipts to the country's consolidated budget. Besides, a taxation procedure of salary fund, namely progressive taxation of individuals was substituted by fixed rates.

The losses in the budget receipts prompted by lowering tax rates and abolishment of a number of duties were avoided owing to expansion of taxation basis and improved collection of taxes. At the same time the modern framework of taxation in Ukraine is not optimal by both distribution of fiscal burden among economic entities and efficiency of tax administration activities. The changes to tax legislation had no reformation nature but were aimed at gaining receipts to the state budget revenues under economic downturn. Specifically some excise duties for certain groups of goods were raised.

The budget declaration for 2011 includes development of tax and budget policy aimed at boosting economic growth by reinforcing regulating and stimulating function of taxes, reforming taxation of individuals (exempt incomes that are under minimum subsistence level), simplifying and unifying tax-affecting legislation and securing its stability, introducing tax stimulus packages for creating new jobs, investing and innovation activities.

#### *4.2. State Budget of Ukraine in 2006-2009 and January-February 2010*

The tools of Ukraine's budget policy pursuant to effective legislation are annual addresses of the President of Ukraine to Verkhovna Rada of Ukraine, Program for economic and social development of Ukraine, annual Budget resolution of Verkhovna Rada of Ukraine, Law on the state budget and resolutions of local self-government bodies on the budgets of territorial communities, budget programs of all levels of the budget system.

During 2004-2009 the principal tools for implementation of the state budget policy were regulations on the state budget and local budgets. The state budget of Ukraine is formed



depending on the aspects of national tax and public finance policies and is a core for the budget system.

In 2009, unlike in previous periods, the Law on the state budget for the next budget period was not passed. This resulted in execution of the budget procedures pursuant to the Budget Code (monthly funding of budget expenditures within 1/12 of the budget assignment in the previous year), but with consideration to details specified by a decree of the Cabinet of Ministers titled 'On measures aimed at arrangement of the budget process in 2010'. The implementation of indicators in all levels of the budget system in 1Q2010 were pursued under absence of the national financial plan, which worsened existing hardships with funding capital expenditures and numerous current expenditures, which do not pertain to the primary.

Starting from 2H2008 a problem associated with mobilization of funds in volumes necessary for the state to implement its functions and duties, including those in the framework of anti-crisis policy, under constantly decreasing receipts to the budget (Table 4.1).

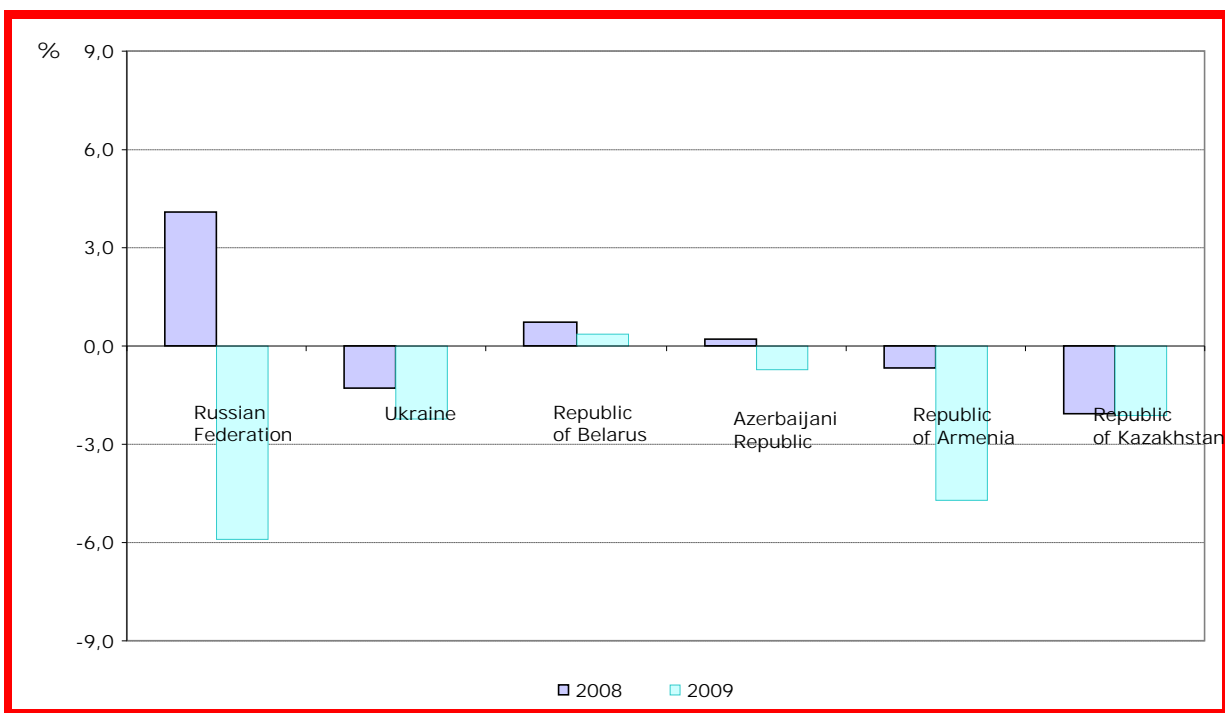


Table 4.1 Key Indicators of Implementation of Ukraine's National Budget in 2007-2009

