



Focus
Ukraine

Scope
Economics

Analyst
Alexander Valchyshen 

Quarterly Report

Since the storm last February



17 JUNE 2015

READ FIRST THE DISCLOSURES SECTION FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

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Executive summary

This is an updated and condensed summary of our macro view for 2H 2015 and 2016-17.

The February financial storm as key theme of the macro outlook. Last February, the economy fell victim to an acute financial crisis which produced, in our view, a lasting impact in two areas.

First, it jolted Ukraine's top authorities into taking action. Upon the threat of imminent collapse of the financial system, politicians and MPs, normally slow to take action, consolidated within mere hours to draft and receive immediate parliamentary approval of legislation required by the IMF to restore FX funds that had been depleted over the past six months. It provided a new impetus for fiscal and monetary authorities to act more aggressively and responsibly. The February storm was transformative: it forced authorities to actively implement prudent economic policymaking.

Second, the financial storm was extremely negative in that it spurred inflation beyond the 50% YoY threshold, drastically reducing household incomes in real terms. Total economic demand contracted in real and US dollar terms. While inflation is not expected to recede to single digits over the forecast period of 2015-17, the hryvnia's is on the path to weaken even further in the future, as described in more detail in the report.

Ukraine's economy: 2015 growth revised downward. Available statistics on high-frequency indicators of key sectors of the real economy—agriculture, industrial, transport, retail trade and construction—through this April reveal signs that recession is deeper than previously forecast. Official statistics for 1Q15 of a 17.6% real GDP contraction revealed a massive 6.5% seasonally-adjusted drop from the previous quarter. In 4Q14, quarter-on-quarter decline also accelerated to 3.8% from 2.1% in 3Q14. The accelerated economic downturn was due to increased Russian military aggression in the Donbas region and due to the contraction of domestic demand caused by the financial storm that has been building since 2H14 and culminated this February.

We expect that the economy will most likely reach its trough in 2Q15 thanks to the fiscal and monetary prudence that was implemented in response to the February storm. We foresee a L-shape trajectory in 2015, implying a 13.1% YoY decline in all 2015, to be followed by a 2.7% YoY rebound in 2016 and 2.0% in 2017, according to our base case scenario.

See "Economic activity update: A downward revision, again" on page 19.

Public finance: High inflation as a boon for state budget. State revenues have risen more quickly as a result of the past devaluation and high inflation which spurred GDP growth in nominal terms. The latest data on the consolidated state budget through April reveal that the 12-month rolling primary balance reported a surplus for the first time since mid-2013 and its current size of 0.7% of GDP was last seen in September 2007 (Chart 54, p.36). PM Yatsenyuk's government's newly instated fiscal prudence refuses to concede to populist calls to increase spending, which is a sign of their strong commitment to the financial stability of past several months that they fought to achieve. Against this backdrop, the state budget is projected to record a small primary surplus this year of 0.3% of GDP

despite planned spending increases on the eve of regional elections in October. This prudent stance is likely to be sustained this year and onwards as a strategy to reduce debt and improve conditions to attract future financing from capital markets.

Public debt, however, is projected to end 2015 at 93% of GDP, increase to 96% in 2016 and then subside to 85% in 2017. This projection incorporates the outcome of external debt operations with coupon and principal haircuts, as detailed below.

External debt operations: A macro case for debt reduction. Our macro model through 2025 indicates that given projected growth at a new normal of 2% a year and the lack of political capacity to run massive primary surpluses (above 0.5%), there is clear evidence that external debt operations require nominal reductions. Without it, the public debt level is seen stuck in the range of 94-107% of GDP through 2020, a fact that firmly qualifies Ukraine's economy as prone to debt crisis permanently. In addition, it does not allow Ukraine's authorities to meeting IMF three targets prescribed by the EFF programme. Our calculations show that a 25% nominal haircut and coupon reduction from the current average 7.6% to 4.5% should fulfill the IMF's targets for external debt operations.

See "External debt operation: Assessment of the macro environment and the outcome" on page 37.

Inflation and monetary conditions. The economy in 2014-15, unlike in the 2008-09 crisis, has become increasingly sensitive to FX moves. Inflation has spiked mainly due to currency devaluation, notwithstanding April's extraordinary CPI increase caused by higher tariffs. As the real income of households and wage-earners has eroded significantly, the first sign of an economic recovery should spur gradual wage increases, providing some resistance to rapid deflation from the current high inflation. Our CPI forecast for 2015 is 52.7% YoY in December 2015, subsiding to 23.6% in December 2016 and 16.7% in December 2017.

Monetary policies will probably maintain capital controls to avoid a new run on the currency. Fiscal prudence following February's storm has resulted in a marked reduction in claims on the central bank on the government since March. However, this stance exacerbated money supply growth, which ticked to new lows in April in nominal terms and was deeply negative in real terms. Official FX inflows by the IMF and sponsored donors for the remainder of 2015 should reverse money supply growth to more pro-growth levels. The base money supply should grow around 27% YoY in nominal terms, as limited by the IMF's EFF program. Broad money supply growth should recover during 2H15 as high interest rates in hryvnia and the global lack of growth momentum for USD should channel inflows back into UAH bank deposits. We also expect that the NBU's key policy rate (at 30% now) could be reduced to 25% in 4Q15, if all else occurs as expected.

External balance: A case for a balanced current account in 2015. On the back of a deeper recession in 2015 than previously anticipated, a more pronounced decline in domestic demand could result in a balanced current account, possibly at 0.1% of GDP, per our forecast. This should deteriorate in 2016 as growth settles to a more moderate range of 1.5-2.3% of GDP. However, authorities already are trying to attract greater FDI this year. It is forecast to recover from the past year's slump of US\$0.3bn to US\$3bn in 2015 and to more than US\$4bn in 2016. The key area of concern in the balance of payments is continued deleveraging by banks and corporations. This lengthy tendency has slowed down somewhat in March-April and, in our view, there is fair chance for recovery in rollover ratios. Our model yields a US\$5bn recovery of FX reserves during 2015 to US\$12.5bn at year-end, US\$21.1bn at year-end 2016 and US\$24.5bn at year-end 2017.

See "External balance: Current account surplus due to recession" on p.40.

UAH: protracted weakness due to inflation. Throughout 2014 and most of 2015, inflation has rapidly eroded the gains in competitiveness obtained after the hryvnia's sizable devaluation. Currently having stabilized at 21.2/USD with capital controls currently in place, the hryvnia should trade at this level through this summer. However, our forecast reveals that the UAH is set to appreciate in real trade-weighted terms, which risks becoming unsustainable. In our view, along with capital controls, the NBU will most likely continue to support the flexibility of the UAH's market rate. This effectively implies a weakening of the UAH rate—per our base case scenario—to 25/USD at year-end 2015, and 32/USD at year-end 2016 and 35/USD at year-end 2017.

This said, however, one should not rule out the UAH strengthening as a tool to fight high inflation. This development is part of our best case scenario.

See "View on UAH: High inflation destroys competitiveness" on p.42.

Domestic politics & geopolitics

Domestic politics is far more likely to preserve the *status quo* than reinvent the government. While populist forces aim for snap parliamentary elections, the rise of political populism is a key risk that has arisen from the post-February financial storm environment that forced the incumbent authorities to embrace fiscal prudence. However, those populist forces remain on the fringe as Poroshenko and Yetsenyuk should retain their hold on power well into 2016. Meanwhile, as the Kremlin's aggressive geopolitics remains a threat, Ukraine's ongoing military stalemate with Russia undermines the solidity of Minsk 2. As a consequence, the economic reintegration of the entire Donbas region into Ukraine's economy most likely will be prolonged beyond 2016.

The February storm

On the nature of the financial storm in February 2015

This February, the incumbent authorities' routine policymaking measures that had worked in the past were deluged by the tidal surge of the hryvnia's 50%+ devaluation.

Despite the expected victory of pro-democracy politicians in the parliamentary elections held in October 2014, the real problem of consensus-building stultified the new administration. Ministry appointments, the implementation of fiscal reforms required by the IMF, and formulating effective state financing policy¹ became painfully slow and controversial, became fodder for the media, and ultimately became damaging to the new administration's global credibility.

This chaotic *status quo* continued from early November through February, as shown in Chart 1 on p.7.

While Russian aggression and the political uncertainty of two consecutive Minsk ceasefire agreements could also be seen as the fuel to this storm, it was really Ukrainian authorities' inconclusive policy- and decision-making during in November-February that were the true causes, as illustrated in Chart 2-Chart 5 on p.8. And despite authorities' well-publicized and ongoing negotiations with the IMF to implement the new funding program, the market ignored these reports as mere chatter and viewed January-February as two months of extended monetary financing of the government's ever-deepening deficit (as depicted in Chart 2 and Chart 4 on p.8) while FX liquid assets rapidly depleted (as shown in Chart 3 and Chart 5 p.8). The series of events depicted in Chart 1 caused a rapid buildup of speculative bets on the hryvnia to weaken during February. Essentially, the market disregarded Ukrainian authorities' promises to implement the IMF's required fiscal reforms and instead believed that they would revert to their old routines of extending monetary financing.

However, something changed. During the most volatile week of FX trading yet seen in Ukraine, the hryvnia at one point fell to over 40/USD in black market trading. When the storm hit in that last week of February, these previously indecisive and timid politicians

¹ This means state budget financing and financing of the quasi-sovereign entities like Naftogaz and others.

woke up, took action, and finally implemented the fiscal reforms required to secure IMF lending (under the EFF program).

Why the February storm snapshot is important: Key takeaways

As inflation spiked well beyond any reasonable (or politically safe) expectations in less than one week, acute anxiety and fear most likely prevailed as top officials convened at an emergency meeting on February 25.

This was because of expected public discontent over exploding prices that moved up in only a few days that week, while prior inflation already had accelerated substantially during 2014. Also, the risk of having the entire financial system meltdown increased dramatically at that point. It posed a serious risk of popular backlash against the incumbents in power, i.e. against those persons attending the emergency meeting.

As inflation spiked well beyond any reasonable (or politically safe) expectations in less than one week, acute anxiety and fear most likely prevailed as top officials convened at an emergency meeting on February 25. This February tumult, regardless of any containment in the near future, will continue to have an impact on Ukraine's economic projections this year and in 2016-17. Had the politicians not taken action, they would have been subjected not only to electoral defeat but also to criminal neglect.

Chart 1. The February storm in the FX market and in the social and political spheres of Ukraine

Daily history of USD/UAH market exchange rate over 1Q of 2015

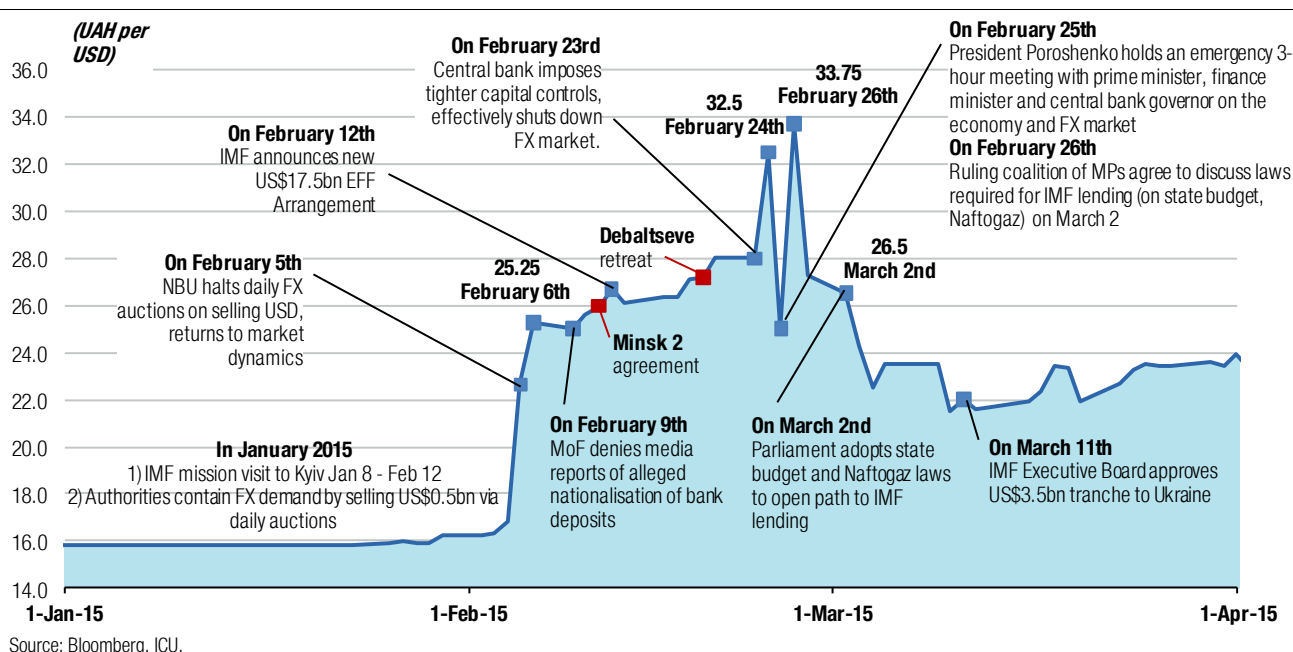
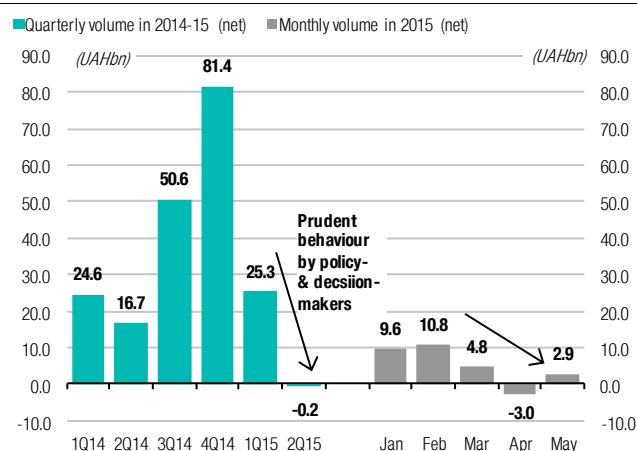
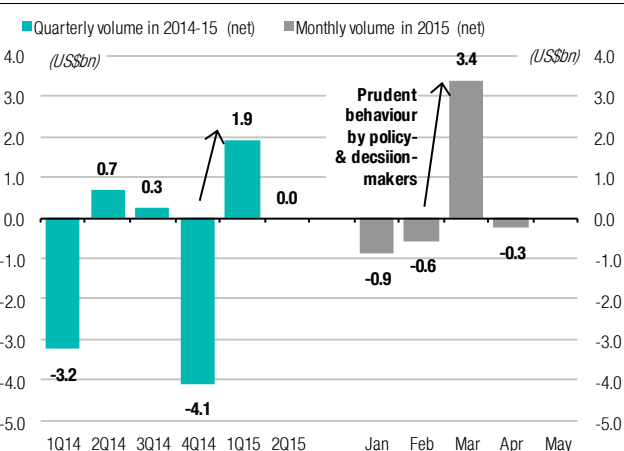
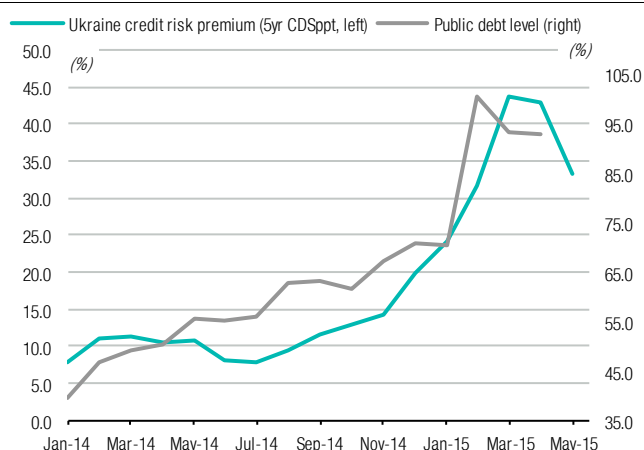


Chart 2. Net volume of government bond purchases by NBU (UAHbn)
History from 1 January 2014 through 13 May 2015


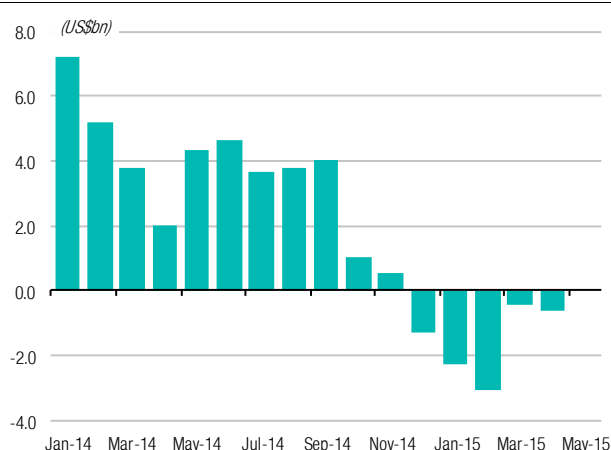
Source: National Bank of Ukraine, ICU.

