Focus
Ukraine

Scope
Economics

Research team
Alexander Valchyshen

Quarterly Report

Practicing a crises slalom

12 NOVEMBER 2014

READ FIRST THE DISCLOSURES SECTION FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

Contents

RESEARCH TEAM

Alexander Valchyshen
Head of research
alexander.valchyshen@icu.ua
Kiev, +38 044 2200120

PUBLICATION DATE

12 November 2014 16:11

Executive summary

This is an updated and condensed summary of our macro view for the 4Q of 2014 and 2015-16.

Ukraine is practicing a crises slalom. In our view, the past 12 months saw acute political crisis followed by currency crisis and then banking sector crisis. A sovereign debt crisis, while being a permanent thing all this time, is likely to evolve into a more acute stage over 2015-16. There are still areas of the economy, where inefficiency and chronic assets erosion has been the norm, that most likely would require the government to accept their debts on its balance sheet. That is why this report highlights the fiscal gap as the key confidence destructor. Hence, public debt level is not stabilizing over the period forecast, restraining growth projections.

Geopolitics: Kremlin complications as a permanent factor. In our view, a wild geopolitics game waged by Russia on Ukraine has been cemented by this year's war and is considered by us a permanent element affecting Ukraine's economy as long as the Kremlin is being run by the *siloviki* class[1]. The Minsk ceasefire agreement has been just a tactical element for Ukraine's authorities and the Kremlin both. The former needed it to take a breather before the October 26 parliamentary elections. And for the latter, it has been an element in a game of seesaw tactics between the powers while it aims to further its own goals.

The Kremlin has two goals: one external and one domestic. Externally, one is about to destabilize Ukraine as much as possible and install a "friendly" administration in Kiev to preside over Ukraine. The other is to mask serial domestic economic mismanagement in Russia and adapt the country's economy to an ever-changing global environment. Both goals are *de-facto* survival measures for the Kremlin. While both aims have not been a 100% success, in our view, this creates natural incentive for the Kremlin to amplify its efforts as a total change of cause is unacceptable for Kremlin.

Hence, Ukraine's economy is at permanent risk of regional geopolitical escalation, which in plain English could be either another wave of Russia's military aggression (after Crimea and Donbas) or perhaps some unexpected surprise in Ukraine that would destabilize its politics and economy.

Politics: Pro-EU and pro-reform agenda of the Poroshenko-Yatseniuk duo consolidates in parliament. The parliamentary elections held on 26 October resulted in a consolidation of the positions of the political parties and blocs with a pro-EU agenda. President Poroshenko's Bloc emerges as the largest faction (about 140-150 MPs), while short of forming a majority on its own. Hence, it will form a majority with the PM Yatsenyuk and City of Lviv Mayor Sadoviy parties, which effectively have similar agendas that differ only slightly. Julia Tymoshenko and Oleg Lyashko, while being too populist, are likely to be engaged by the coalition to widen its base. However, their pro-independence rhetoric and support base overlap with the parties of the new majority and hence they could provide occasional support to the Poroshenko-Yatsenyuk duo if required. And finally, Arseniy Yatsenyuk survives elections as the next prime minister of the reshuffled government,

[1] The faction of hardline former security and military people around the Russia president.

which is set to resume cooperation with IMF on steering the economy out of the current malaise. However, the country's political and bureaucratic system still remains highly resistant to change, which is likely to dog the reforms agenda.

Global economy: unfavourable backdrop. In our view, prospects in the global economy are highly unfavourable for the Ukraine's economy as both its key trade partners—EU and Russia—are struggling. Both are likely to experience recession in 2H14-1H15 and their economies would still be quite sluggish going forward. It is now a widely held view that both economies are to live with weak currencies: EUR is to trade in the markets in the 1.20-1.25 range (or even weaker). A similar story is true for RUB, which is to trade in the 44-48/USD range (or even weaker, too). Key commodities markets—grains and steel—for Ukraine, too, are not bright spots.

Hence, in our view: external demand for Ukraine export produce will be feeble in 2014-15, and implies that domestic demand, driven by fixed investments (businesses to realise adapting modernisation and increase efficiency) will be in the driver's seat. Moreover, Ukraine's economy would tend to adapt to the weak external environment by staying marginally more competitive. This implies a weak currency.

Ukraine's economy: In depression. After a lengthy period of stagnant growth rates, the economy was hit by numerous shocks in 2014—exchange rate adjustment and Crimea annexation over mid 1H, then *de-facto* war with pro-Kremlin militants and Russian army in Donbass— and sank into depression. With numerous crises at hand (from political crisis to currency crisis to bank crisis, and with a sovereign debt crisis is looming) the second half of 2014 is to see a deeper contraction of real GDP than the first half; about 10% versus 2%. Overall, we forecast full-year real GDP decline of 6.3%, and for next year (2015) a nearly 2% decline is seen. Recovery, which starts in 2H15, is projected to result in a full-year increase just in 2016 of only 3% YoY.

Fiscal gap as a key issue of the crisis. Due to the persistent underperformance of the private sector, there have been more and more fiscal gaps emerging. Hence, public debt level went north and is expected to be on this trajectory over the rest of 2014 and 2015. These fiscal gaps are stemming from the energy and banking sectors. One of the gaps has been revealed by IMF between its two missions to Kiev in April and July, when government financing to Naftogaz this year increased nearly two-fold from UAH62bn to UAH115bn. Another gap, which is yet to be enumerated and eventually to be filled by the government financing, is recapitalization of the banking sector. In general, sovereign creditworthiness has been eroded massively this year. With still looming fiscal gaps (in banking sector, in Naftogaz) to be filled by the government, a triple-C credit rating is expected to be attached to Ukraine's government well into late 2015.

Our view on the central government budget deficit this year is at the projected UAH98bn or 6.2% of GDP, if government would not persuade the new parliament to sequester the budget. Total financing needs for this year, estimated at more than UAH208bn, is to be followed by an even bigger bill of UAH300bn and UAH230bn at forecasted FX rates in 2015 and 2016, respectively.

Public debt level is forecast at 71% in 2014, increasing to 85% and 88% in 2015 and 2016, as a rational approach as assumed and wins inside the government, and it runs a tight primary balance of the state budget in the next two years.

Prices and interest rates: everything restrictive over next 6-12 months. In our view, a too high inflation environment that has established itself in the economy creates a vicious circle, when inflation spawns the next wave of devaluation, and then again. No wonder, why the banking sector has been losing household deposits and FX shortage is evident. Overall, a systemic banking crisis is evident, in our view, and requires its resolution for the economy to grow.

At the start of new political cycle after the October 26th elections it is rationale to assume that Ukraine's policymakers are to act rationally too. In practice, things are more complicated and authorities willingness to act in the area of resolving the banking crisis, in our view, is dogged by past habit of maintaining vested interests of private sector conglomerates. That is why monetary conditions in Ukraine generally are projected to be unsupportive to growth till end of 2015.

External balance and the hryrvnia (UAH). Capital inflows is an issue to the economy. In this crisis, the banking and non-banking sectors are showing very modest rollover ratios: 89% and 78%, according to the latest data for September 2014. This is contrary to the post 2008-09 crisis period through 2013, when rollover ratio for non-banking sector borrowings was well above 120%. This year (and likely the next one), it is the government (and NBU) that are borrowing from official sources like IMF and WB.

For 2014, we improved our forecast of current account deficit to US$4.3bn (US$5.5bn previously). A heavy toll of repaying sovereign, quasi-sovereign debt and supporting financial stability through FX market interventions results in a US$11.5bn loss of FX reserves, which are to be at US$9bn as of yearend 2014. Over 2015-16, we expected lower current account deficits than before (see our previous *Quarter Report* "Ukraine to Kremlin: Back off" published on 30 July 2014) and in the range of US$2.4-3.6bn (instead of US$7.0-7.7bn). FX reserves are projected recovering thanks to resumption of IMF programme to US$16.7bn and US$21.9bn as of year end of 2015 and 2016 respectively.

Hryvnia is projected weakening further, while authorities are to restrain the market from a sizable overshoot of the nominal FX rate. In our view, fundamentals and market bias to UAH are pushing its market value into the range of 16.0-17.0 in 2015 and 17.0-18.0 in 2016.

Geopolitics

In our view, such a thing as geopolitics is likely to remain a complicated area for Ukraine as a whole and to its economy as long as the Kremlin is being run by *siloviki* group, where Putin is at heart of the body. The Minsk ceasefire agreement is just a tactical element both for Ukraine's authorities, who need to take a breather, and for the Kremlin, which plays a game of seesaw tactics aiming to further its own goals. These goals are, first: its foreign agenda, to destabilize Ukraine economy and install a "friendly" administration to preside over Ukraine, and second: its domestic one, which is to mask serial economic mismanagement in Russia and adapt its economy to an ever-changing global environment—both *de-facto* survival measures for the Kremlin.

The Kremlin's stance on the situation in Ukraine

On 2 October, in a keynote speech at the annual investment forum held by state-owned investment firm VTB Capital, Russia's President Putin did not miss the opportunity to refer to its neighbor, Ukraine, using the term brotherhood, in the patronising tone that is regarded as a national pastime in Russia. In particular, he said, "it is in Russia's interests to have a reliable, predictable partner and neighbor."

In another statement, he spoke of "a bond between Russia and Ukraine of ethnic, religious, and historical nature." In our view, a simple decoding of these statements in plain English reads: The Kremlin is set to extend its current foreign policy stance of playing geopolitical hardball, destabilising Ukraine's status as a nation and as an economy for the sake of its own furthering, which is essentially a reinstatement of the proxy government in Kiev according to the Kremlin's script of burying the EU's and NATO's[2] bid for membership.

In our view, many statements by Mr Putin on Ukraine made these year effectively mean that the Kremlin seeks further political instability for Ukraine, and presages an extension of the missteps Kremlin has taken in terms of economic policymaking and carrying out vital reforms in Russia.

Also remarkable was Mr Putin's reference to the Western sanctions as, "They are helping strengthen Russia." Our translation of this phrase yields the following conclusion. Over the course of 1H14, we have retained the following view: Russia's geopolitical behavior, (e.g, when it annexed Crimea), state of its economy and the model of governance were, in fact, welcoming the sanctions, which since their inception have been softer in nature.

In our view, after the downing of the MH17 jetliner, the West had a wake-up call for applying only soft sanctions, to raise the bar up to the more serious level (even though the sanctions are still not yet totally severe) of sectoral sanctions. This was the Kremlin's major miscalculation, as Mr Putin, in our view, was tolerant of soft sanctions, not severe ones.

[2] In fact, Ukraine's public uprising against the corrupt Yanukovych regime was not about NATO membership. It seemed back in February of this year, when the Yanukovych presidency was seeing its final days, that public sentiment was not much concerned about NATO membership, and that the only foreign policy issue that did matter then was the EU association agreement, which in essence meant a political move to underscore Ukraine's efforts to emulate the EU—a true democracy governed by responsible leadership.

Summing it all up, the Kremlin has confirmed maintaining its highly assertive stance on Ukraine, seeking to undermine the country on all possible spheres. Implicitly, this approach has been in place since long ago, when Mr Putin took over the political helm in Russia in early 2000, up until this year, when it has become an explicit and permanent fixture of Ukraine’s macro story.

The Kremlin's policy toward Ukraine—to deny it, by any means, possible a Westward path by cutting any link to the West via either an EU association agreement, EU membership, or NATO membership to name just few—is a key destabalising factor in Ukraine’s domestic politics and eventually, its economy. In our view, Mr. Putin's words of wishing Ukraine prosperity is pure cynicism, while in the true sense, the opposite is the desired goal: a state that is poorly governed, permanently in a near–failed status, junk-rated, and untouchable by the West.

In the end, the Kremlin's explicit readiness to intervene into Ukraine's affaire by military force or by secret service destabilization means that its level of impact on Ukraine's policymaking and economy is rather high. This also implies that Ukraine's sovereign credit rating would barely recover to the pre-2008 crisis level (of B1 by Moody's, now it stands at Caa3) over our period of forecast, which is through 2015-16.

To some, a pro-Kremlin government in Kiev is a solution. In our view, such a proposition implies an inherently unstable political and economic state. There is evidence in previous administrations, from that of Mr Kuchma to the most recent one of Mr Yanukovych, that relations with the Kremlin have been synonymous with corruption on a grand scale, and hence readily rejected by the public via revolutionary action.

The West’s stance on the Ukraine situation

In our view, the West’s response to the Kremlin’s acts of aggression has been timid, tardy, and largely less than adequate.

