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Quarterly Report

Ukraine to Kremlin: Back off

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Executive summary

This is our condensed summary of our macro view for the 2H of 2014 and 2015-16.

***De-facto* war: Ukraine responds to Kremlin military assertiveness.** Ukraine's public and its military have been demonstrating due consolidation, commitment, and courage in responding to the Kremlin's aggressive attempt to destabilise the nation and economy through pro-Kremlin militant action. Our calculations indicate that these militants controlled enclaves of the Donbass region, which in total, accounts for a 2% share of Ukraine's territory. As of 28 July, Ukraine's army has managed to push them back, so that pro-Kremlin militants now control only 1.1%. In spite of continued efforts of the Kremlin to destabilise Ukraine, we expect further gradual shrinkage of this ratio down to nil.

Geopolitics: Kremlin military assertiveness is a long-term game. In our view, the Kremlin is frustrated at failing to herd Ukraine together with Belarus and Kazakhstan into its Eurasian Union in a grouping of would-be client states. Ukraine's example of a successful democracy is highly feared at the Kremlin, so Russia may try to replicate its efforts at tactical domination on the region. However, the key reason for this military assertiveness is domestic economic challenges. A stagnant and unreformed economy ruined Mr Putin’s approval ratings over 2012-13 (see “Kremlin aggression: Is there an end game?” on pp.9). No doubt, the Kremlin has been aware of the core of the macroeconomic problems which have built up over years. However, its governance model has narrowed room for reforms. One of the available and favoured options turned out to be the militarist card. It is convenient because it is popular; it focuses on geopolitical rivalry over a well-known and close territory, winning the hearts and minds of the Russian people. Even retaliation by the West for misdeeds is a positive for Kremlin's domestic position, because it unites the Russian public, which is prepared to suffer sanctions as well as endure the needed economic reforms by the Kremlin. The latter is a key and foundation of the entire Kremlin’s highly aggressive foreign policy. To reform and rebalance Russia’s economy will require a lengthy time period, hence, the subsequent, complicated geopolitical game (a smokescreen) is likely to go hand-in-hand with the Kremlin's incumbents’ regime.

MH17 as a game-changer. Before the MH17 tragedy, the Kremlin intended to play its game in such a way as to avoid full-range sector sanctions (limited sanctions are just fine to Kremlin, they are even welcome). After this event, the Kremlin is ready for harsher sanctions. Indeed, MH17 became a game changer as stakes of the geopolitical game have been raised substantially. The Kremlin's geopolitical game has crossed the point of no return both at home (through inflated nationalism and expectations) and abroad.

Global economy backdrop. In our view, Ukraine's economy, which is itself in recession, sees its key trading partners—the EU, Russia, and China—experiencing recessionary conditions, too. Officially, Russia is thinly escaping recession for the second year in a row. The EU is recovering, but with public debt growing and with still-high dependence on external demand. In China, CNY weakness and PPI deflation, in our view, are symptoms of the recessionary conditions at least in the industrial and export-oriented sectors. In every key trading partner, there is a tendency toward low inflation as well as a weaker currency. (See "Global economy", p.15.)

Ukraine politics: Snap parliament elections ahead, Mr Poroshenko likely to cement power. This fall, snap elections are to be held (likely at the end of October). For the most part, we expect pro-EU parties to shine. New names are expected to emerge, like Andriy Sadoviy, currently mayor of the city of Lviv. In the end, moderate, pro-EU politicians will see prominence, solidifying Mr Poroshenko's course. A return by Mr Yatsenyuk as prime minister has a reasonable chance of materialising. (See "Ukraine's politics: Parliamentary elections anticipated", p.11.)

Ukraine's economy: A deepening recession in 2014-15, growth seen in 2016. There are numerous shocks to the economy evident. They include FX devaluation and sharp consumer and investment deterioration that stems from the Kremlin's de-facto war on Ukraine, which has cost lives of civilians and military as well as destruction of civil and industrial infrastructure. Because of this, we revised downward our growth expectations. This year, a 6.5% like-on-like decline is expected (down from the 4.3% contraction we forecast back this April). We also now think that this year's recession will spill over into 2015, when real GDP is forecast to slide 1.5% YoY. Growth of 3.0% YoY is seen in 2016.

State budget: Further stretching of the deficit. Our downward revision of the growth projection for 2014 yields a further increase in the nominal size of the state budget deficit. It now stands at UAH100bn or 6.4% of GDP (the previous forecast was at UAH90bn; 6.1% of GDP). Central bank participation as a contributor to shoring up public finances—through transfers to budget revenues and buying of domestic government debt—is projected to be even stronger this year than in the previous one. As 2H of this year is set to experience a larger deficit than in 1H, there is a risk of a spill-over effect from the expected central bank activism into inflation area. This risk is accounted for in our inflation projections.

Banking sector and monetary policy: Stress-tested. Banks are in crisis. Our estimate of capital shortage is UAH40-50bn. As of now, authorities show reluctance to expose taxpayers to the recapitalising of private banks. The official stress-testing procedure is still underway. Hence, the actual recapitalization process may go beyond the end of this year. No wonder then that banks will struggle to attract those deposits that left the banks over 1H14. Moreover, there is risk that withdrawal of deposits may last into 2H14. This is a risk of inflation, too. The central bank's monetary policy is in a gradual shift from targeting an FX rate to low inflation, a move that places the bank 'behind the curve', in our view.

Prices: A key macroeconomic risk, in our view. This risk is indeed a major one, next to the erosion of confidence by the Kremlin's military aggressiveness towards Ukraine. Authorities are at ease while projecting inflation in the high-teens this December, assuming it is a by-product of FX devaluation and the unfreezing of regulated tariffs. Our forecast for inflation takes account of this authorities' approach as well as the above mentioned risks (budget deficit, central bank activism through domestic QE, low trust of depositors to banks that remain undercapitalised). Hence, it sees headline CPI and PPI at 17.3% and 20.8%, respectively, at year-end 2014. Inflation is indeed to subside in 2015-16, but at a slower pace than the official forecast. Having inflation at this level, which is quite higher than inflation in key trade partners, results in fast-paced loss of competitiveness of Ukraine's economy.

External balance: Secured by official lending. Our estimate for the external balance (see "External balance: Numerous shocks at play," pp.32) projects a US$2.8bn reduction of the FX reserves at the end of 2014. However, their recovery is seen in 2015. Overall, the balance of trade and capital flows over the three-year period of 2014-16 yields a US$1.0bn build-up in FX reserves. This is entirely due to IMF's programme and other official lenders, a prime contribution to external stabilization of the economy.

UAH: Small undervaluation now, high inflation spells weaker currency ahead. In our view, at this moment the hryvnia is marginally misaligned with its fundamental value. Because of three factors—projected strengthening of USD versus major currencies; higher domestic inflation in Ukraine versus its trade partners; and the Ukraine authorities' striving for growth—hryvnia will be allowed flexibility, which will eventually match its fundamental value plus pro-growth margin. Hence, we forecast the UAH to be at 11.9, 13.0 and 13.8 per USD dollar at the end of each year of the 2014-16 period.

Politics & Geopolitics

In 2014, Ukraine decided to align with the EU by signing the association agreement. Now, however, it finds itself consolidating against Kremlin aggression. The latter ranges from the Crimea annexation to deliberate destabilisation of the country and undermining of its economy by enclaves of pro-Kremlin militants in the Donbass region (which now represents only 1.1% of the entire country, having shrunk over the past month from 2.1%[1]). Newly-elected President Poroshenko performed his duties capably via bringing stability in the Donbass region back to normal. In our view, there are grounds to assume that the Kremlin's geopolitical assertiveness towards Ukraine and what it considers other 'weak spots" on the map will be the new norm.

Rejecting the "managed democracy" model

EuroMaidan underscored several key tenets of Ukraine society today. First, in terms of political process, and in general, it views itself as part of European culture. Second, this suggests that Ukraine's society genuinely rejects the political model adopted by most of the ex-Soviet area, ie, the "managed democracy" model that has been defined, tested and propagated by the Kremlin political spin doctors. Third, being fed up with prevalent corruption among the easy-to-buy politicians, the society has raised up to rectify the situation in order to be governed instead by "clean hands."

While attaching itself to a European identity, Ukraine's public has expressed through EuroMaidan its utmost rejection of the Kremlin's newfound imperialist expansion, which has been masked under the supposition that Russia leads the economic integration process throughout the territory of the former Soviet Union. Late last year, it was Ukraine's society (not mainstream politicians), highly skeptical over the Russian "leadership" in economic integration, that raised itself up from a multi-year slump and dissatisfaction with the outcome of the Orange Revolution outcome. Last November, when then-President Yanukovych rejected the Association Agreement with EU, it was the last straw for the most patriotic segment of Ukraine society, which massed together in Kiev's main streets in a lengthy rally that incentivised the responsible politicians to side with the *vox populi*.

Eventually, the EuroMaidan movement did succeed, as true democratic processes were reinstated. Subsequently, Mr Poroshenko was elected president in a first round of elections which were deemed fair and transparent. Thus, an attempt at imposing a "managed democracy" model on the society failed. Furthermore, it sent the Kremlin's "integration" initiative (the creation of a so-called Eurasian Union) into a murky corner of Ukraine's history.

Europe as Ukraine's natural choice

For the average EU citizen who witnessed the economic malaise of the EU over the past several years, it should be a wake-up call to learn that in Ukraine, ordinary people gave their lives this winter for the sake of alliance with the EU, likely concluding that Ukraine's

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[1] Calculation made as of 18 June, 2014 takes into account the size of the Donetsk and Luhansk oblasts under the control of pro-Kremlin militants (map). Our estimate yielded 13,000 km^2. This share is measured versus Ukraine's entire territory (603,628 km^2), including the annexed Crimea Rep. As of July 28th this area narrowed to 6,424 km^2, according to our estimations or 1.1% of the country's territory.

own economic malaise was much more acute than in the EU. Hence, this could be a rational explanation behind the Ukrainians' determination to continue to feed their still-struggling families at home, rather than flocking *en masse* into the EU to take low-paying jobs, competing with emigrants from other low-income EU member states,.

However, the true reasoning behind Ukraine's pro-European choice is not about easier access and travel into the EU, but rather due to the three simple facts:

First, the nation strives for a fairer (rules-based) social system, which has been associated with the European social model since long ago (before Ukraine gained independence in 1991). There was a telling "tweet" recently by a local reporter, who described the situation as such: "…among those who gave their lives at the EuroMaidan, many have never belonged to the EU." Such is the notion that Europe represents a fairer society and more general well-being. Further, the determination on the part of Ukrainians to promote Ukraine's identity in European has not been (and will not be) dented by the recent economic crisis in the EU. Moreover, it will remain strong, even if the EU's economic problems persist further.

Second, having never been governed by a local monarchy, Ukraine has historically been inclined toward a democratic tradition, whose leaders were elected by the public and not installed by various other methods. Hence, the popular view on the governance of its domestic affairs remains a truly democratic tradition instead of other alternatives, such as "managed democracy."

Third, there is wide-spread and centuries-old skepticism among the Ukraine public over the Kremlin's official rhetoric that contradicts its true intentions. This has its roots in the history of the Russian hegemony over Ukraine's land under the tzars, then the Bolsheviks, then the Soviet communists, and that language has become synonymous with suppression and hardship.

Hence, in sum, the Mr Poroshenko signing of the association agreement with the EU should not be underestimated in assessing the prospects for Ukraine's economy. It is a strong anchor for the public as a whole, and aligns politicians and decision-makers to work together to build a modern, EU-like institutions, eliminate economic mismanagement, and initiate prudent economic management.

Kremlin aggression: Is there an end game?

One of the key questions we have heard from buy-side portfolio managers and analysts regarding today's Ukraine-Russia stand-off has been: What is Putin's end game?

Before formulating the answer, it may be worthwhile to consider another question. Does he even have one?

In our view, the Kremlin's aggression towards Ukraine has arisen not exclusively because of Ukraine's choosing alliance with the EU instead of the Customs Union. Out of all driving causes, Russia's own economic issues have been a key factor, too.

Our view on these issues was explained in detail in the previous *Quarterly Report:* "Ukraine: Global war by other means," which was published on 17 April, 2014. We consider this rationale as relevant today, and expect it to be relevant for at least the next couple of years.

In a nutshell, we argue that there is a macroeconomic foundation for the Kremlin's increased assertiveness in its geopolitics.

The Russian economy has been in a stall since 2012, and this year, it is flirting with recession, which could be confirmed by official statistics later in the year. Poor economic performance had backfired on the Kremlin in 2013, when throughout the year, Mr Putin's endorsement index, which is measured monthly by well-known pollster Levada Center (www.levada.ru), was hovering at a historical low of 24 points (for the first time in January 2013, and the last time in November 2013).

The macroeconomic issues, which must be addressed by the authorities in order to reignite growth (and therefore, the general well-being of the voters) have a complex nature requiring time and political capital to address them.

The Sochi Olympics had just a marginal impact on the public's view on the authorities, as Putin's index rose to 31 points in January 2014, up from the multi-year low seen just a few months before. However, the Kremlin's wide-ranging assault on Ukraine—one that ranged from the Crimea annexation to unmasked attempts to destabilise Ukraine through a miniature army of Russian volunteers, to propaganda portraying Ukraine as a national enemy alongside the West—received a welcome response from Russian voters. In effect, Mr Putin's index soared to 67 points in May. In June, the index is expected to stay in the high 60s, a comfortable level for the Kremlin.

Hence, geopolitics has become the shield that, if properly managed by the Kremlin, would on the one hand allow Russian authorities to maintain a high public approval rating, and on the other hand engineer economic reforms needed to revive growth.

The nature of Russia's macroeconomic challenges indeed require some limits to be imposed on the businesses and households. The soft sanctions by the West, which have been in response to the Kremlin's annexation of Crimea, are doing the job just fine, in our view. Hence, the Kremlin implicitly welcomes soft sanctions.

However, the Russian economy would not dare to experience the harder sanctions promised the West in response to the Kremlin's deliberate, explicit and large-scale invasion into eastern Ukraine's. The so-called sectoral sanctions, said to be devised by the US and untested, would likely be harmful and force the populace to endure economic hardship. On top of this, a broader military campaign by the Russian army would surely yield soldier casualties which would slowly give rise to a lasting discontent on the part of the public with the Kremlin. Hence, the Kremlin explicitly views harder sanctions with disfavour.

That said, Putin's end game is to manoeuvre between these two lines, In our view, moving back and forth while dealing with the "Ukraine crisis" of his own invention, careful not to cross the line triggering harder sanctions, as they would be undesirable. At the same time, he is not concerned about crossing the line would initiate softer sanctions, ie, a reversal of the Kremlin's geopolitical assertiveness towards Ukraine over "Russian speakers" and other sensitive issues, simply because the Kremlin requires some external threat, task, or mission that domestic voters would accept easily and favourably.

Hence, in our view, Mr Putin's end game is maintaining his long stay in power. Out of the possible scenarios, the Russian economy does not promise a favourable boost as the backbone of the current economic model of Russia—the exports of hydrocarbons—which has faltered and apparently worn out. Geopolitics remains the key area, therefore, that is capable of providing the needed boost to Mr Putin's political standing. That is why geopolitical instability is the new norm for Ukraine's economy.

As far as the current battles by Ukraine's army in the Donbas region's few enclaves filled with pro-Kremlin separatists, these are likely to recede towards even smaller enclaves (in just the large cities of Donetsk and Luhansk).

Ukraine's politics: Parliamentary elections anticipated

In our view, despite the Russian aggression, Ukraine's politics have come onto more stable terrain after the ousting of the politically bankrupt ex-president Yanukovych. With the election of Mr Poroshenko last May in the first round, and with the sweeping support of his campaign in every oblast, the politics have consolidated behind his mandate of a comprehensive social and economic overhaul of the country. While the presidency has essentially limited powers in Ukraine, Mr Poroshenko is going to urge early parliamentary elections, as the public demands. It is likely that these elections will take place in the country over the next 6-9 months. Despite the early elections to parliament, in our view, there are grounds to assume that PM Yatsenyuk will retain his post, as his performance so far has been generally strong; hence, he would be provided with the opportunity to continue to reform the economy and execute the two-year programme with the IMF.

How the global economy intervenes in geopolitics

In our view, complicated geopolitics as a prominent feature of 2014 is a product of the changes that the global economy has been still undergoing as a whole.

These changes started to unfold at a quite accelerated pace after the financial crisis of 2008. Some economies led this process; while some were led or forced into it.

The former group of the economies consists of the developed market democracies—the US, UK, and Japan—which have allowed activist policymaking for the sake of reinvigorating their country's economic powers.

The latter group is a mix of developed-market democracies, mainly the EU and its monetary union (the Eurozone), and emerging-markets economies, of which the biggest are Brazil, India, Russia and China (the BRICs).

While the EU, Brazil, and India have foreign-policy agendas that have in practice boasted little assertiveness, the remaining lot of Russia and China are of another sort. These are the nations whose political leaders have quite recently been forced to undergo macroeconomic changes. These nations, too, have suspicions towards the established powers deeply embedded into their national DNA—hence, their nationalistic sentiment is highly sensitive, when they perceive that those powers challenge their sovereign rights.

Political leaders in Russia and China, faced with the challenge of reforming the economy without a loss of domestic credibility, are counterweighing this effort with ambitious endeavors in geopolitics. In the greater geopolitical arena, they have natural rivals and by challenging them, as they perceive it, they drive up domestic approval in a bid to extend their *status quo*—in Russia, that translates to Mr Putin's future presidential term(s). In China, it is still a one-party-rule system.

It is no wonder that both Russia and China, being in dire need of accelerating structural changes in their economies, are playing hardball. The former was waging a tacit war on the part of "Russian speakers" in the "near abroad" states[2] that, according to a Kremlin allegation, was through the whims of the West, while the latter has territorial claims to many neighbors, including Japan, the Philippines, and Vietnam, for starters.

[2] For now, Ukraine only. Later on, it could be other parts of the former Soviet Union like, Moldova or some of the Baltic states.

Meanwhile, Russia's economy has been in a chronic slowdown over the past couple of years, and grapples with the likely future of a crude oil price that will go lower than $100/bbl[3]. This suggests a struggle for President Putin to deliver on all his pre-elections promises of better welfare. China has been in a slowdown, too, and its Politburo indeed struggles with engineering economic changes to retain the 7.5%+ real GDP growth a year to make its vast nation more economically stable.

Table 1. BRIC countries and their economic and military power capabilities

			2011 data		Military manpower (000s)			
Country	**Area (km2)**	**Population (m)**	**GDP (US$bn, PPP)**	**GDP (US$bn)**	**Active military**	**Reserve military**	**Paramilitary**	**Total**
Brazil	8,515,767	199	2,816	2,477	318	1,340	395	2,053
Russia	17,098,242	144	3,217	1,901	766	2,000	474	3,240
India	3,287,590	1,210	5,758	1,864	1,325	1,155	2,288	4,768
China	9,596,961	1,351	13,496	7,322	2,285	510	1,132	3,927
Total	**38,498,560**	**2,903**	**25,287**	**13,564**	**4,694**	**5,005**	**4,289**	**13,989**
BRIC/World (%)	**25.8**	**42.0**	**27.9**	**19.3**	**23.3**	**17.4**	**23.8**	**20.9**
World	148,940,000	6,916	90,647	70,294	20,144	28,815	18,056	67,016

Notes: PPP – purchasing power parity.
Sources: The 2011 International Comparison Program by UN; Global Firepower; Wikipedia.

Is MH17 a game-changer? Implications

On the afternoon of 17 July, the complicated geopolitical game waged by the Kremlin in Ukraine took a peculiar twist.

The tragic loss of 298 civilians of many nationalities on Malaysia Airline flight MH17, apparently shot down by a surface-to-air missile in Ukraine's airspace, may become a turning point in the Ukraine-Russia geopolitical stand-off.

International air security specialists have yet to carry out a complete investigation at the site of the crash. They need to provide the leaders of the countries who suffered losses of their citizens in the jet crash with a thorough accounting. While pro-Kremlin militants control the crash site and are reportedly uncooperative and disturbing vital evidence, the fact that representatives of an international investigative community need full access to the area (with a radius of couple of kilometers) is becoming a political pressure point on the Kremlin and its militant arm in the eastern Ukraine.

There are two major paths which could develop from this point: the Kremlin (read: pro-Kremlin militants on the ground) could cooperate with representatives of the international community on the investigation; or they might not (read: pro-Kremlin militants may damage the evidence and refuse access to the black boxes). In our view, the Kremlin will appear to be cooperative while talking to global powers, while at the same time tacitly allow pro-Kremlin militants the freedom to have free reign on controlling the issue—hence, delaying and complicating the investigation of the jet crash. It may take months for any well-grounded conclusions to emerge (developments over the three days that followed that crash suggest that events will unfold in the latter manner).

Moreover, the Kremlin will not bow to calls, which began right after the MH17 jetliner crash, to cut off supplies to the militants in the eastern Ukraine.

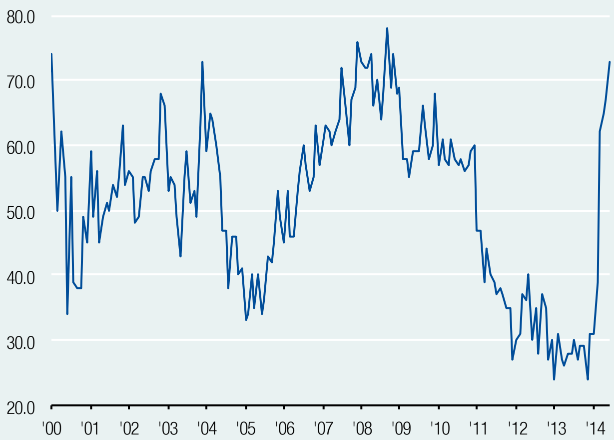
[3] Less than US$100 per barrel.

Hence, the Kremlin is proving that it has strong bonds (liabilities) with militants in the parts of the Donbass region of Ukraine. However, the Kremlin at the same time appears to have no control over two groups in the region as events there are unfolding that seem to have passed the point of no return.

The first of them is the pro-Kremlin militants. Ukraine intelligence points to these as killers of the passengers onboard MH17 jetliner. The US authorities confirm this information with their own intelligence. The western countries whose citizens died in the crash align with this version as well.

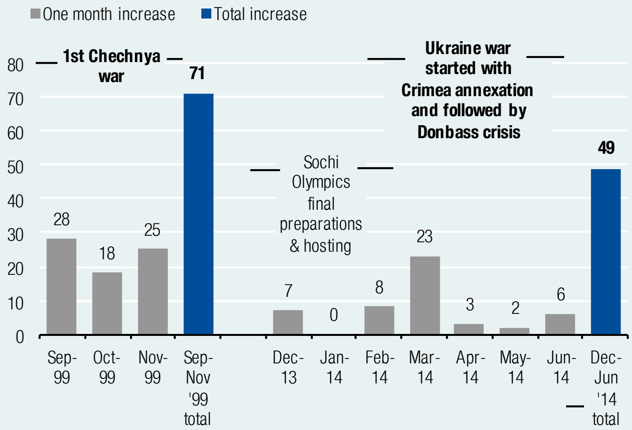
The second is the Russian voters. The Kremlin proved successful in manipulating the media and playing with popular themes while regaining public support. The two charts below clearly depict the Kremlin's underlying forces behind its policies. Mr Putin's entire career as a top Russian ruler had seen just two instances in which his approval rating soared at unprecedented speed[4]. If Mr Putin would have bowed to the West's calls to withdraw support from pro-Kremlin militants in Donbass, he would have lost public support.

Chart 1. Putin endorsement index (points)
History from January 2000 through June 2014



Source: Levada.

Chart 2. Putin's most successful campaigns on gaining public approval: Episodes of the Putin index monthly uninterrupted increase



Sources: Levada, Investment Capital Ukraine LLC.

To summarise, the MH17 jetliner crash is indeed a game-changer. However, it is not a turning point for de-escalation of the Ukraine-Russia military stand-off (read: war). It is a point, after which the Kremlin has no other options but to further escalate the stand-off. This is because its militants in Donbass are supplied with arms while voters at home demand resolution.

For Ukraine, this has the following implications.

First, Russia's political establishment and the public at large agree to endure sanctions by the West, which will increase the Kremlin's assertiveness in its geopolitical game. This should be viewed as the Kremlin's readiness to cross the upper line—to raise the stakes of the game and test the West (US, EU, and others) to impose "sector sanctions."

[4] The first was during his first appearance at the helm of the Kremlin in the fall of 1999, when he led a second war campaign on Chechnya. Then, his approval rating increased from, literally, zero by double-digit rates every month throughout September-November 1999. The second such period of subsequent monthly increases of Putin's approval rating is taking place now and has been on display since December 2013. The Sochi Olympics made some contribution to the trend, however, a more vibrant anti-West and anti-Ukraine democracy campaign defending "Russian speakers'" rights (highly popular among the Russians) was a key factor that propelled his approval rating upward.