Indicators	Performed in 2007, UAH million.	Growth rates versus previous year, %	Performed in 2008, UAH million.	Performed versus previous year, %	Amended plan for 2009	Growth rates to actual indicators of the previous year, %	Performed in 2009, UAH million	Performed versus previous year, %	Implementation of the annual plan in 2009, %
<b>Revenues</b>	<b>165 942,1</b>	<b>124,3</b>	<b>231 686,3</b>	<b>139,6</b>	<b>245 309,4</b>	<b>105,9</b>	<b>225 319,9</b>	<b>97,3</b>	<b>91,9</b>
<b>Tax receipts, including</b>	<b>116 670,8</b>	<b>123,1</b>	<b>167 883,4</b>	<b>143,9</b>	<b>175 476,2</b>	<b>104,5</b>	<b>148 915,6</b>	<b>88,7</b>	<b>84,9</b>
tax on corporate profit	33 964,0	131,3	47 456,3	139,7	41 936,1	88,4	32 569,8	68,6	77,7
value added tax	59 382,8	117,8	92 082,6	155,1	94 839,6	103,0	84 596,7	91,9	89,2
excise duty on goods produced in Ukraine	8 990,4	120,0	10 125,0	112,6	19 453,7	192,1	17 584,5	173,7	90,4
excise duty on goods imported to Ukraine	1 495,5	142,3	2 553,0	170,7	4 387,4	171,9	3 690,0	144,5	84,1
import duty	9 588,9	137,5	11 932,8	124,4	10 382,9	87,0	6 328,8	53,0	61,0
Non-tax receipts	42 114,7	117,8	52 817,6	125,4	57 368,6	108,6	66 296,4	125,5	115,6
Revenues from capital transactions	1 769,9	319,2	2 125,3	120,1	2 460,4	115,8	1 060,1	49,9	43,1
from governments of other countries and international organizations	104,5	68,0	135,2	129,4	838,0	619,9	645,3	477,3	77,0
Special purpose funds	930,5	138,1	1 022,7	109,9	424,9	41,5	633,6	62,0	149,1
Official transfers	4 351,7	276,2	7 702,0	177,0	9 579,3	124,4	7 769,0	100,9	81,1
<b>Expenditures</b>	<b>174 235,9</b>	<b>127,1</b>	<b>241 454,5</b>	<b>138,6</b>	<b>274 156,4</b>	<b>113,5</b>	<b>242 356,7</b>	<b>100,4</b>	<b>88,4</b>
<b>Current expenditures</b>	<b>148 407,3</b>	<b>122,0</b>	<b>215 855,1</b>	<b>145,4</b>	<b>213 369,1</b>	<b>98,8</b>	<b>231 991,1</b>	<b>107,5</b>	<b>108,7</b>
including service of sovereign debt	3 349,9	107,7	3 774,7	112,7	14 227,3	376,9	9 038,7	239,5	63,5
domestic	743,4	83,1	857,2	115,3	9 246,1	1 078,6	4 659,9	543,6	50,4
foreign	2 606,5	117,7	2 917,5	111,9	4 981,2	170,7	4 378,9	150,1	87,9
<b>Capital expenditures</b>	<b>25 828,6</b>	<b>167,1</b>	<b>25 599,4</b>	<b>99,1</b>	<b>н/д</b>	<b>н/д</b>	<b>10 365,6</b>	<b>40,5</b>	<b>н/д</b>
including acquisition of fixed assets	6 728,7	163,0	7 119,5	105,7	н/д	н/д	3 648,9	51,3	н/д
<b>Lending</b>	<b>1 518,6</b>	<b>-</b>	<b>2 732,5</b>	<b>-</b>	<b>2 715,9</b>	<b>99,4</b>	<b>2 828,8</b>	<b>103,5</b>	<b>104,2</b>
<b>Deficit / surplus</b>	<b>-9 812,5</b>	<b>-</b>	<b>-12 500,7</b>	<b>-</b>	<b>-31 563,0</b>	<b>252,5</b>	<b>-19 865,6</b>	<b>158,9</b>	<b>62,9</b>
<b>Funding</b>	<b>9 812,5</b>	<b>-</b>	<b>12 500,7</b>	<b>-</b>	<b>31 563,0</b>	<b>252,5</b>	<b>19 865,6</b>	<b>158,9</b>	<b>62,9</b>
<b>Loans</b>	<b>10 447,6</b>	<b>88,1</b>	<b>17 675,6</b>	<b>168,4</b>	<b>88 877,4</b>	<b>502,8</b>	<b>97 074,4</b>	<b>549,2</b>	<b>109,2</b>
domestic	3 573,0	-	11 648,6	326,0	70 069,5	601,5	55 105,9	473,1	78,6
foreign	6 874,6	66,9	6 027,0	87,0	18 807,9	312,1	41 968,6	696,3	223,1
<b>Repayments</b>	<b>6 470,6</b>	<b>65,7</b>	<b>6 028,2</b>	<b>93,2</b>	<b>-27 447,7</b>	<b>-455,3</b>	<b>31 304,7</b>	<b>519,3</b>	<b>-114,1</b>
domestic	2 366,8	56,9	3 659,7	154,6	-14 518,0	-396,7	17 924,9	489,8	-123,5
foreign	4 103,7	72,2	2 368,4	57,7	-12 929,7	-545,9	13 379,8	564,9	-103,5

Source: Ministry of Finance of Ukraine

Under such circumstances – the actual budget deficit remaining moderate of 2.4% of the GDP in 2009 (which is far lower than in a numerous CIS countries – Exhibit 4.3), the hidden deficit by the special fund rose substantially due to insufficient funding of the budget expenditures. In fact, while payables as of Jan. 1. 2010 in the general fund retained at the level of the previous budget period, the non-fulfillment of budget indicators of the special purpose fund in funding anti-crisis measures led to rising indebtedness of managers of the budget funds in 9 times to UAH1 275.1 million.



**Exhibit 4. Ratio of Deficit / Surplus of the National Budget to GDP in Some CIS Countries, %**

Source: Credit-Rating

Pursuant to the Law on the National Budget of Ukraine for 2010 the budget revenues were planned in the amount which is 18.7% more than the figures of actual revenues recorded in the previous year. The growth of the budget revenues shall be recorded at 133.5% to the actual figures recorded in the previous year. At that the budget deficit in 2010 shall be at 5.3% of the forecast figures of the nominal GDP.

Considering low pace of receipts to the national budget in 1Q2010 (14.6% of the amount of revenues planned for 2010) we may expect the difficulties with balancing budget indicators in the current budget period remain. In 2010 the burden on the budget revenues will rise driven by necessity for prolongation of anti-crisis measures, specifically in the banking sector. Besides the burden on the budget expenditures will be imposed by rising social standards, and, consequently, by increasing expenditures for funding public sector and covering deficit in the Pension fund. At that there will remain the necessity for repayment of payables accumulated in the previous budget period, and for expenses aimed at servicing increased sovereign debt.

The national budget and tax policies were affected in 2004-2008 by stable economic growth accompanied by certain political conflicts, which impeded efficient cooperation between different branches of power. Due to the fact that the steps necessary for reforming tax and budget systems were not taken in the period of stable growth of the national budget revenues, the extent of the crisis impact on Ukraine's public finances in 2009 appeared to be wider than in a number of other post-Soviet countries.

The deceleration in the pace of social and economic development arising starting from 2H2008 had negative impact on pace of principal tax receipts, which to certain degree was contributed to by insufficient efficiency of the budget-relating policy as a tool of macroeconomic regulation. Over the entire period of its existence the budget policy of Ukraine was aimed at maintaining budget balance and social sector, whereas the function of creating incentives for long-term economic growth and economy development has not been realized in full. Despite of the fact that Ukraine's budget revenues calculated per capita are in excess of the figures recorded in the majority of CIS countries, major expenditure objectives remain current expenses for funding public sector and administration.

In 2010 the burden on the national budget revenues will rise driven by necessity in prolongation of anti-crisis measures, specifically in the banking sector. Besides the burden on the budget expenditures will be imposed by rising social standards, and, consequently, by increasing expenditures for funding public sector and covering deficit in the Pension fund, and for expenses aimed at servicing increased sovereign debt.

#### *4.3. Credit and Monetary Policy*

The key objective of Ukraine's credit and monetary policy after the financial crisis of 1998 was maintaining exchange rates of the national currency. Under significant surplus in the balance of payments in the past few years, the National Bank of Ukraine purchased excessive amounts of foreign currency in order to maintain exchange rate. Despite this, the hryvnya exchange rate strengthened twice – in 2005 and 2008.

The necessity in purchasing considerable amounts of foreign currency on the inter-bank market prompted high growth rates of monetary aggregate. In combination with rising prices on the global commodity markets and liberal fiscal policy this put additional inflation weigh on the economy that peaked in 2008. It should be noted that high inflation was inherent for the majority of CIS countries, although average rates of consumer price growth during 2004-2008 was even higher than in other countries of the region. The exceeding inflation rates in Ukraine over those in other countries – trading partners – was leading to aggravation in competitive strength of Ukrainian economy and in balance of account of the current transactions. To decrease inflation rates the National Bank of Ukraine took numerous measures, specifically in 2008 the rate was raised to 12% from 8%. In combination with liquidity crisis this led to certain decline in inflation rate in 2009.