Chart 3. Flow-based volume of change in net external assets by monetary sector, which includes banks and NBU (US\$bn)
History from January 2014 through April 2015


Source: National Bank of Ukraine, ICU.

Chart 4. Public debt level (% of GDP) and Ukraine credit risk premium (5yr CDS, ppt)
History from January 2014 through April 2015


Source: National Bank of Ukraine, ICU.

Chart 5. Net external assets by monetary sector, which includes banks and NBU as of end of period (US\$bn)
History from January 2014 through April 2015


Source: National Bank of Ukraine, ICU.

Economic policymaking over the rest of 2015 is going to be drastically different from what it was over the last eight months, with its priorities set at stabilizing the already depressed currency and taming inflation. With this in mind, public debt issuance will be minimal in comparison to 2014, sovereign and quasi-sovereign external debt will be restructured, and official FX reserves will be restored in line with IMF guidelines.

However, there is a risk of the resurgence of sheer political populism as long-standing advocates of state paternalism like Yulia Tymoshenko try to capitalize on the average Ukrainian's current misery. This risk emerged in early May, immediately following the government's long-postponed decision to increase natural gas and utilities tariffs.

Current political cycle

The current political cycle which began after the parliamentary elections last October should extend well beyond 2015.

The usually heated fray of local politics saw a rise of sporadic talk (in both conventional and social media) of early parliamentary elections. Proponents of the parliamentary re-shuffle have been referring to the political commitment under the Minsk 2 agreement² to rewrite the constitution and to the shifting public opinion which portrays PM Yatsenyuk as a key victim of the political developments. Since the parliamentary elections, his bloc was effectively won over by the competing party and blocs.

Because of this, broad political consensus is far more likely to preserve the *status quo*.

The adoption of a new constitution which would decentralize power supports a broad public consensus that Ukraine does not need federalization. As the Kremlin heartily advises federalization (see Chart 6), it is effectively rejected. Any shift in this direction is diluted by political class. However, in response to obligations to Minsk 2, the amendments to the constitution will be adopted, which would not change a political consensus of no need for snap parliamentary elections.

Chart 6. Ukraine's public view on state set-up: a unitary state vs. a federal one (%)

According to the opinion poll conducted by Kyiv International Institute of Sociology published on 26 March 2015³

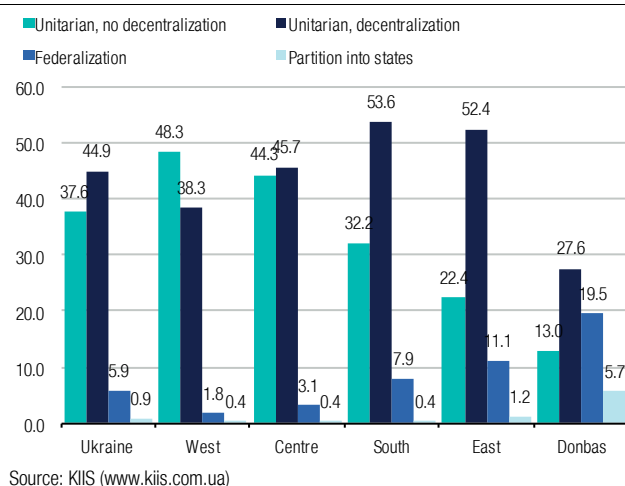
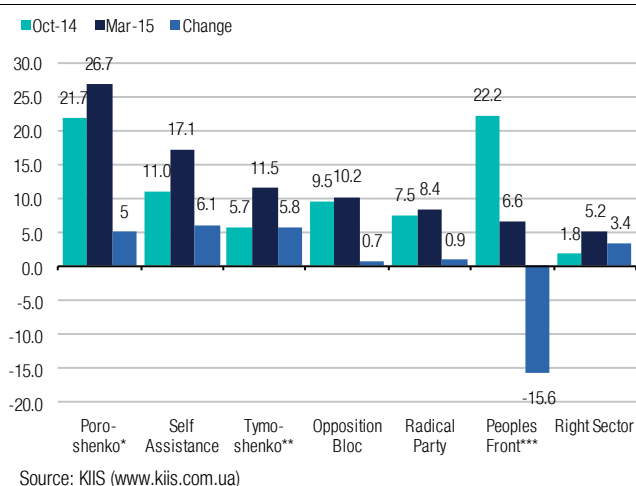


Chart 7. Political preferences by the Ukraine public as of March 2015 versus October 2014 (%)

According to the opinion poll conducted by Kyiv International Institute of Sociology published on 26 March 2015



Collapsed public support for Yatsenyuk's political party as recorded by the opinion poll this March (See Chart 7) has indeed increased pressure on PM Yatsenyuk to realign government policies (an implicit invitation to resign) after the austerity measures were implemented.

This pressure has been building from the opposition party controlled by oligarchs and supporters of fugitive ex-President Yanukovych⁴, as well as from the parties inside the ruling coalition, the most vocal being Yulia Tymoshenko's, that strive to capitalize on the popular discontent over price inflation, namely higher utilities bills. In this regard, we consider Yatsenyuk's departure from the government as unlikely as it would undermine not

² Our general skepticism over the Minsk 2 ceasefire agreement is explained in this report dated 13 February 2015 (pdf) <http://www.icu.ua/download/1126/ICUMacrolnsight-20150213.pdf>

³ See details here (in Ukrainian) http://kiis.com.ua/materials/pr/20152603_ratings/Ukraine2000_Results3.pdf

⁴ These are represented by Sergei Lyovochkin, formerly chief of staff to Yanukovych, who appeared in the US media earlier this year with op-ed 'My Ukraine Is Slipping Away' in the Politico Magazine (link: <http://www.politico.com/magazine/story/2015/01/ukraine-is-slipping-away-114466.html>)

only the parliamentary coalition but also the course of the economic recovery program supported by the IMF and other official lenders.

In his most recent interview in *Financial Times* on May 22, PM Yatsenyuk's statements⁵ depicted him as a responsible leader who is eager to defend the course of harsh economic reforms mandated under the IMF program. In this double-edged sword environment, in which society demands economic and political progress which inflicts economically and politically painful adjustments, few politicians covet Yatsenyuk's job. As a result, the economy continues to contract severely, as indicated by April's statistical data. Fully aware of the necessary pain, Yatsenyuk forges ahead. For President Poroshenko, making Yatsenyuk weather the public disapproval is plausible as he would rather sustain his public approval rankings.

The fragility of geopolitics

It is becoming increasingly evident that the Minsk 2 agreement will not produce the results in the pre-determined time desired by the leaders of Ukraine, France, Germany and Russia.

Ukraine will never see Russia withdraw its weaponry and militants from Ukraine and regain control of the now ungoverned Russian-border enclaves of the Lugansk and Donetsk oblasts.

The Kremlin, cognizant of its unrealistic demands for federalization, will continue to keep the enclaves highly militarized and eagerly resume fighting to fortify their stronghold over new transport hubs and industrial centers (like the city of Mariupol).

For the western parties, this agreement has been a convenient framework to calm the heated standoff that produced fractures inside the western institutions (primarily inside the EU itself).

By June 29, the EU has to decide on the degree of Russian sanctions and whether to continue or reduce them, upon evaluation of their performance of the Minsk 2 agreement. Most likely, there will be no changes⁶.

The Kremlin's geopolitical posturing as intertwined with economics

For the Kremlin, which has been enjoying high approval ratings since early 2014, it was vitally urgent this winter to reverse the collapsing public mood as Russia has been suffering under the acute macroeconomic adjustment that occurred from December 2014 through February 2015 (Chart 8, p.11).

While a macro adjustment in the Russian economy that began in 2014 continues to unfold, the acute phase of the adjustment occurred last December and at the very beginning of this year. The Kremlin realized that it had to react this winter. It reversed its zigzagging economic policymaking. Authorities abandoned a weak ruble policy approach that had been publicized as one that encourages import substitution among other macroeconomic benefits

⁵ Full transcript of the interview is here:

<http://www.ft.com/intl/cms/s/0/22c6ee0c-0053-11e5-b91e-00144feabdc0.html#axzz3b8L03zdv>

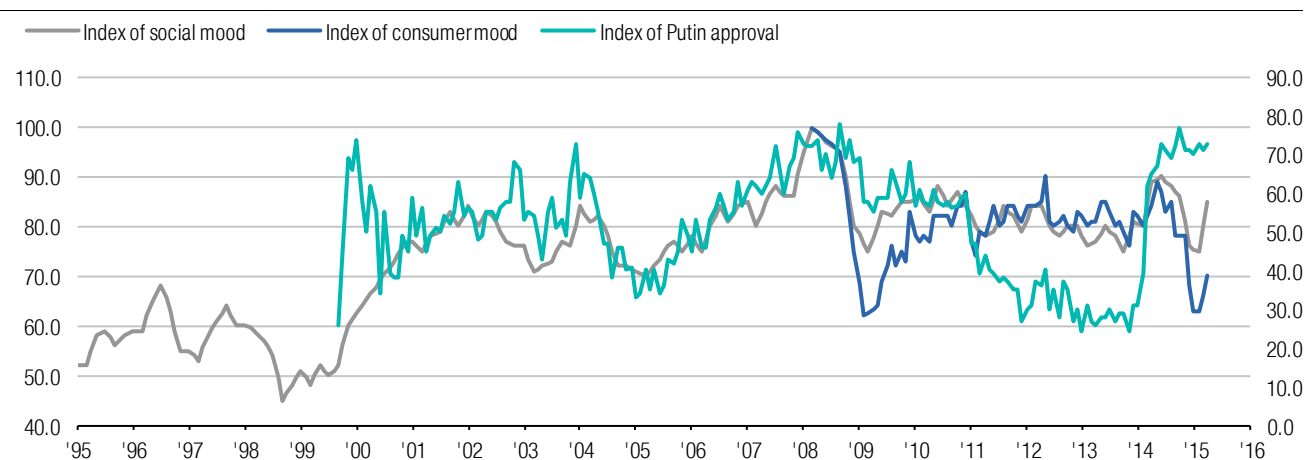
⁶ This means infighting is being holding with casualties being suffered by the Ukraine army side at average speed of one soldier killed every 24 hours and 48 minutes. This is based upon the public information that 90 Ukraine soldiers were killed between February 18th, when Minsk 2 was eventually put in place after Debaltseve offensive by Russia military. Hence, it is assumed this data of casualties does not include the losses during the Debaltseve battle, for which data is variable.

due to the fear of inflation that had been swiftly accelerating and hence proved difficult to restrain.

As a solution, the Kremlin engineered a wave of FX supply into the market (which was coming from the balance sheets of its ministry of finance and central bank, and then by *de-facto* state-run corporate champions that were also encouraged to increase net FX supply). This turned the ruble's FX market into an attractive investment scenario for outside investors. When the ruble recovered to 50/USD, consumers were relieved and inflation receded significantly (*de-facto* disinflation) over the following 6-12 months. Public mood indicators, as measured by Moscow-based Levada Centre⁷, recovered significantly, marking broad public approval of the policy change.

Chart 8. Public opinion in Russia: Putin's approval index versus two mood indices of social mood and consumer mood of the public

Monthly history from January 1995 through April 2015



Source: Levada.ru, ICU.

Also, the policy turn supported by the Kremlin's pacifying rhetoric in the run-up to the Minsk 2 agreement had two objectives: (1) prevent a new wave of economic sanctions by the West which would aggravate the already quite severe macro adjustment; and (2) portray its external policy toward its public as a pro-peace stance.

This policy turn has brought advantages and disadvantages. While the benefit is disinflation toward single-digits in 2016, the cost is a loss of competitiveness. The mere fact that a real GDP contraction most likely accelerated in early 2Q15 and 1Q15 exceeded expectations underlines a simple fact that the ruble was cheap and highly competitive in 1Q only to become less competitive at the beginning of 2Q.

Hence, the macro adjustment in the Russian economy should continue to be volatile and uncomfortable for the Kremlin and the public as well as to the nations entangled by the Kremlin's geopolitical posturing. Simply put, the Kremlin uses aggressive geopolitics to fuel nationalism and consolidate public opinion behind the perceived leader.

However, as Chart 8-Chart 10 shows the current peak of Putin's popularity (above 70 points) is in its twelfth consecutive month (through April).

The last great run of Putin's popularity occurred in 2007-09 and lasted for 17 consecutive months (Chart 10 below). It was supported by fast economic growth in 2005-07 and early 2008 as well as by geopolitical posturing in the short Georgia war in August 2008. Then, the

⁷ More details here: <http://www.levada.ru/eng/indexes-0>

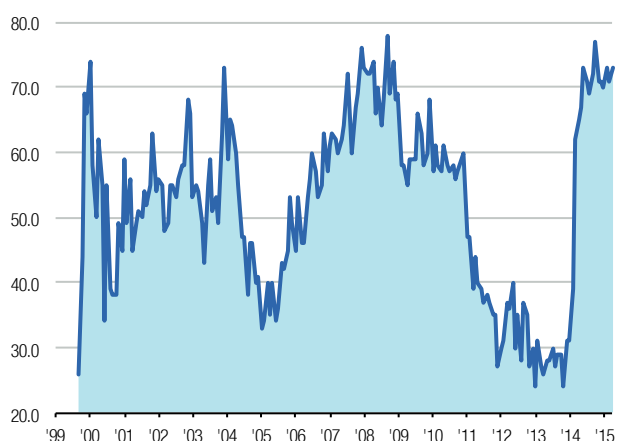
recession of 2008-09 put an end to Putin's high approval rating and initiated a five-year decline of popularity through the end of 2014.

Currently, the Kremlin has two conflicting developments: (1) geopolitical posturing again (as occurred in 2008) brings a popularity dividend; and (2) an economic recession that promises to be lengthy and hence will damage the Kremlin's high approval rating. Current developments have one huge difference from the 2008 historical resemblance – they are more protracted.

If history provides any guidance for the future, one would expect some activity this fall, possibly in October, when Putin's high popularity streak would start outlasting the 2007-09 precedent. That is the most likely time when the Kremlin, which has a history of governing by trying to outmanoeuvre the future challenges it is expected to face, will utilize all available tools to sustain or bolster its high popularity.