Nevetheless, rather than choose to escalate the military conflict, the West opted for a more resourceful way of punishing Russia via economic sanctions. In our view, the very last layer of sanctions imposed on banks and the oil sector in the wake of the MH17 jetliner downing has effected a significant sea change in the geopolitical standoff between the two powers. For the Kremlin, these sanctions, along with generally weak macroeconomic conditions globally, is a quite unpleasant matter. Moreover, the threat to impose more sanctions on Russia if the Kremlin chooses to send its troops outside the currently held of parts of Donbass is another indication that the West (primarily the US and EU) has become weary of the sabre-rattling on the part of the Kremlin, and will stand by its hard line.

In the EU, which has been prone to political interference by the Kremlin over past years, Germany’s leadership in particular appears to be shrugging off public calls for a compromise with the Kremlin. Across the broader EU, policymakers who are well known as prominent Russia experts and promote the “give Putin another chance", and "neutralise Ukraine” approach have been persistently vocal, but still staying on the sidelines.

Thus, in Germany, Professor Hans-Werner Sinn, head of Germany's IFO Institute and an influential, Munich-based economics commentator, called on Western thinkers for compromise, initially, with an op-ed in the *WSJ* this May entitled, "Let's give Putin another chance." Naturally, the German business lobbiers were supportive of the idea. However, the ruling incumbents were not.

In the UK, Christopher Granville, a Russia expert and CEO of Trusted Sources, a research firm, called to neutralise Ukraine in his op-ed on ProjectSyndicate.com. This initiative, of course, received a welcome reception in the Kremlin, while not so much in the West.

If the EU rolls back sanctions alongside the US, then it could provide grounds for or even an explicit invitation to stage another wave of military provocation and destabilisation in Ukraine. This move is our projected worst-case scenario, however. While the Kremlin's continued focus on undermining Ukraine is our base-case scenario. It is likely to do through the Donbass territory under its *de facto* control, as well as through other parts of Ukraine, such as the Kherson oblast, because it borders Crimea, which has been annexed by the Russian military, and the Odessa and Vinnytsia oblasts, because they border Transdnistrier, which a Kremlin-bankrolled territory fully capable of staging an invasion if the order is given. Other surprise developments are likely.

Politics

Parliamentary elections held on 26 October resulted in a consolidation of the various positions of the political parties and blocs with a pro-EU agenda. However, still, the political and bureaucratic system remains highly resistant to change, which is likely to dog the reforms agenda. President Poroshenko's Bloc is likely to emerge as the largest faction, while short of forming a majority on its own. It is to form a majority with the PM Yatsenyuk and Lviv Mayor Sadoviy parties, which effectively have similar agendas that differ only slightly. Despite Julia Tymoshenko and Oleg Lyashko being too populist, however, they are in talks to strengthen the base of the coalition and join it. And finally, the next prime minister is to be Arseniy Yatsenyuk, staying focused in implementing the IMF programme.

The system proves rigid still

The way the reforms agenda in Ukraine has been stalled and is painfully proceeding in only a few areas is prove that the country's political and bureaucratic systems are strongly rigid, with built-in resistance to change, especially to change on a grand scale.

That is why, in our view, in terms of swift reforms implementation, the new parliament that is emerging after the 26 October elections will tend to be described by pundits as performing midway through a disappointment and encouragement for perseverance.

It is noteworthy that the addition of some of the Maidan civil activists into the political blocs present in the parliament will sharpen the focus of the leading and long-serving politicians.

Despite the fact we believe the pro-EU political formations will gain a majority overall, the usual internal squabbles as well as pervasive politically (and financially) vested interests are likely to dog the reforms agenda still.

The fact that many of the Yanukovych bigwig loyals have succeeded being re-elected via regional constituencies spells trouble for a pro-reform parliament. A number of MPs, who used to be in the Communists or Party of Regions factions have scrambled into the newly elected parliament via democratic elections and will most likely continue their highly populist agenda and generally destructive practice of pulling Ukraine back under the Kremlin's umbrella.

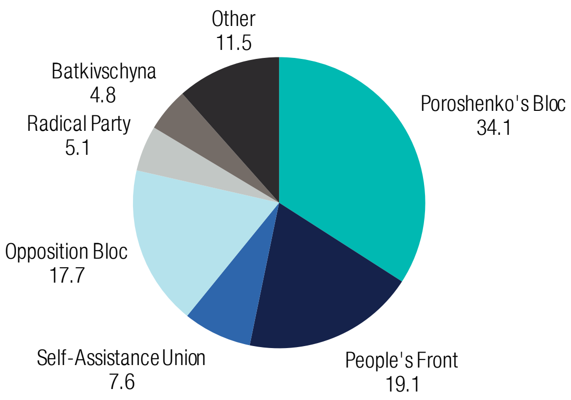
Composition of the new parliament

The parliamentary majority, in our view, is likely to be formed by Mr Poroshenko's Bloc, together with the Yatsenyuk party called People's Front and Samopomich (Self-Assistance) led by Lviv Mayor Andriy Sadoviy. Together they would command 260-265 MPs. On the back of this coalition, the government led by Yatsenyuk will be re-shuffled. Yatsenyuk's people are likely taking over the fiscal policy issues, while Poroshenko's turf remains monetary policy, foreign relations and the security and military issues. Sadoviy has sidelined himself from active politics in the parliament as he obviously put his sight on the next presidential elections in five years time, where he is going to take part. Sadoviy's people will likely fill minor positions in the government.

The opposition Bloc of pro-Kremlin politicians is going to stay in the opposition. Tymoshenko and Lyashko's Radical Party are adhering to a highly populist economic agenda. At the same time Tymoshenko's Batkivschyna and Lyashko's Radical Party have overlapping mindsets with the majority of the Poroshnko-Yatsenyuk duo on the same side of general issues like the Westward path of the independent Ukraine. On this ground, these parties are able to cooperate, and Poroshenko and Yatsenyuk will likely use this chance to pass legislation that requires constitutional majority.

Chart 1. Forecasted breakdown of the future parliament by leaders of the political parties

According to the data of Central Election Committee, as of 3 November 2014



Source: pravda.com.ua, ICU.

Global economy

In our view, prospects in the global economy are highly unfavourable for the Ukraine's economy as both its key trade partners—EU and Russia—are struggling. Continued recessionary trend in China's industrial sector, as evidenced by a two-year long PPI deflation, suggests that global steel prices are to stagnate, which is a negative development. Weakness of the crude oil price, which eventually crossed the US$100 level, is projected there to stay in the period of forecast.

Developed economies: Polarisation of macroeconomic conditions? Not so fast

Of the four leading global developed economies—the US, Eurozone, UK, and Japan—the economies of the European Union have emerged as the least capable to stage a recovery after two "Greats"-- the Great Recession of 2008 and the Great Debt Crisis in the Eurozone in 2010-13.

Judging from a number of economic activity indicators—unemployment, inflation (see charts below), and, hence real GDP growth—the Eurozone is gradually approaching a saturation point that would force authorities (fiscal and/or monetary) to take remedial action.

Over the course of 2014, the Eurozone's low inflation and high unemployment rates have been pointing to a gradual worsening of the area's economic prospects; however, the financial markets dealing in Eurozone sovereign debt have been relatively quiet, despite still-growing public debt levels in the region to the extent that it is believed that the ECB would stage a major intervention if another wave of debt crisis erupts.

Thanks to the US economy's gradual recovery and the Fed's determination to end QE this month, the euro's exchange rate has devalued from 1.39 earlier this year to 1.25 currently. This adjustment, if a near 1.25 dollar-per-euro rate is sustained over time (a likely scenario), would aid the Eurozone economy, which is at risk of entering another recession.

With the global economy still enmeshed in a painful rebalancing (as evidenced by the adaptation paths chosen by China and Russia; see the following section for details), it is very likely in our view that there is little room for a sustainable recovery of one of the large global economies in the near future. Only the US economy has, over 2014 to date, appeared to be gradually recovering from the 2007-08 recession.

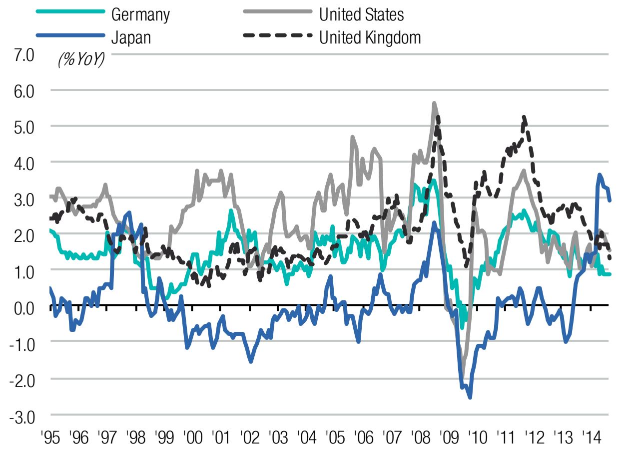
Given the Eurozone struggles and the emerging economies' sluggishness, the sustainability of the US recovery is seen as not 100% assured, however. Slow and uneven growth in the US is more likely. Hence, in our view, the US dollar rally has reached a plateau that should extend for the next 3-6 months, after which it is forecast to appreciate at a slower pace. We have incorporated this view in our base-case scenario.

In our worst-case scenario, another wave of debt crisis erupts in the Eurozone, because of a deeper recession taking place than was previously forecasted (Russia and China factors could play out in this regard; for instance, Russia could act even more aggressively than before toward Ukraine), pushing the euro's exchange rate further down beyond 1.2, and even to parity.

In our best-case scenario (also the least likely one), the Eurozone would swiftly resolve its domestic issues with debt and diverging competitiveness, while the US economy would be plugged by a surprise economic shock, creating a weaker US economy versus the Eurozone's relative strength.

Chart 2. Consumer price conditions in the G4 (% YoY)

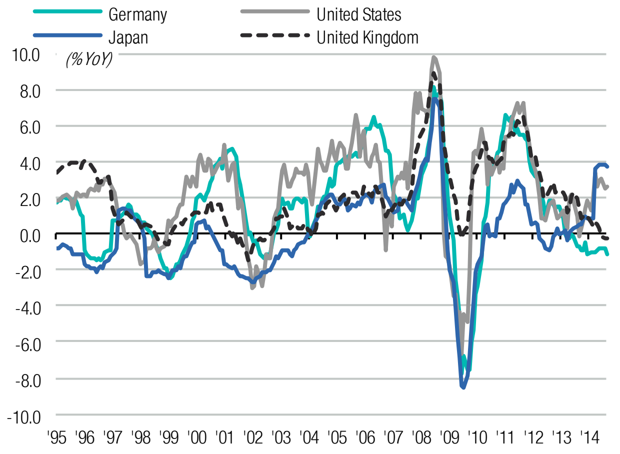
Monthly history from January 1995 through September 2014



Sources: Bloomberg, ICU.

Chart 3. Producer price conditions in the G4 (% YoY)

Monthly history from January 1995 through August 2014



Sources: Bloomberg, ICU.

Emerging economies: Adaptation is key

There are two vital economies for Ukraine – Russia and China. In our view, both are adapting to ever changing global macroeconomic environment. The former is trying to influence its adaptation through aggressive geopolitics, which have a great deal of macroeconomic foundation. The latter, being itself an instigator of the great commodities boom in 2000s, is undergoing a slow rebalancing because of the Great Recession. For China, it results in a stagnation of the industrial sector, where excess of installed capacity is an issue.

In China, a lengthy period of PPI deflation—it lasts 27 months from July 2012 to September 2014—spells a dilemma for the authorities. Lower external demand (because of stagnant EU and a bit more reliant on itself US) puts pressure on authorities to handle the issues of employment and wage growth (both are likely tending to be worth). The widely held consensus that China real GDP is on the declining path from 7.5% YoY suggests a soft landing of the economy. However, it is not a coincidence that China turned to more assertive relations with neighbourhood nations (ex Russia) at the time of increased economic challenges that surely create social strain. In this regard, we think that China's monetary authorities will further experiment with FX flexibility and will allow CNY a measured weakness (the one that was observed in 2Q14 when USD/CNY was hovering inside the 6.21-6.26 range). In our view, for a more lively economic activity, a weaker Chinese currency is a logical path. Hence, in our base case scenario the CNY exchange rate returns to the 6.20-6.25/USD area over next 6-12 months down from 6.12/USD.

In Russia, there is a mix of cyclical and structural factors that serve as drag on the economy, which has been "slowing down" (official wording) over past four years now. In our view, the real growth is likely to be flat this year. Many contribute this year's economic debacle to sanctions imposed by the West. In our view, this explanation is a simplification.