**Table 4.2. Key Figures Representing Ukraine's Credit and Monetary Policy in 2004-2009**

Indicator	Unit of measurement	2004	2005	2006	2007	2008	2009
Inflation	%	112,3	110,3	111,6	116,6	122,3	112,3
National Bank Rate	%	9	9,5	8,5	8	12	10,25
Official reserves of the National Bank	USD billion	9,7	19,4	22,4	32,5	31,5	26,5
Money supply (reserve money)	UAH billion	53,8	82,8	97,2	141,9	186,7	195,0
Money supply national	UAH billion	125,5	193,1	259,4	391,3	512,5	484,8
Cash in money supply	%	33,7	31,2	28,9	28,4	30,2	32,4
Monetization of economy	%	36,4	43,8	47,7	54,3	54,1	53,0
Deposits of residents (excl. deposit corporations)	UAH billion	84,6	134,8	185,9	283,9	359,7	335,0
Loans granted to residents (excl. deposit corporations)	UAH billion	88,6	143,4	245,2	426,9	734,0	723,3
Official exchange rate USD/UAH	UAH/ USD 100	530,5	505,0	505,0	505,0	770,0	798,5

*\*calculated from 2007*

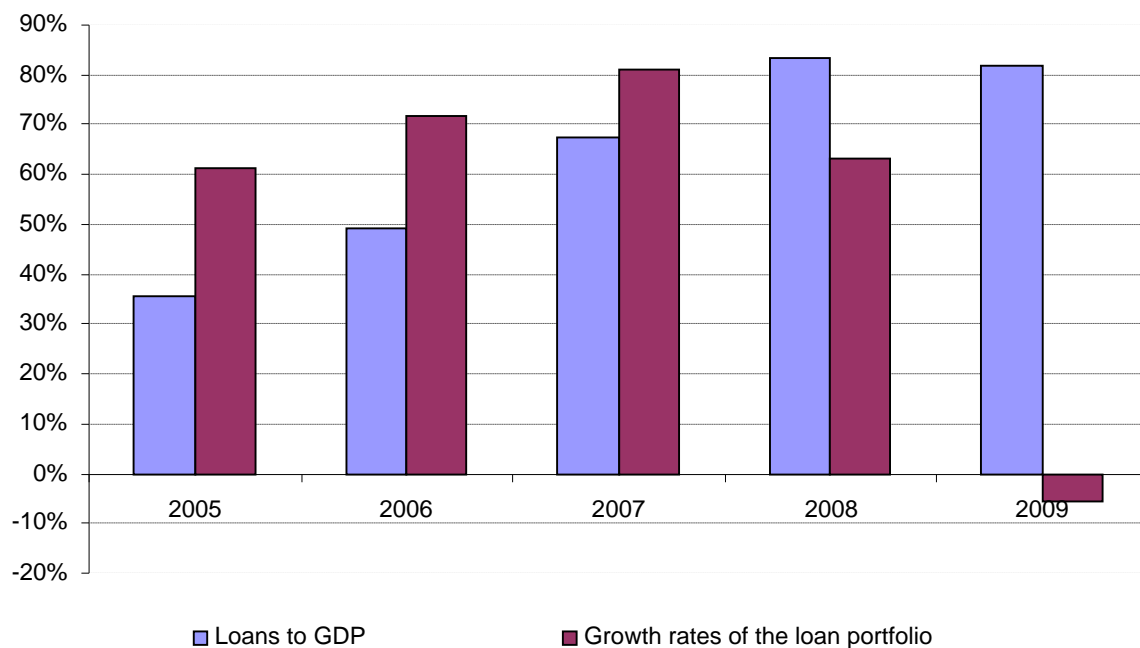
*Source: <http://www.nbu.gov.ua>*

The financial crisis prompted sharp outflow of speculative capital from Ukraine, which put significant pressure on UAH exchange rates. Despite of energetic interventions performed by the National Bank in 4Q2008, the depreciation of Ukrainian national currency was the most severe in comparison with other CIS countries.

#### *4.4. Banking System*

The banking system of Ukraine encompassed 175 operating banks as at March 1, 2010, with 51 of them being with foreign capital (18 banks with 100% foreign capital). The Ukrainian banking sector is less concentrated in comparison with other countries in the region, as around 50% of the system is concentrated in 10 banks, whereas in Russia, Kazakhstan, and Belarus – only in 4-5 banks.

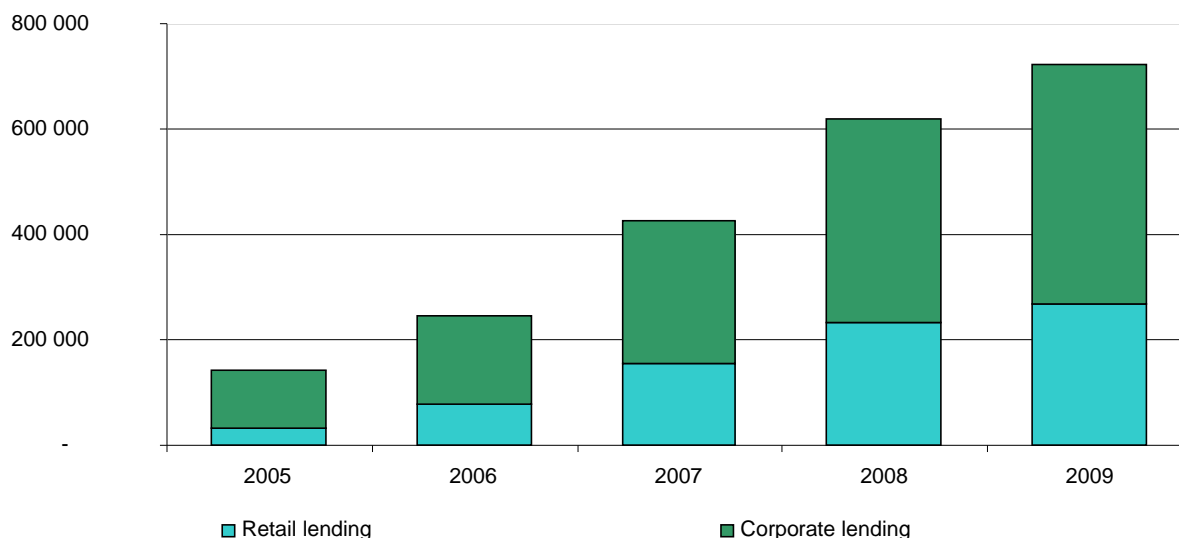
A rapid growth of the banking system assets reported in 2005-2007 and in 3 quarters of 2008 was fueled by economic growth, inflow of foreign capital and demand for loans, which entailed increase in credit and currency risks, and liquidity risks. The pace of banking system's asset growth decelerated considerably starting from 4Q2008, with the system's total assets shrunk by 5% in 2009 amounting to UAH880.3 billion, due to banks' suspension of lending and raised requirements for borrowers in order to accumulate liquid funds. The ratio of internal loans to the national GDP is recorded at over 80%, which is far exceeding region's average figures.