Chart 9. Putin approval index*

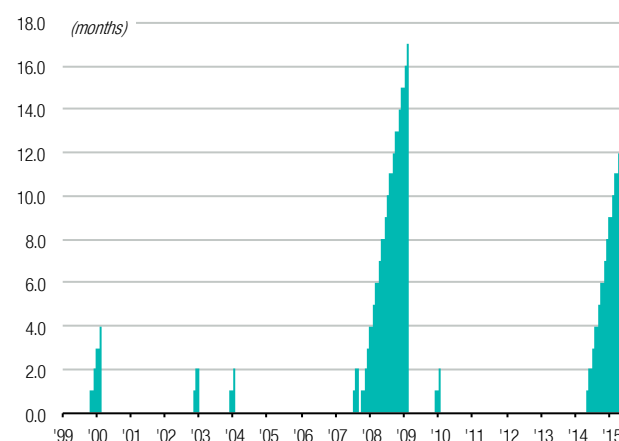
Monthly history from August 1999 through April 2015



Note: * this index was suspended by Levada for publication October 2014 (ICU's communication with Levada on this issue is [here](#)). The index is calculated as difference between those who approve and those who disapprove Putin. Levada continues publishing these series of data.
Source: Levada.ru, ICU.

Chart 10. Consecutive months in which the Putin approval index sustains at 70 points*, a near overwhelming public approval

Monthly history from August 1999 through April 2015



Note: This is calculated as an accumulated sum of months, when the index was in the near proximity to 70 points, which is more than a 5% negative deviation from the 70 points threshold at least once in two months.
Source: Levada.ru, ICU.

The Kremlin's agenda for the rest of 2015 should be determined as follows. On June 29, the EU is scheduled to decide on a regime of sanctions to impose on Russia. Following this meeting, the Kremlin will hold snap elections in several federal units in September in an effort to re-affirm its public image. On the former issue, as the Kremlin will probably manoeuvre the EU to soften its stance for future concessions, we expect little to no aggression in the Donbas region until after the meeting. The latter issue is a bit different: the Kremlin will probably increase its propaganda in July-August to bolster nationalism, most likely by escalating military aggression. Realizing the high geopolitical and economic risks of eliciting too much negative global sentiment, the Kremlin will probably only push to the extent that it can sustain its popularity while avoiding harsher sanctions from the West.

For Ukraine, this means the Minsk 2 agreement holds much less weight than otherwise hoped. The ungoverned enclave filled with pro-Kremlin militants and the Russian army is likely to remain in place, awaiting orders from the Kremlin to resume fighting. This severely limits the entire Donbas region from recovering to normal functionality in 2015-16.

Global economy

Two main themes in the global economy are relevant to Ukraine.

First, China's economy still produces deflationary spillovers into the global economy. Its industrial producers have been reducing their prices over the last 2.5 years, and this has intensified over the past several months as PPI deflated 4.6% YoY in April from 3.3% in December. Commodities markets will remain stagnant as long as China's spare industrial capacity remains unutilized, a fairly long-term perspective. This specifically relates to the poor outlook for Ukraine's steel exports which are restrained additionally by the Donbas war.

Second, the US economy stumbled in 1Q15, contracting 0.7%, inducing the Fed to postpone the rate increase until this fall. Moreover, investors will review their bets on the US dollar which had appreciated steadily from last July through March. Hence, the relative weakness of the US economy and the Fed's cautiousness over tightening monetary policy provide relief to EM economies, including Ukraine's, by alleviating national currencies' weakness.

US: Normalization of the monetary policy

The timing of the US Fed's interest rate increase is the key issue this year. Not only will the US set the stage for higher rates globally but it will also establish the procedure of policy normalization and transition that will be followed by other economies.

Because of the weak real GDP growth in 1Q, with a preliminary reading of 0.2% increase was later revised to a 0.7% decline after a second estimate was published on May 29⁸, the Fed revised its schedule. This downward revision also brought the US dollar's nine-month rally from July 2014 through March 2015 to a halt in April (Chart 11 and Chart 12 on p.15).

However, in May the strength of the dollar once again underscored that markets tend to believe that the pattern of growth in early 2015 mirrors the pattern of 2014, when after a weak 1Q (real GDP decreased by 2.1%), stronger quarterly growth followed, resulting in a full-year real GDP increase of 2.4% YoY, or 0.2ppt stronger than in 2013. This kind of development is implied by the forecast of 2015 full-year real GDP as produced by the following sources: the IMF (+3.1%⁹), Bloomberg consensus view (+2.5%) and WSJ's Economic Forecasting Survey (+2.2%¹⁰).

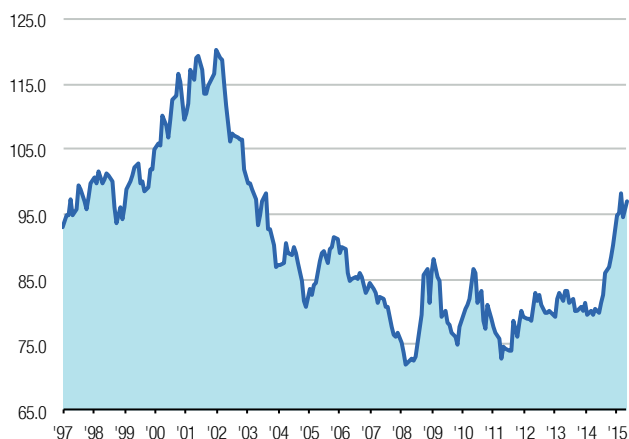
⁸ http://www.bea.gov/newsreleases/national/gdp/2015/txt/gdp1q15_2nd.txt

⁹ <http://www.imf.org/external/pubs/ft/weo/2015/01/pdf/tblparta.pdf>

¹⁰ As of May 29th. Source: <http://projects.wsj.com/econforecast/#ind=gdp&r=10>

Chart 11. US dollar index* (DXY, points)

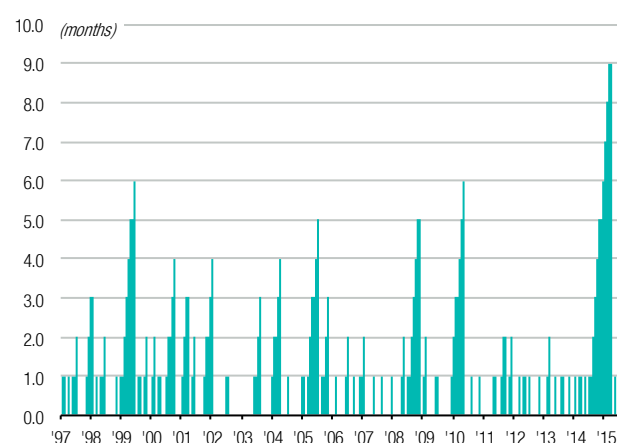
Monthly history from January 1997 through May 2015



Note: * values end of the period, for May 2015 the value is as of May 28th.
Source: Bloomberg.

Chart 12. Number of months of straight appreciation of DXY*

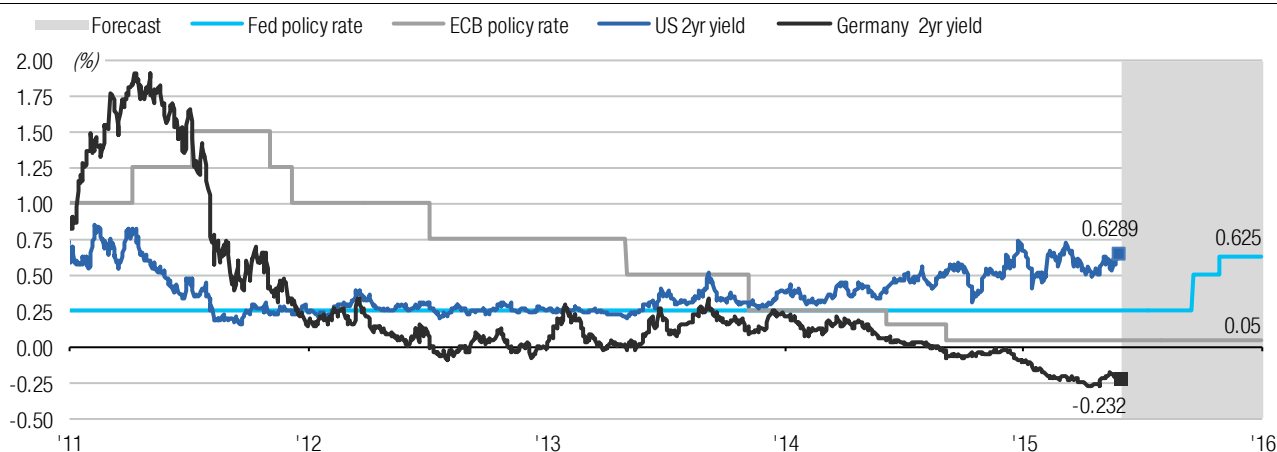
Monthly history from January 1997 through May 2015



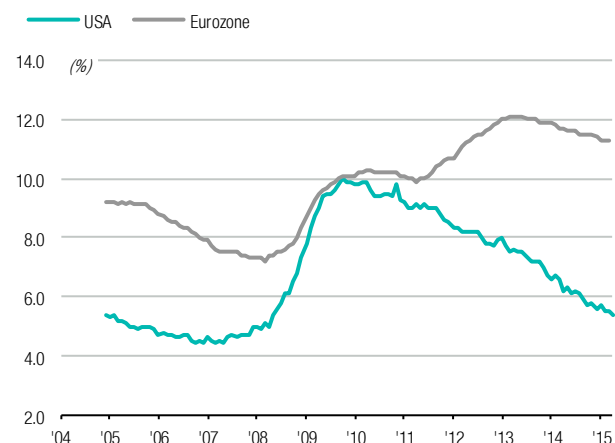
Note: * values end of the period, for May 2015 the value is as of May 28th.
Source: Bloomberg, ICU.

Chart 13. Policy rates by US and Eurozone monetary authorities and yields on short-dated government bonds of US and Germany (%)

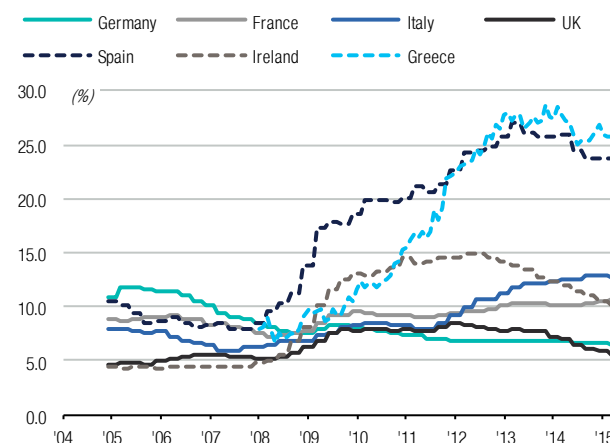
Daily history from 1 January 2011 through 28 May 2015



Source: Bloomberg, ICU.

Chart 14. Unemployment in the US versus Eurozone (%)

Source: Bloomberg.

Chart 15. Unemployment in the selected countries of EU (%)

Source: Bloomberg.

Moreover, this view of the US economy taking the lead is being supported by the US dollar index (DXY) holding near this year's high of 100 points and by the 2-year US Treasury note yield trending upwards over the past 18 months at 0.6%, suggesting that US Treasury investors believe that the Fed will increase rates this year. The bond market appears to project the Fed rate at 0.63% by year-end, in accordance with recent Fed projections¹¹ showing a Fed rate-setter consensus of 0.625%.

Thus, the consensus view is that the US Fed will begin to raise its policy rate during the September meeting¹². This is in an environment where monetary conditions in relative terms among the major global economies—the US versus the eurozone, China and other BRIC economies—provide support to a strong US dollar over the next 12 months.

Eurozone: A lengthy exit from the debt crisis

In contrast to the US, the eurozone has been mired by a prolonged resolution of its debt crisis, especially in the southern countries. Italy and Spain have been fighting to stay afloat, while Greece is apparently becoming a permanent crisis story as its economy is unable to launch a turnaround. For this reason and a number of others, GDP projections for 2015 for the eurozone fall short of those in the US, with the IMF at +1.5% , Bloomberg at +1.5% and the European Commission revising its spring forecast to +1.5% from its winter forecast of +1.3%. All sources forecast real GDP increases for 2016 of one percentage point above the current year.

It should be noted here that the eurozone's growth story has its own costs and benefits in the relation to its neighbors outside the euro area.

Several advanced economies of continental Europe with independent monetary policies—namely Switzerland, Sweden and Denmark—have tumbled as a result of the ECB's quantitative easing (QE) policy that was launched earlier this year. QE has weakened the euro, which has negatively affected the neighboring currencies by forcing them to appreciate with all else unchanged. The recent publication of 1Q real GDP for the Swiss economy revealed¹³ a 0.2% contraction from the previous quarter, and negative net exports was mentioned as the primary cause. The mere mention of net exports' negative impact implies that the currency appreciation over the period caused the entire economy to contract.

In contrast, however, Poland continued to record robust growth in 1Q15 of +1.0% from the previous quarter¹⁴. Fixed investments remain a significant contributor to overall growth as they rose 2.9% from the previous quarter in 1Q15¹⁵.

Overall, the eurozone's macro story remains quite depressed by low (near anaemic) growth and the ongoing Greek debt crisis that mandates a resolution to prevent its departure from the economic union.

¹¹ <http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20150318.pdf>

¹² 73% of economists that participate in the WSJ's survey point to September
<http://projects.wsj.com/econforecast/#qa=20150501000>

¹³ <http://www.seco.admin.ch/aktuell/00277/01164/01980/index.html?lang=en&msg-id=57432>

¹⁴ <http://stat.gov.pl/en/topics/national-accounts/quarterly-national-accounts/gross-domestic-product-in-the-1th-quarter-of-2015-preliminary-estimate,2,26.html>

¹⁵ From 2Q 2003 through 1Q 2015, the average quarterly growth rate of fixed investments was 2.2% while the average quarterly contribution from net exports was zero, according to our calculations.

For Ukraine, this implies that the euro should remain weak versus the dollar in the coming two years with inflation below the ECB's 2% target.

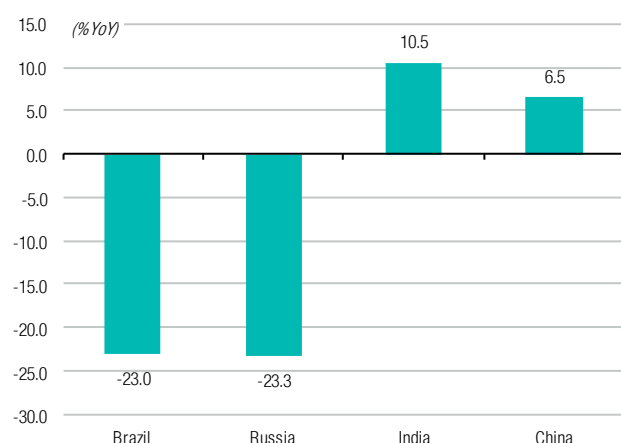
BRIC: Fractured economies

The BRIC economies paint a diverse picture of growth. While India and China are expected to record positive growth rates this year of 7.5% and 6.8%, respectively, to the previous year in real terms, Brazil and Russia are on course to underperform substantially.

According to the IMF's most recent projections (April), Brazil and Russia are both in recession this year, contracting by 1.0% and 3.8% YoY, respectively. Consumer price inflation in Brazil and Russia, albeit for different reasons, has escalated to 7.8% and 17.9%, respectively, well beyond the targets set by national monetary authorities (4.5% with 2ppt deviation margin in Brazil and 4% in Russia). Brazil and Russia have been undergoing quite severe macro adjustments, reducing their economies by a 23% share of their nominal GDP in US dollar terms (see charts below).

Chart 16. Change in nominal GDP in US dollar terms* (%YoY)

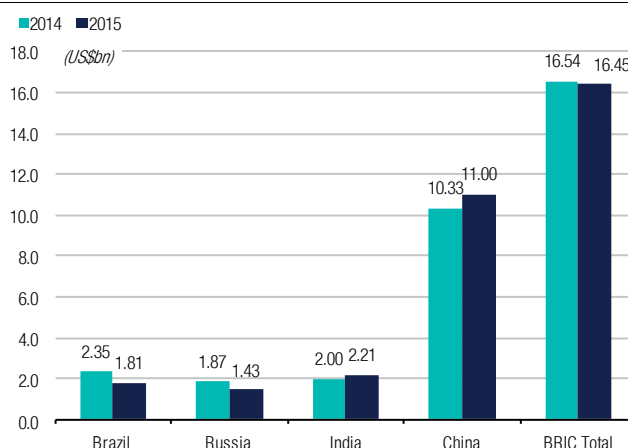
2015 versus 2014



Note: * For China and India the data is by IMF; for Brazil the data is by Financial Times, for Russia the data is by Russia's State Statistics Committee and ICU.
Source: IMF, Financial Times, ICU.