Indeed, on net today's sanctions do harm, however, the pre-MH17 sanctions[3] were quite soft and encouraged domestic consolidation in Russia, which supported economic activity at some extent. This argument implies that even without sanctions by the West (a reaction to Kremlin's aggressiveness toward Ukraine and land grab in Crimea and Donbass) Russian economy was on course to experience a very tough environment of weaker domestic demand, scarce credit, lower oil prices and eventual need for authorities to devalue the domestic currency (which has been persistently overvalued over past few years). In our view, the key structural element of the Russian economy is its political system, a primary factor. Indeed, there are economic factors, too, but they are secondary.

Going forward, there is a requirement for the Russian economy to have its currency properly valued on the market. Hence, we project ruble in the range of 44-48/USD[4] over the period of forecast, which for this report goes from 4Q14 through 2016. Exchange rate and inflation dynamics are intertwined as ruble weakening results in accelerated consumer inflation. Hence, there will be some period, up to two years, during which a gradual structural change in the economy would eat down the high exchange rate pass-through in the Russian economy.

All in all, Russia’s economy being governed by politically inflexible authorities is adapting to the changes in the global economy through a mix of self-imposed restrictions. They resemble a desire to become a bit more like China in terms of limitations of capital account operations. This policy choice is not free of mistakes. A key mistake (that caused an unforeseeable event) was to supply the pro-Kremlin militants in Donbass with long-range missile military equipment (that mistakenly downed MH17 passenger jetliner). It caused heavier retaliation from the West with a range of sanctions on banks and energy sector companies. Hence, this Kremlin's policy choice to guide the economy will remain prone to other mistakes, very much fatal ones. That is why (among other things), our view on Russian economy is as one that provides recessionary (and in some case depressionary) spillovers on its trade partners.

Global indicators vital for Ukraine

We base our projections on the global economy view of IMF (in the recently published World Economic Outlook[5]), which states the global economy is growing less than previously forecast: 3.3% versus 3.4% in 2014 and 3.8% versus 4.0% in 2015. In 2016, we tend to view global growth static if compared to 2015.

For Russia, in our view, we tend to be less upbeat than the IMF forecast and hence expect zero growth this year. In 2015-16, a feeble growth rate is forecast, mostly the product of two counterweighing factors: a weaker currency policy is addressing the budget revenues and competitiveness issues (pro-growth), while a political system that supports public sector and hence provides more strain on the private sector is a drag (growth negative).

In the commodities markets, there is continued tendency for a gradual subsiding of the crude oil price (outright decline of crude oil price to US$60 is not our base-case scenario). In the steel markets, we projected a continued stagnation.

[3] The range of sanctions applied by US and EU on Russia in the period between Crimea annexation and shoot down of Malaysia Airlines jetliner (MH17).

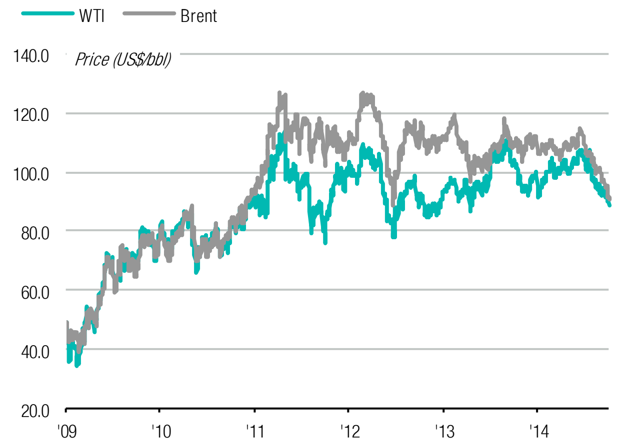
[4] In our view, Russian ruble being at 45/USD is undervalued. Our assessment of the fundamental value for the ruble, which is derived from the real trade-weighted indices, is 40/USD.

[5] http://www.imf.org/external/pubs/ft/weo/2014/02/pdf/text.pdf

For data details see Table 1, p.15.

Chart 4. Crude oil price (US$ per barrel)

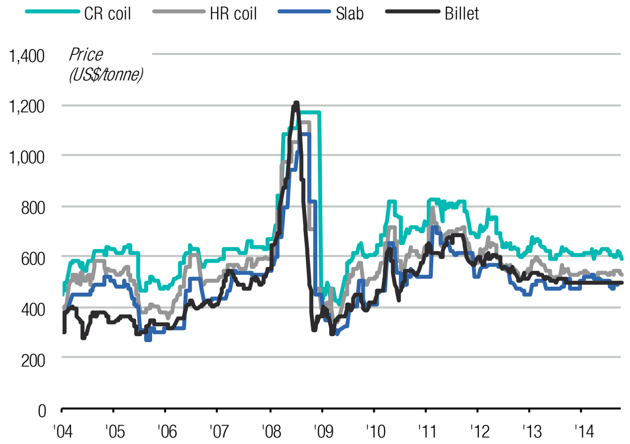
Spot market daily quotations



Sources: Bloomberg, ICU.

Chart 5. CIS export steel prices (US$ 000s per tonne)

Quarterly averages



Sources: Bloomberg, ICU.

Table 1. 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	3Q14E	4Q14F	1Q15F	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F	2014F	2015F	2016F
World real GDP[1]	3.3	3.3	3.3	3.3	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.3	3.8	3.8
Russia real GDP[1]	0.9	0.8	-0.5	-1.0	0.0	0.5	0.5	1.0	1.5	2.5	2.5	2.5	0.0	0.5	2.3
Crude oil (US$[2])	98.7	103.1	84.4	82.0	81.8	81.6	81.4	81.0	80.8	80.6	80.4	80.0	92.0	81.5	80.5
Steel (US$[3])	531.0	532.0	538.0	471.0	587.0	596.0	596.0	596.0	596.0	596.0	596.0	596.0	518.0	593.8	596.0
EUR/USD (eop)	1.37	1.37	1.32	1.25	1.23	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.25	1.20	1.20
USD/RUB (eop)	35.17	33.98	39.60	44.00	45.00	45.00	45.00	46.00	48.00	48.00	48.00	48.00	44.00	46.00	48.00

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: A crises slalom

In our view, the past 12 months saw acute political crisis followed by currency crisis and then banking sector crisis. A sovereign debt crisis, while being a permanent thing all this time, is likely to evolve into a more acute stage over 2015-16. There are still areas of the economy, where inefficiency and chronic assets erosion has been the norm, that most likely would require the government to accept their debts on its balance sheet. That is why this report highlights the fiscal gap as the key confidence destructor. Hence, public debt level is not stabilizing over the period forecast, restraining growth projections.

Collapsing economy due to war and confidence drop

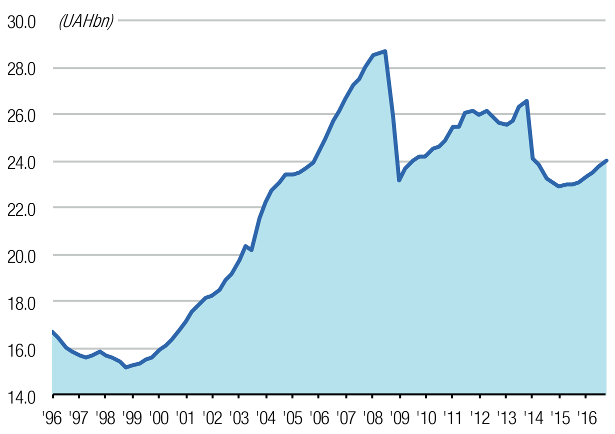
The destruction of confidence that embraced the entire economy is quite a powerful factor that will haunt the economy until late 2015, at least. In our view, there are few areas of the economy where the drop in confidence is evident at first glance. These are banks, fixed-investments, and logistics.

Logistics collapse has links to the war with Russia when a cargo transportation drop took place during the active phase of military operations by Ukraine with pro-Kremlin militants and a bit later with the Russian army. The same is true regarding passenger transportation, which suffered both from Donbass militarization and Crimea annexation as the normal way of life (that was known before) has now gone.

Another factor has been confidence destruction associated with business and consumer decision making. Confidence collapsed in banks and in their capability to service their debt (which are mostly deposits). It collapsed in the hryvnia as the deep devaluation of early 2014 did not go hand-in-hand with inflation restraining monetary measures.

Chart 6. Quarterly GDP size (UAHbn)

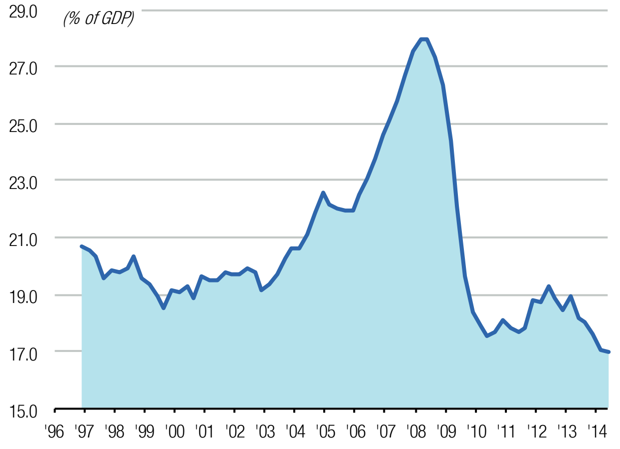
At constant prices of Dec-95, seasonally adjusted; history through 1H14; forecast from 2H14 to end 2016



Source: State Statistics Service of Ukraine, ICU.

Chart 7. Share of fixed investments in GDP (%)

History from 4Q96 through 2Q14



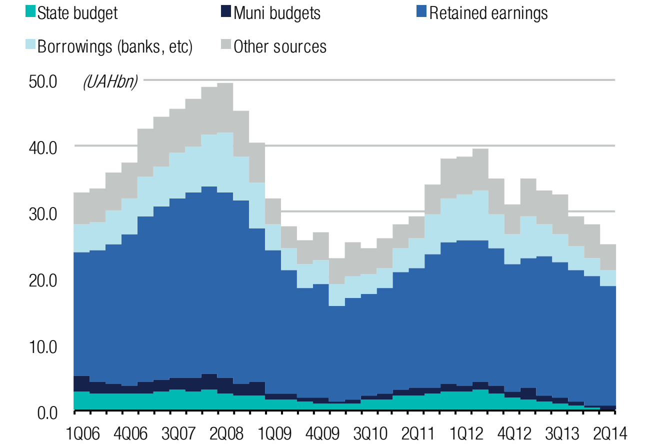
Source: State Statistics Service of Ukraine, ICU.

Confidence destruction is evident in the double-digit decline of fixed-capital formation as reported by quarterly statistical reports on GDP in 1Q and 2Q of 2014. It is to continue in 2H14. As of end of 2Q14 fixed investments as share of GDP stood at 17%, which is a multi-year low suggesting a period of underinvestment has severed even more confidence than in the past few years.

Breakdown of sources of funds to finance the investments, as reported by statistics, indicate that over the 1H14 reliance on their own funds by businesses increased (from an average of 60% seen in 2006-12 to 69.7% in 2Q14). Bank financing as a financing source dropped from 14% to 9.2% over the same time period.

Chart 8. Historical breakdown of quarterly volume of investments by source of funding (UAHbn)

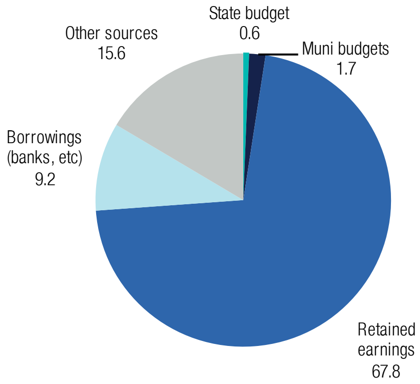
At constant prices of Dec-2005, seasonally adjusted; history from 1Q06 through 2Q14



Source: State Statistics Service of Ukraine, ICU.