**Exhibit 1. Key Indicators of Ukraine's Banking System, %**

*Source: National Bank of Ukraine*

The structure of the banks' loan portfolio is dominated by loans granted to economic entities. However, during 2005-2007 the lending to individuals was growing vigorously which entailed high credit risks as the banks' aggressive expansion allowed for insufficiently severe obligors' solvency assessment.



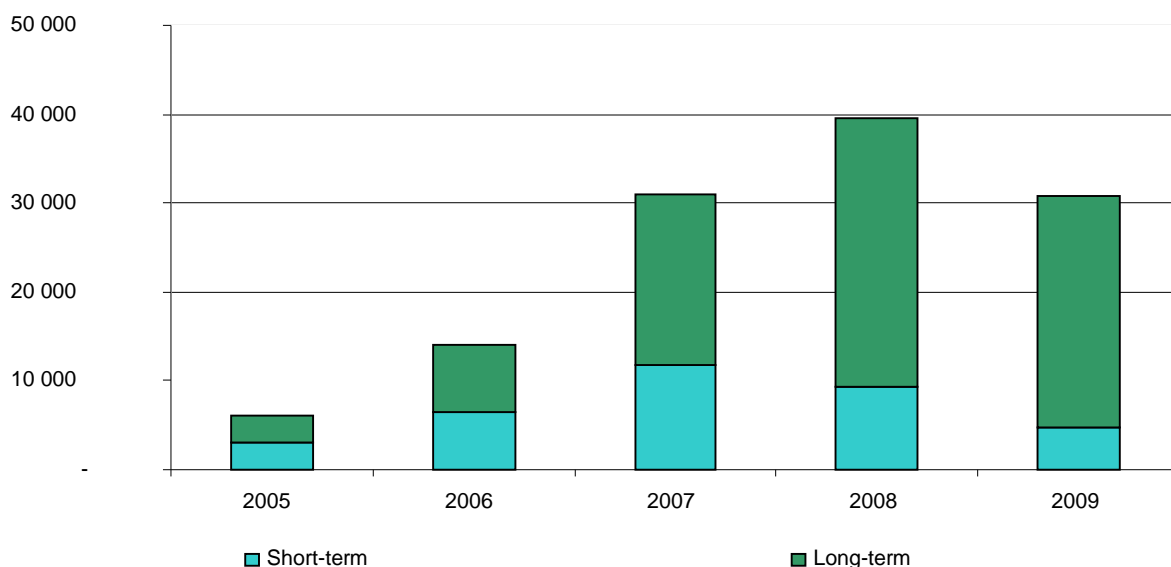
**Exhibit 3. Growth of the Loan Portfolio by Segments, UAH million**

*Source: National Bank of Ukraine*

We should note low vulnerability of Ukraine's banking sector to credit risks pertaining to economy sectors – the principal amount of loans was granted to trading companies (35.8% of non-financial corporates), processing companies (22.7%), and companies engaged with real estate operations (16.8%).

Like in the majority of CIS countries, the Ukrainian banking system has high level of currency risks: as of Jan. 1, 2010 over 50% of loans were denominated in foreign currencies. The financial crisis led to eroded obligors' solvency and depreciation of the national currency, which in its turn prompted severe aggravation in the quality of banks' loan portfolios. During 2009 the amount of trouble debts rose 4 times and amounted to UAH69.9 billion or 9.4% of overall amount of loans (amount of overdue debts was 9.4%). In Credit-Rating's opinion the trend of aggravating asset quality is likely to retain in 2010.

High growth of deposits was recorded in the past few years, though the level of deposits in the country was far lower than lending volumes. That made Ukraine's banking system dependent upon external funding. Under adversities in the financial market and outflow of capital from emerging economies the resources of Ukrainian banks shrunk drastically. We should also note poor public confidence in the banking system resulting in outflow of funds in late 2008 and early 2009 – which made the regulator impose moratorium on early withdrawal of bank deposits.



**Exhibit 3. Foreign Debt of the Banking System, USD million**

*Source: National Bank of Ukraine*

The eroding asset quality and shrinking resources prompted sharp decline in capitalization and liquidity of the banking system. In relation to this the National Bank of Ukraine took measures aimed at stabilizing in the financial market: in 4Q2008 the amount of refinancing was reported at UAH88.66 billion and at UAH64.4 billion in 2009. As of early 2010 the indebtedness of the banking system towards the National Bank was recorded at UAH86.3 billion. Despite all the measures taken by the regulator, some banks failed to restore their solvency that entailed introduction of temporary administrations to the institutions, with 3 banks (Rodovid, Kyiv, Ukgasbank) recapitalized by the state in 2009 for the total amount of UAH19.6 billion. We should also note backing provided by foreign parent banks to their Ukraine-based subsidiaries, which accounted for the major part of foreign direct investments to the country in 2010.

After the financial crisis of 1998 the principal component of Ukraine's credit and monetary policy was stability of the exchange rate. The inflation rates in the country were much higher during 2004-2008 than in countries – key trading partners. This prompted aggravation in competitive strength of Ukraine's economy and deterioration of environment for domestic producers. A sharp decline in export and capital outflow in late 2008 prompted depreciation of the national currency, which was the most severe in the CIS region at over 60%.