Chart 17. Nominal size of BRIC economies* in US dollar terms to decrease 0.6% to US\$16.45bn (US\$bn)

2015 versus 2014



Note: * For China and India the data is by IMF; for Brazil the data is by Financial Times, for Russia the data is by Russia's State Statistics Committee and ICU.
Source: IMF, Financial Times, ICU.

For Ukraine, two vital economies—Russia and China—are among its top five trading partners.

Both have been experiencing macroeconomic adjustments since 2012 and have also taken increasingly assertive geopolitical stances. While China has undertaken more accommodative policies for the adjustment, Russia has been under a more profound economic adjustment, reacting by initiating a military intervention into Ukraine (with the annexation of Crimea and an ongoing military invasion into Donbas) that resulted in a subsequent set of sanctions by the West. In our view, Russia's geopolitical stance has been a buffer for domestic discontent over ongoing macroeconomic changes that are both lengthy and largely socially painful.

We expect the economies of China and Russia to be weak.

Russia is forecast to be in recession, with a very soft recovery to begin in mid-2016. Our forecast for 2015 is -3.2% YoY, followed by a 0.5% increase in 2016, accelerating to +1.5% YoY in 2017. The low growth rates are driven by hesitant macroeconomic policies which

operate in an environment of a militarized public aimed to strengthen the Kremlin's grip on power (a prime target). These policies, enmeshed in detailed macroeconomic negotiations by top government officials from the central bank and economic ministry, resulted in harsh swings in key macro parameters and sizably severed inflation. Headline CPI is running now beyond 15%, although it is expected to moderate somewhat by the end of this year. While there is widely held view that inflation in Russia is going to be in the single digits starting in 2016, it is going to be well above those of its main trading partners, namely China and the EU. This development of the inflation differential is quite important in our view, because it will lay down the foundation of its sub-par economic growth rate in the near future after the current recession. The Russian economy, which had been suffering from the flush of petrodollars by having poor standing in competitiveness from the mid-2000s and prior to 2014, has stepped into 2Q 2015 with no competitiveness gains after the harsh adjustment seen in the prior four months from December 2014 through March 2015. This implies that Russian authorities will struggle to modernize its economy to increase its potential and actual growth rates. Because of this, we remain bearish on the ruble in our 2015-17 forecast.

We believe that the Chinese authorities are trying to tread a fine line between the need to rebalance the economy, a lengthy process that is ongoing and at quite an early stage, and retain its political structure of "one party" rule, through the stable rise in perceived well-being and prosperity. For this reason, China's authorities are clearly more cooperative with the US and the West in general than Russia.

China's recent aim to gain membership to the IMF's SDR basket has been gradually proceeding. Boosted by a number of respected economics commentators who proclaimed that the CNY 'is no longer undervalued', a notion we also share, the official inclusion of the CNY into the SDR basket is as much of an economic issue as a geopolitical issue. US authorities are hesitant to change their opinion of the CNY being undervalued and allow the CNY to enter the SDR basket.

Meanwhile, China's rebalancing its economic growth from investment-oriented to consumption is painful to both the local economy, which is slowing, and foreign trade. The continued deflation of producer prices in China, which has been ongoing for 34 consecutive months, provides deflationary pressure on the global economy and especially on economies dependent on commodities exports. For Ukraine, China's rebalancing and its future prospects mean that steel prices will probably stagnate rather than rise in the forecast period.

Key indicators vital for Ukraine's economy

Growth assumptions

Our macro model has global macro inputs like real GDP change in the global economy, which is derived from the most recent IMF World Economic Outlook April 2015¹⁶. This indicator remains at +3.5% for 2015 and then progressively increases across 2016-17 toward +3.8% each year. This projection is just one deviation from our *Quarterly Report* published on 12 March 2015 when 0.1ppt lower growth was assumed for 2016-17.

For the Russian economy, our current forecast assumes improved growth prospects with a 3.2% contraction in 2015 now versus the 5.0% contraction in the March forecast. This is to

¹⁶ <http://www.imf.org/external/pubs/ft/weo/2015/01/index.htm>

be followed by +0.5% and +1.5% real GDP increase recovery in 2016 and 2017, respectively, while the previous forecast projected -1.0% in 2016 and +2.0% in 2017.

Commodities

As indicated above, steel market prices are projected to stagnate in 2015-2017, while the crude oil price (WTI) is forecast at levels that correspond with futures market valuations. They yield average yearly prices for crude oil at 56, 61 and 65 US dollars per barrel in 2015, 2016 and 2017, respectively.

Chart 18. Crude oil price (US\$ per barrel)

Spot and futures market daily quotations

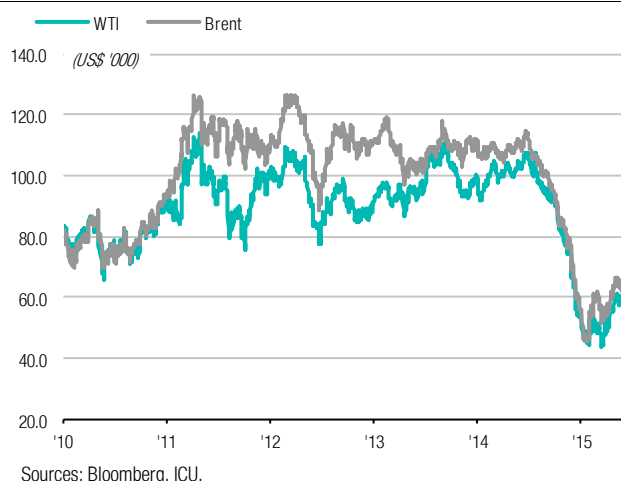


Chart 19. CIS export steel prices (US\$ 000s per tonne)

Quarterly averages

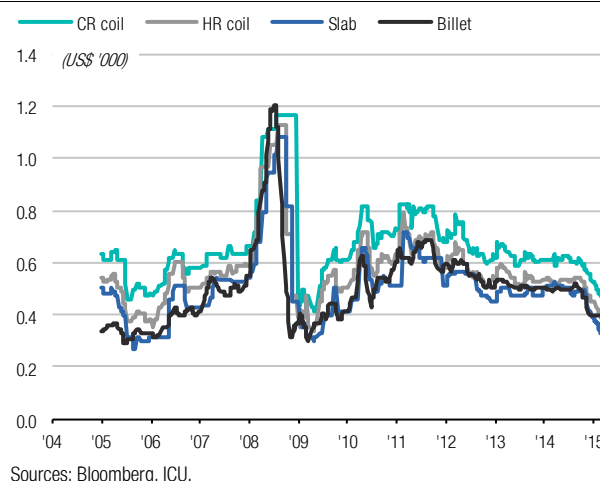


Table 1. ICU's 3-year quarterly and yearly forecast for the global economy's key indicators vital to Ukraine's economy, according to our base-case scenario

	Quarterly forecast												Annual forecast		
	1Q15E	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F	4Q17F	2015F	2016F	2017F
World real GDP ¹	3.5	3.5	3.5	3.5	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.5	3.8	3.8
Russia real GDP ¹	-1.9	-4.0	-4.0	-3.0	0.5	0.5	0.5	0.5	1.5	1.5	1.5	1.5	-3.2	0.5	1.5
Crude oil (US\$ ²)	53.4	55.0	56.0	58.0	59.0	60.0	61.0	63.0	64.0	65.0	66.0	65.0	55.6	60.8	65.0
Steel (US\$ ³)	407.0	373.0	347.0	359.0	371.0	383.0	395.0	407.0	407.0	407.0	407.0	407.0	371.5	389.0	407.0
EUR/USD (eop)	1.12	1.11	1.10	1.10	1.10	1.10	1.10	1.10	1.20	1.20	1.22	1.22	1.10	1.10	1.22
USD/RUB (eop)	58.19	53.00	53.00	55.00	57.00	60.00	62.00	62.00	65.00	62.00	62.00	62.00	55.00	62.00	62.00

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 economy: Key themes

In this section, we provide details of our revision of the 2015 real GDP contraction to 13.1% from the previously forecast 7.6% decline. In 2016, the revision implies rationale for a 2.5% rebound, followed by a 2% growth rate, establishing a new normal growth level for Ukraine's economy in the environment of tamed economic activity globally.

Economic activity update: A downward revision, again

An accelerated collapse in 1Q15 forces the revision

Given the accelerated collapse of Ukraine's economy in 1Q 2015, as confirmed by official statistics at the end of April, there is substantial evidence that our previous forecast of a full-year real GDP decline in 2015 of 7.6% is too optimistic. To be more precise, our previous forecast for 1Q was a 13.0% YoY contraction, and the official figure for 1Q came in at a staggering decline of 17.6% YoY and 6.5% QoQ.

The high-frequency statistical indicators (monthly statistics through this April on the key sectors of the economy: agriculture, industrial, transport, construction and retail trade, Chart 22-Chart 27 on p.22) and modelling of their future path in 2015-17 tell us that the overall economic contraction for full-year 2015 will be 13.1% YoY. This is our base case scenario (60% probability). A more optimistic outcome (30% probability) could see a real GDP decline in the single digits at the same level as our previous base case scenario of -7.6% YoY. A pessimistic view with a decline exceeding 13% has a 10% probability, in the event of a full-blown war waged by Ukraine against Russian aggression.

A more granular view of the path of the economy in 2015 says that even with such a sizable downward revision of 2015 growth, growth rates in seasonally adjusted terms QoQ indicate that the economy should be stabilizing in 2Q and begin a recovery. This is due to the sharp collapse of the economy in 1Q by 6.5% QoQ (the official rate) and in every quarter of 2014 by an average rate of 2.6% QoQ.

The factors that support our future growth projections, implying a FY 2015 real GDP decline of 13.1% YoY rebounding by 5.0% YoY in 2016 and 3.8% YoY in 2017, are described below. They include: 1) political commitment to establishing macro stability, which goes hand-in-hand with commitment to the IMF programme; and 2) exchange rate flexibility which, despite its negative impact on domestic consumption, provides flexibility to the industrial producers to gaining competitiveness.

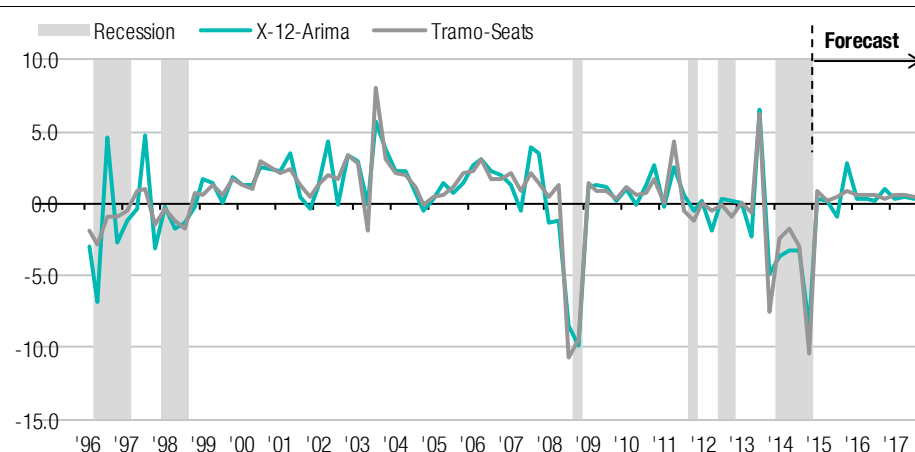
Overall, this approach to future economic activity results in the on-quarter growth rates as depicted in Chart 20 on p.20. Hence, the economy should be recession free following 2Q15 as quarter-on-quarter growth rates of seasonally adjusted GDP become positive. The key risk here, of course, is Russian aggression, whether it is being contained or erupts into a new wave of violence.

The largest contributors to the economic contraction in 1Q15 were household consumption and fixed investments. More details on these issues are described in the following

subsections: (1) "Fixed-investments: A weak side of the economy" on p.26 regarding fixed-investments, (2) "Regional pattern in the industrial sector performance" on p.25, "Retail gasoline market as bellwether of economy" on p.28 regarding household consumption.

Chart 20. On-quarter real GDP growth – history from 1Q 1996 through 1Q 2015 and forecast for rest of 2015 and 2016-17 (%)

Percentage change of quarterly volume of GDP at constant prices and in seasonally adjusted terms to previous quarter



Note: Seasonal adjustment is done by ICU via Eurostat software DEMETRA v2.2 for the series of quarterly GDP from 1Q97 through 4Q17. This data differs from the Ukraine's official data. Source: State Statistics Service of Ukraine, ICU.

A case for the L-shaped economy in 2015, subpar growth in 2016-17

Given the limitations of external demand as well as of Ukraine's authorities in stimulating domestic demand, there is a growing case for an L-shaped economy in 2015. With Ukraine's public debt is about 90% of GDP, budget deficit financing through borrowing from private creditors is non-existent. Monetary easing is denied as a method to grow the money supply. If authorities were to try this, they will only fuel inflation by further devaluing the currency. This would erode household purchasing power further and push popular sentiment well into the hands of populists and the opposition.

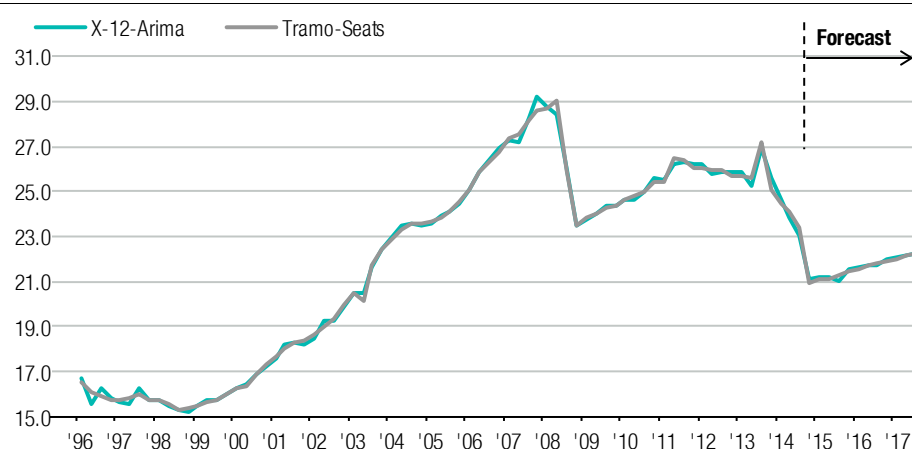
Hence, in an environment like this, the authorities' highest priority should be to stabilize the economy, i.e. halt the collapse experienced in 2014-1Q15. In our view, they effectively achieved this in late February and March when they passed the package of laws that opened the door to IMF financing.

Due to a more-than-expected decline of real GDP in 2015 (-13.1% now versus 7.6% in March), a rebound of growth in 2016 of +2.7% should be higher than previously anticipated (0%). This is to be followed by a more moderate +2.0% real GDP growth rate in 2017 (previously, +2.6%).

If this growth materializes in 2015-17, then quarterly GDP will still be 20% below its peak before EuroMaidan and subsequent to Russia's military aggression, and 19% smaller than the peak before the 2008 recession (Chart 20 on p.20). This underperformance of Ukraine's economy merely illustrate the mediocre impact that the expected growth rates for 2016-17. For Ukraine's economy to recover from the great recessions of 2008-09 and of 2014-15, more robust growth is needed.