Second, the above means that the social and economic shock Ukraine is currently suffering due to its war with Russia is to become worse. Domestic confidence (among consumers and businesspeople) is likely to remain low, ie, no significant recovery is in sight. That would mean that household consumption and business investments are to be depressed. Trade flow with Russia is likely to face more limitations. Trade with other countries is likely to be sluggish, too, as an even more assertive Russia (more so than before the MH17 crash) implies a recessionary wave across the European continent, where Russian capital (from both oligarchs and middle-income people) was previously in play.

Scenarios: Geopolitical spillovers

Our base-case scenario embraces the idea that the MH17 jetliner crash is a game changer that has unexpectedly pushed Kremlin to playing by a more hard-line script than before. Hence, it would take more resources (human and capital) for the Ukraine army to sustain a lengthy and successful campaign in Donbass and eradicate the militants. The Kremlin, which is ready to cross (or rather has crossed) the line in facing more severe sanctions by the West, is likely to keep destabilising Ukraine by all available means over the next few years and unfold a series of surprise events in geopolitics, domestic politics, and in the economic sphere. The West's reaction to the MH17 crash and to the Kremlin's increased assertiveness is still fragmented[5]. Hence, the Russian economy appears mostly unaffected: it is to register a mediocre growth rate in 2014 (well below 1% YoY, while our forecast is 0.2% YoY). But, this is fine with the Kremlin, as such still soft sanctions by the West will allow and even assist it in carrying out its unpopular economic reforms.

In our worst-case scenario, the Kremlin crosses the red line, is hit with harder sanctions by the West, and stages a military intervention into mainland Ukraine of a larger proportion than before (or a second military intervention into Ukraine's territory in 2014, after the Crimea annexation) aimed at creating the same kind of republic it now maintains in Georgia and Moldova out of Donbas. In that case, Kiev would lose control over this territory (presumably all of Donbass). Then, as the consolidated West (the US, EU, and other developed-economy countries) dares to impose harder sanctions ("sector sanctions) on the Russian economy, the Kremlin would further step up its aggressiveness towards official Kiev by trying to spawn a separatist movement in other oblasts on the Ukraine's south and east, such as the Odessa and Kharkiv oblasts. This scenario purports a messy development—a full-on, raging war between the Ukraine and Russia military—that would cause both nations to suffer deep recessions. Other parts of the region, like Belarus and Kazakhstan, which are heavily dependent on Russian demand, would follow suit. The Eurozone economy would also therefore see a sharp contraction of demand for produce from Russia, with a noticeable a recession to follow in this region.

[5] Even after adoption of the wider sanctions by the EU, and then the US on 29 July.

Global economy

Complicated geopolitics have engendered downside pressure on growth of the economies near the Ukraine-Russia stand-off, primarily the EU. Meanwhile, our view on the global economy rests on a range of expectations about a dearer US dollar value versus the currencies of major global economies. Steadily recovering growth in the US, while still at a sub-par level, is still ahead of the Eurozone's economic sluggishness, which is expected to be protracted. Due to China's visible tendency to restructure its economic model, we forecast no pick-up in the global steel prices from today's level. Due to ongoing complications in geopolitics, which involve oil-producing regions like the Middle East, a crude oil price reduction a bit below US$100/bbl is forecast to take place not this year, but likely in 2015. In Russia, authorities are engineering ways to fix their own economic model. The existing issues before the Kremlin are many and complex. Luckily, Russia's public balance sheet is strong, and therefore, the markets will not force an outright macroeconomic correction there. This allows the Kremlin to focus on managing the process of a macroeconomic correction, a process likely to be lengthy, at least a couple of years, in our view. Along the way, real GDP growth in Russia is going to be sub-par (less than the 4% YoY it was targeting back in 2012), the taming of inflation will not be a strong point of the economy, and the value of Russian currency will be allowed to fluctuate more widely than now, resulting in a gradual weakening of the RUB towards 40/USD.

Macroeconomic conditions in key economies

Given our considerations of geopolitics (above), there is sizable risk at play that the global economy will suffer a slowdown from the Ukraine-Russia stand-off that is engendering more and more casualties as well as narrowing the possibilities for de-escalation. Even without this crisis, macroeconomic conditions globally have been quite complicated due to unsynchronised policymaking and an uneven pace of recovery.

US

For at least the past year, our view was that US economy should be recovering steadily, allowing the foundation for the Fed to complete QE tapering later this year and starting to raise the key rate next year. Taking this into account, we expected that US Treasury yield curve would go up (thus, 10-year note yield would go beyond 3%) and this would boost US dollar value versus the major currencies.

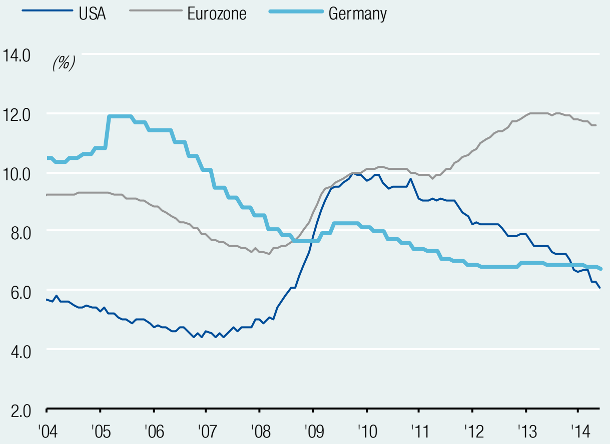
However, 1Q14 was weak in the US (officially -2.9% annualised) due to, as reported, unnaturally cold winter. Market expectations for the US economy were trimmed recently, indicated by the yield of 10-year Treasuries, which has been flocking around 2.5%. Despite strong monthly jobs reporting which revealed unemployment rates in the US economy as low as 6.1% at the end of June, the Fed remains rather cautious and promises rates will stay low in order to preserve financial stability and sustain recovery.

This could serve as an explanation as to why the US dollar value as tracked via the USD index (Bloomberg: DXY) has been glued to the 80-points line for the last 2.5 years. The long-anticipated recovery of the US dollar has failed to materialize, and the current expectation for real GDP growth in 2014 has been trimmed to below 2%, while back in the beginning of this year it was in the 2.7-2.8% range.

This said, however, we stick to the view that the outlook for the US dollar is to appreciate gradually, with growth expected to return in 2Q14. The Fed should gradually accommodate expected incoming positive data and begin to worry less about financial stability with respect to a new increase in the key rate.

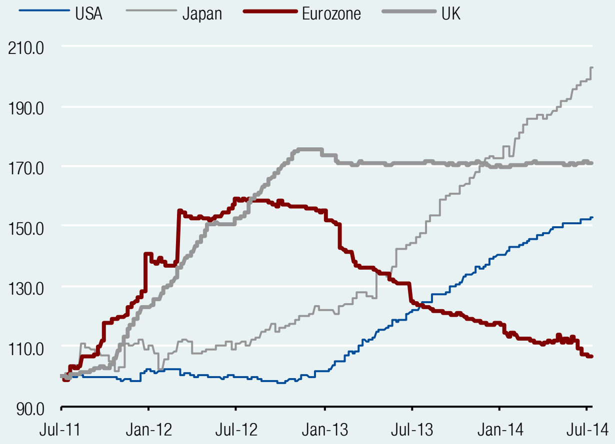
Moreover, the Eurozone economic conditions require a more activist ECB, a positive for the USD, allowing us the grounds to forecast a stronger greenback versus the key currencies going forward, ie, later on in 2H14 and 2015.

Chart 3. Unemployment rates in USA, Germany and in the Eurozone as a whole (%)



Source: Bloomberg.

Chart 4. Relative size of the major global central banks rebased at 100 points as of June 2011



Source: Bloomberg.

Eurozone

There have been two key underlying problems causing the Eurozone's ongoing sluggishness.

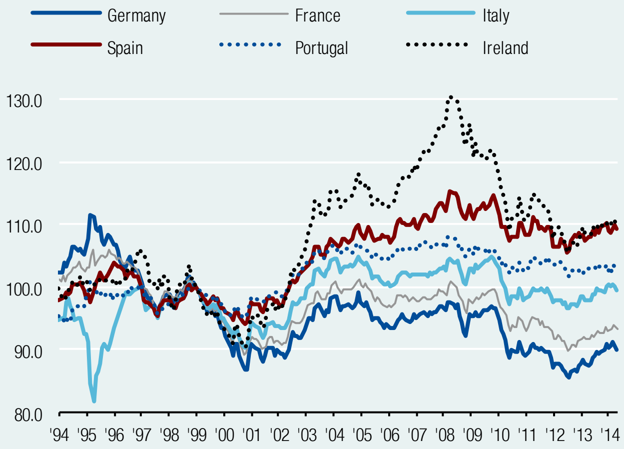
First, is the competitiveness divergence between member states, where on one side of the spectrum, there are crisis-prone economies, while Germany is on the opposite side. Over the 1H this year, this issue did not evolve in a healthy direction, as the divergence widened instead of narrowing, as it should have done. Thus, Germany's real effective exchange rate, a measure of competitiveness that is reported by the BIS, declined 0.9% over the January-May period. Italy's and Spain's declined, too, but at a slower pace – by 0.4% and 0.8%, respectively. It should be noted here that in Eurozone history, competitiveness convergence has usually been a painful exercise, and hence a rare, short-lived episode and thus incomplete, with its members mainly diverging since the single currency inception in 1999. Going forward, the required convergence of a sensible dimension is still unlikely.

Second, it is external demand on which Germany, the EU's economic backbone, depends. While demand from the US and UK promises to recover—as these economies have been pulling themselves out of the past crisis at an accelerated rate—there is an emerging-markets demand that has been stagnant recently. BRIC as a whole, a key bloc of the EM space, is undergoing fundamental macroeconomic changes, a lengthy process that has not reached the equator yet, in our view. Overall, net exports as a driving force of the Eurozone economy is gradually wearing out.

Hence, the Eurozone as a whole will enjoy just sub-par real GDP growth rates in the coming few years, and economic policymakers (ECB and national governments) will be challenged to engineer an overhaul of the Eurozone's model. There is an increased expectation that ECB will act, starting in 2H14, to defuse deflation risk, reversing the trend of *de facto* contraction of its balance sheet, as compared with other major global banks (see Chart 4, p.16). A weaker EUR is forecast to be a by-product of this monetary action.

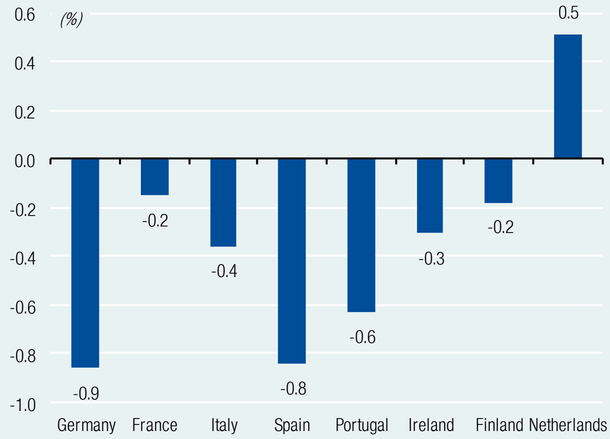
In our base-case scenario, the single currency weakens to 1.34 at the end of 3Q14 and further down, to 1.32, at the end of this year. Then, in the second half of 2015 the EUR's exchange rate versus the US dollar is assumed at 1.28 (see Table 2, p.9). Also, the Eurozone's inflation is forecast to recover from the current 0.5% YoY toward the target area of 2% over the course of 2015-16.

Chart 5. Eurozone selected economies' real effective exchange rates: History from January 1994 through May 2014
Rebased at 100 as of January 1999



Source: BIS.

Chart 6. Eurozone selected economies' real effective exchange rates: Percentage change of May 2014 to December 2013



Source: BIS.

China

In China, the presence of producer price deflation alone, spanning from early 2012 and still running at 1.1% YoY this June, suggests that profound changes are taking place in the second-largest global economy. There is still stellar real GDP growth rate of above the 7% YoY level recorded in 1Q, firming up expectations that over the next few years, it will be sustained, albeit at a marginally lower pace. According to Bloomberg, the consensus forecast for 2014 is +7.4% YoY and +7.2% YoY a year in 2015 and 2016, respectively.

Meanwhile, headline consumer inflation has been hovering at 2.5% YoY recently, suggesting that the much-talked-about rebalancing of the economy (from net exports and fixed investments towards consumption) takes place and is traceable in the statistical numbers. Reduction of the current account surplus to as low as 1.95% in 2013 could serve as a confirmation of the process under way.

However, in our view, the Chinese leaders would be focused much more about retaining social peace than about the speed of rebalancing the economy. Hence, we consider CNY weakening, as observed over March-April, which is officially presented as a step forward for FX market liberalisation, as a supplemental process to the ongoing structural changes taking place in the economy. We read these development in the following way: Chinese authorities are unable to tolerate further current account surplus contraction, and moreover, allow it to shift into deficit. Hence, its vast exports-oriented factories and their mass employment will suffer due to loss of competitiveness. We are therefore inclined to accept the market economists' forecast of China's current account deficit this year and next of 2.2%, up from 2013's 1.95%.

While the FX market saw local currency gains over June, we consider that the CNY will be allowed to trade lower than in the stronger forecast for the CNY value to the US dollar of 6.05, much lower than the forecast of 6.25-6.30 in the next 12 months. Moreover, the weaker currency would likely eliminate PPI deflation.

Russia

In Russia, Kremlin policymakers succeeded in inserting geopolitics, which breeds increased trade-protectionism and reliance on domestic product into the domestic economic toolkit. After a grand slowdown in 2013, when real GDP slowed to 1.3% YoY after 3.4% a year before, this year's consensus forecast is well below 1% for the entire year. A more detailed analysis of the economic performance in 1H indicates that Kremlin policymakers, according to their own statements, are thinly escaping recession. After 1Q, when the economy contracted in seasonally adjusted terms by 0.3% over the 4Q of 2013, it reportedly stayed flat in the 2Q as compared to the previous quarter.

Based on such a performance, we upgrade our view on Russia's real GDP growth this year to 0.2% YoY in our base-case scenario, from the 0.4% contraction we sought in our previous publication. This factors in that the Kremlin and the West are finding a delicate balance between the former's assertiveness in the so-called “near abroad" and the latter's reluctance to imposing sanctions on Russia’s violation of international law. As we pointed out above, the Kremlin’s strategy, while actually invading Ukraine, is not to cross the red line of harsher sanctions. At the same time, we believe it is not going to drop its current practice of destabilising Ukraine. This is because it is maximising prospects for a positive effect on the domestic economy; Western soft sanctions allow the Russian economy to experience a needed jolt, while harder sanctions would result in greater harm to the Russian economy.

This said, however, we still view a number of fundamental weaknesses in the Russian economic operations, all of which were chronicled in our previous *Quarterly Report* “Ukraine: Global war by other means” (17 April 2014). They still are relevant today. In short, we think that outsized political promises for improved social welfare on the part of the Russian government came hand-in-hand with a too-optimistic view on the economy. We regard this outcome as a miscalculation in the Kremlin’s policy. They raised the stakes of their game this year by playing the geopolitical card, which leaves ordinary people suffering and others losing their lives in the Ukraine's two eastern oblasts. While Russian voters wholeheartedly support the endeavour, the Kremlin policymakers gained only some breathing space for a patchy job of repairing the economy. The remedial work is going to be quite lengthy, because the authorities cannot fix the issues once and for all, nor quickly. That is why we tend to think that if the West continues to underestimate the Kremlin’s underlying issues over its brutal policy toward Ukraine (in fact, this is part of our base-case scenario), then the Kremlin would likely continue to exploit its current policy toward Ukraine over an extended period of time (at least for this year and the next).

Meanwhile, the key underlying issues in Russia are its too-high inflation, a tight labour market, and an uncompetitive exchange rate of the national currency. In our view, a tight labour market (with the most recent reading of the unemployment rate at 5.4%, a better reading than before the 2008 crisis), contributes a lot to the stickiness of the headline inflation. It also results, in our view, in increased passing through from the exchange rate decline to consumer price increases. After all, the Russian central bank operates a monetary policy in which national currency has been persistently positively misaligned[6] over the past 10 years, with a short break in 2009, right after the financial crisis of 2008.

These are issues that are impossible to correct swiftly. Our take is that the Kremlin is set for a gradual and managed correction of the macroeconomic issues at hand. Thankfully, the Russian public balance sheet is strong—bolstered by a low debt level and awash with

[6] Positively misaligned currency means overvalued currency.

hydrocarbon export proceeds, while the crude oil price is above US$100/bbl— allowing it to focus on engineering a correction, and it is free from market pressure to correct.

All in all, over our forecasted period of 2H14 and 2015-16 we tend to forecast low real GDP growth for Russia (because of this gradual approach to fixing the issues and lack of market pressure), consumer price inflation ranging in 5-7% YoY and RUB's nominal exchange rate weaker than it trades now.

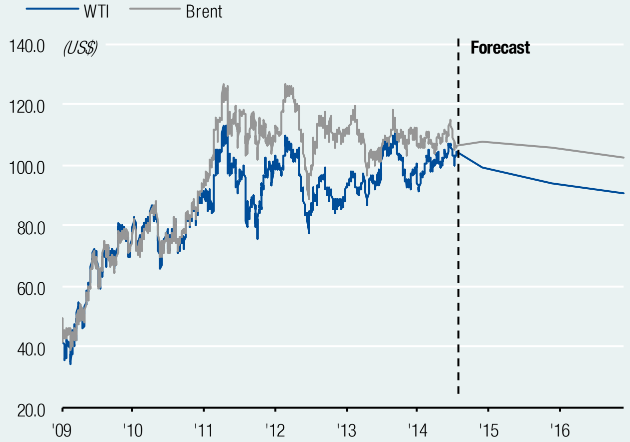
Commodities vital to Ukraine

Due to an increased level of complications in global geopolitics, ranging from Russia's "near abroad" to the Middle East region, oil producers are likely to enjoy this year as another 12-month period when the crude oil price remains at a historically high level. Our view on the crude price that is incorporated into our three-year forecast for 2014-16 assumes that at on a base-case scenario, crude oil (WTI) drops in 2015 to US$97.7, and then to US$92.8 in 2016 (see Table 2, p.20).

Our view on Ukraine's export steel prices incorporates the expected path of the global economy and China in particular. Both are expected to be subdued if compared to 2010-11, when economies were in rebound from the great financial crisis of 2008, thanks to massive stimulus by developed and emerging markets. The next couple of years are expected to see non-synchronised growth paths between key developed and emerging markets. As far as China is concerned, its own structural changes leave little chance for creating a steel demand increase, which would have lifted global steel prices. Hence, we forecast steel prices for Ukraine's exports to flat line (see Table 2, p.20).

Chart 7. Crude oil price (US$ per barrel)

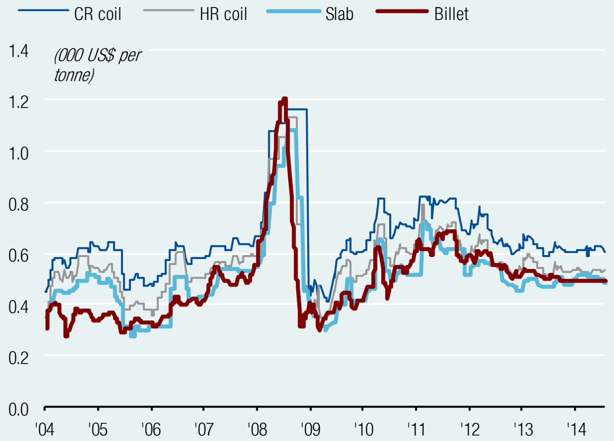
Spot and futures market daily quotations



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 8. CIS export steel prices (US$ 000s per tonne)

Quarterly averages



Sources: Bloomberg, Investment Capital Ukraine LLC.

Table 2. ICU's 3-year quarterly and yearly forecast for the global economy's key indicators vital to Ukraine's economy, according to our base-case scenario

			Quarterly forecast										Annual forecast		
	1Q14	2Q14	3Q14F	4Q14F	1Q15F	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F	2014F	2015F	2016F
World real GDP[1]	3.4	3.4	3.4	3.4	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	3.4	4.0	4.0
Russia real GDP[1]	0.9	1.2	-0.5	-1.0	0.0	0.5	0.5	1.0	1.5	2.5	2.5	2.5	0.2	0.5	2.3
Crude oil (US$[2])	98.7	102.8	102.0	101.0	99.8	98.6	97.4	95.0	94.2	93.4	92.6	91.0	101.1	97.7	92.8
Steel (US$[3])	531.0	532.0	495.0	500.0	508.0	534.0	534.0	534.0	534.0	534.0	534.0	534.0	514.5	527.5	534.0
EUR/USD (eop)	1.37	1.37	1.34	1.32	1.30	1.29	1.28	1.28	1.28	1.28	1.28	1.28	1.32	1.28	1.28
USD/RUB (eop)	35.17	33.98	36.00	36.50	37.00	38.00	39.00	39.50	39.50	39.50	39.50	39.50	36.50	39.50	39.50

Notes: [1] real GDP growth rate to previous year; [2] crude oil price is WTI crude and priced as per barrel; [3] steel price is HR coil price and priced as per tonne;
[4] crude oil and steel prices are the average for the period.

Source: ICU.

Ukraine's economy: Update

Ukraine's economy is forecast to experience a quite protracted recession, which is to last through 2014 and into early 2015. Overall, we reviewed downward the pace of real GDP contraction in 2014 from 4.3% YoY (April's forecast) to 6.5% YoY now. In 2015, there is still contraction of the economy of 1.9% YoY, followed by +3.1% recovery in growth in 2016 only. Budget deficit is on the rise this year amounting to 6.4% (ex-Naftogaz). In the face of a gaping budget deficit due to the underperforming economy, the key burden of propping up the economy is falling on the shoulders of the central bank, which is expected to continue domestic quantitative easing (QE) increasing its holding of government debt. The banking sector has been hit hard by this year's adjustment; hence, required recapitalisation to the tune of UAH40-50bn and depositors trust is low. In this light, we see increased risk of inflation acceleration from current near 12% YoY for headline CPI and 15% YoY for PPI towards 17% YoY and 20% YoY this December. This inflation shock is expected to abate by mid-2015. With domestic inflation running ahead of key trading partners, a factor that is coupled with prospects of the US dollar gradual strengthening, Ukraine's currency, the hryvnia is forecast to weaken marginally from early 2015, while the UAH's FX rate is forecast to be at 11.9, 13.0 and 13.8 per US dollar, respectively, at the end of each year during the forecast period of 2014-16.

Economic activity taking a hit due to FX adjustment and Kremlin invasion

In our last *Quarterly Report* "Ukraine: Global war by other means" (published on April 17th), we assumed that the Kremlin would consider replicating the Crimea annexation with other oblasts of Ukraine, mainly on the east. Then we considered the three oblasts of Kharkiv, Donetsk and Luhansk as most vulnerable. At the same time, we assumed also that the Ukraine government's willingness to fight the aggressor with arms (not like in Crimea, when the army was ordered to keep calm in the face of an invasion of the Russian army and special forces).

In reality, it turned out, the Kremlin's aggression was limited to invasion by small-scale battalions of the Russian "volunteers," and failed to cover that entire region; the Kharkiv oblast was left unscathed from invasion by these Kremlin's special forces, while the Donetsk and Luhansk oblasts fell victim to them, where enclaves of "no-official-rule" were spawned. The Kremlin miscalculated the level of support its policy garners among the population on the ground. Hence, the Kremlin's aggression into Donbass lost steam. Moreover, Ukraine's army has consolidated and has been staging a special operation on cleaning these enclaves of the pro-Kremlin militants. It freed the city of Sloviansk, once a stronghold of the pro-Kremlin militants. Then, it encircled the remaining enclaves of pro-Kremlin militants in the larger cities of Donbass—Donestk and Luhansk—including the neighboring districts (in total, these account for 2% of Ukraine's territory).

The statistical data available for 2Q reveals that retail trade and passenger transport are the most severely hit sectors of the economy. The key reasons behind their collapse—as shown on Chart 11-Chart 12, p.23—are: first, currency devaluation impacted the purchasing power of the households in general and particularly in relation to purchasing imported goods; and second, passenger transportation took a severe hit, too, which is attributable to a large extent to the annexation of Crimea (which used to accommodate mostly Ukrainians from the mainland); and then, third, *de-facto* war in Donbass. In June, the monthly volume of retail trade[7] was down 10.6% compared with the same month a year ago. Over the same time frame, passenger transportation turnover[8] dropped 31.2%.