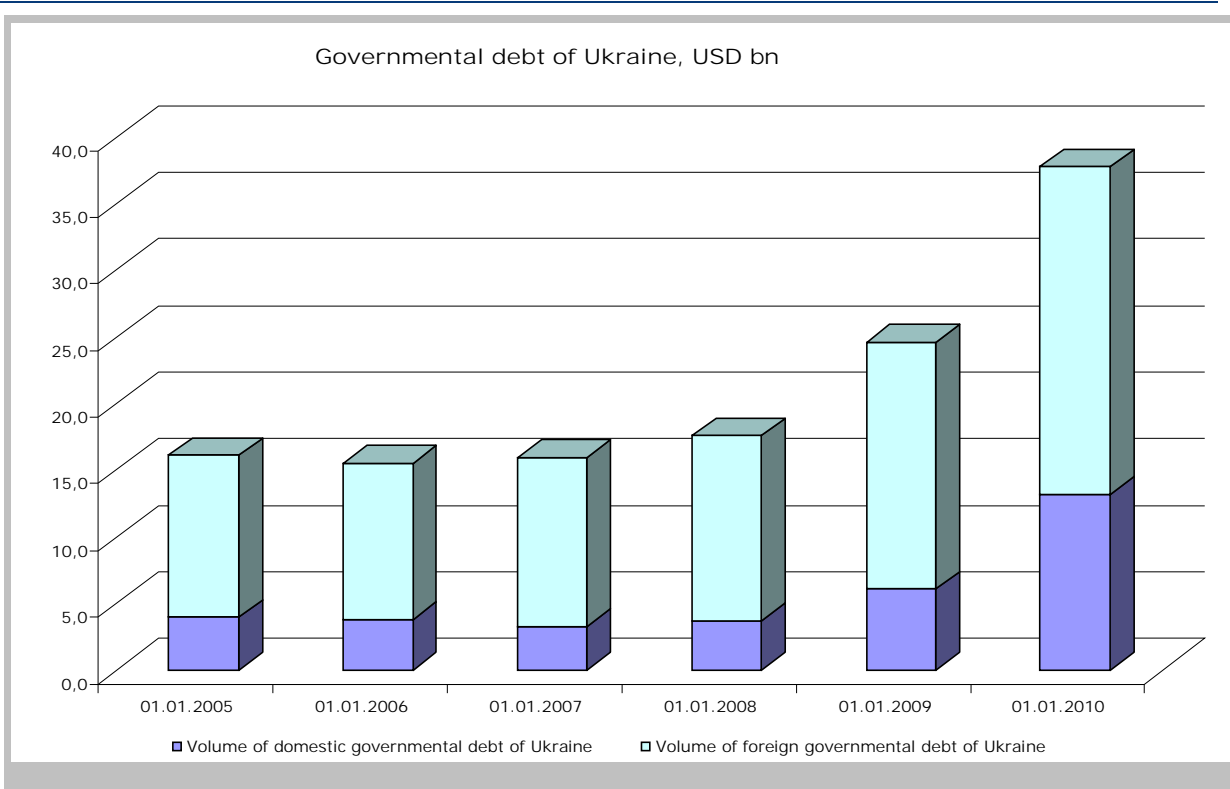
Large amount of conditional liabilities associated with necessity in backing financial sector, combined with weakness of the banking system and low confidence have to a great extent limited creditworthiness of Ukrainian government. Vigorous growth of the banking system in pre-crisis period and high specific gravity of foreign currency-denominated loans prompted severe erosion in its asset quality under impact in external negative factors in 2008-2009. The dependency upon foreign loans and low public confidence triggered a sharp outflow of capital from the banking sector in this period. These risk to a certain degree were compensated for by high specific gravity of foreign capital and backing provided by parent banks to their Ukraine-domiciled subsidiaries. The eroded asset quality and shrinking resources resulted in drastic decrease in capitalization and liquidity of the system. In order to maintain the financial system the Government and the National Bank of Ukraine allocated significant funds, which overall amount was recorded at over UAH170 billion or 19% of the GDP in 2008-2009.



## 5. Governmental Debt Policy

According to the Budget Code, the governmental debt of Ukraine is the total amount of the state's debts, which consist of the issued, but not repaid debt obligations of the state, including debt obligations of the state, which become effective due to issued guarantees to loans and obligations. Limits of the domestic governmental debt and foreign governmental debt are determined by the law on governmental budget for the next financial year. In general, volume of the key amount of the governmental debt shall not exceed 60% of actual annual volume of GDP in Ukraine.

Over 2006-2009, volume of the national government's debt taking into account the debt, secured by the government, showed a trend towards increase – over the past four years the debt increased in 2,4 times (Exhibit 5.1).



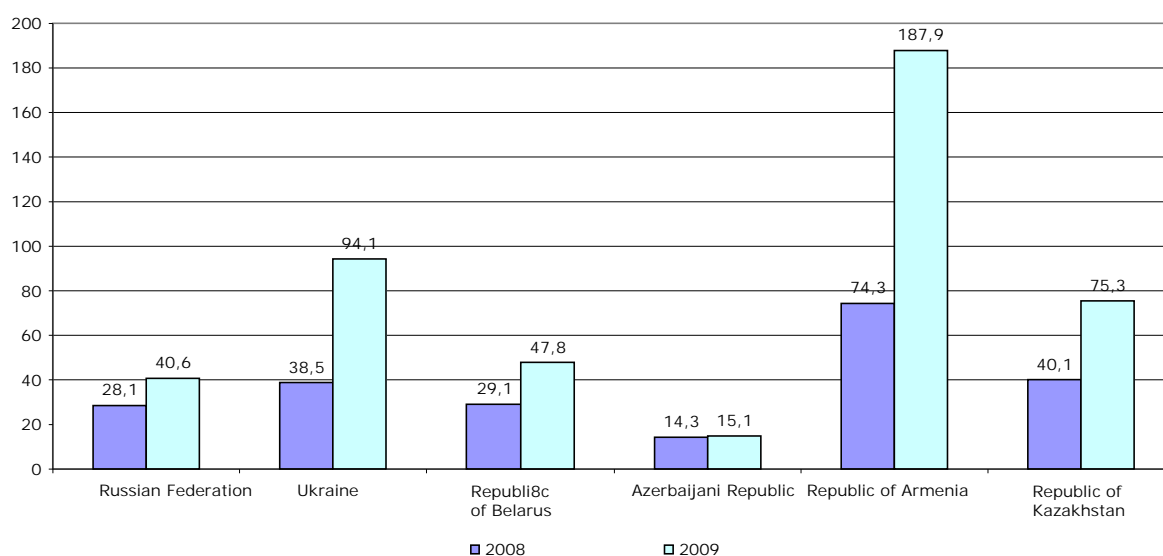
**Exhibit 5.1 Gross debt of the national government of Ukraine, USD bn**

*Source: Ministry of Finance of Ukraine*

Increase of the debt of the national government was supported by structural disbalances in the budgetary and foreign-trade spheres as well as by increase in prices for energy resource. According to the results of 2009, volume of the governmental debt increased by 53,4% up to USD 37 759m as of January 01, 2010, but ratio of the governmental debt to GDP increased by 19,3 p. p. to 32,9%, that was a moderate level. Share of the guarantees of the national government was within 17.9-31.0% in the general debt structure.

Increase of the amount of governmental debt and debt secured by the state in 2009 was provided due to issuance of sovereign bonds to increase the authorized fund of Neftegaz Ukraine NJSC and replenishment of the Stabilization Fund. Besides, the second tranche of the loan from the International Monetary Fund and the first loan from the World Bank were received to rehabilitate the financial sector.

Due to the increase of the governmental debt in 2009, the expenditures of the state budget for governmental debt servicing increased in 2,3 times, compared to the year 2008, up to USD 1,1bn. Share of the expenditures for governmental debt servicing in the expenditure item of the state budget of Ukraine was 3.7% in 2009 that was by 2.2 p.p. more than in previous budget period.