Chart 9. Breakdown of 2Q14 quarterly volume of investments by source of funding (%)

100% = UAH20bn

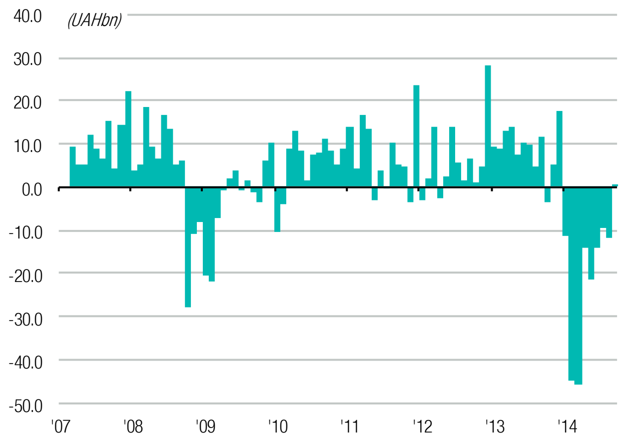


Source: State Statistics Service of Ukraine, ICU.

The banks as a whole are an epicentre of that process of confidence destruction. In this January, the sector has experienced the first month of deposits withdrawals. Since then, every month through August, for which the latest statistics are available, banks have been losing deposits (see chart below). Over January-August, the banking sector lost deposits (excluding exchange rate revaluation factor) in total of UAH172bn. This trend halted in September and October as abnormal queues in some banks are still visible.

Chart 10. Monthly volumes of deposit flows* (UAHbn)

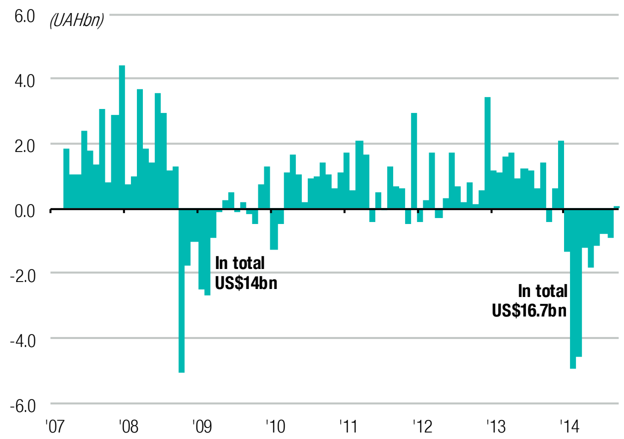
Monthly history from January 2007 through September 2014



Note: * all deposits, adjusted for FX rate change; all deposits, including households and non-financial corporations. Source: NBU, ICU.

Chart 11. A US dollar equivalent of the monthly deposit flows

Monthly history from January 2007 through September 2014



Source: NBU, ICU.

The charts above depict current and previous episodes of deposit withdrawal from the banking system. The previous banking crisis in 2008-09 lasted seven straight months and saw a US dollar equivalent of deposits withdrawn to US$14bn, of which US$8bn were household deposits. The current crisis has lasted 11 months already and has seen a total of US$17.6bn of deposits withdrawn (of which US$11.8bn were household deposits) during January-September.

Fiscal gap as a confidence destruction factor

In our view, a key element of the ongoing confidence destruction is fiscal gap and government financing needs. Over the course of the last 12-month period, the forecasts of the fiscal gap of the central government for 2014 have been revised down, indicating that public finances have been in deterioration.

IMF's initial projection of the deficit made in May was UAH78bn or 5.2% of GDP. It was revised up in August to UAH88bn or 5.8% of GDP.

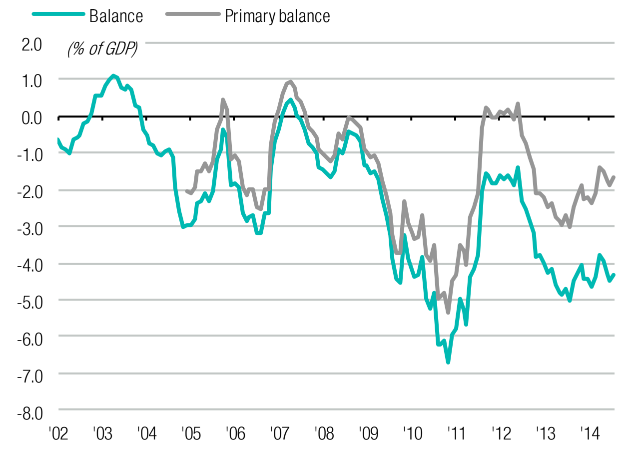
Our own forecasting of the matter fell victim of the same nature – every next forecasting review ended up with downward revision. Thus, a year ago our forecast of 2014 budget deficit was UAH78bn or 5.1% of GDP; this April, it was seen at UAH89.6bn or 6.1% and its current assessment is UAH98bn or 6.2%.

Apart from this, there is Naftogaz financing needs. Naftogaz's deficit has been a subject of quite sizable downward revision in a matter of few months between IMF's programme launch this May and the following programme review by the Fund made in August. It rose from UAH50.4bn or 3.3% of GDP in May to UAH65.3bn or 3.4%. Albeit more spectacularly, IMF found this August that Naftogaz reguires more support from the taxpayer than it sought in May – government financing for Naftogaz was upped by nearly double from UAH61.6bn to UAH115.2bn, because of re-assessed arrears and 'other' items.

Another fiscal issue that has a fluid nature is the banking sector support by taxpayers' money. So far, government and central bank extended UAH4.2bn this year to beef-up the State Deposit Guarantee Fund (there is a need to add UAH10bn more into the fund till the end of 2014 to cover existing liabilities upon the failed banks). It still remains a great unknown how much of taxpayer’s money would be required to recapitalize the banking sector. The IMF programme says the government is allowed to inject UAH15bn in state-run banks while the rest of the sector is sought to be recapitalised by shareholders' money. So far, shareholders' did not start capital injections, staging only verbal exercises trying to assure that they will do it in the future. The uncertainty regarding state involvement in the banks recapitalisation pushes professional investors into Ukraine's sovereign debt to assume a scenario that is worse than the one as detailed in the IMF's updated programme.

Chart 12. State budget deficit (% of GDP

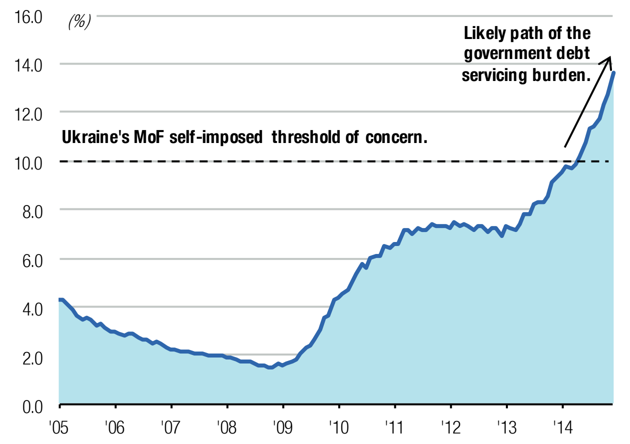
12-month rolling data. History from January 2002 through August 2014



Source: Ministry of Finance of Ukraine, ICU.

Chart 13. Ratio of debt servicing to revenues (%)

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



Source: Ministry of Finance of Ukraine, ICU.

Fiscal situations have been highly strained this year. Central government budget deficit has been hovering around 4.3% of GDP level in 12-month rolling terms this year. This result is not so bad if one takes into account the dire collapse in activity that has been evolved from bad to worse. A step up in taxation was the key fix to the issue. Expenditures cut was modest and was rather a twist as savings on a certain expenditure item was provided for expenditure on the military. The weight of past recap bonds (local currency long term bonds issued to recapitalize Naftogaz, banks and other state entities) that carry a 15% semi-annual coupon and increased borrowing in general have been pushing the debt service expenditure to 12% of revenues now. It is forecast to end this year at 13.6% and at 18.4% at the end of 2015. This development is a fiscal burden that results from fiscal neglect (sustaining deficits while their elimination or tapering is required instead).

In terms of total financing needs this heavy year is just followed by an even heavier one. While this year's financial needs of the central government is estimated at UAH208bn, next year's forecast at UAH300bn (FX portion of debt is based on our FX rates forecast). And this increase is taking place despite our assumption that the government acts rationally and does not rush to increase nominal budget expenditures too much, given double digit inflation.

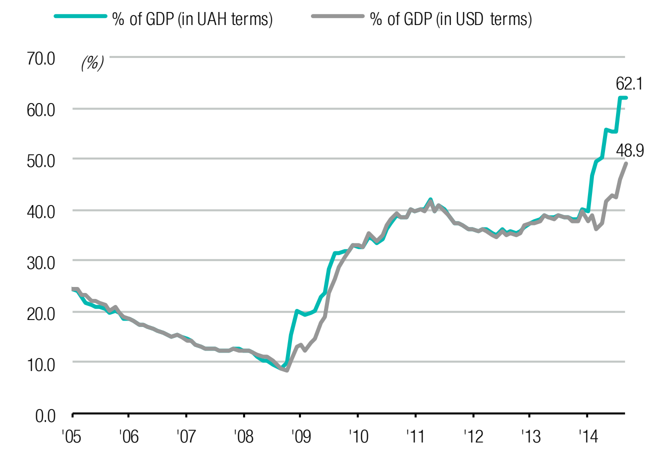
Given the deficits, our public debt level projections are 70% in the end of 2014, 85% and 88%[6] in 2015-16 on the back of assumptions that government runs a smaller deficit of the primary balance during next two years, however the government will continue assuming more debt on its balance sheet while recapitalising banks and Naftogaz.

[6] These public debt ratios are calculated upon the local-currency volumes of debt and GDP as of yearend. It is assumed that banking sector recapitalization costs would amount to 10% of GDP, these costs will fall on 2015.

Regarding the Russian Eurobond covenant

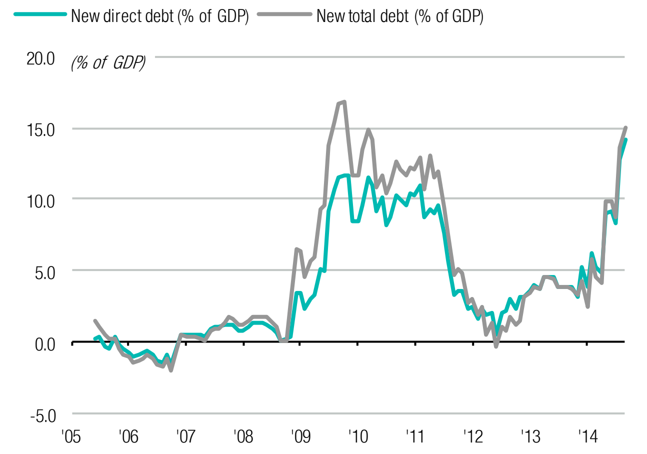
There is widespread and legitimate concern over the 60% debt-to-GDP covenant built into the US$3bn Eurobond[7] prospectus, which has been defined by the Russian government, an ultimate holder of the note. The risk is that the Kremlin would add pressure to the Ukraine's government on top of the existing pressure it has in the military and energy security spheres. In our view, this risk does exist, although in practical terms the Ukraine's has (albeit a limited) room to manoeuvre as the covenant wording is loosely written (it does not define a precise formula for the debt ratio calculation). Thus, Ukraine's public debt level based on UAH data is higher than one based on the USD data (Chart 14): as of September the UAH-based ratio was 62.1% while the USD-based one at 48.9%[8]; these figures are projected to be at 71.6% and 55.8% respectively as of this December. The last figure, the US dollar base debt-to-GDP ratio, is calculated upon the assumption that UAH's FX rate is weakened to 16/USD and nominal debt volume is not increased sizably. Such assumptions, in our view, fit well into the Ukraine's authorities most recent policymaking manoeuvring: 1) there is a hard (albeit costly) peg in FX policy of holding UAH at near 13/USD; 2) the next disbursement of IMF money (two tranches should be received as one instalment) is postponed till early January 2015 as both IMF and Ukraine are not accelerating it; 3) Ukraine's statistics office has published better-than-expected 3Q real GDP reading (it reported a 5.1% YoY decline while frequent data indicators was painting a bit bigger drop). Another little bit of surprise for the 4Q should not be ruled out. Hence, if summed together this manoeuvring is capable to move Ukraine's public debt-to-GDP ratio through the 2014 yearned and into 2015 at below 60% level, albeit if one calculates it in the foreign currency terms.

Chart 14. Public debt level (% of GDP)
History from January 2005 through September 2014



Source: Ministry of Finance of Ukraine, ICU.

Chart 15. Pace of public debt accumulation (% of GDP, 12-month rolling data)
History from January 2005 through September 2014



Source: Ministry of Finance of Ukraine, ICU.

[7] Due in December 2015.

[8] This figure is obtained by dividing the US dollar stock of public debt, which is US$74.3bn, and divided by the 12-month volume of GDP, which is US$151.8bn, a sum of 12 volumes of monthly GDP in US dollars for each month from October 2013 through September 2014.