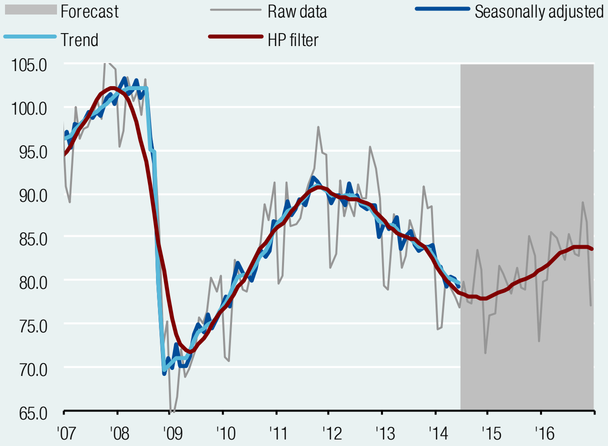
Meanwhile, the available data on industrial production shows that the (entire industrial) sector has been down, too. However, it has been in a protracted decline for a couple of years before and this year the trend continued (see Chart 9, p.22). Due to this factor, the sector appeared a bit more resilient than retail trade and passenger transportation. Thus, industrial production index contraction amounted to 4.7% YoY in 1H14. For the second half of this year we expect recession, and geopolitical shock will take its toll on the sector, hence, the decline is set to extend. Full-year contraction of the sector is forecast at 8.5% YoY. In the following years of 2015-16, the industrial production index is seen to increase 2.0% and 5.0% respectively.

In conformation of the thesis that households were more vulnerable in the current economic and geopolitics crisis, there is data on cargo transportation turnover[9] showing that in 1H14, it declined by just 0.7% YoY, while in June alone, it rose 1.5% YoY.

At the same time, statistical data on industrial orders (Chart 10, p.22) revealed that they were on the rise in May, as both domestic and foreign orders rose[10] by 6.7% and 22.1% YoY, respectively. It is noteworthy that foreign orders in particular have been on the rise since April (when they added 18.4% YoY). During the 1Q, foreign orders were declining. Hence, an on-year increase in foreign industrial orders during April-May could be an indication that the currency devaluation did have a positive impact on the economic activity, as foreign demand is gradually returning.

Chart 9. Industrial production index: history for 2004-13 and 1H14 and forecast for 2H14 and 2015-16

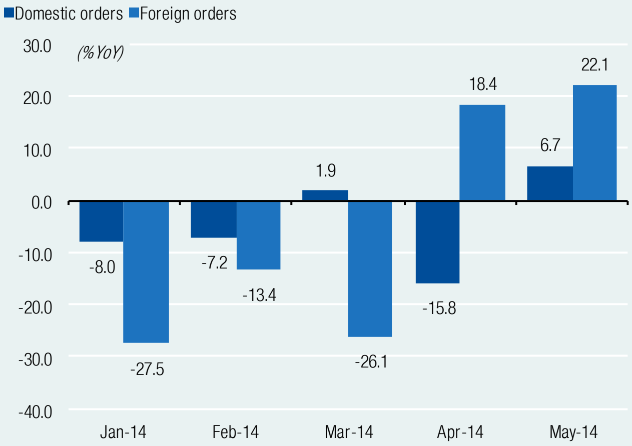
History from January 2007 through May 2014



Sources: States Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 10. New industrial orders on-year change of monthly volumes (% YoY)

History from January 2014 through May 2014



Sources: States Statistics Service of Ukraine, Investment Capital Ukraine LLC.

[7] In constant prices and in seasonally adjusted terms.

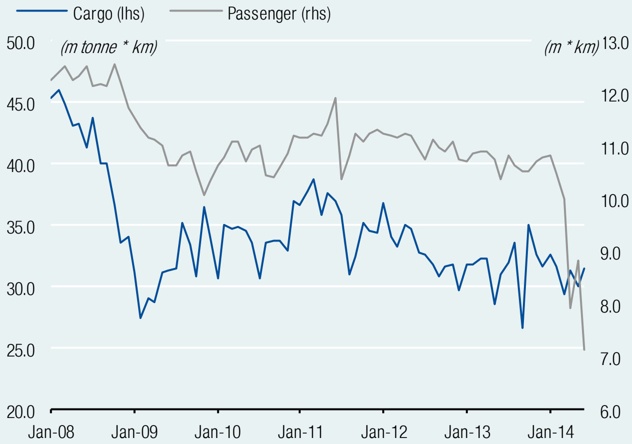
[8] Measured in passenger-kilometers. Monthly data is seasonally adjusted.

[9] Measured in tonne-kilometers. Monthly data is seasonally adjusted.

[10] In nominal terms, not seasonally adjusted.

Chart 11. Transportation turnover, seasonally adjusted data

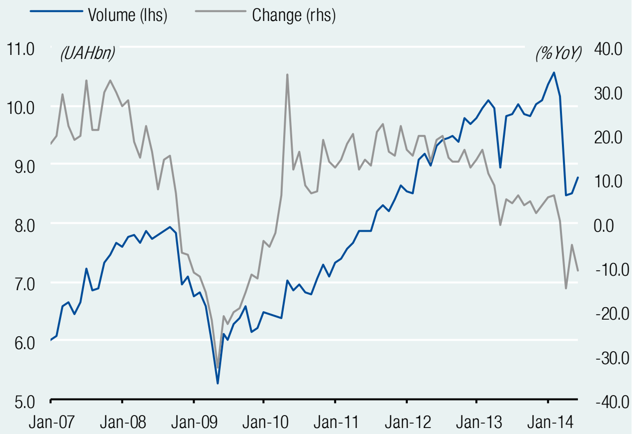
History from January 2008 through June 2014



Sources: States Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 12. Retail trade turnover, seasonally adjusted data

History from January 2007 through June 2014



Sources: States Statistics Service of Ukraine, Investment Capital Ukraine LLC.

In general, we view this year's economic activity as mired in a sizable recession. Our base-case forecast of full-year real GDP contraction amounts to 6.5%, of which 1.1% on-year decline in 1Q was followed by an estimated drop of 5.6% in 2Q and over 2H economic contraction likely to be at 9.5% YoY. Next year, we revised our view from 2.0% YoY real GDP increase to a contraction rate of 2% YoY, because we see there are downside risks mounting over the economy from the banking sector side, accelerating inflation and prolonged Kremlin military aggression, which seeks to keep Ukraine as destabilised as possible. Only in 2016 do we expect a more meaningful recovery from this macroeconomic shock which we currently observe; one that would amount to 3% real GDP increase.

In our worst-case scenario, the Kremlin would massively escalate the war in Donbass by massing more troops there and hence urging the West to introduce sectoral sanctions on the Russian economy, which would aggravate its current conditions and eventually result in a lasting recession of the economy. For sure, the Kremlin would retaliate against the West by further aggravating its stance on Ukraine waging a full-blown offensive with an aim to extend the Ukraine's territory under war closer to Kiev. At this point, Ukraine's economy would be devastated (in 2014-15 real contraction of the economy would amount to 20-30%) and hence economic hardship would be pervasive as most resources—human as well as capital—would be channelled to defence. Under this scenario, the Kremlin would indeed impose an unofficial depression union, in which the Russian economy, itself in recession, on par with a depression shock, would absorb Ukraine and other economies that largely depend on trade with Russia (namely, Belarus and Kazakhstan[11]). Similarly, the EU would run a high risk of slipping into recession again, as demand for its exports from Russia would decline.

[11] Kazakhstan is mentioned here to indicate its high dependence on the Russian demand for its produce, excluding exports of hydrocarbons.

Public finances: A bouquet of shocks on display

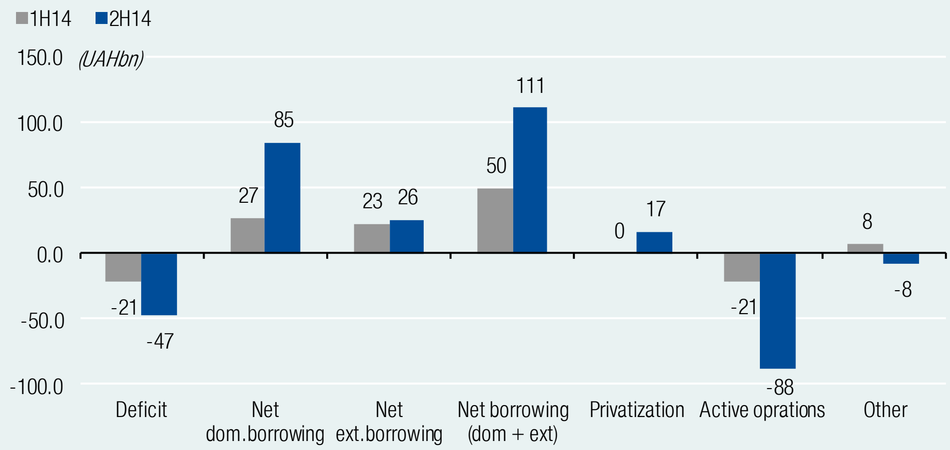
Our revised forecast of the real GDP change in the 2H of 2014 shows an increase in the central government budget deficit[12] of 0.3ppt. Back in April, our forecast of a full-year budget deficit stood at 6.1% of GDP (UAH90bn). Now, it is revised up to 6.4% of GDP or UAH100bn.

Total financing needs for the government for this year amount to UAH209bn, or 13.4% of GDP (as a reminder: in 2013, the government's total financing needs amounted to UAH146bn or 10% of GDP).

The government has filed with parliament amendments to the 2014 state budget law and they are likely to be adopted[13]. These amendments do not envisage a change of the size of the deficit (UAH69bn). However, in our view, the weak point of the proposals is that they still overestimate the revenues side.

The charts below (Chart 13-Chart 15, p.25) provide a glimpse of the budget deficit for 2014. Each of the first two charts depict full-year deficit and financing sources, which were broken down into 1H history and then forecast for 2H. The first of them is depicting the official view on the public finances. The second is ICU's view. Both views say the lion’s share of the full-year deficit falls into 2H. Domestic currency borrowings appear as a key source of financing. External financing is evenly spread between 1H and 2H of the year.

Chart 13. Ukraine's government budget deficit and sources of financing (UAHbn)
Data for 1H of 2014 is history and **data for 2H is government forecast**

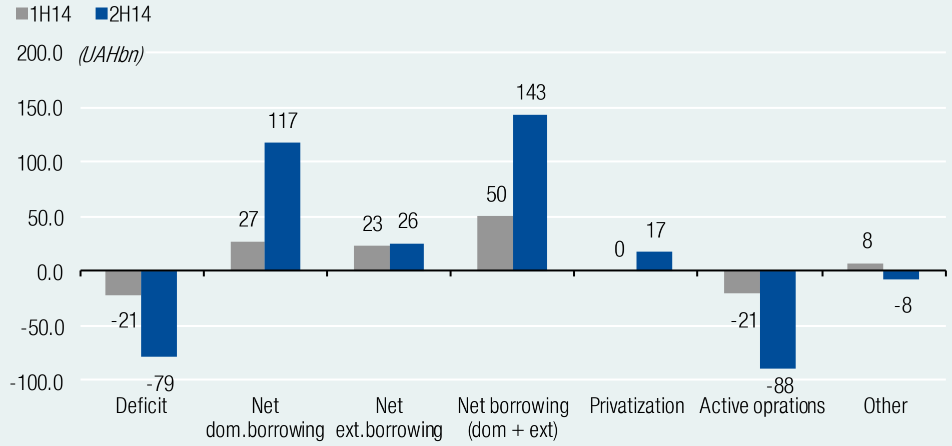


Sources: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

[12] This does not include the Naftogaz deficit.

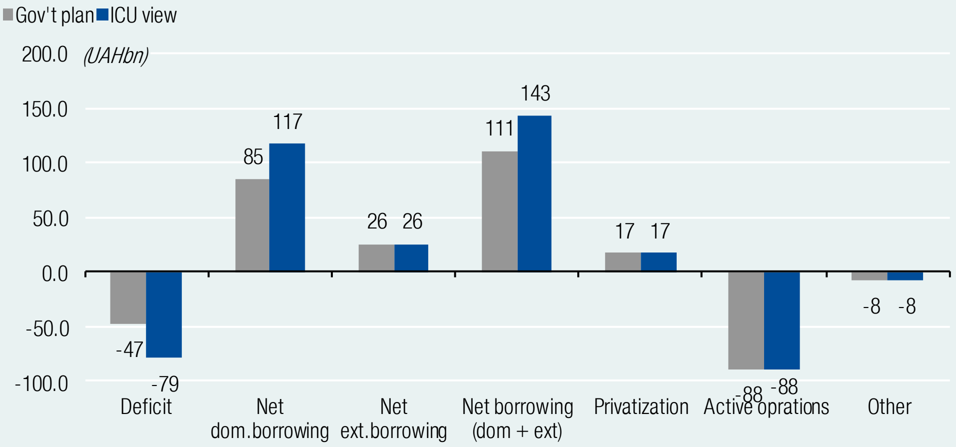
[13] On 24 July, the parliament failed to pass these amendments. Coalition technically collapsed. PM Yatsenyuk stepped down due to disagreement with some of MPs from ruling coalition over the package of laws needed to pass. Despite such a failure, in our view, the parliament is to pass the changes on 30 July.

Chart 14. Ukraine's government budget deficit and sources of financing (UAHbn)
Data for 1H of 2014 is history and **data for 2H is ICU forecast**



Sources: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 15. Difference between Ukraine's government and ICU views on the 2H14 state budget deficit and sources of financing (UAHbn)



Sources: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Government's FX balance sheet

Out of this year's financing needs, there is US$7.2bn of foreign currency debt, including principal and interest that falls due in 2014. This part of the government financing needs is fully covered by the funds provided over 1H and yet to be provided in 2H by IMF.

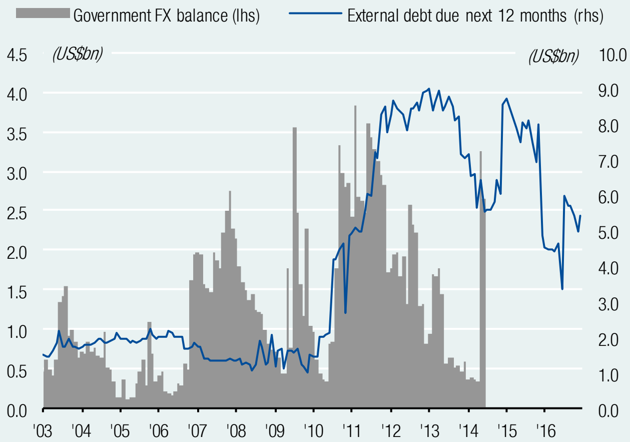
As of the end of May, official statistics showed that Ukraine's government boosted its FX cash balance to more than US$3bn (Chart 16), thanks to official lending from the IMF and other donors. On the back of the FX debt repayments in June and July, this FX balance likely dropped to US$0.5bn. It is set to recover as the next IMF tranche of XDR0.9bn (US$1.4bn) has to arrive in August after the recent second review by the IMF. Over the course of 2H14, there will be two more reviews of the programme by the IMF (25 September and 15 December), and after each, the IMF is likely to provide XDR0.9bn (US$1.4bn). Hence, successful implementation of the programme[14] will secure IMF funding

[14] Without grave breach to the “letter and spirit” of the mutually agreed-upon programme. This means that IMF is flexible to Ukraine's current economic conditions, accepting the fact that its economy and nation at war are facing unprecedented economic challenges. Western political support to Ukraine also serves as a pre-condition to mutual commitment between Ukraine's government and the IMF to adhere to the programme.

to Ukraine's government, making the latter's FX cash balance high enough to service and repay its FX debt.

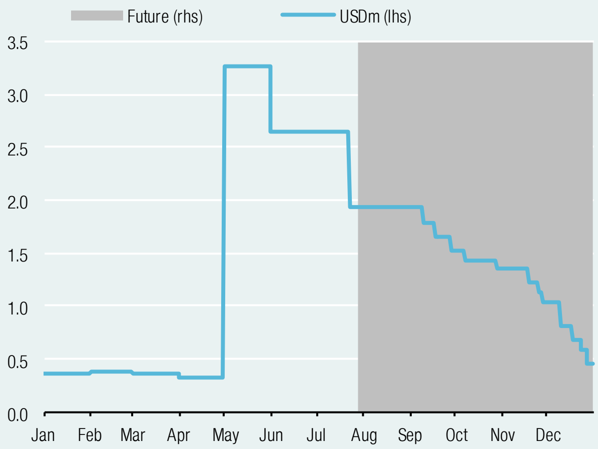
Chart 16. Ukraine government's FX cash balance[1] and FX debt due next 12 month period (US$bn)

History from January 2003 through June 2014. Forecast for 2H14 and 2015-16



Note: [1] the balance stood at US$2.6bn as of end June 2014.
Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 17. Monthly projections of Ukraine government's cash balance in foreign currencies in 2014 (US$bn)



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Government's UAH balance sheet

The secured position of FX balance sheet (by IMF and other official lenders like the US, EU, and Japanese governments) provides the Ukraine government the comfort to balance its local currency books while keeping a watchful eye on the domestic financial stability (as local authorities perceive).

We assume that authorities would target stability in terms of: (a) no nominal contraction of the state budget expenditures (excluding capital expenditures); (b) no run on the currency and on banking sector as a whole; and (c) no grave breach of the IMF programme.

In this regard, we observed some rather tricky developments. Due to shocks of a multiple nature (FX adjustment, Crimea annexation, *de facto* war in parts of Donbass), the government experienced underperformance in terms of budget revenues, especially those collected from economic agents.

The Chart 18 (below) depicts the level of revenues (expressed as percentage of GDP) the government receives from the economy, excluding the transfer of income from the central bank. Amid an extended stagnation of the economy since 2012 that turned into a protracted recession since 2013, this level was in sharp decline, below the 20% threshold and even lower. Thanks to the central bank's transfers and net purchases of domestic government bonds, which have been growing from year to year (Chart 20 and Chart 21 below), the government managed to balance its books in 2012-13.

Over 1H this year, government has been even more stretched than in the preceding years. So far this year, the NBU's transfer amounted to UAH22.0bn for the January-May period (this translates to UAH42.3bn for the 12-month period through May 2014). In total, state budget law for 2014 envisages that NBU transfer amounts to UAH22.8bn, suggesting that once again the government will most likely overuse this revenue source[15]. NBU's transfer proved to have high correlation with government's debt servicing expenditure (Chart 19 on

[15] In 2013, NBU transferred UAH31.8bn into budget revenues or 1.8 times more of the planned UAH16.0 as was envisaged by the state budget law for 2013. In 2014, in our view, NBU is forced to nearly double the target (see pp.40-42 for more details).

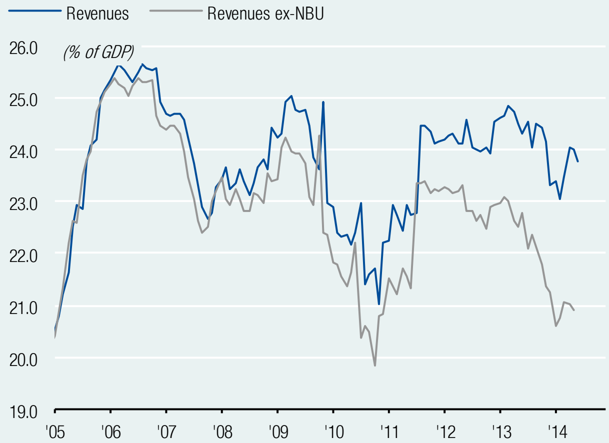
next page). The latter is forecast to reach UAH45bn; hence the former could match this volume at the year end. This effectively means that NBU would transfer UAH23bn in the June-December period on top of UAH22bn provided in January-May. (More details on this assumption are in the Appendix "NBU's part in government's revenues: How big and regular?", p.45)

On the other hand, even with the above mentioned NBU transfer prospect, the increased budget deficit issue remains. It is forecast by us to amount to UAH100bn (6.4% of projected GDP). Hence, this size of the deficit (before proposed UAH40bn cut in expenditures) provides enormous pressure on the central bank to monetize the government debt (this pressure would be still high if the UAH40bn expenditure cut had been passed). So far this year, NBU accumulated in net terms UAH45bn in its portfolio of government debt, which stood as of mid of July at UAH190bn or 62.6% of total outstanding of the domestic government debt. Over the past 12-month period, its net accumulation amounted to UAH58bn (Chart 21).

With the size of the deficit at this proportion—ours is UAH109bn versus the government's UAH69bn—there is risk that inflation expectations in the economy would be picking up, given that inflation accelerated over 1H due to devaluation, an increase in regulated tariffs (natural gas, electricity, home utilities) and a current general easing of the government, which previously held a firm grip on businesses to limit their ability to pass cost increases on to their consumer, in this particular matter.

Chart 18. State budget revenues: total and excluding NBU's transfer (% of GDP)

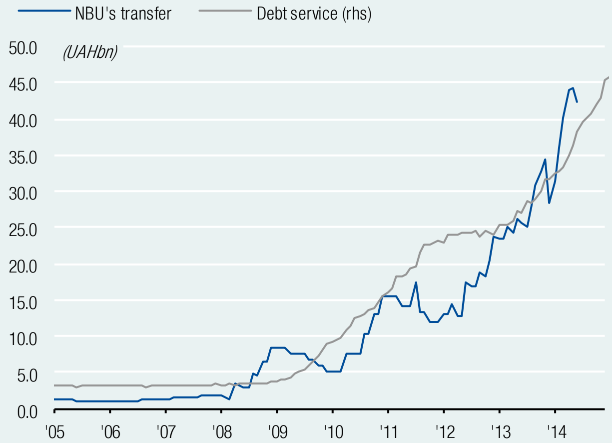
12-month rolling data. History from January 2005 through June 2014



Sources: Ministry of finance of Ukraine, Investment Capital Ukraine LLC.

Chart 19. A near perfect matching between NBU's transfer into state budget revenues and debt service expenditures (UAHbn)

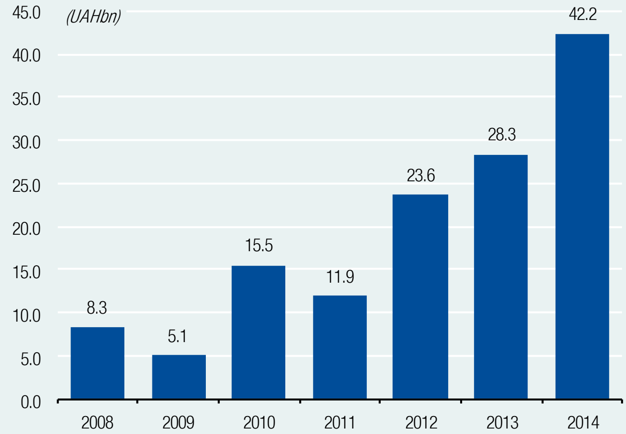
12-month rolling data. History from January 2005 through June 2014, forecast of debt service expenditures for 2H14



Sources: Ministry of finance of Ukraine, Investment Capital Ukraine LLC.

Chart 20. NBU's transfer to the state budget revenues (UAHbn)

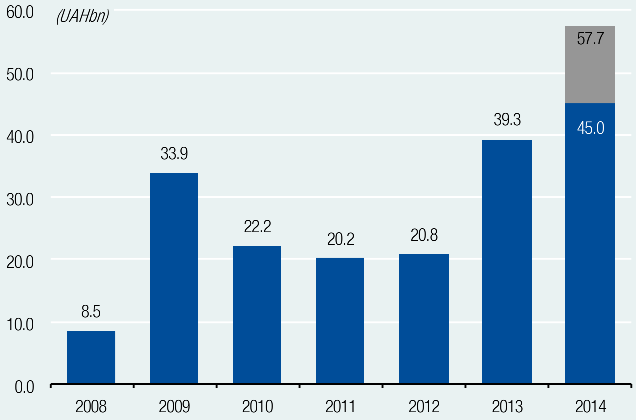
12-month rolling data as of end of period. For 2014, the volume is for the period June 2013 through May 2014



Sources: Ministry of finance of Ukraine, Investment Capital Ukraine LLC.

Chart 21. NBU's net accumulation of domestic government debt (UAHbn)

12-month rolling data as of end of period. For 2014, blue bar depicts year-to-date volume and grey bar depicts the last 12-month volume.



Sources: Ministry of finance of Ukraine, Investment Capital Ukraine LLC.

Quasi-sovereign balance sheet

On top of the central government deficit there is a wealth of quasi-sovereign liabilities, which appear underfunded and hence require government support: Naftogaz (near UAH60bn being revised recently to UAH100bn), State Deposit Guarantee Fund (UAH15bn), and commercial banks (UAH15bn[16]).

With regard to Naftogaz, the impact on the sovereign balance sheet is much less inflationary, as all local-currency debt monetization made by NBU is matched by Naftogaz's FX purchases to import payments. These have been rare this year as official Kiev and the Kremlin collided in a confrontation which has yielded a dead end so far. Ukraine's government insists on the total renegotiation of the natural gas purchases agreement with Russia, as the latter imposes a severe burden on the economy.

The government continues to book natural gas imports from Russia by the price that was in effect in 1Q14. Meanwhile, the Kremlin books its supplies by the price that is implied by the 2009 agreement (US$485), see Chart 22-Chart 25 on p.29. The gap between the two is likely to be a disturbing factor for the economy as it would imply a risk for sovereign pay on accumulated liabilities. The risk is if sides do not agree and an international court decides against Ukraine; then Ukraine's government would be forced to repay this debt in one installment.

Gazprom is mulling US$4.5bn outstanding debt on unpaid imports. This year's external debt repayments for Naftogaz amount to nearly US$2bn (principal and interest).