**Exhibit 5.2 Direct debt burden of the national government's budget in certain states of CIS, %**

*Source: according to the information of the Ministries of Finance of the CIS states*

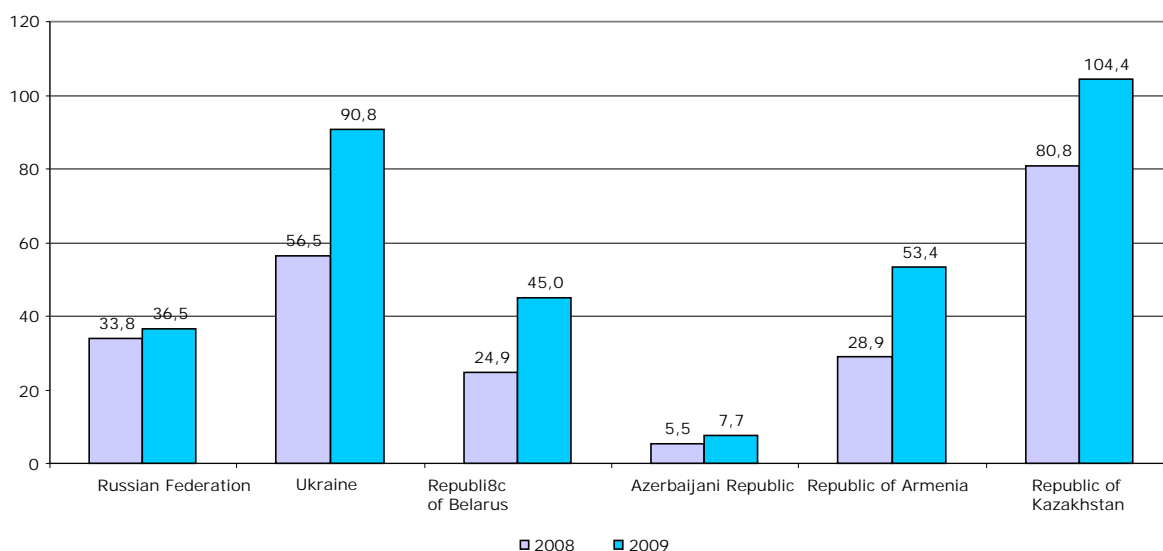
The draft budget for 2010 stipulates further increase of the governmental debt volumes. Particularly, domestic borrowings are expected at the level of UAH 66,2bn (including the issue of sovereign bonds to the amount of UAH 47,9bn for direct budget financing and UAH 18,3bn – for financing of the Stabilization fund). Amount of the foreign borrowings is expected at the level of UAH 34,1bn, including the issue of foreign governmental bonds – UAH 10,4bn, loan of the International Monetary Fund – UAH 16,0bn, loan of the World Bank – UAH 4,0bn, financing of the development projects (loans of the European Bank for Reconstruction and Development, International Bank for Reconstruction and Development, Japan Bank for International Cooperation) – UAH 3,7bn.

Absolute indices of the gross domestic debt of Ukraine over 2004-2009 had a trend to the increase and the growth rate of the foreign debt of governmental authorities was lower than the growth rate of the total foreign debt (except for the year 2009). In general,

volume of the foreign aggregate debt of the state amounted to USD 103 973m as of January 01, 2020 and increased by 2.3% compared to the beginning of the year.

Foreign debt of the governmental authorities amounts to 17,1%<sup>3</sup> in the total amount of the foreign aggregate debt of Ukraine. The key amounts of the foreign governmental debt are the following: sovereign debts of the years 2003-2007 and loans from the international financial organizations.

Ratio of the total foreign debt of the state to GDP (by years) in 2009 increased by 34,3 p. p. to 90,8% that exceeded a threshold value (50-60% of GDP) in accordance with international standards. Ratio of the gross foreign debt to the export of goods and services over 2005-2008 was within 74,2-124,9%, but according to the results of 2009 the ratio increased up to 191,6% (under the critical threshold value of 190%-220%).



**Exhibit 5.2 Ratio of the total foreign debt to GDP in certain states of CIS, %**

*Source: according to the information of the Central Banks of CIS states*

In 2010, ratio of payments for the short-term foreign debt servicing was 36.3% with respect to the export of goods and services in 2009 under the threshold value of 20%. About USD 19.7bn<sup>4</sup> will be used to repay the foreign debt in 2010. At the same time, the state's gold and foreign currency reserves decreased by USD 5bn (or by 16%) up to USD 26.5bn in 2009 as of January 01, 2010 according to the NBU. The reason of reduction was the deficit of current account of the balance of international payments.

In future, we may expect for further increase of the state's foreign debt provided by the increase of amounts of borrowings of the national government due to attraction of the cash funds from IMF and other international financial organizations. The cash attracted

<sup>3</sup> Excluding the loans of the International Monetary Fund, which belong to the debt of the monetary accommodation bodies according to the methodology of IMF

<sup>4</sup> Excluding the percent for foreign debt servicing

will be used to cover the deficit of the balance of international payments as well as to support liquidity of the sector of governmental finance.

The consolidated governmental debt (gross debt) of Ukraine over 2006-2009 showed a stable trend to increase. As of January 01, 2010, ratio of the gross debt of the national government to the state's GDP was 32,9% (moderate level). At the same time, level of the direct debt burden of the state budget was high. The increase in volumes of the governmental debt provided for the increase of a share of the expenditures for its servicing in the expenditure item of the state budget of Ukraine by 2.2 p.p. to 3.7% in 2009 compared to the year 2008.

Excess of the total foreign debt of Ukraine over the threshold values together with a significant share of the short-term debt in the general structure of foreign debts tells us about substantial risks, which limit the creditworthiness of Ukrainian borrowers, including the national government. At the same time, the situation of foreign debt servicing is worsen due to significant reduction of the volumes of foreign economic activities, particularly we can see the increase of a ratio of the volume of payments for foreign debt servicing to the volume of export of goods and services. Over 2009, this index increased up to 36,3% under the threshold value of 20%.

Negative consequences of the world financial crisis, heightened by a short-term nature of the foreign debt of Ukraine, will negatively affect the state's debt steadiness in future. At the same time, insufficient level of balance of the governmental finances will promote active actions of the national government, focused on attraction of the borrowings both in domestic markets and from international financial organizations.

## 6. Plans and Development Trends

Unstable political situation over the past four years, confrontation of governmental branches and as a result inability of the political elites to develop common approach to the long-term development of the country led to the absence of united strategy for social and economic development in Ukraine. Generally, some trade programs are being implemented in the country, but they are not coordinated.

In the short term, activities of the national government of Ukraine will be focused on stabilization of the financial and economic situation in the country and liquidation of the consequences of the financial and economic crunch. At the same time the situation is worsen by high energy intensity of the key export-oriented branches of the industry.

The main project, which is being implemented in the country, is the preparation to EURO 2012. In accordance with the developed governmental program, the national government has adopted the list of investment projects to be carried out over 2010-2012 and which stipulate the capital investments in the objects amounting to UAH 8.8bn. The draft budget for 2010 stipulate the appropriation of UAH 6.7bn from the Stabilization Fund to implement the abovementioned arrangements.

## Conclusion

According to the analysis' results Ukraine has been assigned a credit rating of cisA with stable outlook.