Chart 21. Quarterly volume of GDP at constant prices and in seasonally adjusted terms – history from 1Q 1996 through 1Q 2015 and forecast for rest of 2015 and 2016-17 (UAHbn)

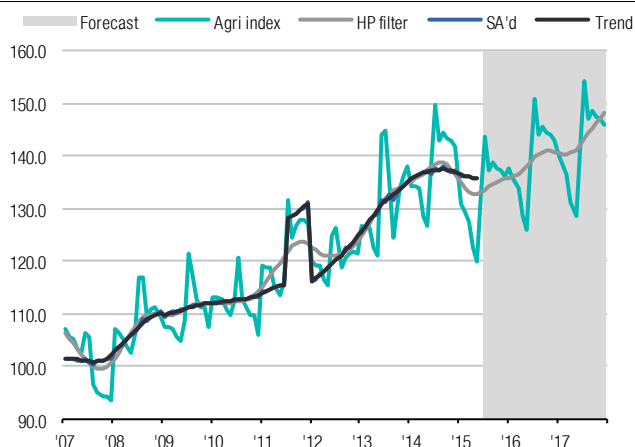
Percentage change of quarterly volume of GDP at constant prices and in seasonally adjusted terms to previous quarter



Note: Seasonal adjustment is done by ICU via Eurostat software DEMETRA v2.2 for the series of quarterly GDP from 1Q97 through 4Q17. Source: State Statistics Service of Ukraine, ICU.

Chart 22. Agriculture production index

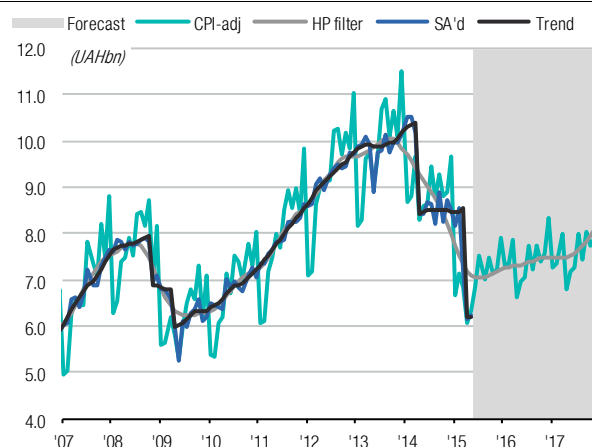
History (from January 2007 through May 2015), forecast for the rest of 2015 and 2016-17



Source: State Statistics Office of Ukraine, ICU.

Chart 23. Retail trade (UAHbn, at constant prices of Dec-1999)

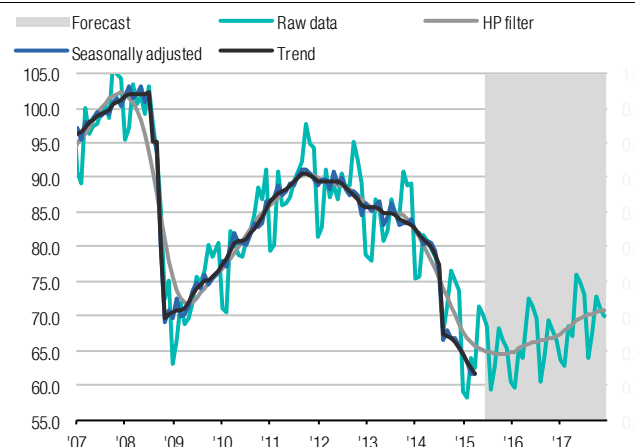
History (from January 2007 through May 2015), forecast for the rest of 2015 and 2016-17



Source: State Statistics Office of Ukraine, ICU.

Chart 24. Industrial production index

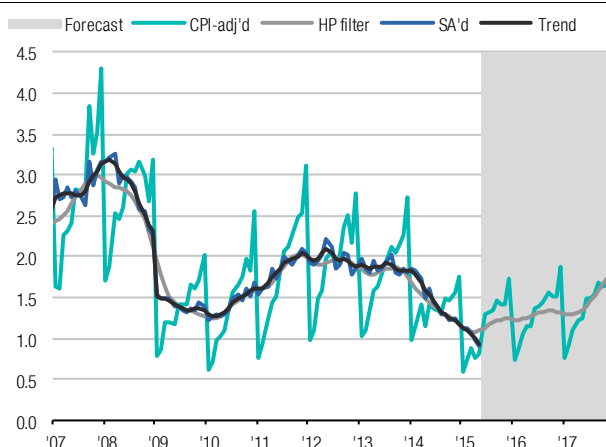
History (from January 2007 through April 2015), forecast for the rest of 2015 and 2016-17



Source: State Statistics Office of Ukraine, ICU.

Chart 25. Construction (UAHbn, at constant prices of Dec-2001)

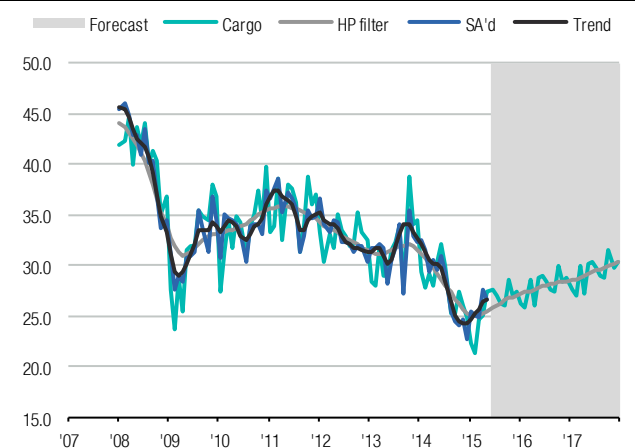
History (from January 2007 through May 2015), forecast for the rest of 2015 and 2016-17



Source: State Statistics Office of Ukraine, ICU.

Chart 26. Cargo transportation turnover (m tonne * km)

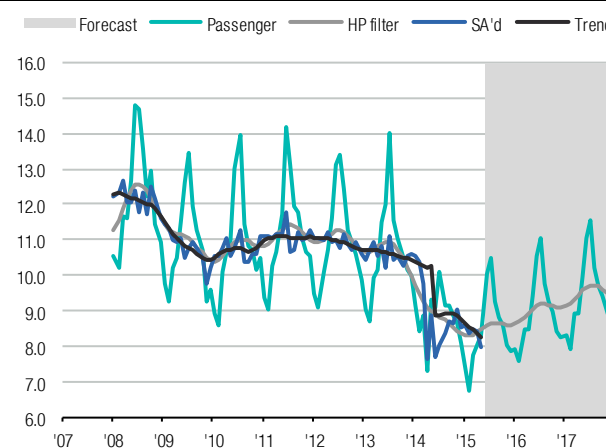
History (from January 2007 through May 2015), forecast for the rest of 2015 and 2016-17



Source: State Statistics Office of Ukraine, ICU.

Chart 27. Passenger transportation turnover (m * km)

History (from January 2007 through May 2015), forecast for the rest of 2015 and 2016-17



Source: State Statistics Office of Ukraine, ICU.

Fixed-investments: A weak side of the economy¹⁷

Fixed-investments in 1Q15 dropped 14.8% YoY, excluding Crimea and the occupied enclaves of the Donetsk and Luhansk oblasts. Of the 25 regional units of the country, which consists of 24 oblasts and the city of Kyiv, five posted an increase in investments.

The city of Kyiv, which accounts for the largest share of investments in Ukraine (in 1Q15, its share was 42.6% of total investments at current prices of UAH44.7bn, or slightly more than US\$2bn), saw a 31.7% increase in investments. Kyiv's share most likely reflects a phenomenon of reporting entities, when an entity files statistical forms by its legal, corporate address while its physical economic activity occurs in another region.

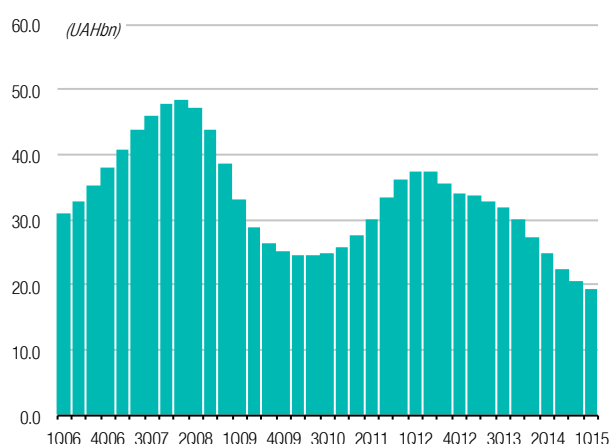
Other oblasts that reported year-on-year increases in investments in real terms were Volyn (bordering Poland, up 66.6% YoY), Symu (bordering Russia to the north, up 9.8%), and Khmelnytsk and Cherkasy (central oblasts, up 12.1% and 4.7%, respectively).

The most depressing regions in 1Q were Donetsk and Luhansk (infiltrated by Russian army militants), where investments dropped 70.9% and 94.1%, respectively. Other oblasts close to the war zone included Poltava (down 45.6%), Zaporizhyya (down 30.7%), Odessa (down 32.9%), and Kherson (down 53.1%).

Agriculture, telecommunications, education, and leisure/hospitality saw investments increase. Industrial and construction declined 37.4% and 21%, respectively.

Chart 28. Quarterly volume of investments in the economy at constant prices of December 2005*

Seasonally adjusted data, history from 1Q of 2006 through 1Q of 2015

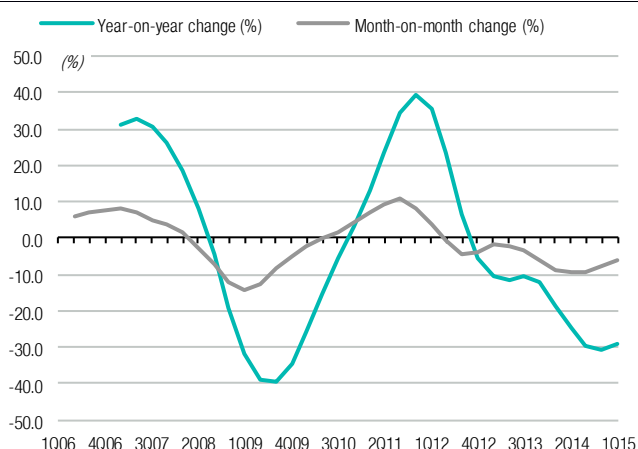


Note: * adjusted by CPI.

Source: State Statistics Committee of Ukraine, ICU.

Chart 29. Growth rates of investments (%)

Seasonally adjusted data, history from 1Q of 2006 through 1Q of 2015



Source: State Statistics Committee of Ukraine, ICU.

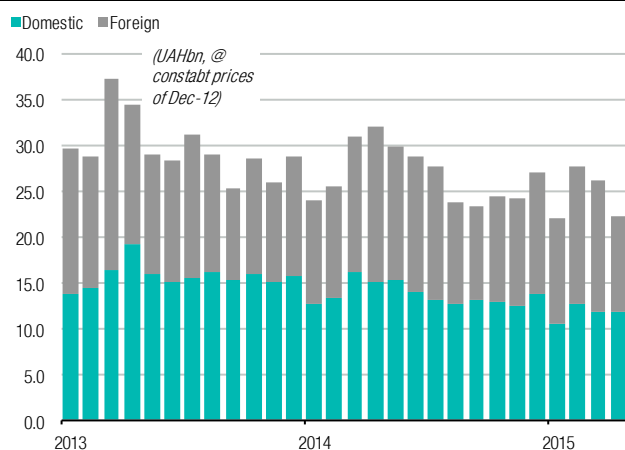
New industrial orders in January-April 2015

The monthly statistical data on new industrial orders available through April suggests that despite nominal increases in volumes, the inflation- and FX-adjusted volumes indicate that the economy has been under distress. As shown in the charts below (Chart 30-Chart 32, p.24), the current orders are well below volumes seen a year ago; however, a month-on-month increases in overall orders in US dollar terms in March-April allows some hope that the economy could be bottoming.

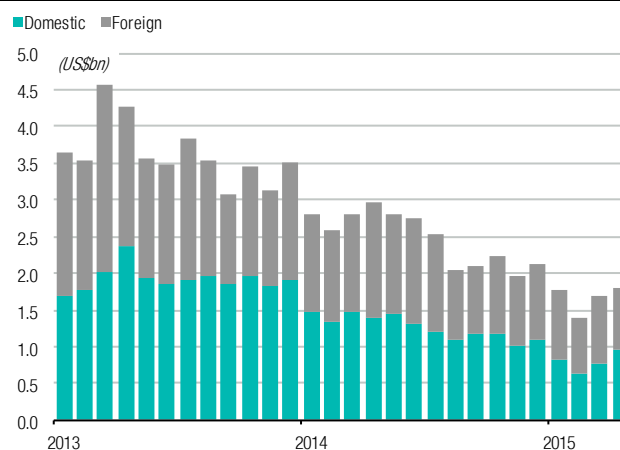
¹⁷ Originally this analysis appeared in the Daily Insight published 29 May 2015, <http://www.icu.ua/download/report/596/ICUDailyInsight-20150529.pdf>

Chart 30. New orders in the industrial sector: CPI-adjusted volume¹ (UAHbn, left) and FX-adjusted volume² (US\$bn, right)

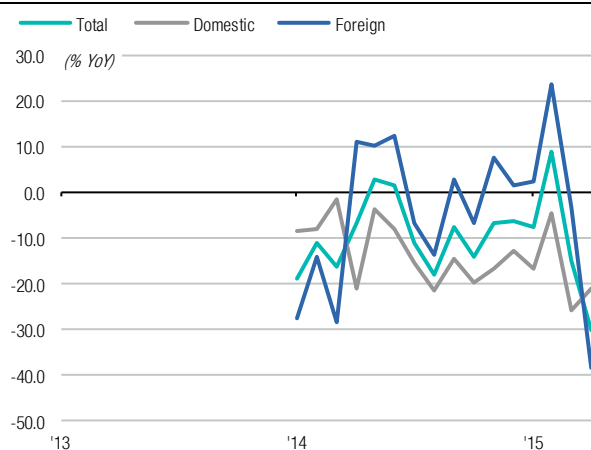
Monthly volumes. History from January 2013 through April 2015



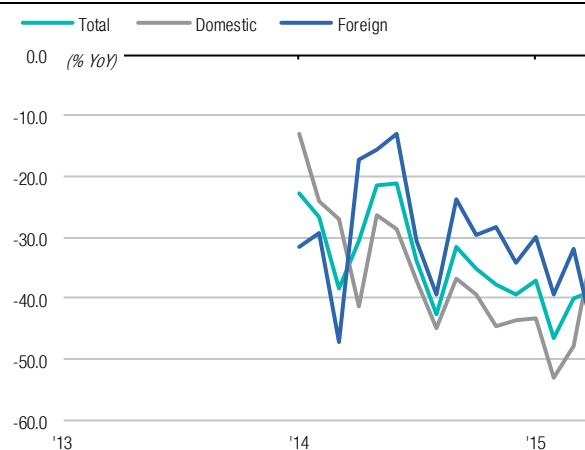
Note: [1] In constant prices of December 2012, adjusted by CPI.
Source: State Statistics Committee of Ukraine, ICU.



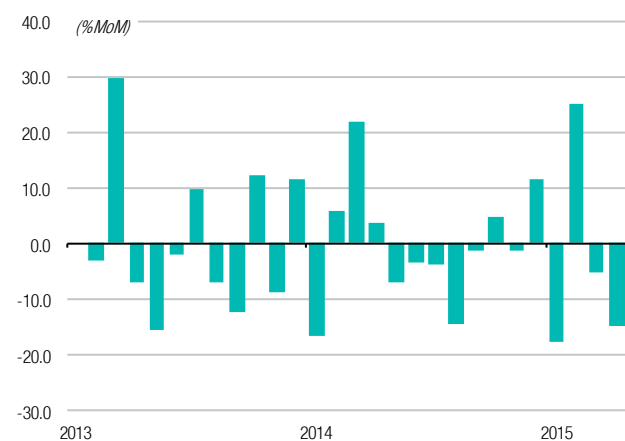
Note: [2] Adjusted by market FX rate.
Source: State Statistics Committee of Ukraine, Bloomberg, ICU.