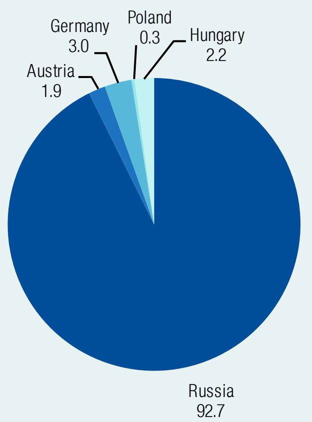
Over 2014, Ukraine's government plans to recapitalize Naftogaz by UAH100bn, which is an equivalent of US$8.7bn. This may be evidence that Kiev officials are building up Naftogaz's balance sheet so that it would be able to repay the external debt when it comes due. However, Naftogaz external debt being paid this year would also mean that official FX reserves are under pressure all year long. Hence, for Ukraine's authorities it would be crucial to maintain financial stability, such as preventing a new run on the local currency or

[16] Data taken from the Memorandum of Economic and Financial Policies between IMF and Ukraine's government as of 22 April 2014. Given the continued Kremlin destabilization of the Ukraine's economy through Crimea annexation and Donbass war, these figures are likely to be corrected upward.

on the commercial banks' deposits. The key remedy for official Kiev to tame this risk is to adhere to the IMF programme, securing official funding that comes along with it.

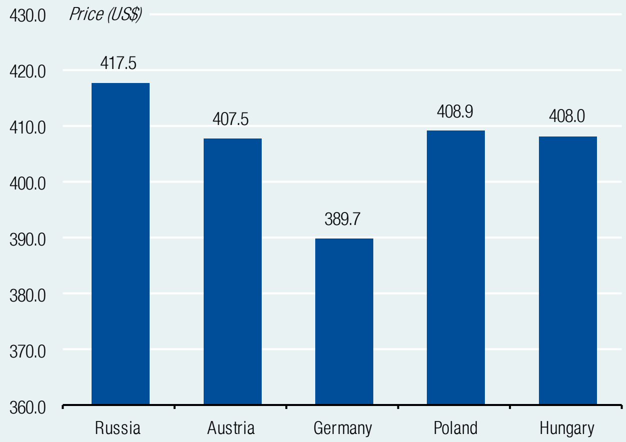
Chart 22. Breakdown of natural gas supplies by legal contract 2013 (%)

100% =



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

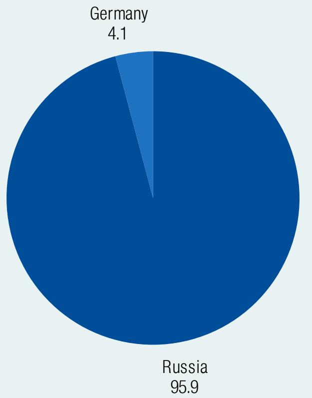
Chart 23. Average yearly price of imported natural gas by supplying countries in 2013 (USD per 1,000 m^3)



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

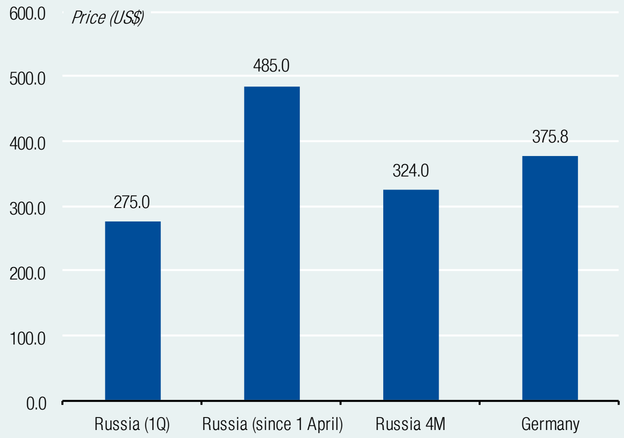
Chart 24. Breakdown of natural gas supplies by legal contract 1H14 (%)

100% = 14.5bcm



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Chart 25. Average yearly price of imported natural gas by supplying countries in 4M14 (USD per 1,000 m^3)



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Prices: An area of concern

Ukraine's price level—both the consumer segment and the industrial producers' segment—has soared over the course of 1H. The driving forces are sharp and sizable currency devaluation (as NBU de-pegged the currency in 1Q), the launch of the procedure to increase regulated tariffs (expected to be phased into several step-up increases over 2014-16) and general relaxation of the central government's grip on businesses (the newly installed government tries to be pro-business and at the same time unwillingly unties the hands of business owners to test their price power, all the while passing the additional costs onto their consumers).

In the end, there is a quite disturbing development over 2014 with regard to prices. Headline CPI rose from 0.5% YoY at the end of 2013 to 11.9% YoY as of end 1H14. PPI spiked from 1.7% YoY to 15.8% YoY over the same time frame. Tariff increases have yet to take place, the consumer price index is forecast to increase further over 2H14, and the same is expected for PPI. At the year-end 2014 we forecast CPI and PPI to stand 17.2% and 17.7%, respectively.

It is noteworthy that authorities have been careful about allowing the central bank to monetise the government debt that would end up in cash outside of the banks. NBU stopped banks from collapsing under the weight of deposit runs and stabilized the banking sector. However, the risk still exists that the current shaky situation with regard to depositors' confidence in the banks may worsen again. This would eventually push the authorities to intervene and disburse the newly-printed cash, which would leak outside the banks, creating an additional pressure on consumer prices. We deem this risk as being under control of the authorities.

However, the key area of concern is that authorities have been failing in stemming inflation expectations. The NBU appears to be taking a lengthy period for transitioning from FX peg to inflation targeting. The central bank itself has repeatedly stated that this year it expects headline CPI to be in the high double-digit territory (17-20%).

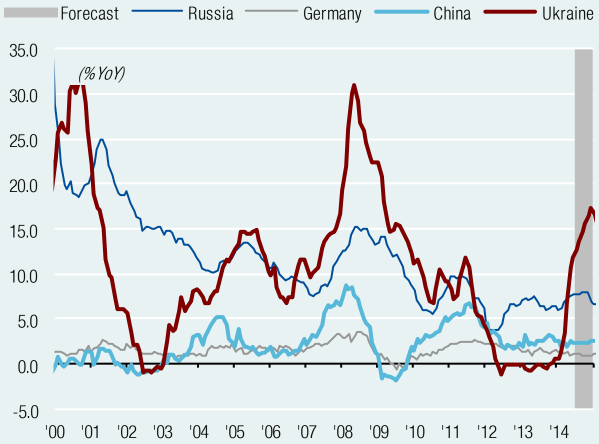
In our view, having such volatility in prices (low, near-zero, price inflation over 2012-13 and then a spike towards high-teen numbers as expected this December) is disparaging evidence of extended macroeconomic mismanagement. Indeed, there is a liability for official Kiev, under the IMF programme, to stick to the low inflation policy in some period of time. However, the inflation expectations, in our view, are damagingly propped up by lack of any targeted action regarding increasing price levels.

Fast-paced acceleration of inflation and likely cementing of the inflation expectations among the consumers and business owners are troubling *per se*. However, it is more troubling if this issue is viewed from the point of losing cost competitiveness with key trade partners[17]. The very fact that consumer and producer price inflation in Ukraine has been back to well above the inflation experienced by trade partners--such as Russia, EU, and China, to name just few—pushes the economy into the troubled territory of lost competitiveness, which was gained quite painfully through nominal devaluation, in an accelerated fashion.

[17] Thus, in Russia we forecast year-end CPI and PPI at 6.9% and 8.5% this year, slowing down over 2015-16 to the range of 5-6% for CPI and 6-7% for PPI. In Eurozone, current economy recovery has been protractedly weak and low inflation has become a symbol of this period for the entire EU, where some countries face deflation. Thus, the leading economy of the EU, Germany, has CPI inflation that is expected to hit 1.0% at the end of this year and well below 2% over next 2015-16 (a quite similar path of inflation is expected regarding producer prices). In China, there is currently a deflation of producer prices taking place, while CPI is running at about 2.5% YoY and market expectations are for about 3% consumer inflation each year in 2015-16.

Chart 26. Headline CPI (%YoY)

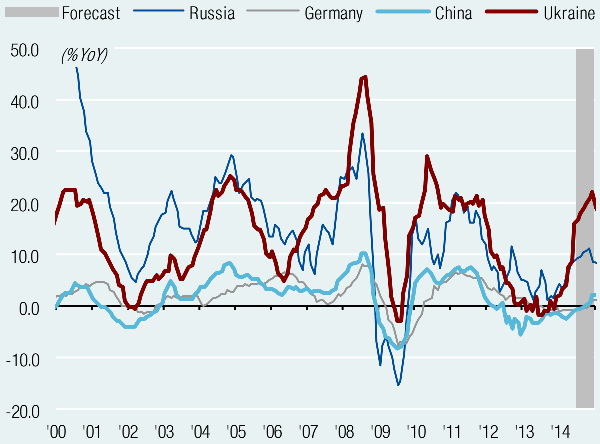
History from January 2000 through June 2014, forecast for 2H14



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Chart 27. PPI (%YoY)

History from January 2000 through June 2014, forecast for 2H14



Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Monetary policy and banking sector: Under stress test

The banking sector has been under severe stress this year due to (1) sizable withdrawal of deposits under the last few months of Yanukovych; (2) substitution of lost deposits with central bank funding; (3) the FX devaluation; (4) loss of business in Crimea; and (5) general low business confidence due to current war in parts of Donbass.

To some extent, the banks suffered, too, from their own high-risk business models of competing for depositors' money by offering high interest rates and then translating them into high-yield and high-risk loans. The existing deposit-insuring scheme, which is routinely funded by the banks but remains extremely underfunded when a bank-run strikes, contributed to the prevailing high-risk bank models.

As a result, the current economic crisis in the country leaves the sector as a whole with total recapitalization needs of UAH40-50bn[18]. The government appears unwilling to again take over the recapitalization issue, i.e. via using the taxpayers' money (own balance sheet). It looks like it is going to use official financial assistance from abroad (of donor countries and international financial institutions) in recapitalizing the banks that would need additional capital. As of September, authorities are set to finalize the stress test procedure of 35 top banks and recapitalize those that need external assistance (likely many privately owned banks).

As of now, in our view, it is early to conclude that the current run on bank deposits exhausted itself. On the surface, it may calm down over the next few months. At the time, when the Kremlin is forecast to continue destabilizing Ukraine with more assertiveness after the tragic loss of 298 civilian people onboard the MH17 jetliner, the economy is forecast to deepen its contraction over 2H. Despite high nominal rates the banks promise on deposits, these remain low in real terms as inflation has been on a steep spike recently. This would mean that depositors would be cautious in returning their cash to banks. Moreover, the so-called smart money depositors may react to the Ukraine's economic developments in unison with private lenders of the Ukraine's government. The latter, in our view, are likely to attach sicker risk premiums to the sovereign bonds traded in the secondary market,

[18] More details on the banks' health are in ICU's forthcoming banking report.

because inflation and hence competitiveness will be deteriorating over the rest of 2014. Therefore, the extension of the current bank run[19] or (a more extreme development) the appearance, after a pause, of a new one appears more likely than dismissively unlikely.

In regard of such a macroeconomic reality, where inflation is accelerating and competitiveness of the economy erodes, interest rates are likely to stay high (around 20%). They would still be rather slim in real terms.

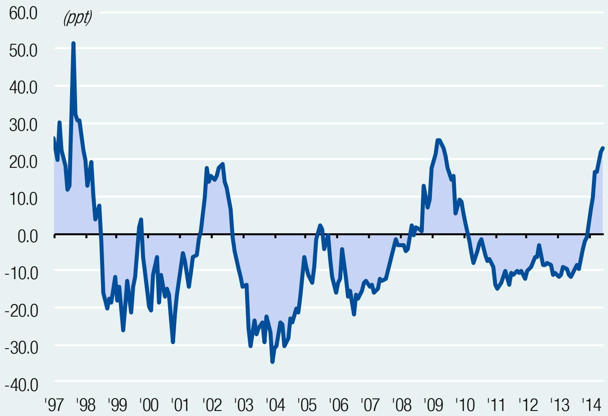
Chart 28. Money supply growth (%YoY, at constant prices of December 1996*)

History from January 1997 through June 2014

Note: * Adjusted by CPI
Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 29. Money supply growth: cash[1] versus non-cash[2] components (ppt)

History from January 1997 through June 2014



Notes: [1] M0 on-year growth rate at constant prices of Dec-97; [2] M2-M0 on-year growth rate at constant prices of Dec-97. Adjusted by CPI.
Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

External balance: Numerous shocks at play

Our view on the external balance for 2H14 and the next two-year period, 2015-16, is grounded in the following assumptions.

Adjustment shock to domestic demand took place; to pass away over 3Q14

First, on the back of sizable nominal and real devaluation of the local currency, the underlying demand in the economy—which inversely correlates with merchandise trade balance excluding trade in minerals—adjusted down. Thus, ex-minerals imports growth has been in the red over the past five months through May 2014[20], resulting in a 23.0% YoY drop in the January-May period. Meanwhile, ex-minerals exports slowed 9.9% YoY over the same period. Hence, when underlying demand adjusts down, the ex-minerals trade balance goes up. The latter reached US$3.3bn in the last 12 months from June 2013 through May 2014. It should be noted here that historically Ukraine's underlying demand was correcting down under the weight of FX adjustment (like in 2008-09), resulting in a strong recovery of the ex-minerals balance to US$6bn (see Chart 32, p.36). Monthly data on the ex-mineral trade balance (Chart 31) reveals that in the last three months (March-May) the surplus was back above US$1bn each month, reaching an all-time high of US$1.2bn in May. This may

[19] We consider that episodes of serious bank runs are characterized by the fact that monetary aggregates such as M0 and M2, excluding M0, are swapping their growth rates in real-terms, i.e. when M0 is leading while M2 (ex-M0) is lagging and the percentage-based difference between these two monetary aggregates growth rates approaches 10% or exceeds 10%. See Chart 28 and Chart 29 on p.25.

[20] In seasonally adjusted terms and at current prices.

indicate that downside adjustment on the underlying demand of Ukraine's economy has been quite powerful and as time goes by the 12-month rolling ex-mineral balance is likely to head closer to the US$6bn threshold over the course of June-August. However, given the projected trajectory of the PPI-based real trade-weighted index of the Ukraine's currency[21] over 2H14 and in 2015-16 (Chart 33, 36), it is likely that underlying domestic demand recovers gradually and, hence, ex-minerals trade surplus slows down from the near US$6bn area to US$3-4bn. The factor in play is accelerated inflation, which is projected to go up further in 2H14 and reach high-teen territory both for CPI and PPI.

External demand weakness is lasting factor

Ukraine's exports are to suffer from weak external demand, which is another factor that we assume in our forecast. Two major destinations for exports are Russia and EU, and both, being highly interconnected by trade and capital flows, are facing sluggish demand for imports. In the EU, this sluggishness is ruled by the fiscal and monetary policies.

In Russia, there is a mix of economic policies, trade protectionism and military assertiveness. Russian merchandise imports have been contracting since March through May[22], the latest statistical data available. Its imports from Germany have been on the decline since February 2013. Its imports from Ukraine have been in a sizable decline as well since September 2012. This evidence suggests that Russia's slowdown-turn-recession has just started surfacing and likely it will take some time to recover. For Ukraine, which was among the first Russian trade partners that started to lose market share, it is unlikely that it would start re-gaining market share ahead of other trade partners of Russia. Moreover, the current Ukraine-Russia military stand-off (*de-facto* war) damages the trade flow between the two countries.

Naftogaz's natural gas imports

Natural gas imports are one of the trickiest issues in the Ukraine's economic story. The current Ukraine-Russia military stand-off cost the former Crimea, which has been annexed, and Donbass, which has become a war zone. The dispute naturally embraced the natural gas flow, where pricing has been a dispute issue for years. Now, because of inflexible positions, the sides are well apart from striking a deal any time soon[23]. Russia claims to be paid according to the 2009 agreement since 2Q, which in itself is a controversy. Moreover, it cancelled the US$100 discount it was providing earlier on the grounds that it annexed Crimea, hence, the discount became invalid automatically. Ukraine claims it has a legitimate right to re-negotiate the 2009 agreement as it imposes a sizable burden on the economy and its pricing terms are unmerited.

So far, Ukraine books natural gas supplies at the price that was effective in 1Q14, which is effectively slightly above US$270, and at the same time tries to diversify supplies by tapping EU market, where it is able to buy natural gas at US$380. Meanwhile, the Russian

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[21] According to our calculations, it has negative correlation with ex-minerals trade balance of 72.2%. The data series used for the calculations span from January 2006 through May 2014. Before January 2006, the data series do not yield a strong correlation. A likely explanation of increased correlation between the two series of data is that over 2006-07, the economy had been booming and domestic demand has been one of the key driving forces of the GDP growth.

[22] Based on the monthly trade data published by Russian state customs service (www.customs.ru). The growth rates discussed here are year-on-year percentage change of 12-month rolling volume of imports.

[23] The sides trade accusations with each other. Kiev claims US$6bn it overpaid Moscow for gas under the 2009 agreement, which imposes a high price on natural gas. Moscow in return claims US$4.5bn of arrears. Since June 16th 2014 Gazprom stopped supplies for Ukraine's needs. On July 24th Ukraine's government officials once again reiterated that Kiev is ready to return to the negotiation table with EU and Russia. (At the same time, Kiev officials doubt that talks with Russia could be fruitful.)

government books the natural gas it supplies into the Ukraine's pipeline system at price of US$488[24].

In peacetime (best-case scenario), Ukraine's government could have options to get this dispute resolved through the international courts, awaiting a judgment, or relying on the EU powers to convince Gazprom to become more flexible during a possible new round of talks between the sides.

In times of *de-facto* war (base-case scenario), Ukraine has switched to increased reliance on "reverse supplies", i.e. buying the natural gas from the EU. In 2013, those supplies, just being tested, accounted for a small portion or less than 5% of total imports. This year's "reverse supplies" are to level up with imports from Russia to make up the natural gas balance for this year.

Overall, we project full-year imports of natural gas to amount to 25bcm each year in 2014-16 (2014-15 consumption is cut back due to recession, and then from 2015 on, as recovery takes hold, more efficient domestic usage will require lower imports). In our view, the government will seek an effective import price to pay for gas obtained via "reverse supplies" from EU – this is US$380 per 1,000 m^3.

For Ukraine's economy it is a ruinous path to pay according to the 2009 agreement, which implies the natural gas price will be US$487 on average from 2Q14 through 4Q14 and then US$481 and US$457 in 2015 and 2016, respectively. Our modeling of the balance of payments under this price assumption (if other things stay intact) yields a serious loss of reserves each year in 2014-16 (in the range of US$2.2-3.8bn a year. In reality, such a loss could lead to another run on the currency as confidence would slump in the authorities' ability to balance its foreign currency books.

Flows of capital

Our assumptions for the base-case scenario include: first, authorities adhere to the two-year stand-by arrangement[25] with IMF, effectively executing the programme of the macroeconomic changes mutually agreed to by the sides over the course of 2014-15 and early 2016.

So far, authorities obtained from IMF first tranche XDR2.1bn (US$3.2bn) and set to receive in 2014 three tranches each worth of XDR0.9bn (US$1.4bn). In total, Ukraine will borrow from IMF US$7.4bn, then a total of US$8.5bn follows in 2015 and the remaining part of the assistance of US$1.21bn arrives in early 2016[26]. Another source of funding from official sources amounts to a total US$6.3bn, which is to arrive according to a pre-agreed schedule —part of the stand-by arrangement with the IMF[27].

There are signs that authorities would try to opportunistically access the Eurobond market for funding. We assume this strategy of the Ukraine's government rational as its sovereign and quasi-sovereign external debt burden is quite sizable for 2014-15 years (it stands at US$8.4bn and US$8.5bn respectively in 2014 and 2015[28]).

Thus, we assume that this year the government issue of a US$1bn Eurobond is quite possible as global capital markets were quite warm to EM debt recently. Hence, we

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[24] This is ICU's own calculations given the terms of the 2009 agreement and cancelation of the US$100 discount.

[25] Full text of the programme is accessible at this hyperlink.

[26] See details here at Table 2, p.22.

[27] See details here at Table B, p.27.

[28] These figures are principal repayments. They do not include interest payments.

assumed a 100% rollover in 2014 for sovereign Eurobond maturities. Next year, in 2015, when the total volume of Eurobonds due stands at US$4.3bn (of which US$3bn is Russian state money), we are less certain of the ability of the government to rollover that debt through new Eurobond issuance. Hence, we assigned a 35% rollover ratio. This means that in 2015 Ukraine taps the Eurobond market with total Eurobond issuance of US$1.5bn. In 2016, the rollover is assumed at 89%.

Our concern is twofold. First, Ukraine's troubles are set to persist (recession and the Kremlin's military assertiveness in the east enclaves of so-called "separatists"), keeping the risk profile of the sovereign at an elevated level. Second, authorities have been taking baby steps in reforming the economy, in our view, postponing tackling high inflation for some later period. According to our observations, high inflation leads to increased of risk premium on sovereign debt. This would limit access of Ukraine's government to the Eurobond market.

Eurobond issuance by banks and corporations is assumed to resume in 2015, though just partially (50% rollover ratio means some borrowers are still considered too risky and therefore unable to borrow) and in 2016 a 100% rollover ratio is assigned.

In 2014, net FDI flows collapse under the weight of the Kremlins' military aggression resulting in a protracted recession. They are assumed recovering in 2015 to US$4.6bn and to US$5.0bn in 2016.

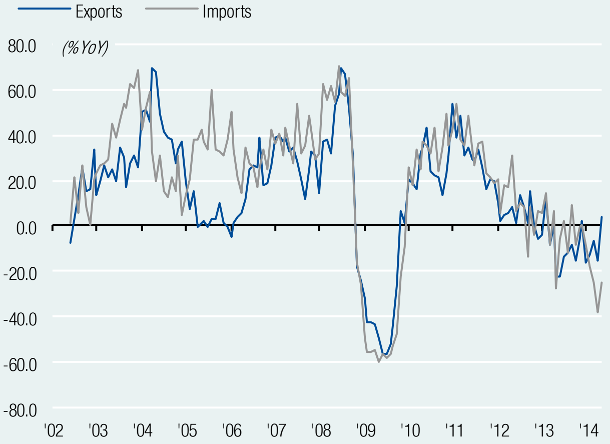
Reflecting still shaky macroeconomic conditions and slow progress of the economic reforms, we assume that domestic demand for FX cash remains in place, amounting to US$5bn in 2014, increasing to US$6bn next year and then sliding back to US$4bn in 2016.

Conclusion

In our view, Ukraine's external balance remains rather stretched (see Table 3 on p.37). FX reserves, which started at US$20.4bn at the beginning of 2014, are projected to be at US$21.5bn at the end of 2016. Hence, reserves accumulation over the three-year period amounts to just US$1bn. There is high risk that our projections are to be corrected for the debt owed to Gazprom on natural gas supplies (US$5bn), which would require additional borrowing to mirror this bill if Ukraine's counter claim to Gazprom (US$6bn) is ignored.