Regarding the sovereign external debt restructuring

This issue was reviewed in more detail in the recently issued report *Bond Market Insight* "New challenges and risks" (24 October 2014[9]). There are three issues that should be taken into account and that back the "no restructuring" account during next 6-12 months. First, the IMF programme excludes this move and after an expected programme review this December, this stance is likely to be retained. Second, total sovereign external debt is rather small if one excludes the US$3bn Dec-15 Eurobond, a political issue, which is hardly negotiable in theory and in practice. Third, below is an extract from the above mentioned report that touches the issues of underlying government's need for restructuring. (In the meantime, in our view, a sovereign debt crisis has been brewing, although the authorities pretend it is not. This situation has a fair chance to deteriorate after the state recapitalization of the banking sector, which will push the public debt level beyond 80%, up to 90% in the 2015-16 period. Then, sovereign debt restructuring could become a way out for authorities. At the same time, it is quasi-sovereign borrowers that are to follow through external debt restructuring since 2015.)

"In between, from the end of the 1990s until late 2003, Ukraine's authorities adhered to a tight fiscal policy by limiting the government budget deficit to near zero as a share of GDP and by lowering budget expenditures to 26% in 2002 from 30% in 1998 and 38% in 1997 (in consolidated terms, Naftogaz's balance was not an issue at the time). Hence, Ukraine's authorities had started a pro-growth macroeconomic policy before the external debt restructuring took place and adhered to it for next several years ended in mid-2004.

This time, in 2014-15, there is a risk that Ukraine's authorities, if allowed by creditors to restructure external debt, could easily wean themselves from unpopular fiscal policy required going forward, because they have been continuously reluctant to do this over the past several years.

Having restored its IMF program since May 2014, the government still displays little progress in reducing public sector deficits and trimming expenditures. State budget expenditures in consolidated terms now stand near 34%. The budget deficit is expected to be at 6% this year and 5% next year. Naftogaz's balance still has a glaring deficit of 4% as projected by the IMF for this year. In our view, this risk of still prevailing fiscal imbalances is evident in the ongoing trust destruction in the economy and in the financial markets. Not only do Eurobond sovereign investors consider debt claims on Ukraine's government as high risk, but domestic players - like bank depositors who have been withdrawing deposits to purchase hard currency all this year - think the same way. If Ukraine were to request external debt restructuring before it achieves the necessary fiscal consolidation, domestic financial conditions would only deteriorate further. A flight to safety would gain momentum and only result in increased FX devaluation, higher bank recapitalization needs, and more public debt. To avoid further trust destruction in the economy, the government will make a concerted attempt to restore business and consumer confidence by reducing corruption and tightening fiscal discipline."

Prices and interest rates: everything restrictive

In our view, the current high level of inflation—being spiked this year from near zero to 17.5% YoY (CPI) and 26.9% YoY (PPI) because of regulated tariffs increase and currency

[9] http://www.icu.ua/download/975/ICUDebtInsight-20141024.pdf.

devaluation—has created a kind of vicious circle, when high inflation feeds devaluation expectations on its own.

This circle means inflation is so high so that it destroys depositors trust in the banks as devaluation expectations are still there. Simply stated, high and double-digit inflation produces nothing but devaluation pressure on the currency, which may end up with another FX overshoot. And then the cycle (devaluation=>inflation=>no credit=>high risk aversion) starts again.

In our view, that is the story of the current situation. No wonder that banks are not lending, they are in the epicentre of the systemic banking sector crisis. Debt monetization by NBU (domestic QE) provides relief for the government, which takes over the debt of quasi-sovereign entities at accelerated speed and does not have access to private creditors' market, except IMF programme funding.

In our view, the start of new political cycle after the October 26th elections provides a logical expectation of Ukraine's policymakers acting rationally. However, rationality has a bit different dimension in Ukraine's power halls so far than in the other economies that fought the recent economic crises with success.

Nevertheless, NBU's policy stance is forecast to become more restrictive in order to break the above mentioned circle when high inflation spawns imminent currency devaluation. Banks recapitalisation is likely to be accelerated painfully as existing shareholders would try to preserve the status quo. Also, NBU will be forced to abandon the FX peg of 12.95/USD as a lack of trust—in the sustainability of public finances, as well in the banks as a whole, due to slow and less-credible banks' recapitalisation process—place a heavy burden on FX reserves, which are declining because of internal capital flight away from UAH risk.

Our forecast for inflation is that double-digit rates remain till early 2016, however, current inflation peak takes place in 1Q15 than gradually subsides. CPI and PPI at the end of 2015 and 2016 are forecast at 11.1% and 10.5% YoY, 8.2% and 10.5% YoY, respectively.

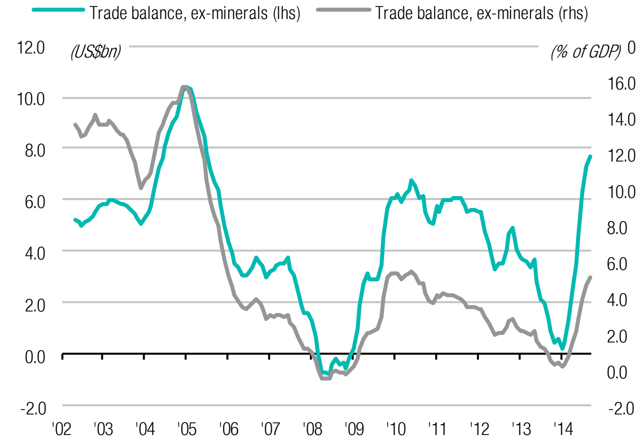
Domestic credit is forecast to be scarce through 2014-15 with 2016 seeing some sensible recovery in bank lending. Access to external credit is expected to remain restrictive till the end of 2H15, when it will become clear whether Ukraine's government is capable of returning to the Eurobond market without official assistance. Our base-case scenario envisages a rational approach to the matter from the authorities to gain this access in 2016.

External sector: Is there more adjustment ahead?

Judging from the above mentioned developments, the answer to the question for this section's title is affirmative. The Crisis in the banking sector has reached systemic proportions, hence, future fiscal gaps, which include banking sector recapitalisation needs, Naftogaz and state budget financing needs, are looming large.

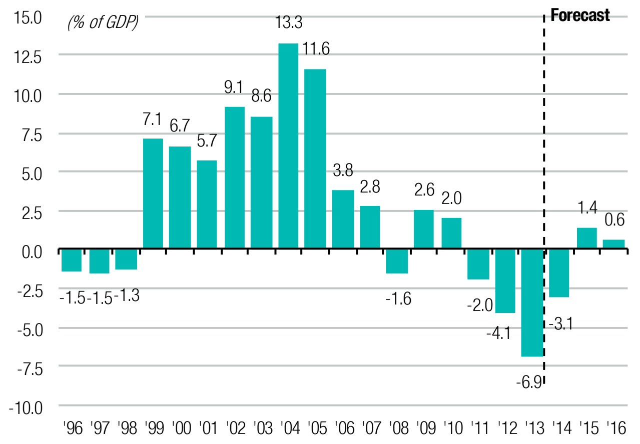
There are other macroeconomic factors that point to a still existing devaluation pressure on the currency and hence a nominal correction of the FX rate. One of the indicators is broad current account balance, which is a sum of current account balance and net FDI, projected for this year to stay in deficit of 3.1% of GDP, meaning a shortage of capital inflows.

Chart 16. Ex-minerals merchandise trade balance (12-month rolling data)
History from January 2002 through September 2014



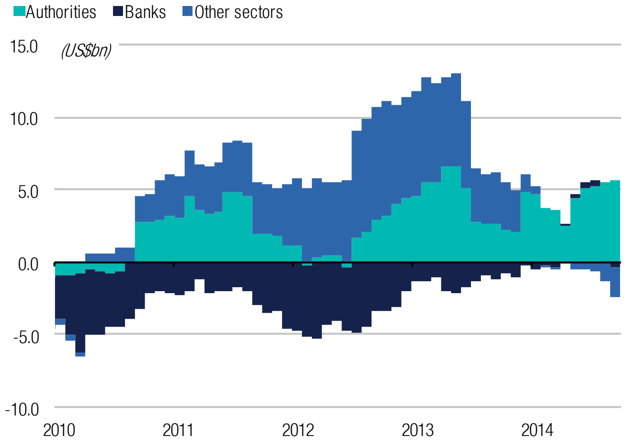
Source: State Statistics Service of Ukraine, National Bank of Ukraine, ICU.

Chart 17. Current account balance plus net FDI: history and projections
History from 1996 through 2013, forecast for 2013-16



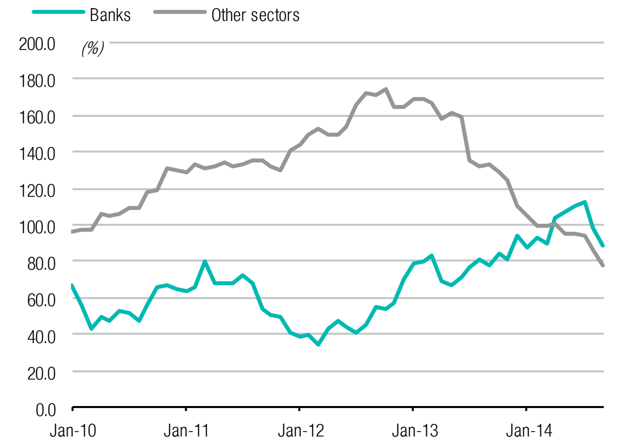
Source: State Statistics Service of Ukraine, National Bank of Ukraine, ICU.

Chart 18. Net flow of cross broader lending by borrower type (US$bn, 12-month rolling data)
History from January 2010 through September 2014



Source: National Bank of Ukraine, ICU.

Chart 19. Rollover ratios for cross border borrowing by banks and corporations (%, 12-month rolling data)
History from January 2010 through September 2014



Source: National Bank of Ukraine, ICU.

Moreover, capital account data reveals a sizable collapse of private sector borrowings (Chart 18-Chart 19), where the rollover ratio on borrowings by the corporate sector turned to below 100% in 2014 after several recent years being well above 120% and peaking to 170% in mid 2012. This development confirms that a confidence drop inflicted the corporate sector – after years of banks deleveraging in the regard of external borrowing, now it is the turn of the corporate sector to deleverage as external creditors become shy to Ukraine corporate risk.

In this environment of confidence drop, it is natural for the authorities to accelerate borrowings to prop the economy. Hence, resumption of lending under an IMF programme and from other official creditors appears vital and is at the core of our base-case scenario.

Given the fact that Ukraine's economy has been in the midst of the systemic banking crisis, there is little ground to assume for the recovery of confidence of the private sector and resumption of abroad borrowings by the corporate sector will take place over next 12 month period. The matter is the banking crisis has just passed its first iteration of asset quality review and stress tests under (quite soft) assumptions and hence appears less credible than it ought to be, in our view. Recapitalisation plans, while being formulated, are appearing quite vague and indicating that shareholders are not preparing to rush with this process. Hence, the authorities are likely to prop up the banking sector with its balance sheet and will be forced to cover recapitalisation costs (of credible size that amounts, as a principle with broad application, to 10% GDP[10]). This exercise would keep Ukraine sovereign credit ratings at low level. In its turn, this would limit private sector ability to borrow from external markets.

This year's delays in the implementation of economic reforms (due to the ongoing war with Russia in Donbass and with the high risk of new escalation of the aggression; then, due to parliamentary elections held at the end of October) IMF programme financing has been arriving later than planned. Instead of having three reviews of the programme, developments went off track, so the second review was made in August instead of July and the second review will take place in December instead of September (with IMF arriving in January 2015).

Lower than expected external borrowings and ongoing reduction of household deposits in the banking sector as a whole provided a run on the currency, and declining FX reserves. On top of that, Ukraine committed to pay US$4.6bn to Gazprom (covering past debt and pre-pay upon 4bcm of natural gas imports during November-December).

All these factors mentioned above promise to lower FX reserves as low as to US$9bn at the end of 2014[11]. Such a low volume of FX reserves by itself is capable of spawning a new wave of devaluation expectations among the public. To counter this tendency, Ukraine's authorities are likely to boost their reforms credentials in the eyes of IMF and other official lenders by re-shuffling the government and making more progress in the banking sector crisis resolution. In our view, the IMF programme could be reviewed with an increase of lending volume (from US$17bn to US$20-25bn) to boost FX reserves volume to the level of US$17bn as of 2015 and US$22bn in 2016. See Table 2 on p.25.