## Appendices

## Sampled Social and Economic Indices of CIS States

	Nominal GDP per capita, USD		Dynamics of real GDP, %		Share of the employed population, %		Average monthly salary, USD	
	2008	2009	2008	2009	2008	2009	2008	2009
Russian Federation	9 994,7	9 104,5	105,6	92,1	48,3	48,9	588,5	622,0
Ukraine	3 913,5	2 488,2	102,1	85,0	45,3	44,3	343,3	238,5
Republic of Belarus	6 217,0	5 029,3	110,0	100,2	47,4	48,6	468,2	348,7
Azerbaijani Republic	5 460,6	4 856,6	110,8	109,3	46,6	48,3	343,0	372,5
Republic of Armenia	3 679,9	2 577,1	106,8	85,6	34,5	34,0	285,6	269,4
Republic of Uzbekistan	1 011,9	1 136,5	109,0	108,1	40,0	40,5	224,0	н/д
Republic of Tadjikistan	691,8	628,1	107,9	103,4	29,3	н/д	67,7	88,7
Kyrgyz Republic	889,6	822,2	107,6	102,3	41,4	н/д	148,3	141,8
Republic of Moldova	1 769,3	1 495,0	107,2	93,4	36,6	33,2	243,2	223,4
Republic of Kazakstan	8 410,7	6 693,3	103,3	101,2	49,7	49,4	494,4	450,9
Turkmenistan	5 969,4	6 290,8	110,5	106,1	н/д	н/д	212,1	221,5

Source: Intergovernmental Statistical Committee of CIS, National Statistical Service, Central banks and Ministries of Finance of CIS states



## Sampled Financial Indicators of CIS States

	Revenues of the State budget per capita, USD		Expenditures of the State budget per capita, USD		Ratio of deficit/surplus of the State budget to GDP, %		Ratio of assets of the banking system to GDP, %		Dynamics of assets of the banking system, %	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
Russian Federation	2 224,9	1 712,0	1 816,0	2 248,8	4,1	-5,9	67,3	75,4	116,0	102,2
Ukraine	954,6	612,8	994,8	659,2	-1,3	-2,2	97,5	109,8	143,6	71,3
Republic of Belarus	2 296,2	1 720,7	2 254,0	1 702,3	0,7	0,4	52,0	63,4	160,6	96,6
Azerbaijani Republic	1 546,3	1 450,3	1 534,5	1 484,3	0,2	-0,7	27,0	33,7	152,8	113,5
Republic of Armenia	792,6	550,7	818,1	671,4	-0,7	-4,7	28,1	42,5	133,1	106,5
Republic of Uzbekistan	322,4	315,2	307,5	328,9	1,5	-1,2	н/д	н/д	н/д	н/д
Republic of Tajikistan	178,2	162,4	198,7	159,8	1,6	0,4	35,8	36,0	111,7	93,0
Kyrgyz Republic	192,0	201,1	185,8	212,0	0,4	-1,3	29,7	34,6	117,9	110,7
Republic of Moldova	395,3	309,5	400,9	392,4	-0,3	-5,5	62,1	60,9	132,5	86,4
Republic of Kazakhstan	1 738,6	1 170,9	1 416,8	1 313,8	-2,1	-2,1	34,7	44,3	128,5	102,9
Turkmenistan	341,3	312,8	288,0	330,0	0,9	-0,3	н/д	н/д	н/д	н/д

Source: Intergovernmental Statistical Committee of CIS, National Statistical Service, Central banks and Ministries of Finance of CIS states

## Sampled Indicators of the Debt Burden of CIS States

	Direct debt burden of the State budget, %		Ratio of governmental debt to GDP, %		Ratio of total foreign debt to GDP, %		Level of coverage of the total short-term foreign debt by international reserves, %		Level of coverage of the import volume by international reserves, months	
	2008	2009	2008	2009	2008	2009	2008	9M 2009	2008	9M 2009
Russian Federation	28,1	40,6	6,2	7,6	33,8	36,5	589,1	859,6	13,9	21,0
Ukraine	38,5	94,1	9,4	23,2	56,5	90,8	155,4	143,4	3,8	6,3
Republic of Belarus	29,1	47,8	10,7	16,3	24,9	45,0	41,9	42,2	1,0	1,6
Azerbaijani Republic	14,3	15,1	4,1	4,5	5,5	7,7	н/д	н/д	10,1	9,8
Republic of Armenia	74,3	187,9	16,0	40,1	28,9	53,4	284,5	388,0	3,8	8,1
Republic of Uzbekistan	32,7	40,2	10,4	11,1	14,4	9,6	н/д	н/д	н/д	н/д
Republic of Tadjikistan	104,4	120,8	26,9	31,2	44,2	49,6	н/д	н/д	н/д	н/д
Kyrgyz Republic	229,0	245,0	49,4	59,9	73,9	78,0	318,0	388,2	3,6	6,3
Republic of Moldova	82,5	124,4	18,4	25,8	67,9	80,6	121,5	94,1	3,5	4,2
Republic of Kazakhstan	40,1	75,3	8,3	13,2	80,8	104,4	171,8	194,1	4,4	6,6
Turkmenistan	н/д	н/д	н/д	н/д	н/д	4,6	н/д	н/д	н/д	н/д

Source: Intergovernmental Statistical Committee of CIS, National Statistical Service, Central banks and Ministries of Finance of CIS states

## Ukraine's balance of payments over 2006-2009, USD (million)

Key items of the balance sheet	2006	2007	2008	2009
<b>Current account</b>	<b>-1 617,0</b>	<b>-5 918,0</b>	<b>-12 763,0</b>	<b>-1 801,0</b>
<b>Balance of goods and services</b>	<b>-3 068,0</b>	<b>-7 876,0</b>	<b>-14 350,0</b>	<b>-2 022,0</b>
Export of goods and services	50 239,0	64 001,0	85 612,0	54 253,0
Import of goods and services	-53 307,0	-71 877,0	-99 962,0	-56 275,0
<b>Balance of goods</b>	<b>-5 194,0</b>	<b>-10 572,0</b>	<b>-16 091,0</b>	<b>-4 655,0</b>
Export of goods	38 949,0	49 840,0	67 717,0	40 394,0
Import of goods	-44 143,0	-60 412,0	-83 808,0	-45 049,0
<b>Balance of services</b>	<b>2 126,0</b>	<b>2 696,0</b>	<b>1 741,0</b>	<b>2 633,0</b>
Export of services	11 290,0	14 161,0	17 895,0	13 859,0
Import of services	-9 164,0	-11 465,0	-16 154,0	-11 226,0
Revenues (balance)	-1 722,0	-2 117,0	-1 540,0	-2 440,0
Current transfers (balance)	3 173,0	4 075,0	3 127,0	2 661,0
<b>Capital account and financial transactions</b>	<b>3 932,0</b>	<b>15 776,0</b>	<b>9 700,0</b>	<b>-11 925,0</b>
<b>Capital account</b>	<b>3,0</b>	<b>3,0</b>	<b>5,0</b>	<b>595,0</b>
<b>Financial account</b>	<b>3 929,0</b>	<b>15 773,0</b>	<b>9 695,0</b>	<b>-12 520,0</b>
Direct investments	5 737,0	9 218,0	9 903,0	4 654,0
Indirect investments	3 583,0	5 753,0	398,0	-63,0
<b>errors and omissions</b>	<b>93,0</b>	<b>-437,0</b>	<b>531,0</b>	<b>656,0</b>
<b>Balance</b>	<b>2 408,0</b>	<b>9 421,0</b>	<b>-3 063,0</b>	<b>-13 726,0</b>
<b>Financing</b>	<b>-2 408,0</b>	<b>-9 421,0</b>	<b>3 063,0</b>	<b>13 726,0</b>
<b>Reserve assets</b>	<b>-1 999,0</b>	<b>-8 980,0</b>	<b>-1 080,0</b>	<b>5 654,0</b>
Use of loans granted by IMF (net)	-409,0	-441,0	4 143,0	1 228,0