Chart 30. Growth rate of monthly volumes of ex-minerals exports and imports (%YoY, seasonally adjusted)

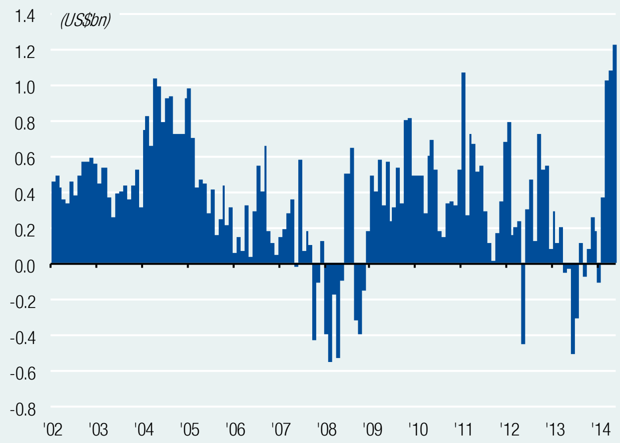
History from January 2002 through May 2014



Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 31. Ex-minerals trade balance (US$bn, seasonally adjusted)

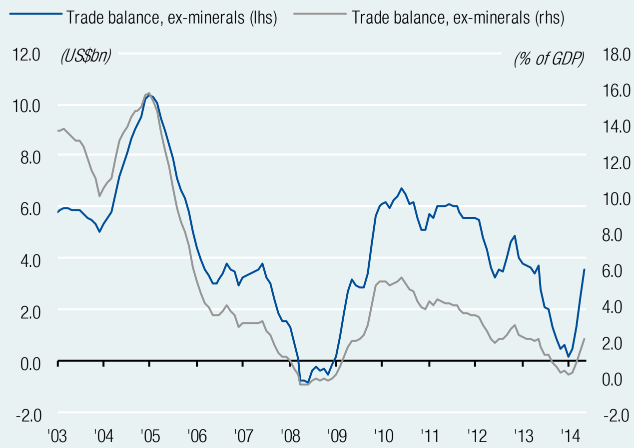
History from January 2002 through May 2014



Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 32. Ex-minerals trade balance[1]

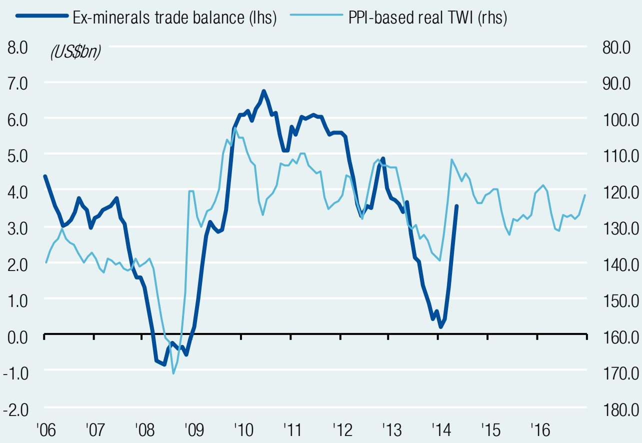
History from January 2006 through June 2014



Note: 12-month rolling data.
Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

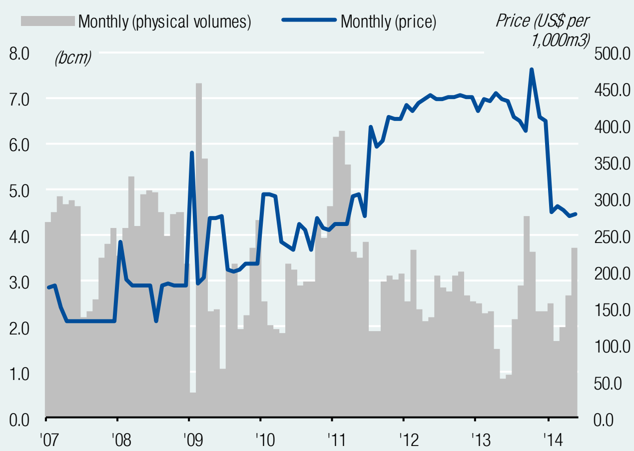
Chart 33. Ex-minerals trade balance[1] and UAH's PPI-based real trade-weighted index

History from January 2006 through June 2014; forecast for 2H14 and 2015-16



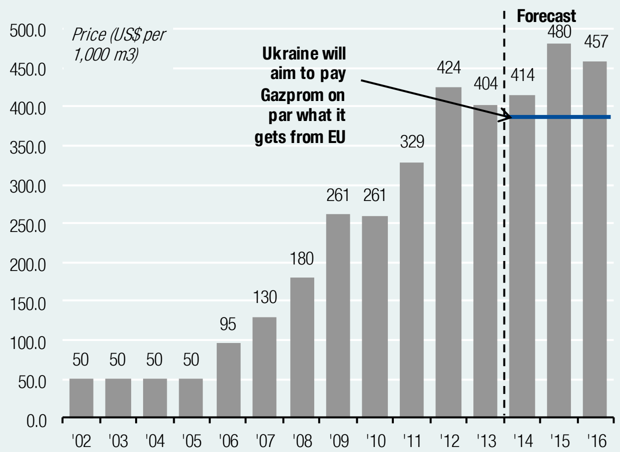
Note: 12-month rolling data.
Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 34. Monthly data on natural gas imports



Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 35. Price on imported natural gas (US$ per 1,000 m^3)



Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Table 3. Ukraine's balance of payments forecast for 2014-16 (US$bn)
Under ICU's **base-case scenario,** Ukraine's authorities adhere to the 2-year IMF programme over 2014-15 and early 2016

Balance of payments (US$m)	Forecast period			Rollover ratios			
	2014	2015	2016	2014	2015	2016	Comment
Current account balance	**-5,450**	**-6,960**	**-7,677**				
Short-term debt[1]	**-64,319**	**-58,395**	**-54,692**				
Government							
Official lenders (IMF)	-2,618	-764	0	382%	441%	0%	IMF's 2yr SBA US$17bn + other official lending
Russian banks	0	0	0	0%	0%	0%	No loans from Russian banks
Eurobonds	-1,000	-4,312	-2,250	100%	35%	100%	Opportunistic access to the market
Domestic FX bonds[2]	-1,909	-1,926	-1,408	40%	40%	0%	Dom FX bonds phased out gradually
Other	-544	0	0	0%	0%	100%	
Central bank							
Official lenders (IMF)	-1,078	-489	0	444%	1575%		IMF's 2yr SBA US$17bn
Other	22	0	0	0%	0%	0%	
Banks							
Eurobonds	-754	-969	-986	0%	0%	100%	Banks bonds after IMF prgm expires
Other lenders	-12,180	-13,662	-16,492	112%	117%	122%	
Corporations							
Eurobonds	-1,645	-1,785	-750	0%	0%	100%	Corporate bonds after IMF prgm expires
Loans	-10,802	-8,743	-8,316	100%	100%	120%	Rollovers ratios at low 100% in '14
Trade loans	-20,186	-16,338	-15,540	100%	120%	120%	The same as above
Other	-11,625	-9,409	-8,949	100%	120%	120%	The same as above
Other	-5,000	-6,000	-4,000				
Total financing needs[3]	**-74,768**	**-71,355**	**-66,368**				
FDI, inflows	271	4,558	4,907				ICU forecast for the period
Borrowings							
Government	10,668	3,034	2,000				
Central bank	4,782	7,693	1,057				
Banks	13,662	16,492	21,135				
Corporations	42,613	40,532	40,116				
Total financing[4]	**71,996**	**72,309**	**69,215**				
Use of reserves	**-2,772**	**+954**	**+2,847**				
FX reserves							
At the start of year	20,416	17,643	18,598				
At the end of year	17,643	18,598	21,445				
Change (%YoY)	-13.6	5.4	15.3				
FX reserves (% of GDP)							
At the start of year	15.4	13.1	13.2				
At the end of year	13.1	13.2	14.0				
Change (ppt)	-2.3	0.1	0.9				
FX res.imports cov.[5] (months)							
At the start of year	3.3	2.6	2.7				
At the end of year	2.6	2.7	3.0				
Change (months)	-0.7	0.1	0.3				

Notes: [1] Short-term debt due in next 12 month period since beginning of the respective year;
[2] domestically issued bonds denominated in foreign currencies (USD and EUR), including USD-denominated Treasury Obligations;
[3] total financing needs equals to the sum of current account balance, short-term debt due next 12 months and demand for foreign currency by households;
[4] total financing equals to the sum of FDI and borrowings by all segments of the economy (government, central bank, banks and corporations);
[5] ratio of imports coverage by FX reserves, measured in months;

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

View on the UAH: Accelerating inflation fast eroding competitiveness

Macroeconomic conditions

This year's currency devaluation is projected to axe the current account deficit from the previous year's US$16.4bn (9.2% of GDP) to US$5.5bn (4.0% of GDP). Such sizable FX adjustment produced lasting damage to the balance sheets of banks, corporations and consumers, i.e. all economic agents that have FX mismatch and there are many of them. The pace of the current recession is likely to force authorities to peruse policies that avoid sizable FX adjustments in the period of forecast (which 2014-16).

At the same time, an overhaul of macroeconomic policymaking has been slow. Authorities are said to be postponing the full-fledged inflation targeting regime into the near future and agreeing to the current acceleration of inflation as a natural by-product of FX adjustment and the unfreezing of regulated tariffs (natural gas, electricity, home utilities). It is the ease with which authorities are talking about inflation this year which makes us a bit concerned. There is risk that inflation expectations will root down among households and businesses. It is likely that after this year's inflation spike, it could be quite challenging for authorities to bring inflation back to the single-digit territory next year (no word of bringing it to 5%).

At the end of this year, we forecast CPI and PPI slightly more than 17% YoY and 20% YoY, respectively, and at the end of next year they are projected to slow to 9% and 11% respectively. This pace of inflation is well above the price levels expected in the Ukraine's key trade partners like Russia, EU members and China. This means that competitiveness gained during 1Q14 is likely to be eroded through high inflation, having negative impact on exports, industrial production and fiscal balance.

All in all, it means UAH has limited prospects to strengthen in nominal terms; rather, prospects are more likely to be weaker.

ICU's trade-weighted indices

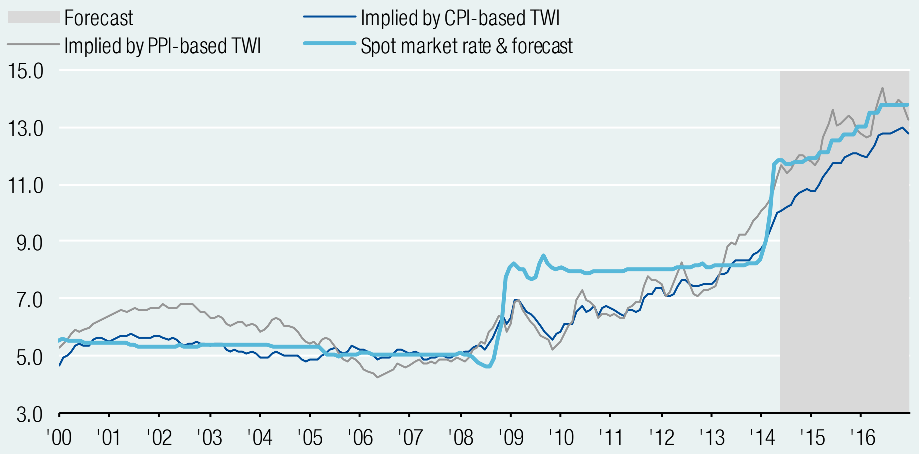
Our in-house method of evaluating a currency's standing via CPI- and PPI-based real trade-weighted indices yields the following: as far as UAH is concerned, it is currently slightly undervalued, and "fair-value" range stands at 10.2-11.4/USD; effectively mid-range fundamental value stands at 10.8/USD.

However, because of higher domestic inflation versus inflation rates in the major trade partners and because of projected strengthening of the US dollar versus major currencies, like EUR, CNY and RUB to name just few, the "fair-value" range moves to 10.8-11.9/USD with mid-range value of 11.4/USD. At the end of 2015 and 2016, respectively, the mid-range value stands at 12.5/USD and 13.0/USD respectively.

In reality, in our view, authorities are to adhere to the IMF programme and provide greater FX flexibility, allowing nominal exchange rate of the hryvina to US dollar to weaken when macroeconomic fundamentals spell such a path. It is rational to assume that authorities, first of all NBU, allow the nominal FX rate to move alongside the above mentioned projections of the "fair-value" ranges (see Chart 36 on p.39). From a rational point of view, by allowing such trajectory of nominal exchange rate change, authorities eliminate undesirable macroeconomic misalignment of the currency's market value from its so-called fundamental value. In Ukraine, as history showed, the risk is that authorities tended to behave irrationally.

Chart 36. Forecast of the UAH's market rate under the projected path of the CPI- and PPI-based real trade-weighted indices for 2014-16

Monthly history from January 2000 through June 2014, forecast through December 2016



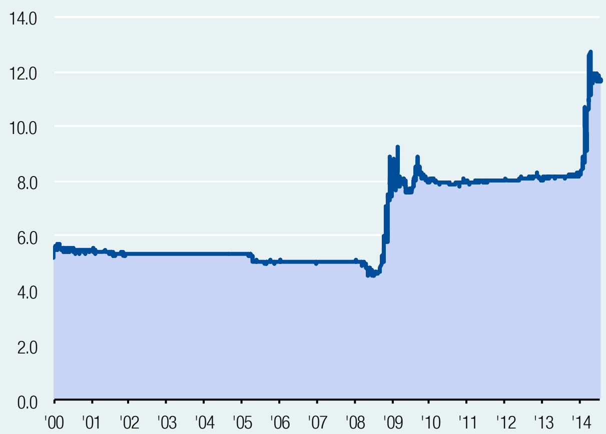
Source: Bloomberg, ICU.

ICU's PPP observations

Our regular monthly price update of the ICU basket of goods provides a glimpse on how UAH undervalued if compared to USD and RUB. More details are in the Appendix section "ICU consumer basket: Observation of Kiev, New-York and Moscow prices" on p.57.

Chart 37. UAH exchange rate per USD set by the market

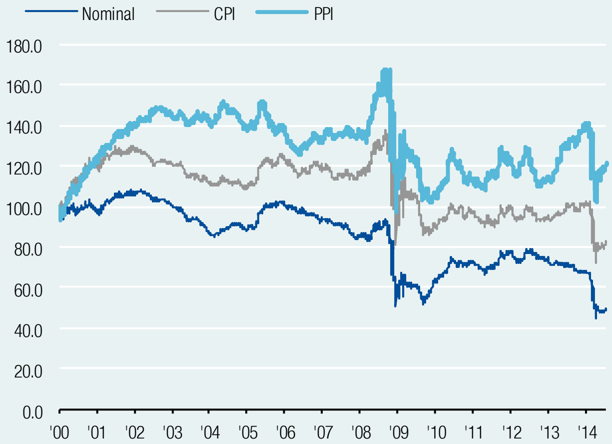
Daily history since 31 December 1999 through 25 July 2014



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 38. UAH nominal and CPI- and PPI-based real trade-weighted indices (TWIs), rebased at 100 points on 31 Dec 1999

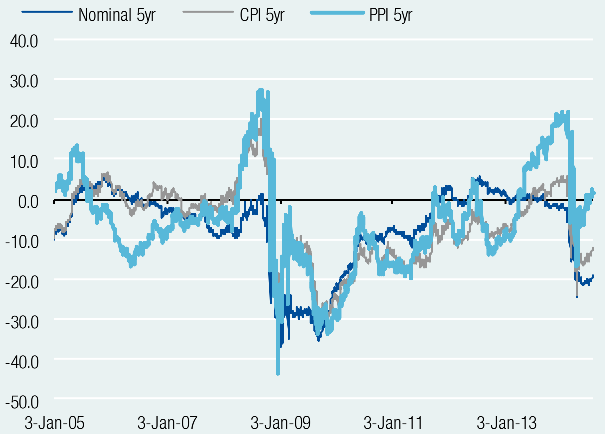
Daily history since 31 December 1999 through 25 July 2014



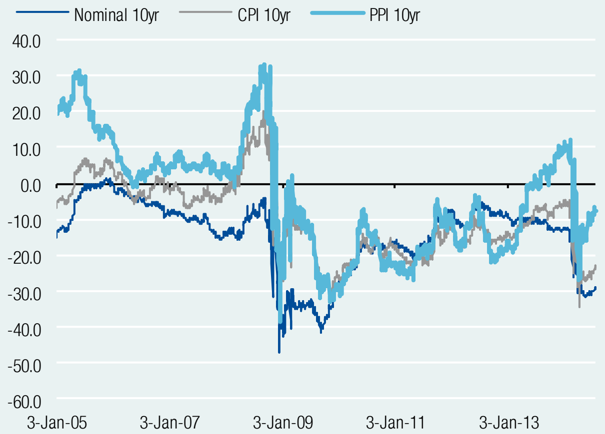
Source: Investment Capital Ukraine LLC.

Chart 39. UAH TWIs misalignment to their 5yr and 10yr averages. Daily history since 3 January 2005 through 25 July 2014

UAH's TWIs less their 5-year rolling averages

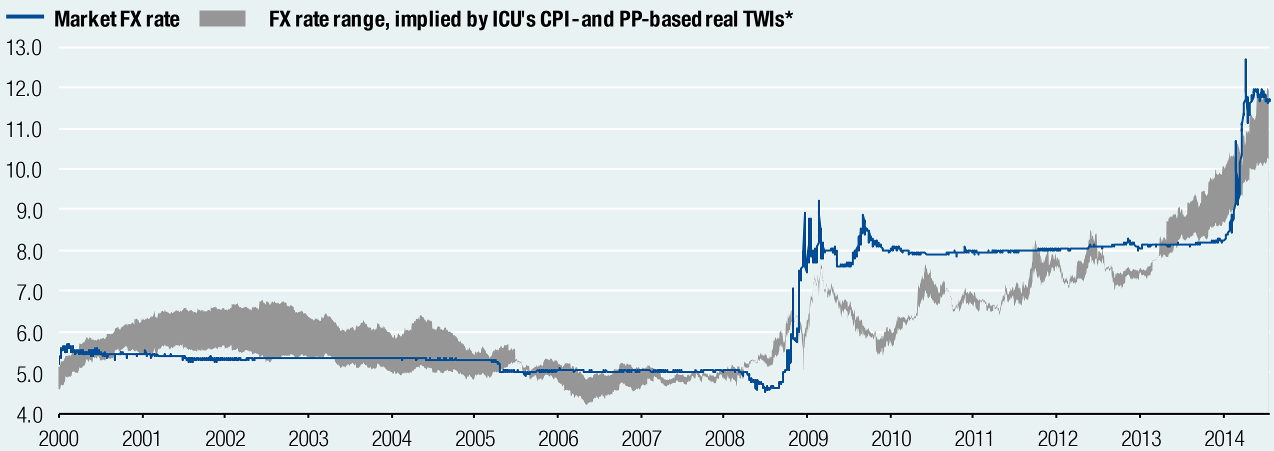


*UAH's TWIs less their 10-year rolling averages**



Note: Data on 10-year rolling averages is available starting from 3 January 2005. Sources: Investment Capital Ukraine LLC.

Chart 40. USD/UAH exchange rate vs. the range of real-TWI-implied rates. Daily history since 1 January 2000 through 25 July 2014



Note: * The USD/UAH rate implied by UAH's real TWI is calculated by multiplying UAH/USD market exchange rate by the ratio of misalignment between the real TWI and its 5-year and 10-year long-term averages. The calculation is based on the four series of TWIs: CPI- and PPI based indices and their misalignment with 5-year and 10-year rolling averages of these indices. The grey-coloured area represents the range of exchange rates implied by real TWIs, where the daily high point is the highest implied rate out of the four series and similarly the daily low point is the lowest implied rate out of the four series. Source: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Estimates for 2013 and forecast for 2014-16

The following two pages of statistics provide ICU's detailed view on future key macroeconomic indicators in the yearly and quarterly perspectives.

Yearly forecast for 2014-16, base-case scenario

Table 4. Forecast of key macroeconomic indicators for 2014-16 (annual)

	Historical data for 2004-12										Forecast by ICU		
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Activity													
Real GDP (%YoY)	12.1	2.7	7.3	7.9	2.3	-14.8	4.1	5.2	0.2	-0.1	**-6.5**	**-1.9**	**3.1**
Nominal GDP (UAHbn)	345	441	544	721	948	913	1,083	1,302	1,409	1,455	**1,558**	**1,730**	**1,967**
Nominal GDP (US$bn)	65	87	108	143	184	114	136	163	174	178	**139**	**137**	**143**
GDP per capita (US$, ann)	1,371	1,850	2,319	3,091	3,982	2,474	2,978	3,572	3,823	3,920	**3,233**	**3,180**	**3,338**
Unemployment rate (%)	8.6	7.2	6.2	6.4	6.4	8.8	8.1	7.9	7.5	8.2	**8.3**	**7.9**	**7.9**
Prices													
CPI headline (%YoY, eop)	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	**17.3**	**8.8**	**8.2**
CPI headline (%YoY, average)	9.0	13.6	9.1	12.8	25.3	16.0	9.4	8.0	0.6	-0.3	**10.5**	**12.3**	**8.5**
PPI (%YoY, eop)	24.3	9.6	15.4	23.2	21.1	15.3	18.8	17.4	0.4	1.7	**20.8**	**10.5**	**10.5**
PPI (%YoY, average)	20.3	17.0	9.6	20.5	33.6	7.4	21.4	19.9	6.0	-0.1	**13.3**	**12.2**	**10.2**
Fiscal balance													
Consolidated budget bal. (UAHbn)	-9.9	-7.5	-3.5	-6.1	-11.3	-34.4	-63.3	-18.3	-46.9	-63.0	**-117.0**	**-113.0**	**-93.0**
Consolidated budget bal. (% of GDP)	-2.9	-1.7	-0.6	-0.8	-1.2	-3.8	-5.9	-1.4	-3.3	-4.3	**-7.5**	**-6.5**	**-4.7**
Budget balance (UAHbn)	-10.2	-7.9	-3.8	-9.8	-12.5	-35.5	-64.3	-23.6	-53.4	-64.7	**-100.4**	**-94.8**	**-80.6**
Budget balance (% of GDP)	-3.0	-1.8	-0.7	-1.4	-1.3	-3.9	-5.9	-1.8	-3.8	-4.4	**-6.4**	**-5.5**	**-4.1**
External balance													
Exports (US$bn)	41.3	44.4	50.2	64.0	85.6	54.3	69.3	88.8	90.0	85.3	**76.8**	**75.9**	**79.0**
Imports (US$bn)	36.3	43.7	53.3	72.2	100.0	56.2	73.2	99.0	104.4	100.8	**81.7**	**82.5**	**86.3**
Trade balance (US$bn)	5.0	0.7	-3.1	-8.2	-14.4	-2.0	-4.0	-10.2	-14.3	-15.5	**-4.9**	**-6.6**	**-7.3**
Trade balance (% of GDP)	7.7	0.8	-2.8	-5.7	-7.8	-1.7	-2.9	-6.2	-8.2	-8.7	**-3.5**	**-4.8**	**-5.1**
Current account balance (US$bn)	6.9	2.5	-1.6	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	**-5.5**	**-7.0**	**-7.7**
Current account balance (% of GDP)	10.6	2.9	-1.5	-3.7	-6.9	-1.5	-2.2	-6.3	-8.2	-9.2	**-3.9**	**-5.1**	**-5.4**
Net FDI (US$bn)	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.8	4.1	**0.3**	**4.6**	**4.9**
Net FDI (% of GDP)	2.6	8.7	5.3	6.4	5.4	4.1	4.2	4.3	3.9	2.3	**0.2**	**3.3**	**3.4**
C/A bal. + net FDI (% of GDP)	13.3	11.6	3.8	2.8	-1.6	2.6	2.0	-2.0	-4.3	-6.9	**-3.7**	**-1.8**	**-1.9**
External debt (US$bn, eop)	30.6	39.6	54.5	80.0	101.7	103.4	117.3	126.2	135.1	142.2	**144.0**	**147.0**	**152.2**
External debt (% of ann'd GDP, eop)	47.2	45.6	50.4	55.8	55.3	90.9	86.1	77.4	77.4	79.7	**103.3**	**107.2**	**106.2**
FX reserves (US$bn, eop)	9.5	19.4	22.3	32.5	31.5	26.5	34.6	31.8	24.5	20.4	**17.6**	**18.6**	**21.4**
FX reserves (% of ann'd GDP, eop)	14.7	22.3	20.6	22.6	17.2	23.3	25.4	19.5	14.1	11.4	**12.6**	**13.5**	**14.9**
External debt / FX reserves (x, eop)	3.2	2.0	2.4	2.5	3.2	3.9	3.4	4.0	5.5	7.0	**8.2**	**7.9**	**7.1**
FX reserves imports cov (months)	3.8	6.4	6.1	6.4	4.5	7.1	6.8	4.5	3.3	2.4	**2.6**	**2.7**	**3.0**
Interest rates													
Central bank key rate (%, eop)	9.00	9.50	8.50	8.00	12.00	10.25	7.75	7.75	7.50	6.50	**6.50**	**6.50**	**6.50**
3-month rate (%, eop 4Q)	15.03	11.46	9.90	7.58	21.60	17.59	6.12	19.72	25.52	6.00	**6.00**	**6.00**	**6.00**
Exchange rates													
UAH trade-weighted index (nominal)	91.29	105.76	96.33	88.22	62.35	62.62	72.39	77.27	74.23	67.38	**49.55**	**47.20**	**44.33**
UAH trade-weighted index (real)	112.78	129.21	123.61	120.06	100.21	90.26	97.73	98.76	94.72	100.84	**85.31**	**84.88**	**82.75**
UAH/US$ (eop)	5.31	5.05	5.05	5.05	7.80	8.00	7.94	8.00	8.05	8.24	**11.90**	**13.00**	**13.80**
UAH/US$ (average)	5.32	5.10	5.03	5.03	5.25	8.03	7.94	7.99	8.08	8.16	**11.16**	**12.59**	**13.71**
UAH/€ (eop)	6.71	7.20	5.97	6.66	7.36	10.90	11.45	10.66	10.36	11.32	**15.71**	**16.64**	**17.66**
UAH/€ (average)	6.62	6.35	6.32	6.89	7.67	11.19	10.54	14.21	14.97	11.17	**15.08**	**16.21**	**17.55**
US$/€ (eop)	1.36	1.18	1.32	1.46	1.40	1.43	1.34	1.30	0.00	1.37	**1.32**	**1.28**	**1.28**
US$/€ (average)	1.24	1.24	1.26	1.37	1.47	1.39	1.33	1.34	1.27	1.37	**1.35**	**1.29**	**1.28**
Population													
Population (million, eop)	47.3	47.0	46.6	46.4	46.1	46.0	45.8	45.6	45.6	45.5	**43.1**	**43.1**	**42.9**
Population (%YoY)	-1.4	-0.8	-0.7	-0.6	-0.5	-0.4	-0.4	-0.3	-0.2	-0.1	**-5.2**	**0.0**	**-0.5**

Notes: eop – end of period; cov – coverage; con'd – consolidated; ann – annualised.