Chart 31. On-year growth rates of new orders in the industrial sector: CPI-adjusted volume¹ (left) and FX-adjusted volume² (right)


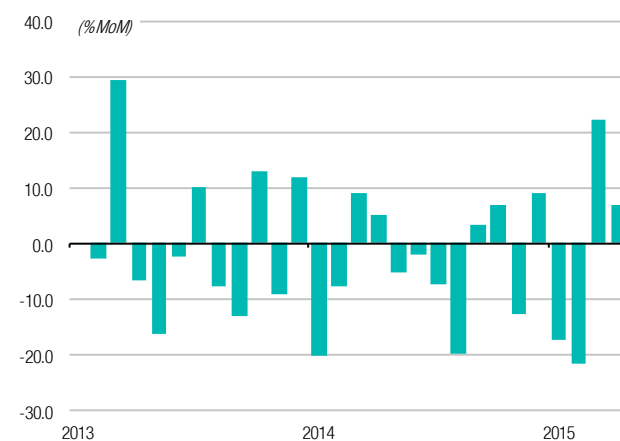
Source: State Statistics Committee of Ukraine, ICU.



Source: State Statistics Committee of Ukraine, ICU.

Chart 32. On-month growth rates of new orders in the industrial sector: CPI-adjusted volume¹ (left) and FX-adjusted volume² (right)


Source: State Statistics Committee of Ukraine, ICU.



Source: State Statistics Committee of Ukraine, ICU.

Regional patterns in industrial sector performance

Due to the Donbas war and Russian recession, the industrial sector has suffered a more profound decline than it did in the previous recession of 2008-09 (Chart 24 on p.22).

The regional breakdown of the industrial production index performance in 2012-15 (Chart 33-Chart 37 on pp. 26-27) shows that the southeastern oblasts where most of Ukraine's industrial sector is located have suffered the most. Two oblasts that are partially occupied by Russian-separatist forces—Donetsk and Luhansk oblasts—have their remaining parts under Ukraine's government. According to Ukrainian official statistics, they are the most depressed in terms of industrial production. Per April's year-on-year sector statistics, the industrial production index in Luhansk declined 90% while that in Donetsk fell 52%.

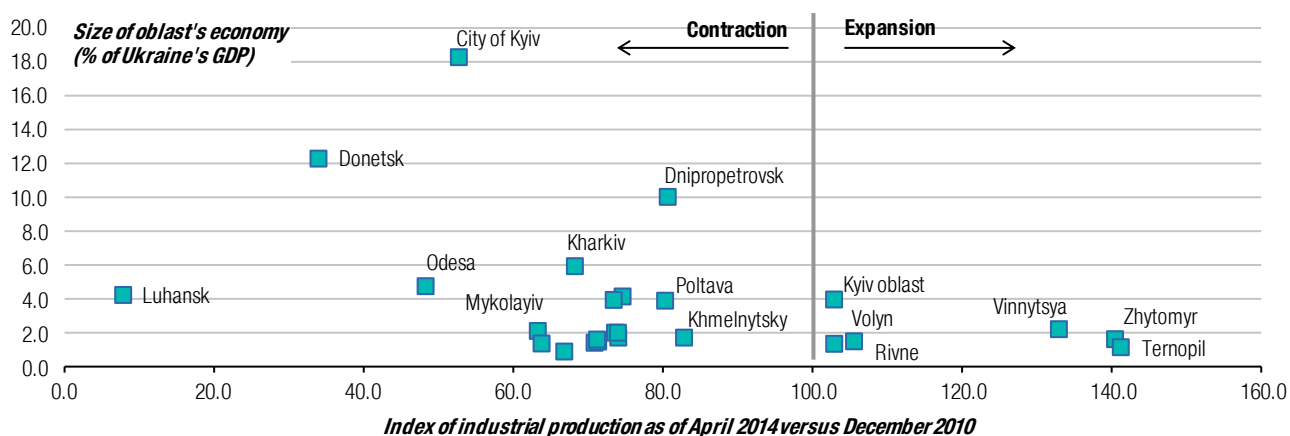
In general, production activity has increased in several western and central oblasts, including Kyiv, Volyn, Rivne, Vinnytyssa, Zhytomyr and Ternopil. However, they are not the core of the country's industrial base.

Kharkiv, Dnipropetrovsk and Zaporizhya, where the large industrial enterprises operate, saw industrial activity down 27%, 12%, and 8%, respectively, in April 2015 from the same month a year ago.

Due to the prevailing decline in industrial output across the country, where only a few oblasts are performing well while the most important areas of industrial production in the central and eastern regions, we expect the industrial production index in 2015 to contract 15% YoY. This severe recession should be followed by mild growth in 2016-17 mainly due to the low base effect.

Chart 33. Ukraine's oblasts plotted by their regional size of the economy¹ versus industrial sector performance in 2011-15²

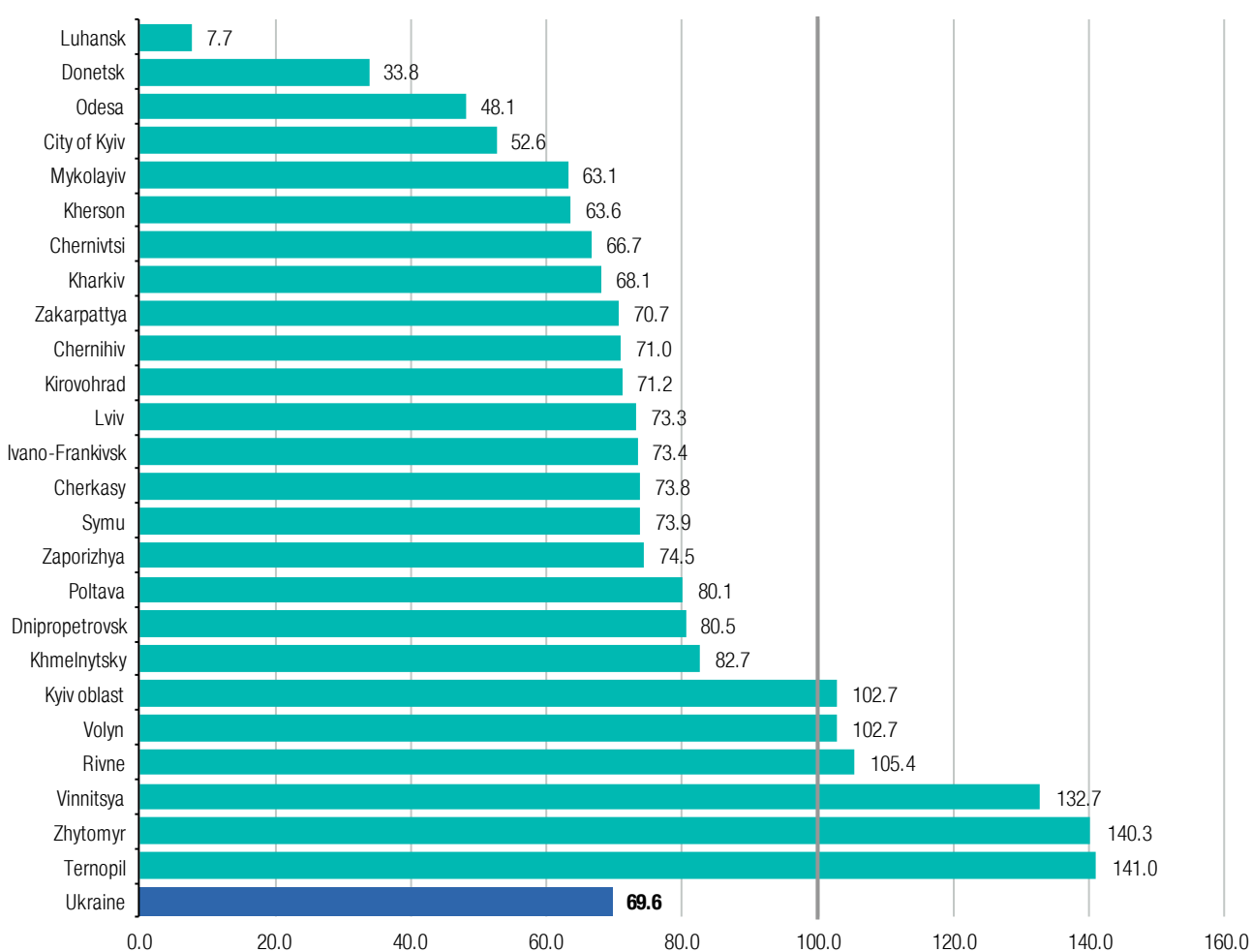
Based upon the seasonally adjustment data of history of industrial production from January 2011 through April 2015



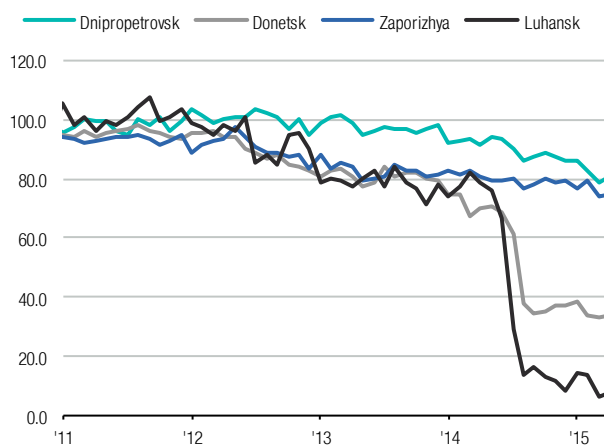
Note: [1] average share of regional GDP in the Ukraine's total GDP in 2004-13, [2] seasonally adjusted data on regional industrial production index, which chain-indexed from 100 points as of December 2010 through April 2015. Source: State Statistics Committee of Ukraine, ICU.

Chart 34. Regional breakdown of industrial production performance as of April 2014 as chain-indexed at 100 points as of December 2010

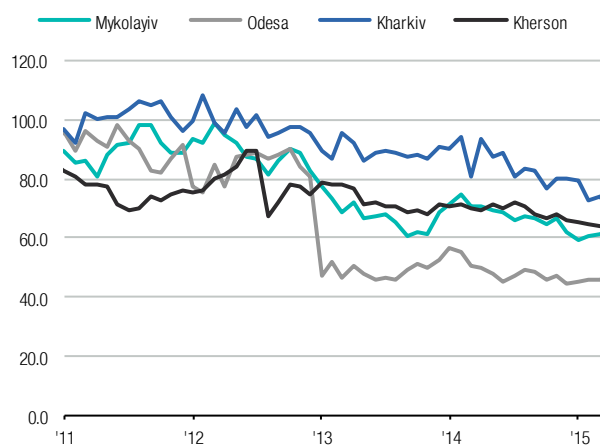
Based upon the seasonally adjustment data of history of industrial production from January 2011 through April 2015



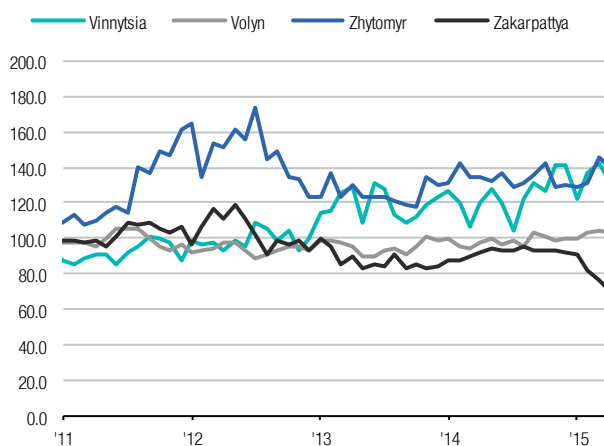
Source: State Statistics Committee of Ukraine, ICU.

Chart 35. Ukraine's south-eastern oblasts targeted by the Kremlin for the "Novorossiya" project*Monthly seasonally adjusted index. History from January 2011 through April 2015*

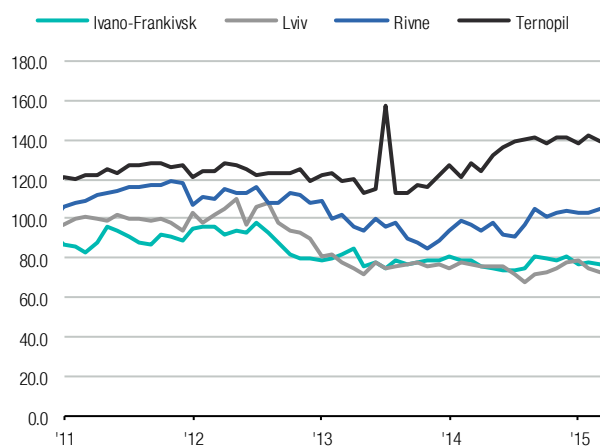
Source: State Statistics Committee of Ukraine, ICU.



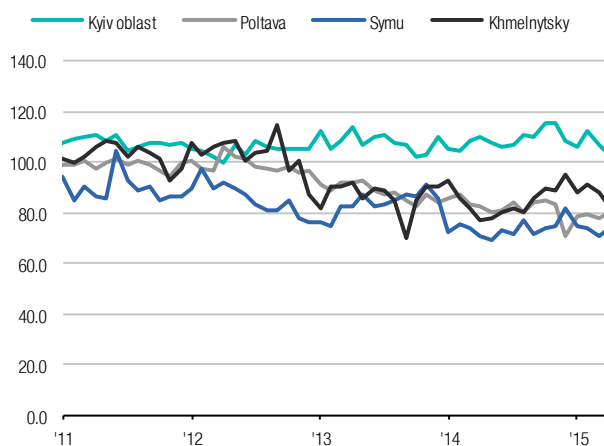
Source: State Statistics Committee of Ukraine, ICU.

Chart 36. Ukraine's western oblasts in many cases less affected by the downturn*Monthly seasonally adjusted index. History from January 2011 through April 2015*

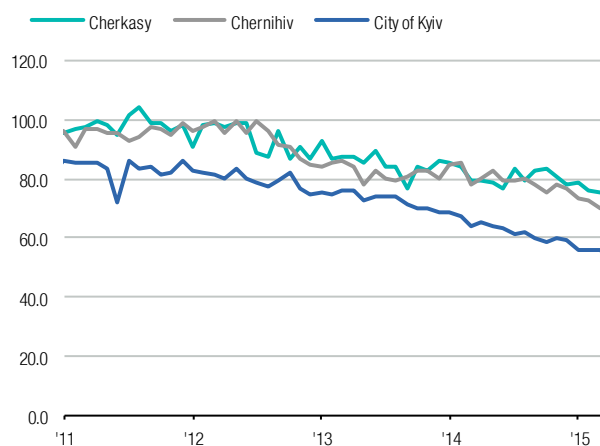
Source: State Statistics Committee of Ukraine, ICU.



Source: State Statistics Committee of Ukraine, ICU.

Chart 37. Ukraine's central oblasts in middle of the range by industrial performance*Monthly seasonally adjusted index. History from January 2011 through April 2015*

Source: State Statistics Committee of Ukraine, ICU.



Source: State Statistics Committee of Ukraine, Bloomberg, ICU.