Source: National Bank of Ukraine

## Structure of the Expenditure and Revenue Items of the Consolidated Budget over 2007-2009

Indicators	Fulfilled in 2007, UAH (million)	Growth rates to previous year, %	in % to GDP	Fulfilled in 2008, UAH (million)	Growth rates to previous year, %	in % to GDP	Fulfilled in 2009, UAH (million)	Growth rates to previous year, %	in % to GDP
<b>Revenues</b>	<b>219 939,1</b>	<b>128,0</b>	<b>30,5</b>	<b>297 844,6</b>	<b>135,4</b>	<b>31,4</b>	<b>288 579,6</b>	<b>96,9</b>	<b>31,6</b>
Tax receipts, including	161 264,2	128,2	22,4	227 164,8	140,9	23,9	208 073,2	91,6	22,8
Individual income tax	34 782,1	152,6	4,8	45 895,8	132,0	4,8	44 485,3	96,9	4,9
Corporate income tax	34 407,2	131,5	4,8	47 856,8	139,1	5,0	33 048,0	69,1	3,6
VAT	59 382,8	117,8	8,2	92 082,6	55,1	9,7	84 596,7	91,9	9,3
Excise duty from the goods produced in Ukraine	9 072,2	120,0	1,3	10 230,1	112,8	1,1	17 934,5	175,3	2,0
Excise duty from the goods imported in Ukraine	1 495,5	142,3	0,2	2 553,0	170,7	0,3	3 690,0	144,5	0,4
Duty on imports	9 588,9	137,5	1,3	11 932,8	124,4	1,3	6 328,8	53,0	0,7
NTR	48 555,8	119,7	6,7	60 495,2	124,6	6,4	74 048,4	122,4	8,1
Capital revenues	6 373,4	198,0	0,9	6 702,4	105,2	0,7	3 653,1	54,5	0,4
From governments of other states and international organizations	104,5	68,0	0,0	135,2	129,4	0,0	645,3	477,3	0,1
Trust funds	3 641,2	169,5	0,5	3 347,0	91,9	0,4	2 159,5	64,5	0,2
<b>Expenditures</b>	<b>226 035,7</b>	<b>129,0</b>	<b>31,4</b>	<b>309 216,2</b>	<b>136,8</b>	<b>32,6</b>	<b>307 312,2</b>	<b>99,4</b>	<b>33,7</b>
<b>Current expenditures including</b>	<b>187 352,4</b>	<b>124,3</b>	<b>26,0</b>	<b>268 036,7</b>	<b>143,1</b>	<b>28,2</b>	<b>287 334,5</b>	<b>107,2</b>	<b>31,5</b>
Payment for the labor of employees of budget organizations	54 214,2	126,2	7,5	72 969,1	134,6	7,7	79 039,6	108,3	8,7
charge on payroll	18 462,8	152,8	2,6	24 733,1	134,0	2,6	26 921,8	108,8	3,0
Drugs and wound textile	3 220,8	129,2	0,4	4 078,7	126,6	0,4	5 408,9	132,6	0,6
Food stuffs	3 961,5	123,0	0,5	5 516,0	139,2	0,6	6 045,4	109,6	0,7
Payment of communal services and energy resources	6 951,1	135,4	1,0	8 760,4	126,0	0,9	11 215,1	128,0	1,2
Current transfers to population	44 835,8	114,2	6,2	71 406,5	159,3	7,5	75 865,0	106,2	8,3
Governmental debt servicing	3 679,0	107,0	0,5	4 264,8	115,9	0,4	9 783,8	229,4	1,1
governmental	811,3	84,3	0,1	929,3	114,6	0,1	4 894,4	526,7	0,5
foreign	2 867,7	115,8	0,4	3 335,5	116,3	0,4	4 889,4	146,6	0,5
<b>Capital expenditures including</b>	<b>38 683,3</b>	<b>157,7</b>	<b>5,4</b>	<b>41 179,5</b>	<b>106,4</b>	<b>4,3</b>	<b>19 977,7</b>	<b>48,5</b>	<b>2,2</b>
Capital assets acquisition	17 881,9	152,4	2,5	21 363,5	119,4	2,2	10 727,1	50,2	1,2
<b>Lending</b>	<b>1 574,7</b>	<b>-</b>	<b>0,2</b>	<b>2 811,4</b>	<b>-</b>	<b>0,3</b>	<b>2 874,3</b>	<b>102,2</b>	<b>0,3</b>
<b>Deficit/surplus</b>	<b>7 671,4</b>	<b>-</b>	<b>1,1</b>	<b>14 183,1</b>	<b>-</b>	<b>1,5</b>	<b>21 606,9</b>	<b>152,3</b>	<b>2,4</b>
<b>Financing</b>	<b>7 671,4</b>	<b>-</b>	<b>1,1</b>	<b>14 183,1</b>	<b>-</b>	<b>1,5</b>	<b>21 606,9</b>	<b>152,3</b>	<b>2,4</b>
<b>Loans</b>	<b>11 915,1</b>	<b>100,4</b>	<b>1,7</b>	<b>17 917,1</b>	<b>147,5</b>	<b>1,9</b>	<b>98 548,9</b>	<b>550,0</b>	<b>10,8</b>
governmental	3 738,0	235,4	0,5	11 890,1	318,1	1,3	56 580,4	475,9	6,2
foreign	8 177,1	79,6	1,1	6 027,0	71,7	0,6	41 968,6	696,3	4,6
<b>Redemption</b>	<b>6 599,4</b>	<b>66,8</b>	<b>0,9</b>	<b>7 111,6</b>	<b>107,8</b>	<b>0,7</b>	<b>31 394,8</b>	<b>441,5</b>	<b>3,4</b>
governmental	2 495,7	59,6	0,3	4 016,5	160,9	0,4	18 015,0	448,5	2,0
foreign	4 103,7	72,2	0,6	3 095,1	75,4	0,3	13 379,8	432,3	1,5

Source: Ministry of Finance of Ukraine

## Ukraine's governmental debt, USD (million)

Indicator	01.01.2005	01.01.2006	01.01.2007	01.01.2008	01.01.2009	01.01.2010
<b>Ukraine's governmental debt, total</b>	<b>16 096,2</b>	<b>15 474,4</b>	<b>15 949,9</b>	<b>17 573,2</b>	<b>24 598,8</b>	<b>37 732,9</b>
<b>Ukraine's internal debt, including</b>	<b>3 949,6</b>	<b>3 799,9</b>	<b>3 288,8</b>	<b>3 724,2</b>	<b>6 060,7</b>	<b>13 166,3</b>
- governmental debt	3 949,4	3 799,7	3 288,7	3 526,0	5 800,9	11 405,1
- secured debt	0,2	0,2	0,2	198,2	259,9	1 761,2
<b>Ukraine's foreign debt, including.</b>	<b>12 146,6</b>	<b>11 674,6</b>	<b>12 661,1</b>	<b>13 849,0</b>	<b>18 538,0</b>	<b>24 566,6</b>
- governmental debt	8 807,8	8 704,2	9 803,2	10 591,7	11 171,8	15 097,6
- secured debt	3 338,8	2 970,3	2 857,9	3 257,3	7 366,2	9 469,0

Source: Ministry of Finance of Ukraine