Sources: State Statistics Service of Ukraine, National Bank of Ukraine, Investment Capital Ukraine LLC.

Quarterly forecast for 2014-16, base-case scenario

Table 5. Forecast of key macroeconomic indicators for 2014-16 (quarterly)

		Forecast by ICU											
	4Q13	1Q14E	2Q14F	3Q14F	4Q14F	1Q15F	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F
Activity													
Real GDP (%YoY)	3.3	-1.1	-5.6	-8.4	-10.6	-3.8	-1.2	-1.6	-1.1	2.5	3.0	3.5	3.5
Nominal GDP (UAHbn)	404.3	313.0	373.2	431.6	440.4	365.1	415.0	468.0	482.4	411.8	470.2	535.1	549.6
Nominal GDP (US$bn)	49.2	34.2	31.7	36.6	37.0	30.2	33.2	36.7	37.1	30.5	34.2	38.8	39.8
GDP per capita (US$, ann)	3,921	3,904	3,692	3,470	3,234	3,141	3,176	3,179	3,181	3,192	3,219	3,271	3,339
Unemployment rate (%)	8.2	8.8	8.9	8.4	8.3	8.2	8.2	8.1	7.9	7.8	7.9	7.9	7.9
Prices													
CPI headline (%YoY, eop)	0.5	3.4	11.9	15.1	17.3	16.1	12.1	10.0	8.8	8.5	8.5	8.5	8.2
CPI headline (%YoY, average)	0.2	1.7	9.8	14.0	16.6	17.1	12.4	10.6	9.1	8.8	8.5	8.5	8.2
PPI (%YoY, eop)	1.7	3.9	15.6	18.6	20.8	20.3	6.7	8.8	10.5	8.8	10.5	10.5	10.5
PPI (%YoY, average)	0.7	3.0	10.5	19.2	20.3	21.5	10.2	7.2	9.9	9.5	9.9	11.0	10.5
Fiscal balance													
Consolidated budget bal. (UAHbn)	-29.9	0.6	-27.2	-37.5	-52.9	-8.7	-24.2	-31.5	-48.6	2.0	-21.4	-26.8	-46.8
Consolidated budget bal. (% of GDP)	-7.4	0.2	-7.3	-8.7	-12.0	-2.4	-5.8	-6.7	-10.1	0.5	-4.6	-5.0	-8.5
Budget balance (UAHbn)	-29.5	-4.1	-23.2	-30.5	-42.6	-8.3	-20.5	-26.2	-39.8	-0.4	-18.7	-22.9	-38.7
Budget balance (% of GDP)	-7.3	-1.3	-6.2	-7.1	-9.7	-2.3	-5.0	-5.6	-8.2	-0.1	-4.0	-4.3	-7.0
External balance													
Exports (US$bn)	22.3	18.3	18.6	19.4	20.5	17.9	17.9	19.1	21.0	19.0	18.6	19.7	21.7
Imports (US$bn)	27.1	19.7	21.1	20.5	20.5	20.4	19.9	20.2	22.0	21.3	20.9	21.1	23.0
Trade balance (US$bn)	-4.8	-1.4	-2.5	-1.0	0.0	-2.5	-2.0	-1.1	-1.0	-2.3	-2.3	-1.5	-1.2
Trade balance (% of GDP)	-9.7	-4.0	-8.0	-2.9	-0.1	-8.2	-6.2	-3.0	-2.7	-7.6	-6.6	-3.8	-3.1
Current account balance (US$bn)	-4.9	-1.3	-2.6	-1.4	-0.1	-2.5	-2.1	-1.3	-1.0	-2.4	-2.4	-1.6	-1.3
Current account balance (% of GDP)	-10.0	-3.9	-8.3	-3.9	-0.2	-8.2	-6.4	-3.6	-2.8	-7.8	-6.9	-4.2	-3.3
Net FDI (US$bn)	0.9	-0.7	0.0	0.5	0.5	0.9	1.2	1.6	0.9	1.1	1.2	1.4	1.2
Net FDI (% of GDP)	1.7	-2.1	0.0	1.3	1.3	2.9	3.5	4.3	2.6	3.7	3.4	3.7	3.0
C/A bal. + net FDI (% of GDP)	-8.3	-6.0	-8.3	-2.6	1.1	-5.3	-3.0	0.7	-0.3	-4.1	-3.5	-0.5	-0.3
External debt (US$bn, eop)	141.5	137.9	109.6	108.3	144.0	144.8	145.5	146.3	147.0	148.3	149.6	150.9	152.2
External debt (% of ann'd GDP, eop)	79.2	78.7	67.0	71.4	103.3	106.9	106.3	106.7	107.2	107.9	108.0	107.4	106.2
FX reserves (US$bn, eop)	20.4	15.1	17.1	17.4	17.6	17.9	18.1	18.3	18.6	19.3	20.0	20.7	21.4
FX reserves (% of ann'd GDP, eop)	11.4	8.6	10.5	11.5	12.6	13.2	13.2	13.4	13.5	14.0	14.4	14.7	14.9
External debt / FX reserves (x, eop)	6.9	9.1	6.4	6.2	8.2	8.1	8.0	8.0	7.9	7.7	7.5	7.3	7.1
FX reserves imports cov (months)	2.4	1.9	2.1	2.4	2.6	2.6	2.7	2.7	2.7	2.8	2.8	2.9	3.0
Interest rates													
Central bank key rate (%, eop)	6.50	6.50	9.50	12.50	14.00	12.00	10.00	8.00	8.00	7.50	7.50	7.50	7.50
3-month rate (%, eop 4Q)	11.71	15.93	18.03	20.00	20.00	18.00	16.00	12.00	10.00	10.00	10.00	10.00	10.00
Exchange rates													
UAH trade-weighted index (nominal)	67.38	57.15	48.13	49.25	49.55	49.23	48.20	47.81	47.20	45.50	44.72	44.60	44.33
UAH trade-weighted index (real)	100.84	89.02	80.18	83.63	85.31	84.49	86.96	86.37	84.88	81.44	84.01	83.77	82.75
UAH/US$ (eop)	8.24	11.38	11.75	11.80	11.90	12.10	12.50	12.75	13.00	13.50	13.75	13.80	13.80
UAH/US$ (average)	8.21	9.16	11.79	11.80	11.90	12.10	12.50	12.75	13.00	13.50	13.75	13.80	13.80
UAH/€ (eop)	11.32	15.66	16.12	15.81	15.71	15.73	16.13	16.32	16.64	17.28	17.60	17.66	17.66
UAH/€ (average)	0.00	12.67	16.20	16.00	15.83	15.85	16.19	16.38	16.64	17.28	17.60	17.66	17.66
US$/€ (eop)	1.37	1.38	1.37	1.34	1.32	1.30	1.29	1.28	1.28	1.28	1.28	1.28	1.28
US$/€ (average)	1.36	1.38	1.37	1.36	1.33	1.31	1.30	1.29	1.28	1.28	1.28	1.28	1.28
Population													
Population (million, eop)	45.50	43.14	43.09	43.08	43.12	43.16	43.12	43.10	43.14	42.95	42.91	42.89	42.94
Population (%YoY)	-0.1	-5.2	-5.2	-5.2	-5.2	0.0	0.0	0.0	0.0	-0.5	-0.5	-0.5	-0.5

Notes: eop – end of period; cov – coverage; con'd – consolidated; ann – annualised.

Sources: State Statistics Service of Ukraine, National Bank of Ukraine, Investment Capital Ukraine LLC.

Appendices: Research details; thematic charts & tables

The following pages contain the details charted and tabled data for the appropriate sections in this report.

NBU's part in government's revenues: How big and regular?

Over the past few years, NBU's participation in the state budget revenues has been increasing. From year to year, the central bank was asked by lawmakers and the government to transfer a bigger volume of its profits into the state budget. Thus, in late 2011, lawmakers approved the state budget law for 2012, where they prescribed NBU to transfer UAH13.2bn. Eventually, it transferred UAH23.6bn or 1.8 times more than the target. This story was repeated in 2013, when NBU's transfer actually paid into the budget 1.8 times the UAH16bn target. Over January-May 2014, NBU was transferring in an average UAH4.4bn a month (or a total of UAH22bn). The key question now is what the central bank is going to do next? In our view, the bank's options are time limited due to recession in the economy.

History

Given the available monthly data on debt service expenditures from the state budget and NBU transfers of its profit into the state budget, the relationship between NBU and MoF depended on the economy. In an acute recessionary period, NBU was asked to accelerate transfers, while the economy recovered and this cash flow was slowing. Nevertheless, in the end our observation of these two cash flows—one is central bank's profit being transferred to the state budget revenues and the second is debt service expenditures[29], which are made from the state budget to government bond holders—came to a conclusion that authorities managed to match them (see Chart 41, p.46). History of these series of data, which is available from December 2004 through May 2014, yields correlation ratio of 93.4%.

Conclusion

This suggests an established strong bond between NBU and government, while making these cash flows. This bond in Ukraine apparently existed under different heads of governments and central bank governors.

Future

Given the recent statement by NBU's governor[30] on the practice, we evaluated the likely scenarios for the rest of 2014. These are in Chart 43-Chart 44, p.47.

If NBU decides that there will be no more transfers during 2H14 on the ground that over 1H it met the target, which is UAH22.8bn, then NBU's transfer as share of projected revenues collapses from 12.5% as of May to 6.4% as of December 2014. In terms of the NBU's transfer coverage of debt service, this ratio would drop, too, from 122% in May to 48% in December.

If NBU adheres to the unwritten rule of the 2008 post-crisis period, when from 2009 to 2013 the average ratio of actual transfer to target was 159%, then the state budget would experience far less contraction of support. Ratio of transfer-to-revenues would slide by just 1.9ppt from 12.5% in May to 10.6% in December. Ratio of transfer-to-debt service slows from 122% to 80%.

If NBU is asked to repeat the previous year's practice, when it was ahead of the prescribed volume of transfer with a 177% actual-to-target ratio, then ratio of transfer-to-revenues

[29] Total of local currency and foreign currency debt service.

[30] More details here (in Russian).

declines from 12.5% in May to 11.8% in December. And ratio of transfer-to-debt service decreases from 122% in May to 89% in December.

In our view, given the severity of the current situation in the economy (a *de-facto* nation at war, recession deepening in 2H14), a more realistic scenario is when the NBU transfer matches debt service in a 100% ratio. Then actual-to-target ratio would rise to a historical high of 199% (by the way, as of May it was 194%) in December 2014. Also, the transfer-to-revenues ratio would increase too from 12.5% in May to 13.3% in December.

Table 6. History of NBU's transfers to state budget revenues in 2004-14 (UAHbn, if not otherwise indicated**)**

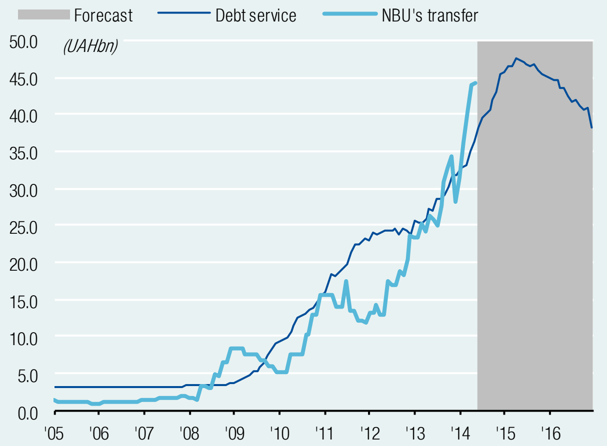
Year	Target volume of NBU transfer	Actual volume of NBU transfer	Actual-to-Target ration (%)	State budget revenues	Actual / Revenues (%)	Debt service expenditures	State budget expenditures	Debt service / Expenditures (%)	NBU transfer / Debt service (%)
2004	1.2	**1.3**	107.5	70.3	1.8	3.1	79.5	3.9	42.0
2005	1.2	**1.0**	79.0	105.3	0.9	3.1	113.0	2.8	30.7
2006	1.3	**1.3**	100.1	133.5	1.0	3.1	137.1	2.3	41.4
2007	1.9	**1.9**	100.7	165.9	1.1	3.3	174.3	1.9	56.4
2008	4.8	**8.3**	172.4	231.7	3.6	3.8	241.5	1.6	220.8
2009	13.8	**5.1**	36.7	209.7	2.4	9.0	242.4	3.7	56.0
2010	10.0	**15.5**	155.5	240.6	6.5	15.5	303.6	5.1	100.1
2011	9.7	**11.9**	123.0	314.6	3.8	23.1	333.4	6.9	51.4
2012	13.2	**23.6**	179.2	346.0	6.8	23.9	395.7	6.0	98.9
2013	16.0	**28.3**	176.9	339.2	8.3	31.8	403.4	7.9	89.0
2014	22.8	**44.3**[1]	194.3[2]	342.9[3]	12.9[2]	45.5[4]	442.6	10.3[2]	97.4[2]

Notes: [1] actual data, which is last 12-month volume through May 2014; [2] calculated ratio based on the actual data on NBU transfer as of May 2014; [3] ICU's forecast of full-year budget revenues; [4] ICU's forecast of full-year debt service expenditure.

Sources: Ministry of Finance of Ukraine, .

Chart 41. NBU's transfer to state budget revenues versus debt service expenditures (UAHbn, last 12-month rolling volume)

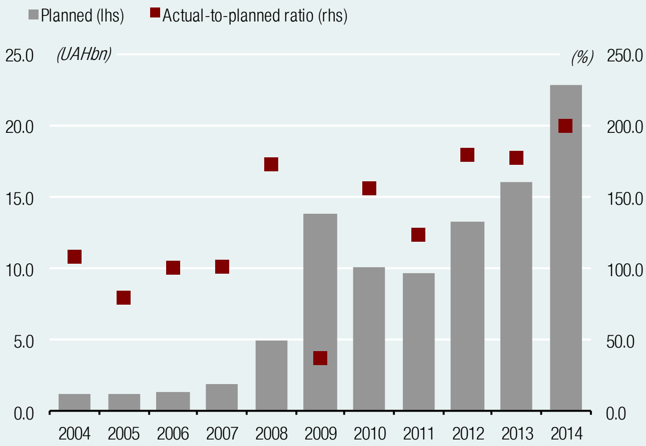
Monthly history from January 2005 through 24 May 2014; for June-December 2014 and 2015-16 is ICU's forecast of debt service expenditures



Sources: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 42. NBU's transfer to state budget revenues: Planned volume versus actual

Yearly history of the planned volume from 2004 through 2014. Forecast of the actual transfer for 2014, history of actual volumes for 2004-13



Sources: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 43. NBU's transfer to state budget as share of budget revenues: Likely scenarios for rest of 2014 (%)

Monthly history from January 2005 through 24 May 2014; for June-December 2014 is ICU's forecast of debt service expenditures and NBU transfer

Note: [1] 177% of target means that NBU's transfer in 2014 repeats previous year's practice when volume of the transfer was 177% of the prescribed target;
[2] 159% of target means that NBU's transfer in 2014 equals to 2008 post-crisis average of the ratio of actual transfer versus the target.
Sources: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 44. NBU's transfer to state budget as share of debt service expenditures: Likely scenarios for rest of 2014 (%)

Monthly history from January 2005 through 24 May 2014; for June-December 2014 is ICU's forecast of debt service expenditures and NBU transfer

Note: [1] 177% of target means that NBU's transfer in 2014 repeats previous year's practice when volume of the transfer was 177% of the prescribed target;
[2] 159% of target means that NBU's transfer in 2014 equals to 2008 post-crisis average of the ratio of actual transfer versus the target.
Sources: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Ukraine sovereign risk premium and hryvnia's real rate: Correlation issue revisited

We once again re-visited the issue of correlation between Ukraine's sovereign risk premium and hryvnia's real trade-weighted indices. It was initiated in our *Quarterly Report* "Where're we headed from here?" published on 29 October 2014.

Now and then, our research yields a conclusion that risk premium on Ukraine's sovereign debt has better correlation with a PPI-based real trade-weighted index than a CPI-based one. See Chart 45-Chart 49 on p.49.

What is new?

One simple test was carried out. The available series of daily data on Ukraine's 5-year CDS, which spans from 19 August 2004 through now, was matched against the daily data on CPI- and PPI-based real trade-weighted indices. The preferred time frame to test the correlation has been set at 365 days. So, eventually, the key point of interest was how the correlation holds over a historical horizon—from 19 August 2004 through 24 July 2014—if one uses a 365-day rolling correlation ratio as a tool for the test.

The results are shown on Chart 46 below. There is evidence that the correlation varies wildly over time, swinging from positive to negative territories several times. It is interesting that average and median correlation ratios are in positive territory, albeit, of not so impressive size – just over 15% and 32% respectively. Indeed, positive correlation ratios are more frequent than negative ones.

Also, the positive values of correlation ratio between CDS and CPI-based real TWI never went beyond 92.1%, which was observed on 31 January 2012. Similarly, positive values of the correlation ratio between CDS and PPI-based real TWI never happen to go above 93.6%, which was on 2 January 2012.

As far as negative values of the correlation ratios are concerned, they never went beyond 85.0% and 81.8%, respectively, which were observed on 30 August 2010 and 1 September 2010.

Hence, we established a threshold or a floor for a correlation ratio, which would signal that the bond is strong between the data series. Arbitrarily, such a threshold was set at 81.5%. As Chart 47 below shows, positive correlations above 81.5% are more frequent for both CPI- and PPI-based real TWIs. Negative correlations by far are less frequent. And at the end, it is PPI-based real TWI that yields bigger number of occurrences: 229 versus 180 of CPI-based real TWI.

Conclusion

This simple piece of research shows that it is a PPI-based real trade-weighted index of the hryvnia, which allows us to gauge a likely path of the sovereign risk premium.

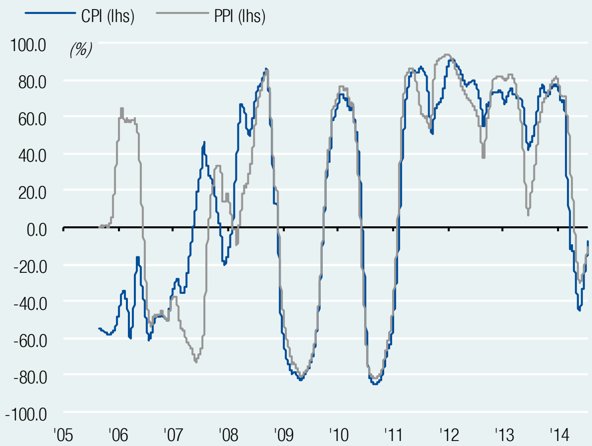
Chart 45. Ukraine 5-yr CDS (rhs) and UAH's CPI- and PPI based trade-weighted indices (lhs)

History from 1 January 2005 through 24 July 2014

Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 46. Correlation ratio (last 365-day rolling data)

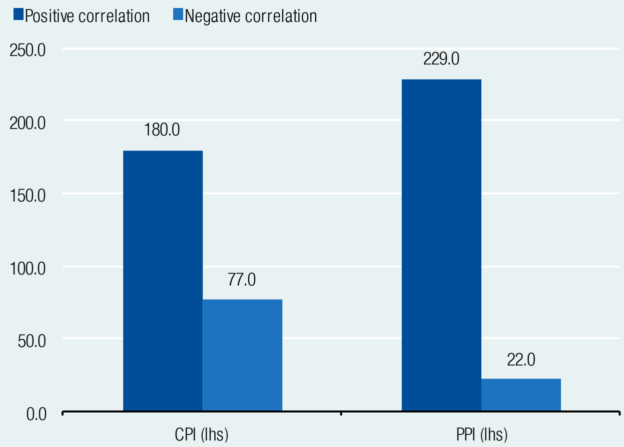
History from 19 August 2004 through 24 July 2014



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 47. How many times occurs correlation ratio above 81.5%

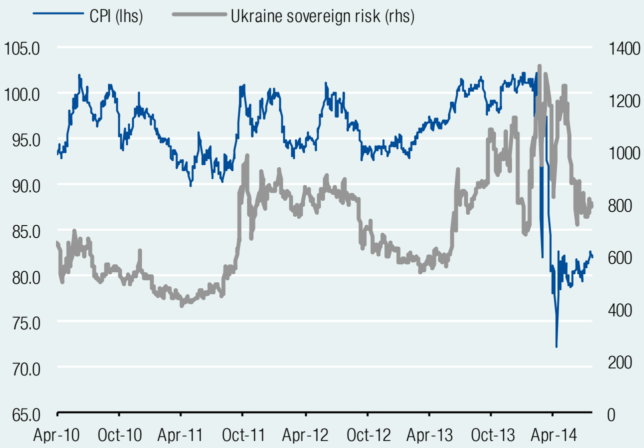
History from 19 August 2004 through 24 July 2014



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 48. Ukraine 5yr CDS vs UAH's CPI-based TWI

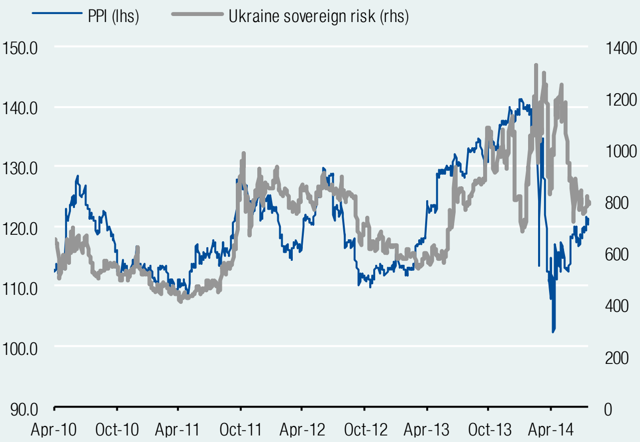
History from 1 April 2010 through 24 July 2014



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 49. Ukraine 5yr CDS vs UAH's PPI-based TWI

History from 1 April 2010 through 24 July 2014



Sources: Bloomberg, Investment Capital Ukraine LLC.

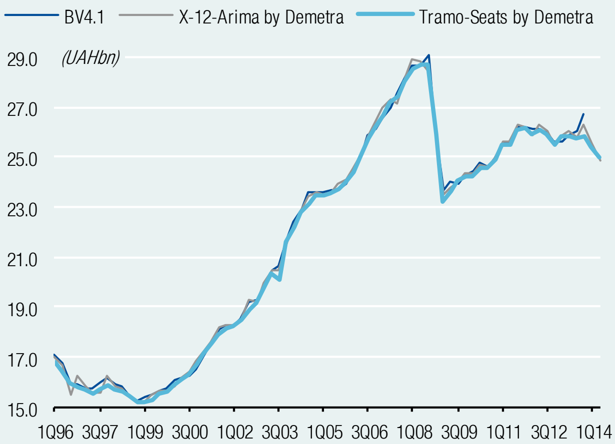
Quarterly GDP: Reported statistics and ICU's calculations

Chart 50. Ukraine's economy from the perspective of quarterly GDP volumes (left) and on-quarter growth rates (right)

History from 1Q96 till 2Q14

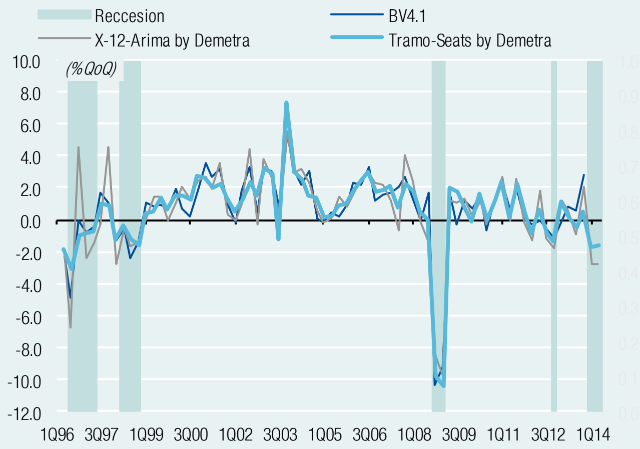
Data is adjusted for inflation and seasonal factors. data is seasonally adjusted by three methods BV4.1, X-12 Arima and Tramo-Seats

Quarterly GDP size in constant prices of Dec-95



Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

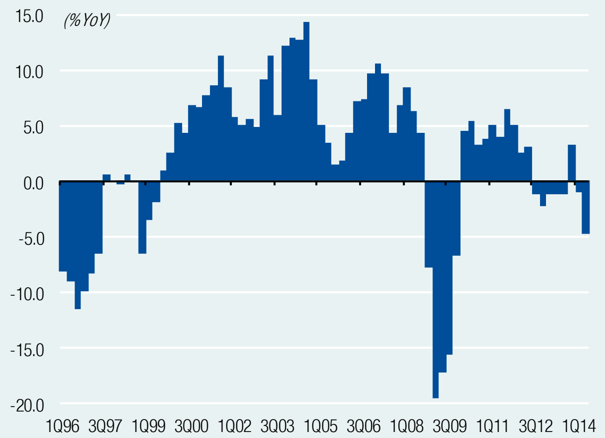
Quarterly GDP growth rates (% QoQ)



Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 51. Reported on-year quarterly GDP growth (% YoY)

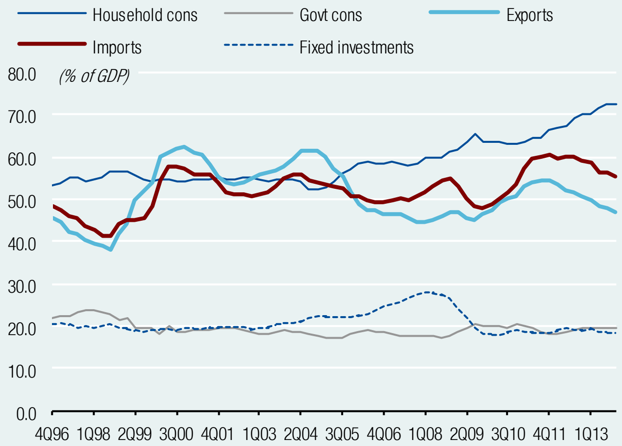
History from 1Q 1996 till 2Q 2014



Source: State Statistics Service of Ukraine.