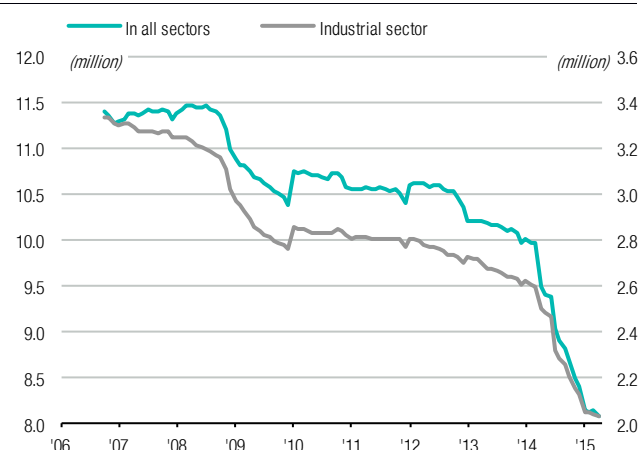
Labor market in April: Wages sit at record lows¹⁸

This April's report on employment conditions did not improve. The economy remains in a depression. National payrolls decreased 56,600, including 10,200 in the industrial sector. Average pay in local currency, while inching up, remains at a near historical low of US\$1.40/hour nationally and US\$1.50/hour in the industrial sector. The national hourly wage rose slightly from March at US\$1.30 seasonally adjusted. Such a decline in the purchasing power of the local currency (CPI was above 60% in April) explains the weak retail sales data reported this year. Most likely, household consumption is under pressure this year. Combined with weak investments in 1Q, this could explain the 17% decline of 1Q GDP.

Given the collapsed purchasing power of the wage-earners and increasing risk of populist backlash on the government, authorities are likely to pass legislature that would increase minimum wages in the economy and index wages in the public sector. Eventually, this would support consumers and push the wage growth in real and FX-adjusted terms (to US\$1.5/hour level and a little above). Overall, however, we do not expect a fast rebound of the average hourly wage indicator (in real and FX-adjusted terms). In the end, depressed level of wages, which is politically inconvenient, will support elevated inflation rate in 2016-17.

Chart 38. Number of employees on payroll (million)

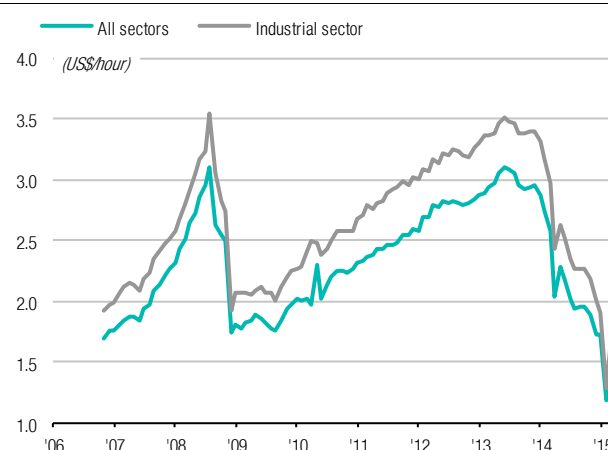
History from November 2006 through April 2015



Source: State Statistics Committee of Ukraine, ICU.

Chart 39. Average hourly wage (US\$ per hour)

Seasonally adjusted data. History from November 2006 through April 2015



Source: State Statistics Committee of Ukraine, ICU.

Retail gasoline market as bellwether of economy

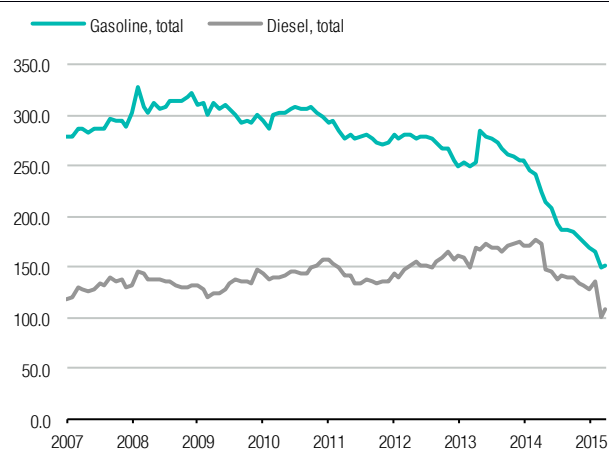
The retail gasoline market in Ukraine separated from the city of Kyiv (Chart 40-Chart 42 on p.30) indicates the difference between consumer behavior in Kyiv from the rest of the country. Retail sales of gasoline (in tonnes) in April fell 32% YoY from the same month a year ago for the entire economy.

It is interesting that statistical data on retail sales in Kyiv was affected more by the economic downturn than the rest of the country – down 37% versus 31%, respectively. As Kyiv is the most populated urban area with large suburbs (including both primary and summer residences) with the highest commuter and traffic rates, the larger drop of gasoline consumption in Kyiv versus other parts of the country means that the consumption

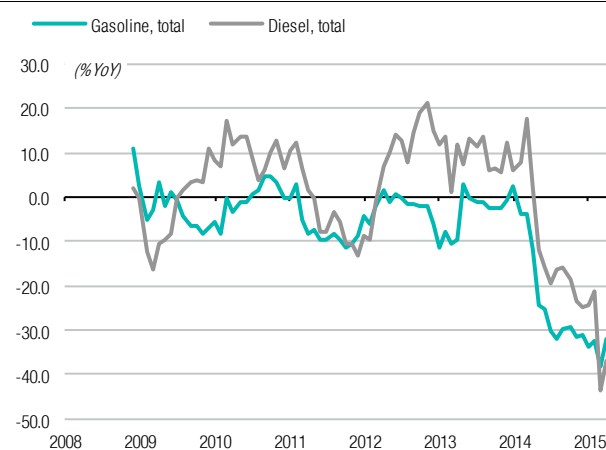
¹⁸ Originally this analysis appeared in the Daily Insight published 29 May 2015, <http://www.icu.ua/download/report/596/ICUDailyInsight-20150529.pdf>

downturn is widespread and not concentrated in areas bordering Russian aggression and occupation.

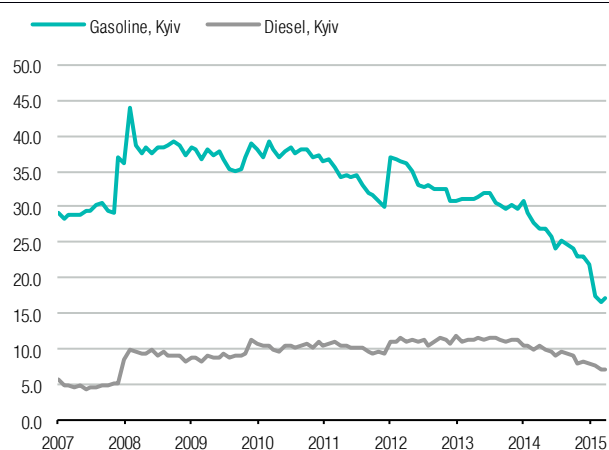
A silver lining of the recent data from this market is that fuel consumption slightly increased in April, up 1.7% (seasonally adjusted) from the previous month for car fuel and 8.8% month-on-month for diesel fuel. In the city of Kyiv, gasoline sales increased 2.0%, but diesel sales continued to decline by 1.8%. In the rest of the country excluding the city of Kyiv, tonnage sales of car fuels in the retail networks rose 1.6% and 9.6%, respectively, for gasoline and diesel.

Chart 40. Retail consumption of the car fuels in entire country: volume (000 tonnes, left) and growth rates (%YoY, right)*Monthly volumes, seasonally adjusted. History from January of 2006 through April of 2015*

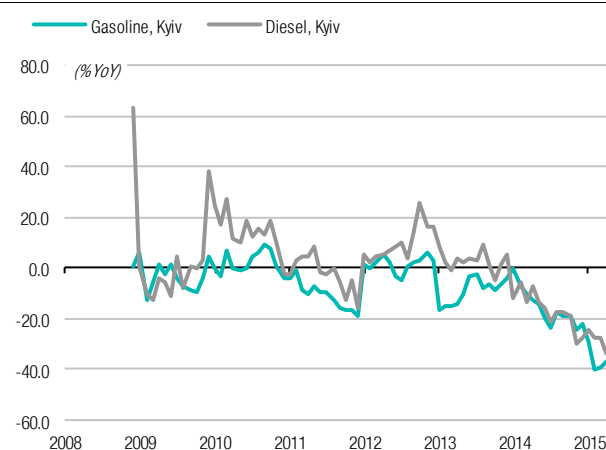
Source: State Statistics Committee of Ukraine, ICU.



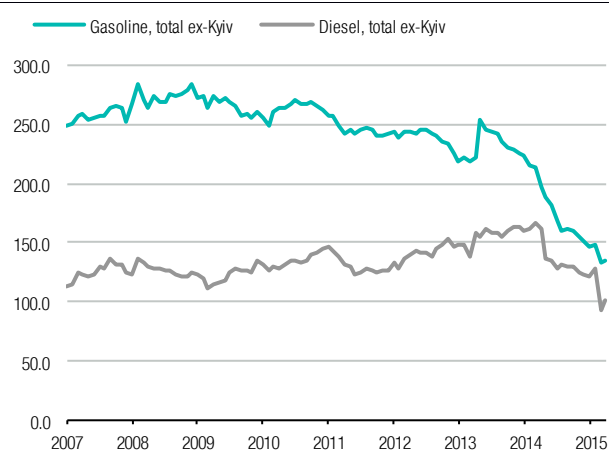
Source: State Statistics Committee of Ukraine, ICU.

Chart 41. Retail consumption of the car fuels in the city of Kyiv: volume (000 tonnes, left) and growth rates (%YoY, right)*Monthly volumes, seasonally adjusted. History from January of 2006 through April of 2015*

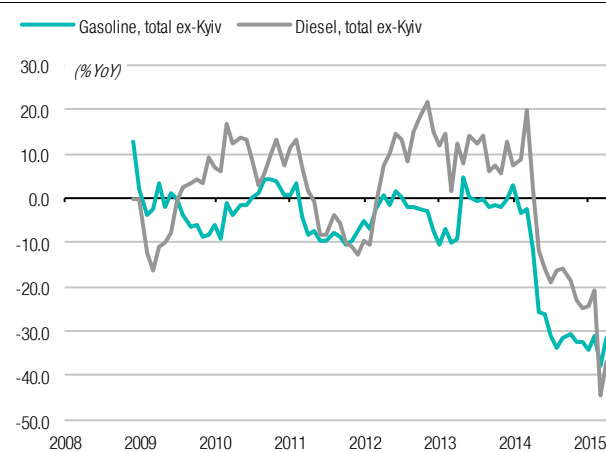
Source: State Statistics Committee of Ukraine, ICU.



Source: State Statistics Committee of Ukraine, ICU.

Chart 42. Retail consumption of the car fuels in the entire country excluding city of Kyiv: volume (000 tonnes, left) and growth rates (%YoY, right)*Monthly volumes, seasonally adjusted. History from January of 2006 through April of 2015*

Source: State Statistics Committee of Ukraine, ICU.



Source: State Statistics Committee of Ukraine, ICU.

Monetary conditions: 1H broaches crisis, 2H stabilizes

When the financial storm struck, Ukraine's central bank and the government, which had been bankrolled by the former by a sizable extent over 2014 and through February 2015, realized that they had to change their monetary policy to calm down the FX market, albeit for a while.

The policy had been to support the economy by accumulating the domestic claims on the government, where the latter's entities like Naftogaz and the Deposit Guarantee Fund eventually produced demand for the hard currency. In effect, the central bank's sheet netted two flows – one of expanding local currency claims and liabilities and the other of contracting foreign currency claims and liabilities. FX reserves, which had been stretched in the fall of 2014 and came under extreme strain in mid-1Q15, limited how much they could accumulate.

Thus, during 2014, the banking sector dealt with deleveraging the non-government sector as the government continued to issue debt (leveraging up) and deplete FX reserves. Meanwhile, monetary conditions were contractionary: growth of the base money last December was very timid at 8.5% YoY in nominal terms (in inflation-adjusted terms, it contracted 13.1%); broad money (M3) grew only 5.3% YoY nominally (in real terms, it contracted 15.6%). Generally, domestic credit, albeit collapsing from the previous year¹⁹, was supportive as it expanded UAH27bn in nominal terms. Official FX reserves were depleted by US\$12.9bn to US\$7.5. Despite of number of measures to tighten capital controls, the UAH lost 48% of its value to the US dollar as it closed the year at 15.82/USD (according to Bloomberg). Consumer inflation soared an astronomical 24ppt to 24.9% YoY at year-end.

In January-February 2015, in an attempt to stimulate the economy by monetary means, UAH42bn in local currency government debt was issued in just two months²⁰. At the same time, the non-government sector borrowed from the local banking sector and FX reserves declined by US\$1.9bn to US\$5.6bn. Domestic credit contracted nearly UAH2bn, which is considered to be insignificant. MB and M3 on-year growth rates at the end of February hit 7.5% and 21.6%, respectively, in nominal terms, while in real terms they contracted 20.1% and 9.6%, respectively. The UAH declined a further 42% versus the dollar to close at 27.25/USD at the end of February, causing a tighter capital controls to be introduced. The FX rate decline fuelled on-year CPI further up by 9.6ppt to 34.5% YoY in February and injected a lasting FX-driven impetus to inflation which jumped beyond 50% in March.

Since March, authorities radically changed their strategy to tame runaway currency devaluation and hyperinflation, now known as the February financial storm.

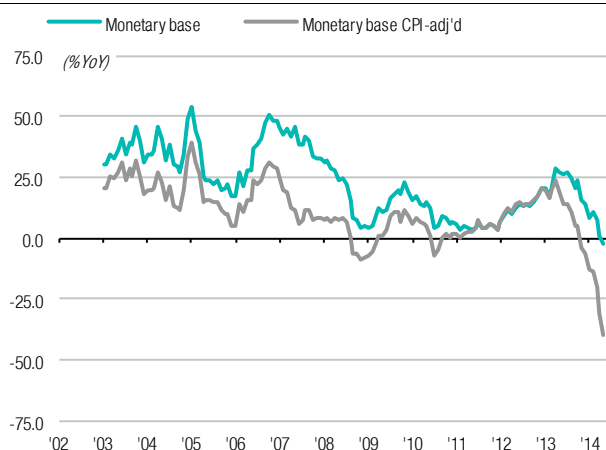
As a result, authorities immediately passed the legislation necessary to launch the IMF program which brought the needed official FX flows in the form of low-interest, long-term debt. In our opinion, this stopped the FX depletion over the previous nine-months and enabled authorities to steadily replenish FX reserves.

¹⁹ in 2013, domestic credit rose by UAH167bn in flow terms, meaning adjusted for FX rates and other non-flow changes.

²⁰ In nominal terms, the banking sector added UAH16bn of local currency government bonds on average per month during 2014.

Chart 43. Base money (BM): growth rates of raw and inflation adjusted volume (%YoY)

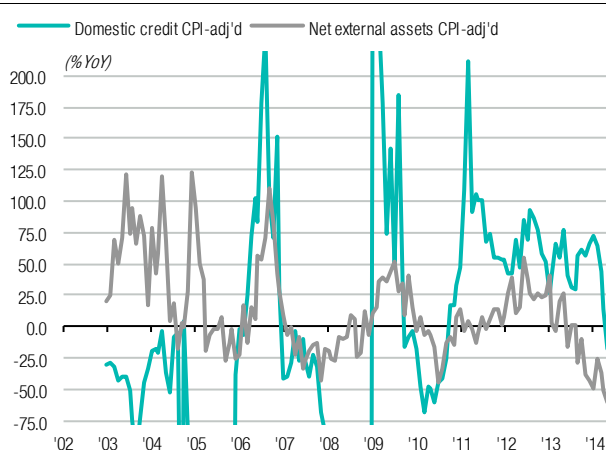
Monthly history from January 2004 through April 2015



Source: National Bank of Ukraine, ICU.