On the other hand, FX adjustment over the course of this year resulted in a recovery of the ex-minerals merchandise trade surplus to nearly US$8bn on the 12-month rolling basis through September 2014, which was well above the US$6bn threshold that coincided with macroeconomic stabilisation and then recovery after the 2008-09 economic crisis (Chart 16). Even in relative terms as a share of GDP, this indicator has approached the level of above 5%, which marked the ceiling of the FX adjustment back in 2008-09. By this logic one could claim that current FX adjustment is enough for the economy.

---

[10] According to IMF papers:
1. Systemic Banking Crises: A New Database
(https://www.imf.org/external/pubs/ft/wp/2008/wp08224.pdf)
2. Systemic Banking Crises Database: An Update
(http://www.imf.org/external/pubs/ft/wp/2012/wp12163.pdf)

[11] Albeit this volume could be higher by some US$2bn if EU provides Ukraine with bridge loan to finance the purchase of the 4bcm in November-December 2015. This was discussed during official talks between Keiv and Brussels on the eve of the recent breakthrough talks with Russia natural gas people (late October) on securing winter supplies by Russia.

Table 2. 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	**-4,298**	**-2,382**	**-3,591**				
Short-term debt[1]	**-62,348**	**-51,995**	**-43,145**				
Government							
Official lenders (IMF)	-2,599	-734	0	218%	1177%	0%	IMF's 2yr SBA US$20-25bn (reviewed)
Russian banks	0	0	0	0%	0%	0%	No loans from Russian banks
Eurobonds	-1,000	-4,257	-2,250	200%	23%	89%	Opportunistic access to the market
Domestic FX bonds[2]	-1,904	-2,122	-1,466	100%	40%	0%	Dom FX bonds phased out gradually
Other	-525	0	0	0%	0%	100%	
Central bank							
Official lenders (IMF)	-1,066	-469	0	270%	2131%		IMF's 2yr SBA US$20-25bn (reviewed)
Other	14	0	0	0%	0%	0%	
Banks							
Eurobonds	-754	-969	-986	0%	50%	100%	Banks bonds after IMF prgm expires
Other lenders	-12,180	-12,047	-13,002	99%	104%	109%	
Corporations							
Eurobonds	-1,645	-1,785	-750	0%	50%	100%	Corporate bonds after IMF prgm expires
Loans	-10,314	-7,507	-6,259	90%	100%	120%	Rollovers ratios at low 100% in '14
Trade loans	-19,275	-14,028	-11,696	90%	100%	120%	The same as above
Other	-11,100	-8,078	-6,735	90%	100%	120%	The same as above
Other	-6,000	-6,000	-4,000				
Total financing needs[3]	**-72,646**	**-60,377**	**-50,736**				
FDI, inflows	43	4,149	4,453				ICU forecast for the period
Borrowings							
Government	9,575	10,487	2,000				
Central bank	2,876	10,000	4,000				
Banks	12,047	13,002	15,146				
Corporations	36,588	30,506	30,379				
Total financing[4]	**61,128**	**68,144**	**55,978**				
Use of reserves	**-11,517**	**+7,767**	**+5,242**				
FX reserves							
At the start of year	20,416	8,898	16,665				
At the end of year	8,898	16,665	21,907				
Change (%YoY)	-56.4	87.3	31.5				
FX reserves (% of GDP)							
At the start of year	12.5	6.6	13.4				
At the end of year	6.6	13.4	16.2				
Change (ppt)	-6.0	6.8	2.8				
FX res.imports cov.[5] (months)							
At the start of year	2.7	1.4	2.8				
At the end of year	1.4	2.8	3.4				
Change (months)	-1.2	1.4	0.6				

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 UAH: Trade-weighted and competitive devaluations approaches

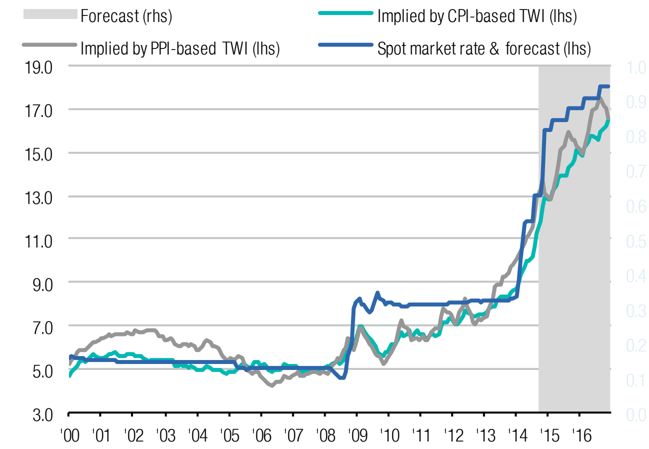
Trade-weighted approach

The above mentioned description of the fiscal gaps and shortages of capital inflows all suggest that UAH is likely to remain under pressure in the FX market. A perspective to end this year with FX reserves in the neighbourhood of US$10bn does just reinforce that pressure.

Our calculations of the historical real trade-weighted indices for the Ukraine's currency yield a fair-value range of 12.3-13.3 with midrange value of 12.8 per US dollar (Chart 22-Chart 25 on p.29). The future real trade-weighted indices for hryvnia, which are based on the expected path of inflation rates and nominal exchange rates in the countries that are key trade partners to Ukraine (from Russia and China to Eurozone members and Turkey), yield a trajectory that would result in a weakening of the national currency towards 16 at the end of 2014 and then towards 18 in early 2016 (Chart 20). Misalignment of the market rate will be negative most of the time, according to our calculations, suggesting that fundamental value of the currency is stronger than the market one (Chart 21).

Chart 20. UAH's exchange rate forecast against the exchange rates implied by ICU's UAH real TWIs (CPI- and PPI-based)

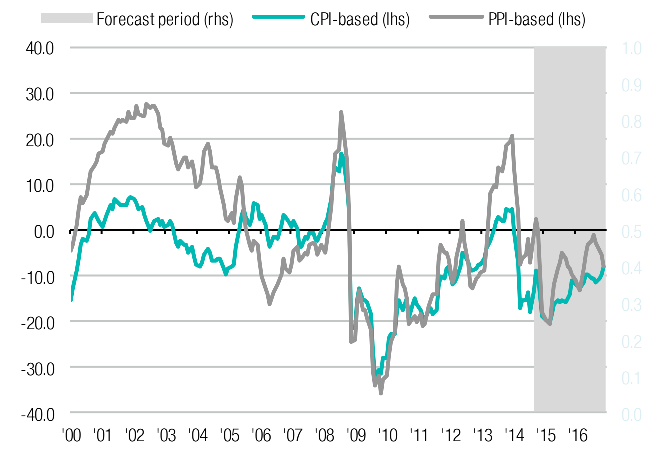
Hryvnia per US dollar. Daily history since 1 Jan 2000 through 10 Nov 2014



Sources: Bloomberg, ICU.

Chart 21. Projected misalignment of the CPI- and PPI-based real TWIs of UAH

Daily history since 1 January 2000 through 10 November 2014



Source: ICU.

In practice, market develops a bias to the future value of the currency, which results in (some cases sizable) misalignment between market rate and the fundamental value as implied by the real trade-weighted valuation. Ukraine's FX market has such a bias, seeing a weaker currency going forward. The next section tests the margins for the UAH's misalignment as NBU, in a post-elections manoeuvre, is set to relax its tight grip on the currency after a recent peg of 12.95/USD.

Competitive devaluations approach

Our estimation of the possible movement of the FX rate in the market, when NBU allows the market to decide, are based on the approach that evaluates the tendency of competitive devaluations that have taken place in the CIS countries over past 12 months. It was Kazakhstan that did this exercise in February this year in a one-off move. Then, Ukraine allowed its currency to drop massively amidst the political and economic disarray in February-March. Russian authorities, too, have been quite relaxed when RUB was weakening since January and were generally okay when ruble went beyond the 40/USD threshold. In Belarus, the currency has been in a slow creeping devaluation trend for several years now.

However, translation of the FX market developments for the national currencies of Ukraine, Russia, Kazakhstan and Belarus into the real trade-weighted values yields the following results (Chart 26-Chart 27, p.30). As of November 5th the Russian ruble declined the most versus the other currencies both by CPI- and PPI-based TWI measurement. Then, it was followed by Ukraine's hryvnia, weakened most by CPI-based real TWI. Kazakhstan tenge was third and lastly Belarus' currency, in fact, was appreciating in real TWI terms.

Hence, all these nations—Ukraine, Russia, Belarus and Kazakhstan—were seen competing with each other in terms of devaluating their currencies to gain the most competitive exchange rate.[12]

Russia is the largest economy out of this group of economies. The rest of the nations have strong trade links vis-à-vis Russia. Hence, due to these two factors, an adjustment of the Russia economy (as the one that takes place today) provides a spill-over effect on these smaller economies. Hence, a Russia ruble devaluation provide a pressure on the currencies of these smaller nations to adjust in order to stay competitive.

For instance, Kazakhstan authorities that made a one-off devaluation of the currency this past winter are probably considering another one as the Russian economy has become more competitive. The same is true for Belarus. that is highly dependent on Russia in trade and capital flows: its currency has been appreciating in real terms over 2014. Hence, to stay competitive it has to devalue the currency, too.

As of today, Russian ruble is pretty much undervalued and its fundamental value, in our view, is 40/USD (see Chart 28 on p.30). On the back of this, our forecast for USD/RUB rate is at 44-45 over 4Q14 and most of 2015 and then it is likely to stay weak trending to 46-48 in 4Q15 and 2016.

In Table 3 on p.30 there is a calculation of the exchange rates for national currencies of this group of nations that eliminate the competitiveness gap vis-à-vis Russian ruble, which has become the most competitive currency in this peer group. These rates are notional ones only.

For Ukraine this exercise yields a range of 14.5-16.6 with midrange value of 15.5/USD.

If UAH's FX rate drops to the midrange rate, which is 15.5/USD or to the lower side of the range, which is 16.6/USD, this would imply that in the real trade-weighted terms UAH's misalignment would be negative in both cases (meaning nominal rate weaker than the fundamental value).

In the former case, if nominal rate drops to 15.5/USD, hryvnia's misalignment (averaging to -17%[13]) is similar to the devaluation episode that was observed in mid March and early April 2014, when FX rate declined sharply from 8.5/USD to 12.2/USD.

In the latter case, if nominal rate drops to 16.6/USD, hryvnia's misalignment (averaging to -24%) is close to the devaluation period seen in late 2008-09[14], when FX rate dropped from 5.1/USD to 8.1/USD.

---

[12] Over past 12-month period, Belarus was not a highly active part of this competitive devaluation process. It did a massive devaluation back in 2011 and since then it was very passive in this regard.

[13] An average between misalignments derived from CPI- and PPI based real trade-weighted indices.

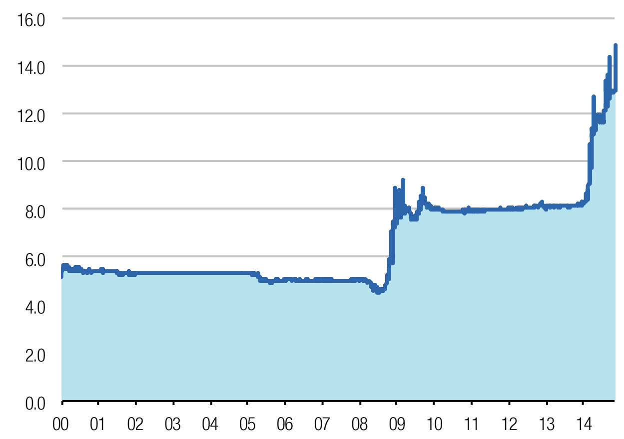
[14] Then, average daily misalignment over December 2008 and entire 2009 was -19%.

In the extreme case, if nominal rate drops to 20/USD, hryvnia's misalignment (averaging to -38%) repeats the devaluation episode that lasted two days in 17-18 December 2008, when FX rate dropped to 8.9/USD and a sizably misaligned hryvnia became even more misaligned. No wonder this episode did not survive even a third day.

These calculations show that our FX forecast for UAH's future nominal FX rate adheres to the idea that Ukraine's currency should be negatively misaligned (undervalued) and the margin of the misalignment is likely to be trimmed by authorities, which would resist sizable overshooting of the FX rate.