Chart 52. Demand-side components of GDP (% of total, LTM)

History from 4Q 1996 till 4Q 2013



Source: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Table 7. Ukraine quarterly GDP size: History from 4Q96 till 3Q13 (UAHm, if not otherwise indicated)
Reported statistics and ICU calculations of quarter-on-quarter growth in real and seasonally-adjusted terms

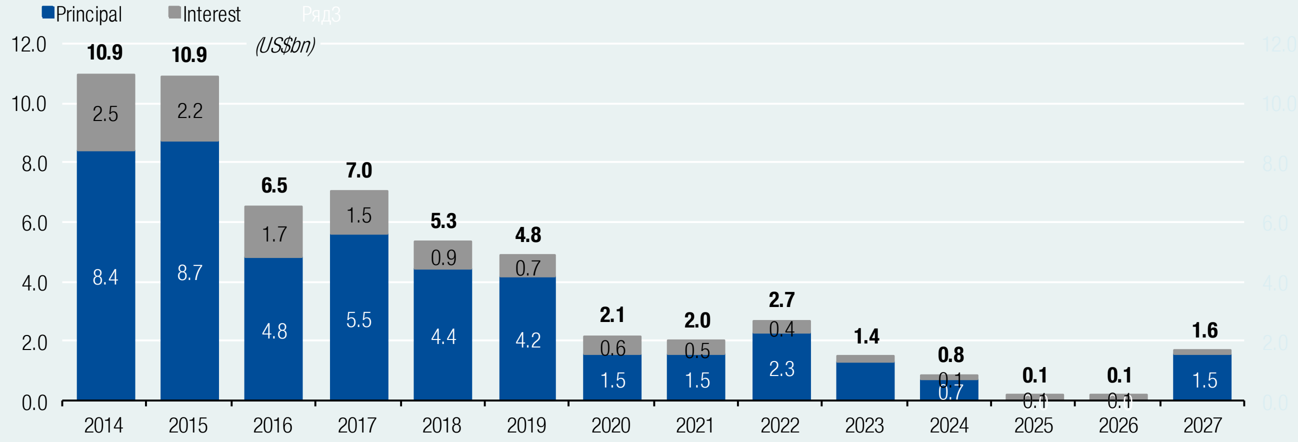
Period	Reported statistics on quarterly GDP				ICU calculations							
	GDP at current prices (UAHm)	Real growth (% YoY, qtly)	Real growth (% QoQ, SA)	Deflator (% YoY)	Real growth (% YoY, ann'd)	GDP at cons prices[1] (UAHm, NSA)	GDP at cons prices[1] (UAHm, SA)			Real GDP growth (%QoQ, SA)		
							BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra	BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra
4Q96	24,454	-10.0		40.1	-9.7	17,404	16,075	16,228	**15,824**	0.8	4.6	0.8
1Q97	18,728	-8.3		22.3	-9.8	14,114	15,777	15,780	**15,779**	-1.9	-2.8	-0.3
2Q97	20,485	-6.6		22.7	-9.1	14,117	15,758	15,586	**15,750**	-0.1	-1.2	-0.2
3Q97	26,076	0.5		15.3	-6.2	17,544	16,049	15,531	**15,687**	1.8	-0.4	-0.4
4Q97	28,076	0.0		14.8	-3.7	17,405	16,122	16,258	**15,984**	0.5	4.7	1.9
1Q98	20,871	-0.3		11.8	-1.6	14,068	16,011	15,744	**15,762**	-0.7	-3.2	-1.4
2Q98	23,367	0.5		13.5	0.2	14,188	15,795	15,701	**15,724**	-1.4	-0.3	-0.2
3Q98	28,908	-0.1		10.9	0.0	17,538	15,379	15,435	**15,479**	-2.6	-1.7	-1.6
4Q98	29,447	-6.6		12.3	-1.7	16,256	15,177	15,236	**15,165**	-1.3	-1.3	-2.0
…	…	…	…	…	…	…	…	…	**…**	…	…	**…**
2Q06	126,319	7.2		15.9	3.7	23,023	25,028	25,102	**24,989**	2.2	2.5	2.4
3Q06	152,406	7.3		15.6	5.2	29,301	25,854	25,828	**25,731**	3.3	2.9	3.0
4Q06	159,080	9.6		12.8	7.1	27,659	26,165	26,435	**26,192**	1.2	2.3	1.8
1Q07	139,444	10.6		18.6	8.7	24,253	26,560	27,010	**26,680**	1.5	2.2	1.9
2Q07	166,869	9.7		20.4	9.3	25,260	26,999	27,347	**27,230**	1.7	1.2	2.1
3Q07	199,535	4.4		25.4	8.5	30,592	27,539	27,154	**27,450**	2.0	-0.7	0.8
4Q07	214,883	6.9		26.4	7.9	29,558	28,288	28,243	**28,058**	2.7	4.0	2.2
1Q08	191,459	8.5		26.6	7.4	26,303	28,675	28,920	**28,534**	1.4	2.4	1.7
2Q08	236,033	6.2		33.2	6.5	26,824	28,645	28,859	**28,684**	-0.1	-0.2	0.5
3Q08	276,451	4.3		32.9	6.5	31,892	29,122	28,437	**28,702**	1.7	-1.5	0.1
4Q08	244,113	-7.8		23.3	2.6	27,233	26,102	26,042	**25,888**	-10.4	-8.4	-9.8
1Q09	189,028	-19.6		22.8	-4.8	21,148	23,697	23,494	**23,186**	-9.2	-9.8	-10.4
2Q09	214,103	-17.3		9.7	-10.6	22,181	24,047	23,771	**23,651**	1.5	1.2	2.0
3Q09	250,306	-15.7		7.4	-15.2	26,886	23,962	24,031	**24,076**	-0.4	1.1	1.8
4Q09	259,908	-6.7		14.1	-15.0	25,412	24,254	24,332	**24,231**	1.2	1.3	0.6
1Q10	217,286	4.5	0.7	10.7	-9.2	21,959	24,435	24,388	**24,193**	0.7	0.2	-0.2
2Q10	256,754	5.4	1.4	15.1	-3.5	23,110	24,827	24,692	**24,584**	1.6	1.2	1.6
3Q10	301,251	3.3	0.4	17.5	1.5	27,539	24,650	24,628	**24,588**	-0.7	-0.3	0.0
4Q10	307,278	3.7	0.7	15.6	4.2	25,989	24,944	24,933	**24,885**	1.2	1.2	1.2
1Q11	257,682	5.1	2.0	12.9	4.4	23,066	25,525	25,615	**25,466**	2.3	2.7	2.3
2Q11	311,022	3.9	0.3	16.6	4.0	24,009	25,660	25,610	**25,486**	0.5	0.0	0.1
3Q11	369,818	6.5	2.5	15.2	4.8	29,347	26,181	26,270	**26,064**	2.0	2.6	2.3
4Q11	363,557	5.0	0.3	12.6	5.1	27,309	26,198	26,221	**26,170**	0.1	-0.2	0.4
1Q12	293,493	2.5	-0.8	11.4	4.5	23,584	26,126	25,880	**25,954**	-0.3	-1.3	-0.8
2Q12	349,212	3.1	0.5	9.0	4.3	24,731	26,110	26,341	**26,119**	-0.1	1.8	0.6
3Q12	387,620	-1.3	-1.5	6.2	2.3	28,963	25,956	26,021	**25,890**	-0.6	-1.2	-0.9
4Q12	378,564	-2.3	-0.8	6.6	0.5	26,681	25,663	25,544	**25,543**	-1.1	-1.8	-1.3
1Q13	302,864	-1.2	0.6	4.4	-0.4	23,301	25,664	25,852	**25,826**	0.0	1.2	1.1
2Q13	353,025	-1.3	0.4	2.4	-1.5	24,409	25,882	26,015	**25,875**	0.8	0.6	0.2
3Q13	394,731	-1.2	-0.1	3.1	-1.5	28,616	26,016	25,766	**25,733**	0.5	-1.0	-0.6
4Q13	404,311	3.3	2.1	3.4	-0.1	27,561	26,740	26,283	**25,849**	2.8	2.0	0.5
1Q14	313,047	-1.1	-2.0	4.5	-0.1	23,044	n/a	25,559	**25,400**	n/a	-2.8	-1.7
2Q14	376,345	-4.7	-2.3	11.9	-1.0	23,262	n/a	24,830	**24,991**	n/a	-2.9	-1.6

Notes: [1] at constant prices of December 1995; SA – seasonally adjusted data; NSA --- non-seasonally adjusted data; [2] estimated by ICU.
Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Sovereign external debt: Yearly data on debt due in 2014-27

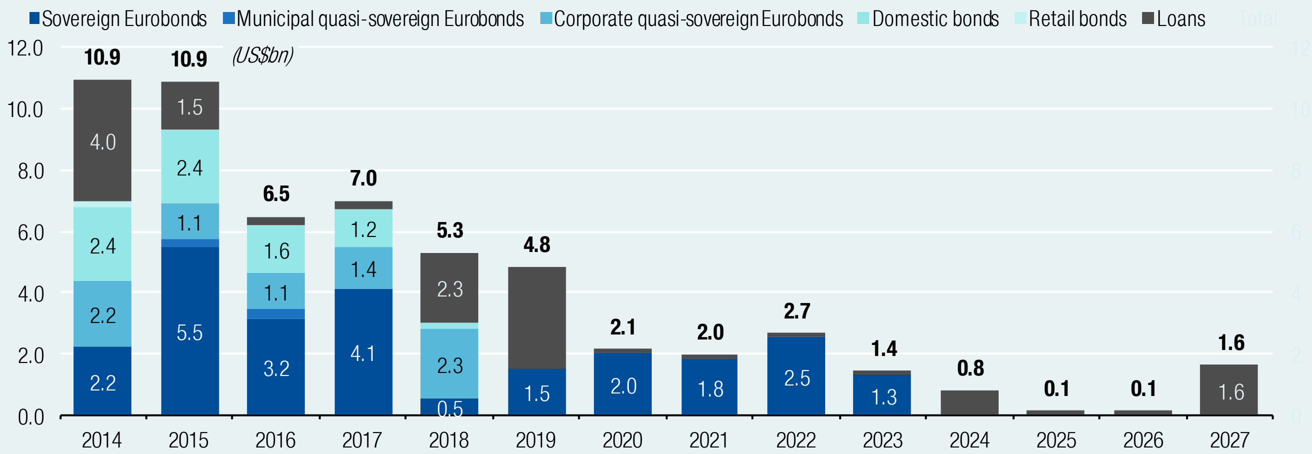
Yearly breakdown of sovereign and quasi-sovereign external debt (charts)

Chart 53. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by cash flow type (US$bn)



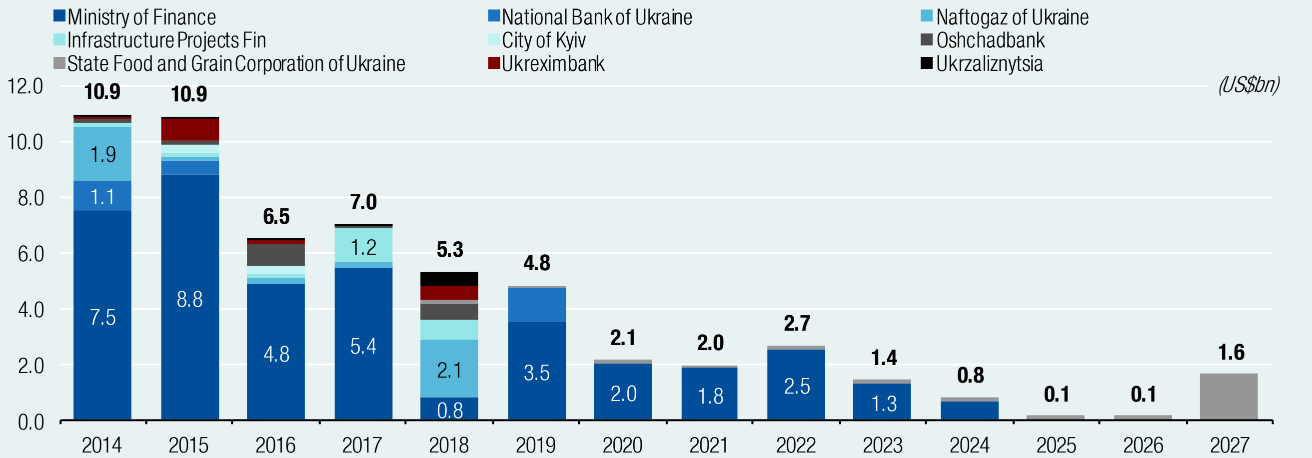
Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 54. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by ultimate borrower (US$bn)



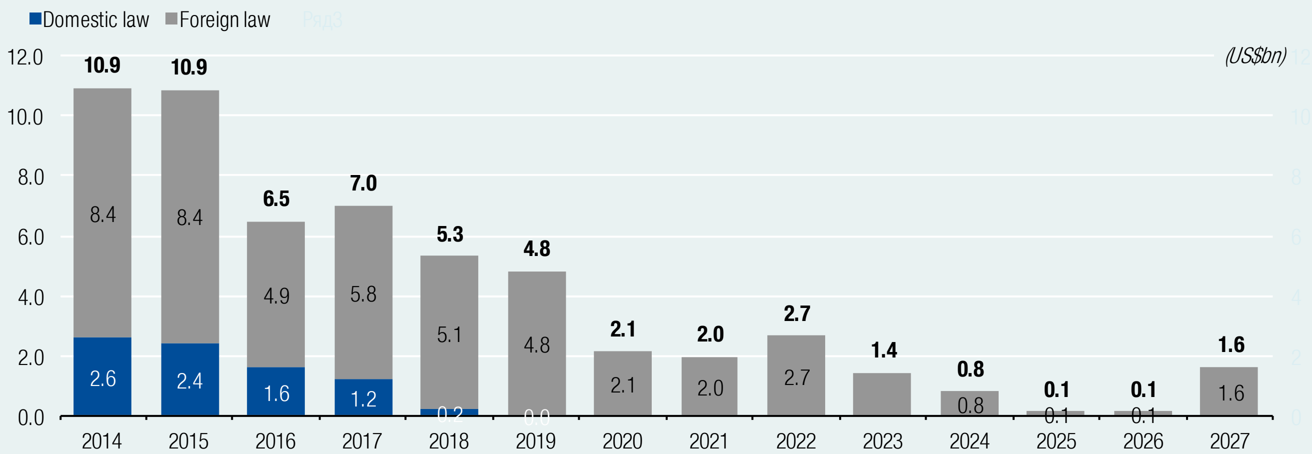
Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 55. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by ultimate borrower (US$bn)



Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 56. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by governing law (US$bn)



Notes: Debt raised under domestic law means government bonds in foreign currencies issued at the domestic bond market.
Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Yearly breakdown of sovereign and quasi-sovereign external debt (tables)

Table 8. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US$m)
By type of debt instrument, data as of 11 April 2014

Year	Principal re-payments							Interest payments							Grand
	Sovrgn Euro-bonds[1]	Muni-cipal Euro-bonds[2]	Corpo-rate Euro-bonds[3]	Local bonds[4]	Local retail bonds[5]	Loans[6]	Total	Sovrgn Euro-bonds[1]	Muni-cipal Euro-bonds[2]	Corpo-rate Euro-bonds[3]	Local bonds[4]	Local retail bonds[5]	Loans[6]	Total	Total
2013	1,000	0	0	1,988	0	6,585	9,573	1,081	20	493	395	17	334	2,340	**11,913**
2014	1,000	0	1,595	1,909	200	3,692	8,395	1,210	20	561	458	17	275	2,542	**10,937**
2015	4,305	250	750	2,125	0	1,247	8,677	1,179	20	378	313	0	294	2,184	**10,861**
2016	2,250	300	825	1,408	0	0	4,783	916	0	314	187	0	284	1,701	**6,484**
2017	3,300	0	1,088	1,155	0	0	5,543	811	0	281	79	0	281	1,453	**6,996**
2018	0	0	2,190	200	0	2,000	4,390	523	0	93	15	0	284	915	**5,305**
2019	1,000	0	0	0	0	3,160	4,160	514	0	0	0	0	152	666	**4,826**
2020	1,500	0	0	0	0	0	1,500	505	0	0	0	0	144	648	**2,148**
2021	1,500	0	0	0	0	0	1,500	329	0	0	0	0	143	472	**1,972**
2022	2,250	0	0	0	0	0	2,250	269	0	0	0	0	143	412	**2,662**
2023	1,250	0	0	0	0	0	1,250	47	0	0	0	0	143	190	**1,440**
2024	0	0	0	0	0	670	670	0	0	0	0	0	138	138	**809**
2025	0	0	0	0	0	0	0	0	0	0	0	0	133	133	**133**
2026	0	0	0	0	0	0	0	0	0	0	0	0	133	133	**133**
2027	0	0	0	0	0	1,500	1,500	0	0	0	0	0	133	133	**1,633**
Total	**19,355**	**550**	**6,448**	**8,785**	**200**	**18,854**	**54,191**	**7,384**	**60**	**2,119**	**1,447**	**34**	**3,015**	**14,060**	**68,251**

Notes: [1] sovereign Eurobonds; [2] municipal Eurobonds issued by City of Kyiv, which are considered as quasi-sovereign external debt; [3] corporate Eurobonds issued by state-run banks and non-bank entities, which are considered as quasi-sovereign external debt; [4] foreign-currency sovereign bonds issued on the domestic bond market;
[4] USD-denominated sovereign bonds issued domestically with special purpose to be sold to retail investors; [6] IMF loans extended to MoF and NBU.
Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Table 9. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US$m)
By ultimate borrower, data as of 11 April 2014

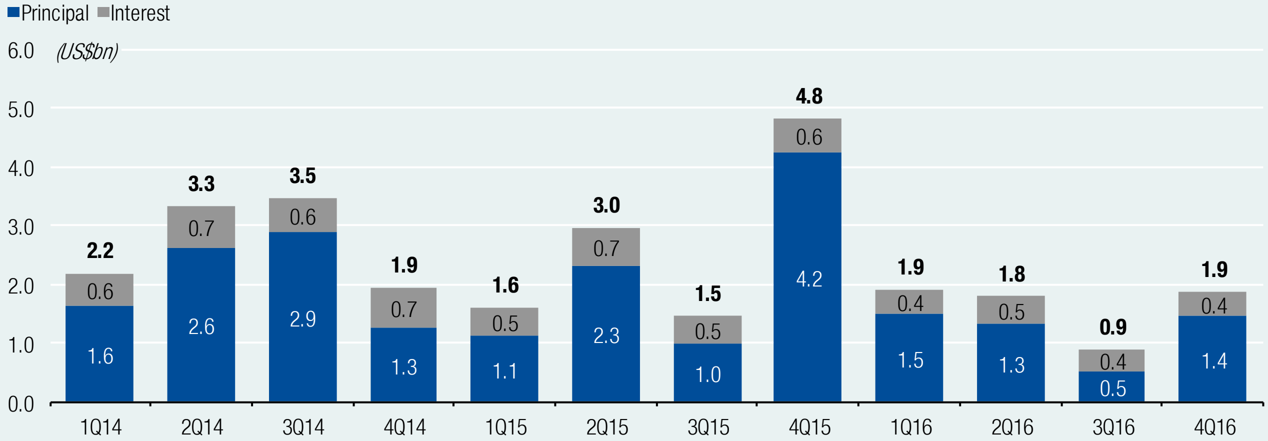
Year	Principal re-payments										Interest payments										Total
	MoF	NBU	Kyiv[1]	Nafto-gaz	Ukr-Inf[2]	Osch-ad-bank	Ukr-exim-bank	Ukr-zaliz-nytsia	Food& Grain[3]	Total	MoF	NBU	Kyiv[1]	Nafto-gaz	Ukr-Inf[2]	Osch-ad-bank	Ukr-exim-bank	Ukr-zaliz-nytsia	Food& Grain[3]	Total	
2013	6,338	3,235	0	0	0	0	0	0	0	9,757	1,603	54	20	322	146	80	92	24	0	2,340	**11,913**
2014	5,724	1,077	0	1,595	0	0	0	0	0	8,395	1,757	34	20	322	146	102	114	48	0	2,542	**10,937**
2015	7,190	487	250	0	0	0	750	0	0	8,677	1,576	41	20	170	146	102	82	48	0	2,184	**10,861**
2016	3,658	0	300	0	0	700	125	0	0	4,783	1,181	37	0	170	146	73	47	48	0	1,701	**6,484**
2017	4,455	0	0	0	1,088	0	0	0	0	5,543	966	36	0	170	146	44	44	48	0	1,453	**6,996**
2018	200	0	0	2,000	690	500	500	500	0	4,390	589	21	0	85	26	22	22	24	127	915	**5,305**
2019	2,980	1,179	0	0	0	0	0	0	0	4,160	535	3	0	0	0	0	0	0	127	666	**4,826**
2020	1,500	0	0	0	0	0	0	0	0	1,500	520	0	0	0	0	0	0	0	128	648	**2,148**
2021	1,500	0	0	0	0	0	0	0	0	1,500	345	0	0	0	0	0	0	0	127	472	**1,972**
2022	2,250	0	0	0	0	0	0	0	0	2,250	285	0	0	0	0	0	0	0	127	412	**2,662**
2023	1,250	0	0	0	0	0	0	0	0	1,250	63	0	0	0	0	0	0	0	127	190	**1,440**
2024	670	0	0	0	0	0	0	0	0	670	11	0	0	0	0	0	0	0	128	138	**809**
2025	0	0	0	0	0	0	0	0	0	0	5	0	0	0	0	0	0	0	127	133	**133**
2026	0	0	0	0	0	0	0	0	0	0	5	0	0	0	0	0	0	0	127	133	**133**
2027	0	0	0	0	0	0	0	0	1,500	1,500	5	0	0	0	0	0	0	0	127	133	**1,633**
Total	**37,900**	**5,977**	**550**	**3,595**	**1,778**	**1,200**	**1,375**	**500**	**1,500**	**54,375**	**9,445**	**226**	**60**	**1,238**	**754**	**424**	**401**	**238**	**1,276**	**14,060**	**68,435**

Notes: Notes: [1] City of Kyiv; [2] Financing of Infrastructural Projects (Bloomberg code: UKRINF); [3] State Food and Grain Corporation.
Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Sovereign external debt: Quarterly data on debt due in 2014-16

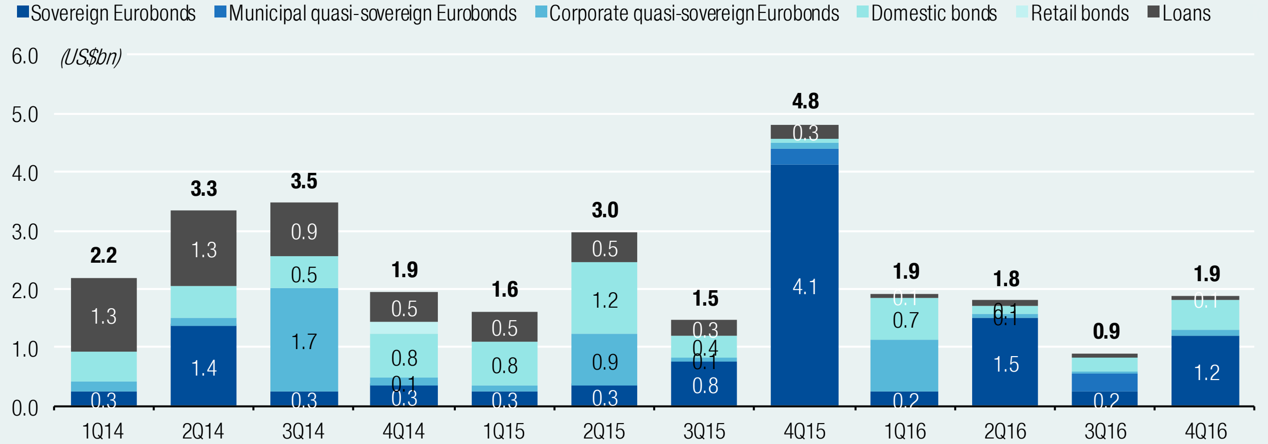
Yearly breakdown of sovereign and quasi-sovereign external debt (charts)