Chart 22. UAH exchange rate per USD set by the market

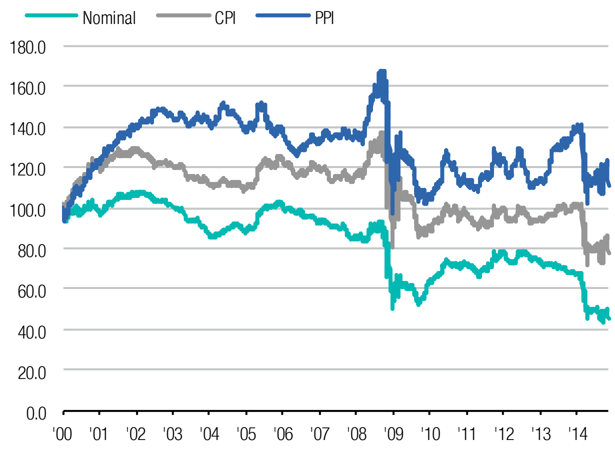
Daily history since 31 December 1999 through 10 November 2014



Sources: Bloomberg, ICU.

Chart 23. UAH nominal and CPI- and PPI-based real trade-weighted indices (TWIs), rebased at 100 points on 31 Dec 1999

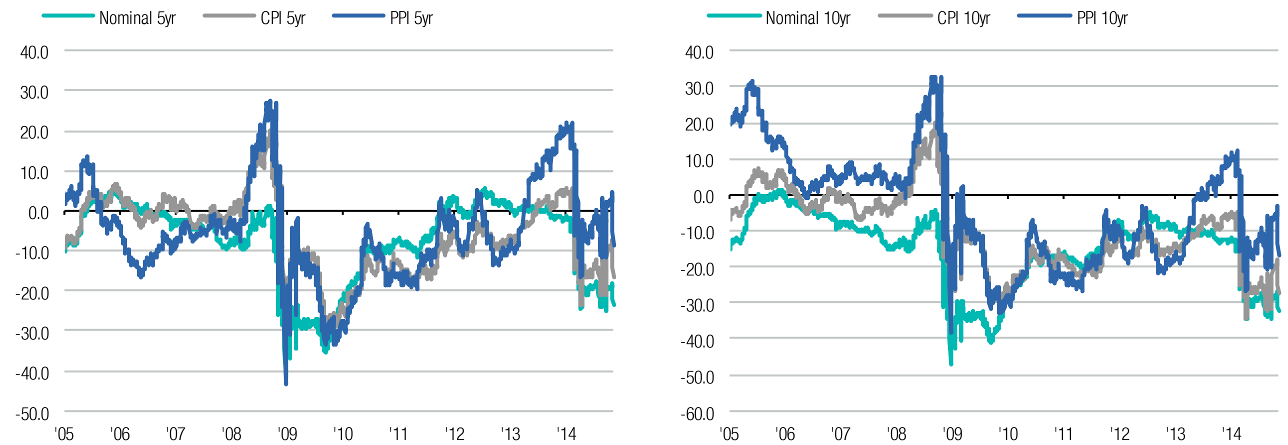
Daily history since 31 December 1999 through 10 November 2014



Source: ICU.

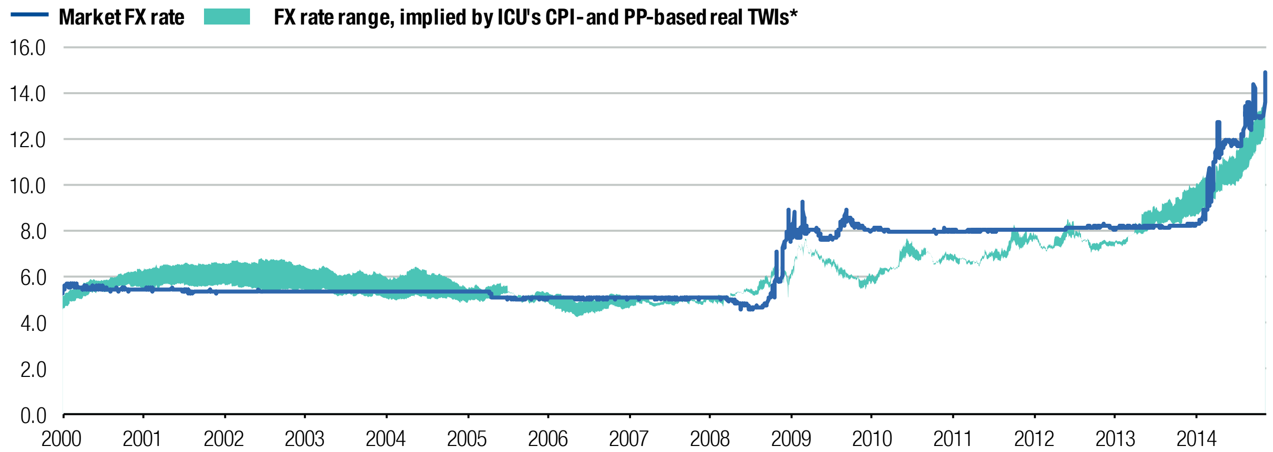
Chart 24. UAH TWIs misalignment to their 5yr and 10yr averages. Daily history since 3 January 2005 through 10 November 2014

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. Source: ICU.

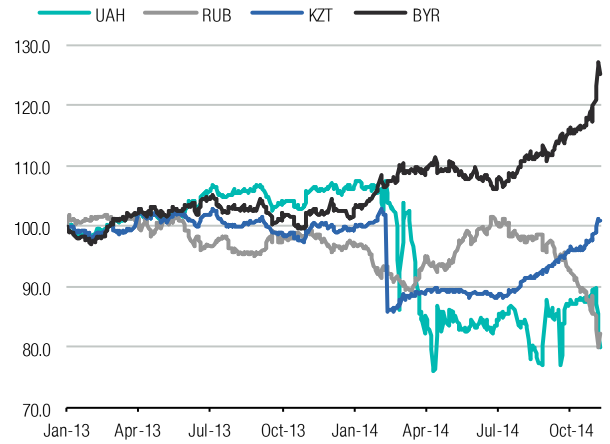
Chart 25. USD/UAH exchange rate vs. the range of real-TWI-implied rates. Daily history since 1 January 2000 through 10 November 2014



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: ICU.

Chart 26. CPI-based real TWIs

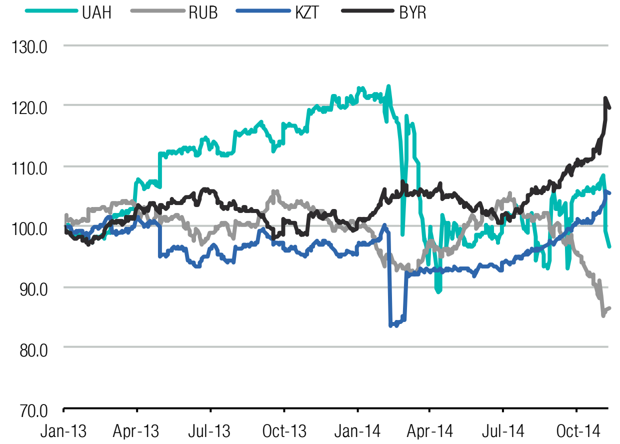
History since 1 January 2013 through 10 November 2014
Rebased 100 points as of 1 January 2013



Source: ICU.

Chart 27. PPI-based real TWIs

History since 1 January 2013 through 10 November 2014
Rebased 100 points as of 1 January 2013



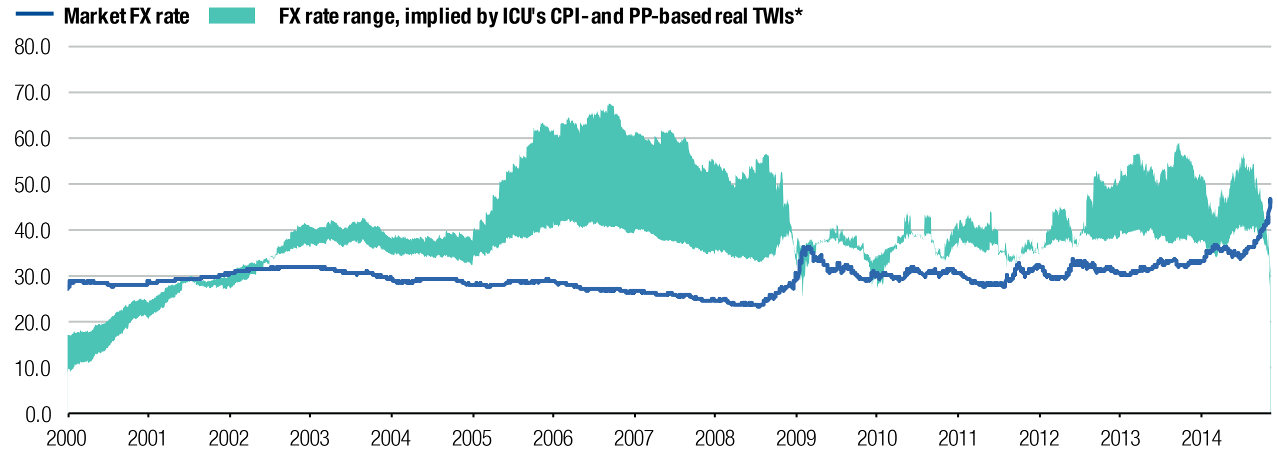
Source: ICU.

Table 3. Ukraine's currency versus Russia, Kazakhstan and Belarus currencies through the prism of real TWI performances[1]

	UAH	RUB	KZT	BYR
Market rate as of 10 Nov 2014				
Per USD	14.854	45.6141	180.87	10,780.00
Real TWIs versus RUB as most competitive ccy in the CIS				
CPI	97.47	100.00	122.81	152.75
PPI	111.65	100.00	122.15	138.44
Notional FX rates to eliminate competitiveness shortfall versus RUB as most competitive ccy in the CIS				
CPI	14.48	45.61	222.12	16,466.35
PPI	16.58	45.61	220.94	14,923.50
Mid	15.53	45.61	221.53	15,694.93

Note: [1] Based on the data depicted on the Chart 26-Chart 27. Sources: Bloomberg, ICU.

Chart 28. USD/UAH exchange rate vs. the range of real-TWI-implied rates. Daily history since 1 January 2000 through 10 November 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: ICU.

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	**-6.3**	**-2.0**	**3.1**
Nominal GDP (UAHbn)	345	441	544	721	948	913	1,083	1,302	1,409	1,455	**1,595**	**1,834**	**2,091**
Nominal GDP (US$bn)	65	87	108	143	184	114	136	163	174	178	**130**	**109**	**118**
GDP per capita (US$, ann)	1,371	1,850	2,319	3,091	3,982	2,474	2,978	3,572	3,823	3,920	**3,023**	**2,534**	**2,740**
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	**22.6**	**11.1**	**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	**11.8**	**17.8**	**9.2**
PPI (%YoY, eop)	24.3	9.6	15.4	23.2	21.1	15.3	18.8	17.4	0.4	1.7	**26.3**	**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	**16.0**	**14.7**	**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	**-112.4**	**-111.7**	**-93.5**
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	**-7.0**	**-6.1**	**-4.5**
Budget balance (UAHbn)	-10.2	-7.9	-3.8	-9.8	-12.5	-35.5	-64.3	-23.6	-53.4	-64.7	**-98.7**	**-94.2**	**-81.5**
Budget balance (% of GDP)	-3.0	-1.8	-0.7	-1.4	-1.3	-3.9	-5.9	-1.8	-3.8	-4.4	**-6.2**	**-5.1**	**-3.9**
External balance													
Exports (US$bn)	41.3	44.4	50.2	64.0	85.6	54.3	69.3	88.8	90.0	85.3	**71.3**	**69.5**	**73.4**
Imports (US$bn)	36.3	43.7	53.3	72.2	100.0	56.2	73.2	99.0	104.4	100.8	**75.4**	**71.6**	**76.6**
Trade balance (US$bn)	5.0	0.7	-3.1	-8.2	-14.4	-2.0	-4.0	-10.2	-14.3	-15.5	**-4.2**	**-2.0**	**-3.2**
Trade balance (% of GDP)	7.7	0.8	-2.8	-5.7	-7.8	-1.7	-2.9	-6.2	-8.2	-8.7	**-3.2**	**-1.9**	**-2.8**
Current account balance (US$bn)	6.9	2.5	-1.6	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.1	**-4.3**	**-2.4**	**-3.6**
Current account balance (% of GDP)	10.6	2.9	-1.5	-3.7	-6.9	-1.5	-2.2	-6.3	-8.2	-9.1	**-3.3**	**-2.2**	**-3.1**
Net FDI (US$bn)	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.8	3.4	**0.0**	**4.1**	**4.5**
Net FDI (% of GDP)	2.6	8.7	5.3	6.4	5.4	4.1	4.2	4.3	3.9	1.9	**0.0**	**3.8**	**3.8**
C/A bal. + net FDI (% of GDP)	13.3	11.6	3.8	2.8	-1.6	2.6	2.0	-2.0	-4.3	-7.2	**-3.3**	**1.6**	**0.7**
External debt (US$bn, eop)	30.6	39.6	54.5	80.0	101.7	103.4	117.3	126.2	135.1	141.5	**134.7**	**140.3**	**144.4**
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	79.2	**103.3**	**128.3**	**122.7**
FX reserves (US$bn, eop)	9.5	19.4	22.3	32.5	31.5	26.5	34.6	31.8	24.5	20.4	**8.9**	**16.7**	**21.9**
FX reserves (% of ann'd GDP, eop)	14.7	22.3	20.6	22.6	17.2	23.3	25.4	19.5	14.1	11.4	**6.8**	**15.2**	**18.6**
External debt / FX reserves (x, eop)	3.2	2.0	2.4	2.5	3.2	3.9	3.4	4.0	5.5	6.9	**15.1**	**8.4**	**6.6**
FX reserves imports cov (months)	3.8	6.4	6.1	6.4	4.5	7.1	6.8	4.5	3.3	2.4	**1.4**	**2.8**	**3.4**
Interest rates													
Central bank key rate (%, eop)	9.00	9.50	8.50	8.00	12.00	10.25	7.75	7.75	7.50	6.50	**14.00**	**10.00**	**8.00**
3-month rate (%, eop 4Q)	15.03	11.46	9.90	7.58	21.60	17.59	6.12	19.72	25.52	11.71	**25.00**	**12.00**	**12.00**
Exchange rates													
UAH trade-weighted index (nominal)	91.29	105.76	96.33	88.22	62.35	62.62	72.39	77.27	74.23	67.38	**44.07**	**41.53**	**39.64**
UAH trade-weighted index (real)	112.78	129.21	123.61	120.06	100.21	90.26	97.73	98.76	94.72	100.84	**76.37**	**77.28**	**76.24**
UAH/US$ (eop)	5.31	5.05	5.05	5.05	7.80	8.00	7.94	8.00	8.05	8.24	**16.00**	**17.00**	**18.00**
UAH/US$ (average)	5.32	5.10	5.03	5.03	5.25	8.03	7.94	7.99	8.08	8.16	**12.39**	**16.75**	**17.75**
UAH/€ (eop)	6.71	7.20	5.97	6.66	7.36	10.90	11.45	10.66	10.62	11.32	**20.00**	**20.40**	**21.60**
UAH/€ (average)	6.62	6.35	6.32	6.89	7.67	11.19	10.54	14.21	10.60	11.17	**16.47**	**20.23**	**21.30**
US$/€ (eop)	1.36	1.18	1.32	1.46	1.40	1.43	1.34	1.30	1.32	1.37	**1.25**	**1.20**	**1.20**
US$/€ (average)	1.24	1.24	1.26	1.37	1.47	1.39	1.33	1.34	1.31	1.37	**1.33**	**1.21**	**1.20**
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, NBU, ICU.

Quarterly forecast for 2014-16, base-case scenario

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

			Forecast by ICU									
	1Q14	2Q14	3Q14E	4Q14F	1Q15F	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F
Activity												
Real GDP (%YoY)	-1.1	-4.6	-1.1	-4.6	-5.1	-13.7	-5.8	-3.3	-0.1	1.4	2.5	3.0
Nominal GDP (UAHbn)	313.0	376.7	313.0	376.7	456.2	448.7	377.2	432.0	516.5	508.7	428.1	492.0
Nominal GDP (US$bn)	34.2	32.0	34.2	32.0	36.2	28.0	22.9	26.2	30.4	29.9	24.5	28.1
GDP per capita (US$, ann)	3,904	3,698	3,904	3,698	3,468	3,024	2,761	2,627	2,492	2,535	2,576	2,624
Unemployment rate (%)	8.8	8.9	8.8	8.9	8.4	8.3	8.2	8.2	8.1	7.9	7.8	7.9
Prices												
CPI headline (%YoY, eop)	3.4	11.9	3.4	11.9	17.5	22.6	22.6	18.3	15.0	11.1	9.7	9.7
CPI headline (%YoY, average)	1.7	9.8	1.7	9.8	14.7	21.0	23.4	18.6	17.0	12.2	10.2	9.7
PPI (%YoY, eop)	3.9	15.6	3.9	15.6	26.9	26.3	25.7	11.5	6.2	10.5	8.8	10.5
PPI (%YoY, average)	3.0	10.5	3.0	10.5	24.4	26.2	27.0	15.2	7.3	9.5	9.5	9.9
Fiscal balance												
Consolidated budget bal. (UAHbn)	0.6	-20.3	0.6	-20.3	-27.4	-65.3	-15.1	-31.5	-20.2	-44.9	0.2	-24.2
Consolidated budget bal. (% of GDP)	0.2	-5.4	0.2	-5.4	-6.0	-14.6	-4.0	-7.3	-3.9	-8.8	0.0	-4.9
Budget balance (UAHbn)	-4.1	-18.6	-4.1	-18.6	-24.0	-52.0	-13.2	-26.2	-17.7	-37.1	-1.9	-20.9
Budget balance (% of GDP)	-1.3	-4.9	-1.3	-4.9	-5.3	-11.6	-3.5	-6.1	-3.4	-7.3	-0.4	-4.2
External balance												
Exports (US$bn)	18.3	18.1	18.3	18.1	16.8	18.1	17.1	16.9	17.2	18.4	17.8	17.8
Imports (US$bn)	19.7	19.1	19.7	19.1	17.6	19.0	17.4	17.3	17.6	19.3	19.1	18.4
Trade balance (US$bn)	-1.4	-1.0	-1.4	-1.0	-0.9	-0.9	-0.2	-0.4	-0.4	-0.9	-1.2	-0.5
Trade balance (% of GDP)	-4.0	-3.2	-4.0	-3.2	-2.4	-3.3	-1.1	-1.7	-1.4	-3.1	-5.1	-1.9
Current account balance (US$bn)	-1.3	-1.1	-1.3	-1.1	-0.9	-1.0	-0.2	-0.5	-0.7	-1.0	-1.3	-0.6
Current account balance (% of GDP)	-3.9	-3.3	-3.9	-3.3	-2.6	-3.4	-1.1	-1.9	-2.2	-3.3	-5.2	-2.1
Net FDI (US$bn)	-0.7	-0.3	-0.7	-0.3	0.6	0.4	0.9	1.0	1.5	0.8	1.1	1.0
Net FDI (% of GDP)	-1.9	-1.0	-1.9	-1.0	1.7	1.4	3.9	3.7	4.9	2.7	4.3	3.6
C/A bal. + net FDI (% of GDP)	-5.8	-4.3	-5.8	-4.3	-0.9	-2.0	2.8	1.8	2.8	-0.6	-0.9	1.4
External debt (US$bn, eop)	137.4	136.8	137.4	136.8	137.3	134.7	136.1	137.5	138.9	140.3	141.4	142.4
External debt (% of ann'd GDP, eop)	78.4	83.5	78.4	83.5	90.6	103.3	114.3	121.4	129.3	128.3	127.4	126.1
FX reserves (US$bn, eop)	15.1	17.1	15.1	17.1	16.3	8.9	10.8	12.8	14.7	16.7	18.0	19.3
FX reserves (% of ann'd GDP, eop)	8.6	10.4	8.6	10.4	10.8	6.8	9.1	11.3	13.7	15.2	16.2	17.1
External debt / FX reserves (x, eop)	9.1	8.0	9.1	8.0	8.4	15.1	12.6	10.8	9.4	8.4	7.9	7.4
FX reserves imports cov (months)	1.9	2.2	1.9	2.2	2.3	1.4	1.8	2.2	2.5	2.8	2.9	3.1
Interest rates												
Central bank key rate (%, eop)	6.50	6.50	#ЗНАЧ!	#ЗНАЧ!	12.50	14.00	14.00	13.00	13.00	10.00	10.00	8.00
3-month rate (%, eop 4Q)	15.93	18.03	15.93	18.03	20.00	25.00	25.00	16.00	16.00	12.00	12.00	12.00
Exchange rates												
UAH trade-weighted index (nominal)	57.15	49.79	57.15	49.79	47.72	44.07	41.85	42.19	41.02	41.53	42.12	40.92
UAH trade-weighted index (real)	89.02	79.16	89.02	79.16	80.59	76.37	72.36	76.69	75.67	77.28	77.47	78.38
UAH/US$ (eop)	11.38	11.75	11.38	11.75	12.95	16.00	16.50	16.50	17.00	17.00	17.50	17.50
UAH/US$ (average)	9.16	11.79	9.16	11.79	12.60	16.00	16.50	16.50	17.00	17.00	17.50	17.50
UAH/€ (eop)	15.66	16.09	15.66	16.09	17.16	20.00	20.30	19.80	20.40	20.40	21.00	21.00
UAH/€ (average)	12.67	16.03	12.67	16.03	16.98	20.60	20.46	20.05	20.40	20.40	21.00	21.00
US$/€ (eop)	1.38	1.37	1.38	1.37	1.32	1.25	1.23	1.20	1.20	1.20	1.20	1.20
US$/€ (average)	1.38	1.36	1.38	1.36	1.35	1.29	1.24	1.22	1.20	1.20	1.20	1.20
Population												
Population (million, eop)	43.14	43.09	43.14	43.09	43.08	43.12	43.16	43.12	43.10	43.14	42.95	42.91
Population (%YoY)	-5.2	-5.2	-5.2	-5.2	-5.2	-5.2	0.0	0.0	0.0	0.0	-0.5	-0.5

Notes: eop – end of period; cov – coverage; con'd – consolidated; ann – annualised. Sources: State Statistics Service of Ukraine, NBU, ICU.

Disclosures

ANALYST CERTIFICATION

This research publication has been prepared by the analyst(s), whose name(s) appear on the front page of this publication. The analyst(s) hereby certifies that the views expressed within this publication accurately reflect her/his own views about the subject financial instruments or issuers and no part of her/his compensation was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views within this research publication.

EQUITY RATING DEFINITIONS

Buy: Forecasted 12-month total return greater than 20%

Hold: Forecasted 12-month total return 0% to 20%

Sell: Forecasted 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

DEBT RATING DEFINITIONS

Buy: Forecasted 12-month total return significantly greater than that of relevant benchmark

Hold: Forecasted 12-month total return is in line with or modestly deviates from relevant benchmark

Sell: Forecasted 12-month total return significantly less than that of relevant benchmark

Office 44, 11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kiev, 01030 Ukraine
Phone/Fax +38 044 2200120

CORPORATE FINANCE TEL. +38 044 2200120

Makar Paseniuk, Managing Director
makar.paseniuk@icu.ua

Ruslan Kilmukhametov, Director
ruslan.kilmukhametov@icu.ua

SALES AND TRADING TEL. +38 044 2201621

Konstantin Stetsenko, Managing Director
konstantin.stetsenko@icu.ua

Sergiy Byelyayev, Fixed-Income Trading
sergiy.byelyayev@icu.ua

Vitaliy Sivach, Fixed-Income & FX Trading
vitaliy.sivach@icu.ua

Vlad Sinani, Director,
Strategy and Corporate Development
vlad.sinani@icu.ua

Julia Pecheritsa,
Ukraine and CIS International Sales
julia.pecheritsa@icu.ua

Yevgeniya Gryshchenko,
Fixed-Income Sales
yevgeniya.gryshchenko@icu.ua

RESEARCH DEPARTMENT TEL. +38 044 2200120

Alexander Valchyshen
Head of Research
alexander.valchyshen@icu.ua

Alexander Martynenko
Head of corporate research
alexander.martynenko@icu.ua

Bogdan Vorotilin
Financial analyst (Food & Agribusiness)
bogdan.vorotilin@icu.ua

Taras Kotovych
Senior financial analyst (Sovereign debt)
taras.kotovych@icu.ua

Mykhaylo Demkiv
Financial analyst (Banks)
mykhaylo.demkiv@icu.ua

Lee Daniels, Rolfe Haas
Editors

Investment Capital Ukraine LLC is regulated by Securities and Stock Market State Commission of Ukraine (license numbers: dealer activity AE 263019, broker activity AE 263018, underwriting activity AE 263020 dated 11 April 2013).

DISCLAIMER

Additional information is available upon request.