Chart 57. Ukraine's sovereign and quasi-sovereign external debt due in 2014-16: Qtly breakdown by type of cash flow (US$bn)



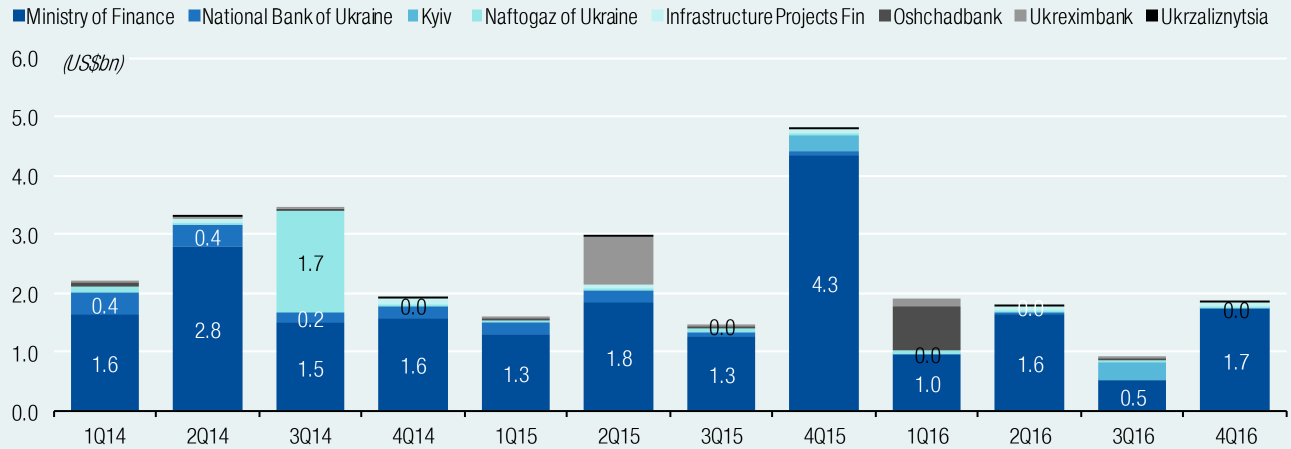
Note: Qtly stands for quarterly. Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 58. Ukraine's sovereign and quasi-sovereign external debt due in 2014-16: Qtly breakdown by type of debt instrument (US$bn)



Note: Qtly stands for quarterly. Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 59. Ukraine's sovereign and quasi-sovereign external debt due in 2014-16 : Qtly breakdown by ultimate borrower (US$bn)



Note: Qtly stands for quarterly. Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Quarterly breakdown of sovereign and quasi-sovereign external debt (tables)

Table 10. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US$m)
By type of debt instrument, data as of 11 April 2014

Year	Principal re-payments							Interest payments							Grand
	Sovrgn Euro-bonds[1]	Muni Euro-bonds[2]	Corp Euro-bonds[3]	Local bonds[4]	Local retail bonds[5]	Loans[6]	Total	Sovrgn Euro-bonds[1]	Muni Euro-bonds[2]	Corp Euro-bonds[3]	Local bonds[4]	Local retail bonds[5]	Loans[6]	Total	Total
1Q14	0	0	0	421	0	1,207	1,628	255	0	152	98	0	61	566	**2,194**
2Q14	1,000	0	0	416	0	1,213	2,629	366	10	128	134	9	57	703	**3,332**
3Q14	0	0	1,595	446	0	839	2,880	255	0	152	98	0	78	583	**3,463**
4Q14	0	0	0	627	200	432	1,259	334	10	128	128	9	80	689	**1,947**
Ttl 2014	**1,000**	**0**	**1,595**	**1,909**	**200**	**3,692**	**8,395**	**1,210**	**20**	**561**	**458**	**17**	**275**	**2,542**	**10,937**
1Q15	0	0	0	686	0	432	1,118	255	0	77	89	0	73	493	**1,611**
2Q15	0	0	750	1,132	0	432	2,314	334	10	128	104	0	77	653	**2,967**
3Q15	500	0	0	307	0	192	999	255	0	77	61	0	70	462	**1,461**
4Q15	3,805	250	0	0	0	192	4,246	334	10	97	60	0	74	575	**4,821**
Ttl 2015	**4,305**	**250**	**750**	**2,125**	**0**	**1,247**	**8,677**	**1,179**	**20**	**378**	**313**	**0**	**294**	**2,184**	**10,861**
1Q15	0	0	825	659	0	0	1,484	238	0	77	48	0	68	431	**1,916**
2Q15	1,250	0	0	74	0	0	1,324	239	0	97	60	0	74	469	**1,794**
3Q15	0	300	0	226	0	0	526	238	0	44	22	0	68	373	**899**
4Q15	1,000	0	0	448	0	0	1,448	200	0	97	57	0	74	427	**1,876**
Ttl 2015	**2,250**	**300**	**825**	**1,408**	**0**	**0**	**4,783**	**916**	**0**	**314**	**187**	**0**	**284**	**1,701**	**6,484**

Notes: [1] sovereign Eurobonds; [2] municipal Eurobonds issued by City of Kyiv, which are considered as quasi-sovereign external debt; [3] corporate Eurobonds issued by state-run banks and non-bank entities, which are considered as quasi-sovereign external debt; [4] foreign-currency sovereign bonds issued on the domestic bond market; [4] USD-denominated sovereign bonds issued domestically with special purpose to be sold to retail investors; [6] IMF loans extended to MoF and NBU.

Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Table 11. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US$m)
By ultimate borrower, data as of 11 April 2014

Year	Principal re-payments									Interest payments									Grand
	MoF	NBU	Kyiv[1]	Nafto-gaz	Ukr-Inf[2]	Osch-ad-bank	Ukr-exim-bank	Ukr-zaliz-nytsia	Total	MoF	NBU	Kyiv[1]	Nafto-gaz	Ukr-Inf[2]	Osch-ad-bank	Ukr-exim-bank	Ukr-zaliz-nytsia	Total	Total
1Q14	1,266	361	0	0	0	0	0	0	1,628	366	6	0	118	0	51	25	0	566	**2,194**
2Q14	2,267	362	0	0	0	0	0	0	2,629	518	5	10	43	73	0	31	24	703	**3,332**
3Q14	1,108	177	0	1,595	0	0	0	0	2,880	376	12	0	118	0	51	25	0	583	**3,463**
4Q14	1,082	177	0	0	0	0	0	0	1,259	497	12	10	43	73	0	31	24	689	**1,947**
Ttl 2014	**5,724**	**1,077**	**0**	**1,595**	**0**	**0**	**0**	**0**	**8,395**	**1,757**	**34**	**20**	**322**	**146**	**102**	**114**	**48**	**2,542**	**10,937**
1Q15	941	177	0	0	0	0	0	0	1,118	363	11	0	43	0	51	25	0	493	**1,611**
2Q15	1,387	177	0	0	0	0	750	0	2,314	462	10	10	43	73	0	31	24	653	**2,967**
3Q15	932	66	0	0	0	0	0	0	999	334	10	0	43	0	51	25	0	462	**1,461**
4Q15	3,930	66	250	0	0	0	0	0	4,246	417	9	10	43	73	0	0	24	575	**4,821**
Ttl 2015	**7,190**	**487**	**250**	**0**	**0**	**0**	**750**	**0**	**8,677**	**1,576**	**41**	**20**	**170**	**146**	**102**	**82**	**48**	**2,184**	**10,861**
1Q15	659	0	0	0	0	700	125	0	1,484	303	9	0	43	0	51	25	0	431	**1,916**
2Q15	1,324	0	0	0	0	0	0	0	1,324	321	9	0	43	73	0	0	24	469	**1,794**
3Q15	226	0	300	0	0	0	0	0	526	277	9	0	43	0	22	22	0	373	**899**
4Q15	1,448	0	0	0	0	0	0	0	1,448	279	9	0	43	73	0	0	24	427	**1,876**
Ttl 2015	**3,658**	**0**	**300**	**0**	**0**	**700**	**125**	**0**	**4,783**	**1,181**	**37**	**0**	**170**	**146**	**73**	**47**	**48**	**1,701**	**6,484**

Notes: Notes: [1] City of Kyiv; [2] Financing of Infrastructural Projects (Bloomberg code: UKRINF).

Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

ICU consumer basket: Observation of Kiev, New-York and Moscow prices

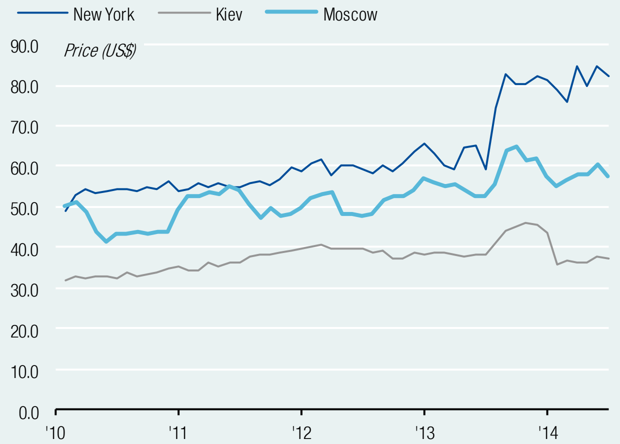
Table 12. ICU consumer basket as of end of July 2014
price observation in the urban areas of Ukraine, USA and Russia, ie, in the countries' most populated cities – Kiev, New-York, and Moscow

Item of the basket	Description	Kiev, central district 28-Jul-14 Price (UAH)	New York metro-politan area 28-Jul-14 Price (US$)	Moscow, central district 28-Jul-14 Price (RUB)
Consumer goods				
Coca-cola (0.5 litre, plastic bottle)	Non-alcohol beverages	7.64	2.25	42.90
Beer Corona Extra (0.33 litre, glass bottle)	Alcoholic beverages	21.29	1.66	83.25
Bunch of fresh bananas (1 kg)	From Ecuador	14.83	1.52	47.90
Pack of milk (1 litter)	Locally produced, soft package, i.e., not glass bottle	9.01	1.95	60.90
Chicken meat (1 kg pack)	Locally produced and branded package, boneless breast	46.95	13.18	185.00
Canned pineapple (0.85 kg, can)	Pineapple circles, Dole brand	29.57	2.55	130.61
Pasta (0.5 kg)	Soft package, produced in Italy	16.47	1.97	49.00
Sugar (1 kg)		13.10	3.72	35.90
Package of table salt (0.5 kg)		6.31	0.74	12.80
Chicken eggs (10 units pack)	White eggs, standard size	18.44	3.16	78.90
Chocolate (100 g)	Made by Craft Foods Corp, Milka brand	12.29	2.20	64.90
Toothpaste (100ml package)	Colgate	29.88	1.68	130.00
Shampoo (200ml package)	Head & Shoulders brand, for normal hair	37.64	2.85	145.00
Toilet paper (4 rolls package)	Kleenex Cottonelle brand, white paper, Regular toilet tissue	30.06	4.13	98.90
Magazine	Men's Health, local edition, A4 format (standard one, not a pocket book format)	28.27	5.99	120.00
Gasoline (1 litre)	Lukoil, regular	15.79	1.04	34.87
Batteries (AA x 4 pack)	A 4-pack of AA Duracell batteries, Alkaline	27.79	5.99	120.00
Coffee (250 g, vacuum pack)	Jacobs Monarch, brick-like vacuum pack	40.27	8.99	159.00
Services				
Underground commute ticket	Within the central part of the city	2.00	2.50	40.00
Cinema ticket	Thursday's night price for the seat with good location, Hollywood film	45.00	14.00	400.00
Total basket value (in local currency)		**452.60**	**82.07**	**2,039.83**
Exchange rate versus US dollar at spot market as of date of observation		12.150	1.000	35.502
Total basket value (in US$)		**37.25**	**82.07**	**57.46**
Overvalued "+" / undervalued "-" (%)				
UAH vs. USD		**-54.61**		
UAH vs. RUR		**-35.17**		
Fair value in the long-run as of observation date				
UAH per USD		**5.515**		
UAH per RUR		**0.222**		

Source: Investment Capital Ukraine.

Chart 60. ICU consumer basket value (US$), from Feb-10 till Jul-14

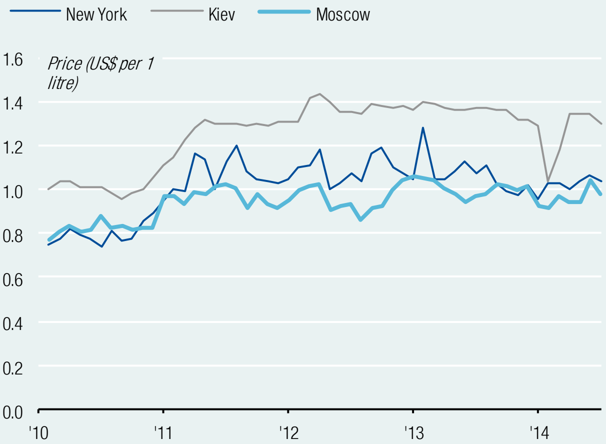
Total value of the ICU basket in US dollar terms



Source: Investment Capital Ukraine.

Chart 61. Gasoline A95 equivalent 1 litre (US$)

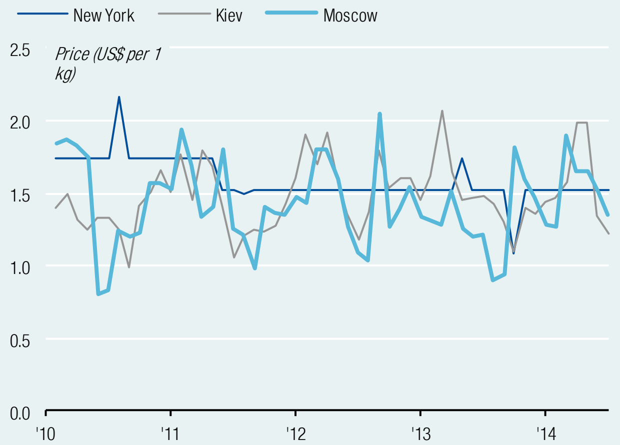
Price history from February 2010 till July 2014



Source: State Statistics Service of Ukraine.

Chart 62. Fresh banana 1 kg bunch (US$)

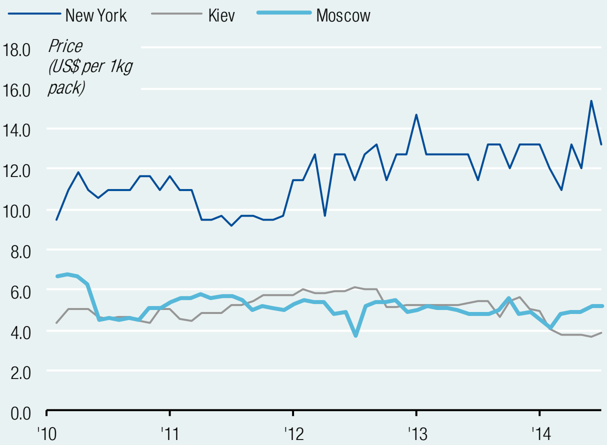
Price history from February 2010 till July 2014



Source: Investment Capital Ukraine.

Chart 63. Chicken meat 1 kg pack of boneless breast (US$)

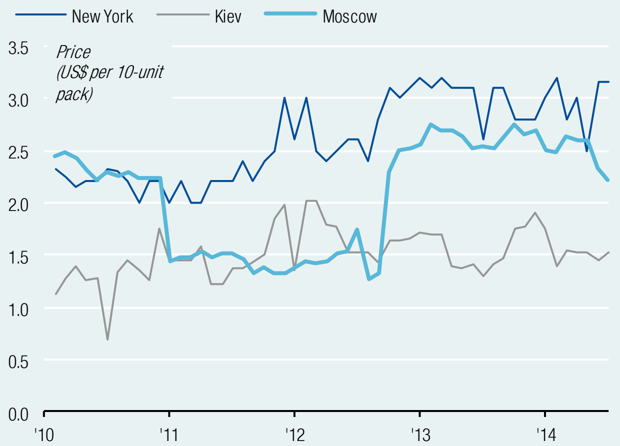
Price history from February 2010 till July 2014



Source: State Statistics Service of Ukraine.

Chart 64. Chicken eggs 10-unit pack (US$)

Price history from February 2010 till July 2014



Source: Investment Capital Ukraine.

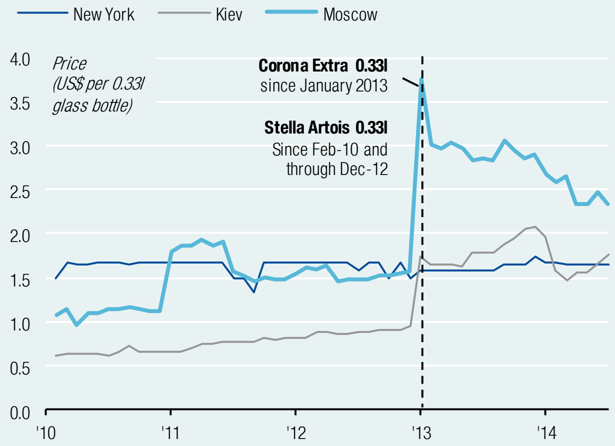
Chart 65. Pasta 0.5 kg soft package Italy-made (US$)

Price history from February 2010 till July 2014

Source: Investment Capital Ukraine.

Chart 66. Beer Corona Extra 0.33 litre glass bottle (US$)

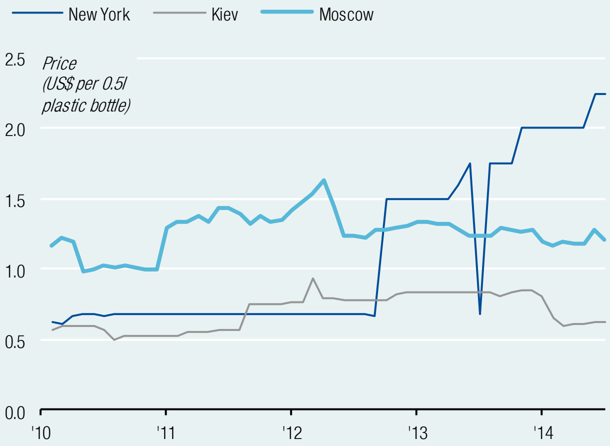
Price history from February 2010 till July 2014



Source: State Statistics Service of Ukraine.

Chart 67. Coca-Cola 0.5 litre plastic bottle (US$)

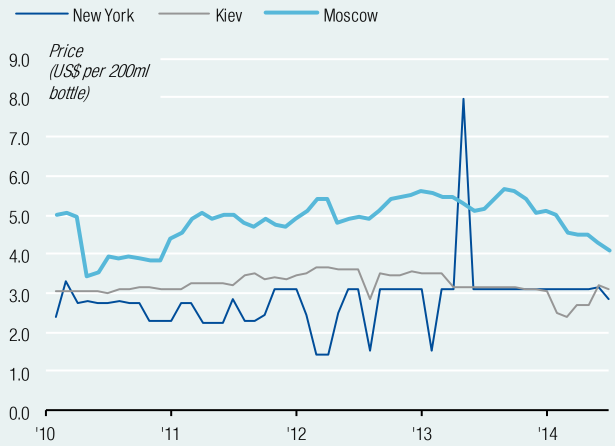
Price history from February 2010 till July 2014



Source: State Statistics Service of Ukraine.

Chart 68. Shampoo 200ml bottle Head & Shoulders (US$)

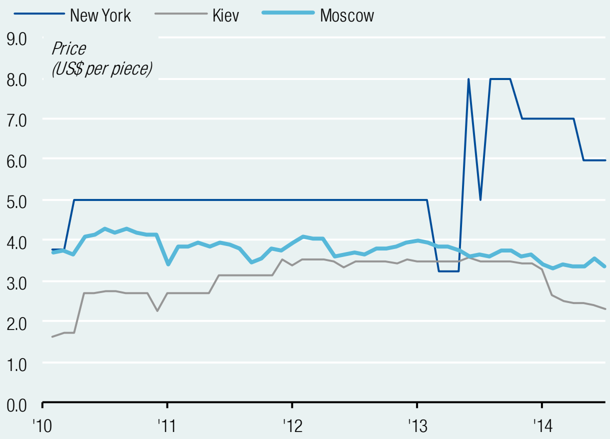
Price history from February 2010 till July 2014



Source: State Statistics Service of Ukraine.

Chart 69. Magazine *Men's Health*, A4 format (US$)

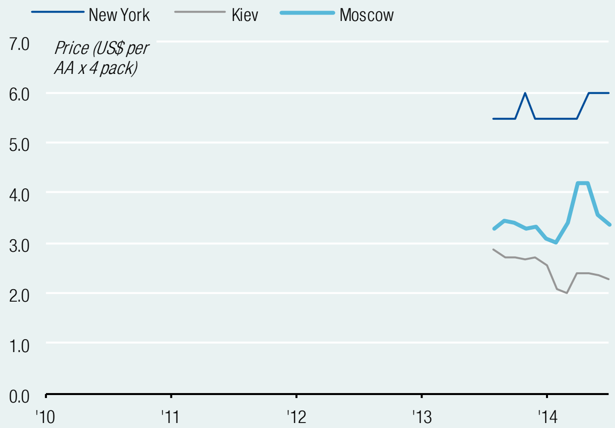
Price history from February 2010 till July 2014



Source: State Statistics Service of Ukraine.

Chart 70. Duracell batteries (AA x 4 pack) (US$)

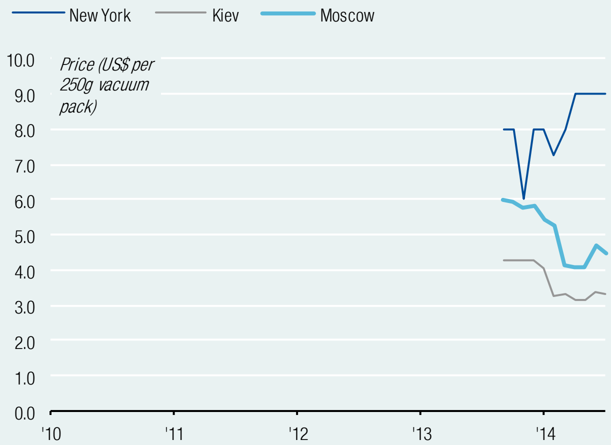
Price history from August 2013 till October 2013



Source: State Statistics Service of Ukraine.

Chart 71. Jacobs Monarch coffee, 250 g vacuum pack (US$)

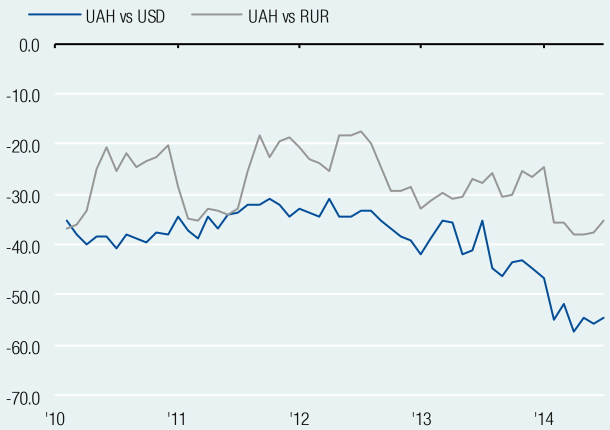
Price history from September 2010 till October 2013



Source: State Statistics Service of Ukraine.

Chart 72. Value gap of ICU basket in UAH vs. USD and RUB (%)

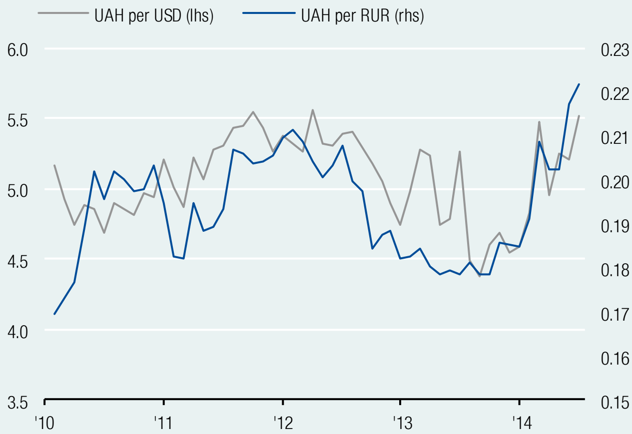
Price history from February 2010 till July 2014



Source: State Statistics Service of Ukraine.

Chart 73. An exchange rate level of UAH per USD and UAH per RUB, which would eliminate the value gap of ICU basket

Price history from February 2010 till July 2014



Source: State Statistics Service of Ukraine.

Disclosures

ANALYST CERTIFICATION

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