Chart 44. Counterparts of base money: growth rates of inflation adjusted volume (%YoY)

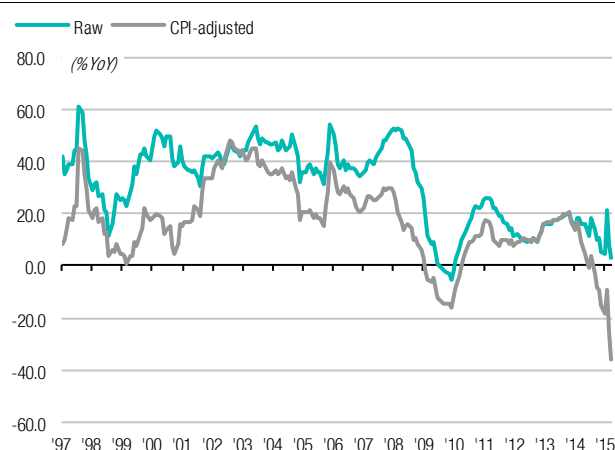
Monthly history from January 2004 through April 2015



Source: National Bank of Ukraine, ICU.

Chart 45. Broad money (M3): growth rates of raw and inflation adjusted volume (%YoY)

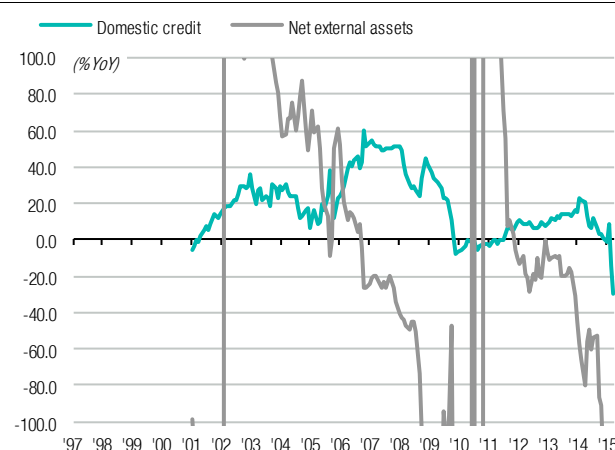
Monthly history from January 1997 through April 2015



Source: National Bank of Ukraine, ICU.

Chart 46. Counterparts of base money: growth rates of inflation adjusted volume (%YoY)

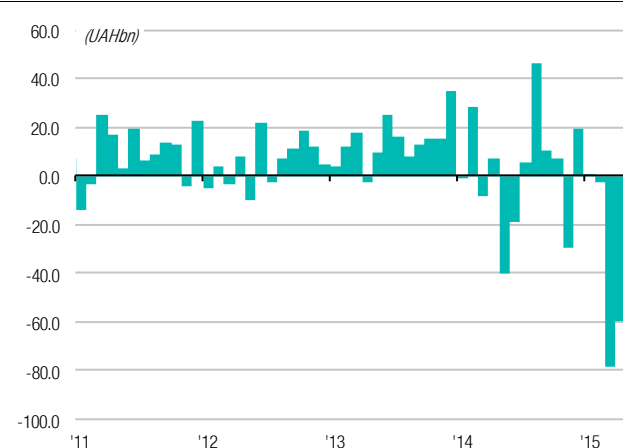
Monthly history from January 2001 through April 2015



Source: National Bank of Ukraine, ICU.

Chart 47. Domestic credit monthly flows (UAHbn)

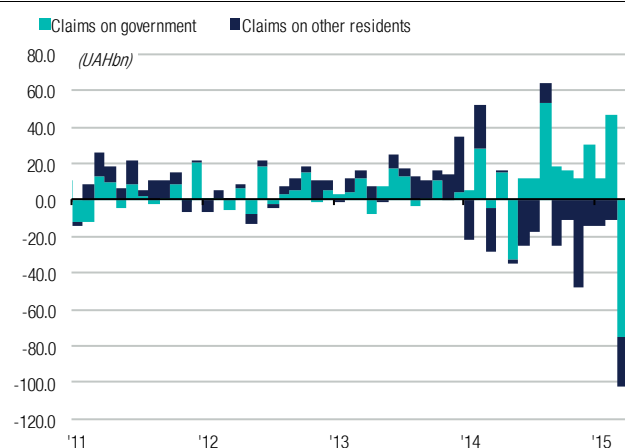
Monthly history from January 2011 through April 2015



Source: National Bank of Ukraine, ICU.

Chart 48. Breakdown of domestic credit monthly flows* (UAHbn)

Monthly history from January 2011 through April 2015



Note: * Flows breakdown is calculated by ICU and does not correspond with domestic credit flow as reported by NBU. Source: National Bank of Ukraine, ICU.

As of the end of May, FX reserves have risen US\$4.3bn to US\$9.9bn. We estimate they will reach US\$12.5bn by the end of 2015.

Quite importantly, in March-February, after the auctions of local currency government bonds and net redemptions of the domestic FX bonds were discontinued, total claims by the banking sector on the government fell UAH140bn. This, combined with the continued deleveraging of the non-government sector with banks, yielded a massive decline in domestic credit by UAH138bn over just two months (see Chart 47, p.32). This apparent credit contraction, normally a shock to the economy, has positive effects. Although M1 and M3 have extended their downward trends through April—the former declined by 2.5% and the latter added just 3.0% in nominal terms while they both declined in real terms by 39.4% and 36.0%, respectively—the UAH FX rate to the dollar recovered at the end of April to 21.25, up by nearly 30%, the level last seen at the end of February.

In our view, the authorities' new policies implemented since late February and March should continue until the external debt restructuring is completed. The best case scenario should be in early fall just before 23 September 2015 when the US\$500m Eurobond matures. Despite the replenishment of FX reserves, money supply growth in the economy is likely to be constrained over this time.

However, UAH deposit inflows visible in April could continue through this summer thanks to the following three factors: 1) a high local interest rates supported by Ukraine's monetary authorities; 2) current low-yields in hard-currency financial instruments; and 3) the current lack of upward momentum for the US dollar in the global financial markets.

In 2H 2015, monetary conditions should become more supportive to the economy if the IMF program stays on track, the external debt restructuring is successfully completed (with the Russian Eurobond continuing to be disputed in the courts), and FX reserves gradually recover. This would allow the government to relax its FX controls and restart weekly primary auctions of local currency government debt to raise funds.

Inflation: Double-digit through the period of forecast

With consumer inflation at 58.4% YoY at the end of May, two factors will prevent fast disinflation in the near future.

First, FX devaluations that occurred during 2014 and peaked this February have been digested by the economy through higher inflation which has eroded gains in macroeconomic competitiveness. Because of the prevailing high inflation, we forecast that the hryvnia will weaken, which will prevent rapid disinflation. Should the currency strengthen, disinflation would become more rapid.

Second, a committed increase of the regulated tariff per the IMF program agreement should also support future inflation from overly rapid disinflation. As far as the rest of 2015 is concerned, Ukraine's authorities are likely to avoid tariff increases prior to regional elections in October.

In our view, the NBU will most likely retain its key rate at 30% through year-end as inflation remains high, averaging 51.3% in 2015. Afterward, the central bank will probably reduce the key rate at a measured pace as inflation expectations are fuelled by wage growth anticipations. Consumer inflation is projected to subside to a yearly average of 30.2% in 2016 and decline to 19% on average in 2017.

Public finances: When inflation is a boon

Despite all of the troubles stemming from severe declines in both economic activity and real incomes, there is a short-lived boon for the government as tax revenues have been growing at accelerated pace since the beginning of 2015. This acceleration stems, in our view, from two sources: tax system revisions initiated by Yatsenyuk's administration in 2014, which apparently bore fruit, as much as from the sizable devaluation of the currency that spurred high inflation.

Thus, the government recorded a deficit-free budget in 1Q15 and in January-April 2015, recording a consolidated budget surplus of UAH14bn in 1Q15 and UAH19bn in 4M15.

The year-on-year growth rate of consolidated budget revenues²¹ was 10.8% YoY as of end-1Q15, up from 5.2% YoY at year-end 2014, and then accelerated further up to 12.8% YoY in April. Excluding NBU transfers from the total volume of revenues, growth rates were 5.6%, 13.1% and 11.4% at the end of, respectively, December 2014, March and April 2015 (Chart 49, p. 35).

Similarly, year-on-year growth of consolidated budget expenditures was just 3.4% YoY at year-end 2014, and then rose to 6.3% YoY at the end of 1Q15 and to 8.4% YoY at the end of April. Primary expenditures during those periods also grew more slowly than revenues (excluding NBU transfers): 0.2%, 1.8% and 3.5%, respectively (Chart 51, p.35).

On fiscal prudence: Growth rates of receipts and outlays in the real economy

In effect, as Chart 53 on p. 35 depicts, Yatsenyuk's administration has been trying to sustain such a pace of collecting budget revenues to cover expenditures. One of our preferred ways of assessing the government's fiscal prudence is measuring the divergence between budget revenues collected from the economy (and not from the central bank) versus primary expenditures.

During 2014, Yatsenyuk's administration managed to sustain a positive divergence, up from April through August (peaking at 6.0ppts). Since then, Donbas war expenses and parliamentary elections dampened the growth and narrowed the surplus to near zero. In 2015 so far, a positive divergence was restored and peaked 7.9ppts in March, only to slide to 5.3ppts in April.

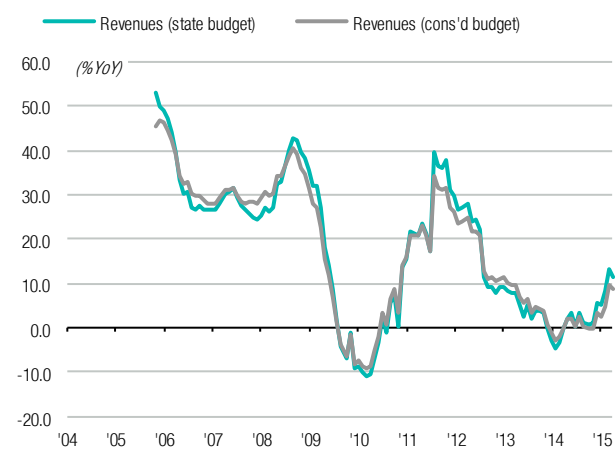
Yatsenyuk's fiscal prudence should continue through the summer until the eve of regional elections when the government will most likely bend to political pressure and increase social expenditures from the state budget. That divergence will equalize and expenditures should be equal to revenues. This should occur within a few months before regional elections in October, and 2015 quite possibly could mirror the pattern seen in 2014, as both years feature elections in October²².

²¹ Here and below, a growth rates represent a percentage change of 12-month volume of state budget indicator from a year ago.

²² Albeit of different scale but of nearly equal impetus to political developments in the country.

Chart 49. Growth rates of the budget revenues, excluding NBU's transfers (% YoY)

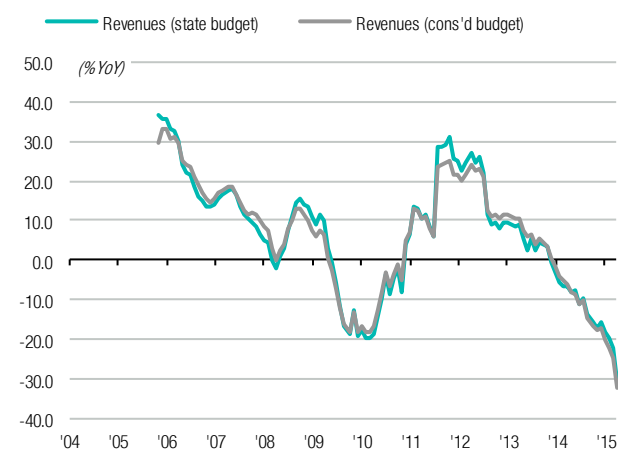
Monthly history from November 2004 through April 2015



Source: Ministry of Finance of Ukraine, ICU.

Chart 50. Inflation-adjusted growth rates of the budget revenues, excluding NBU's transfers (% YoY)

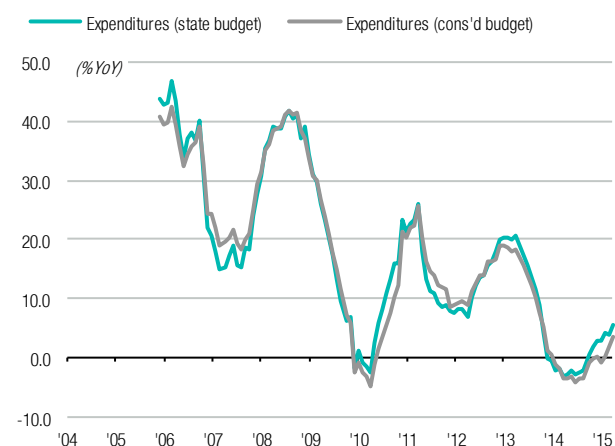
Monthly history from November 2004 through April 2015



Source: Ministry of Finance of Ukraine, ICU.

Chart 51. Growth rates of the budget primary expenditures* (% YoY)

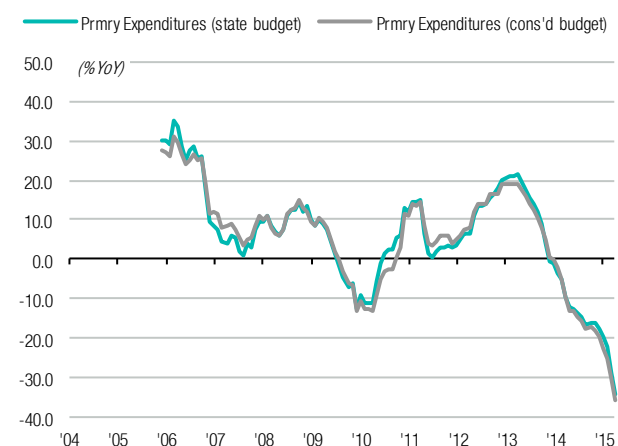
Monthly history from November 2004 through April 2015



Source: Ministry of Finance of Ukraine, ICU.

Chart 52. Inflation-adjusted growth rates of the budget primary expenditures* (% YoY)

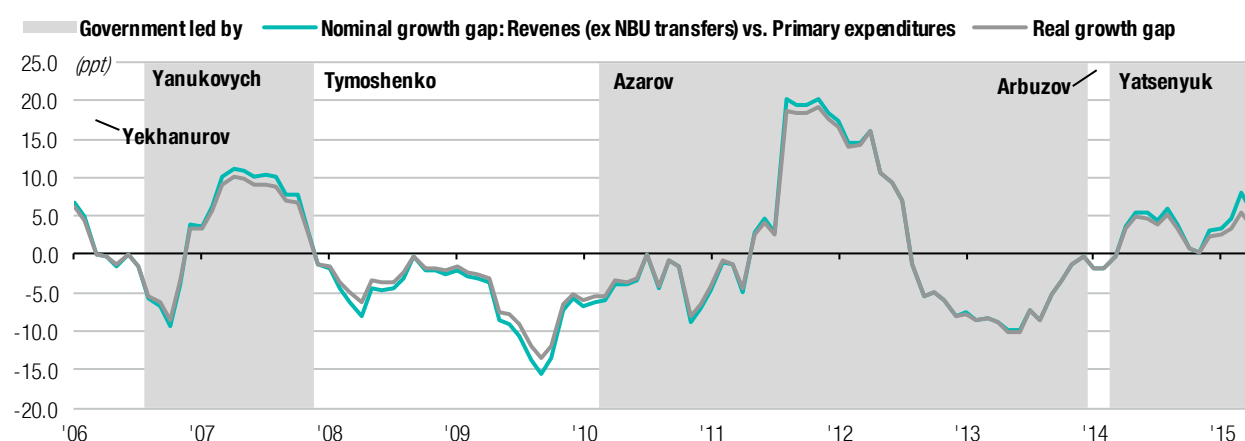
Monthly history from November 2004 through April 2015



Source: Ministry of Finance of Ukraine, ICU.

Chart 53. Divergence of growth rates between budget revenues¹ and primary expenditures² (ppt)

Monthly history from January 2006 through April 2015. Charts are based upon trailing 12-month volumes of state budget revenues and expenditures



Note: [1] excluding NBU transfers, [2] total expenditure less interest payments. Source: Ministry of Finance of Ukraine, ICU.

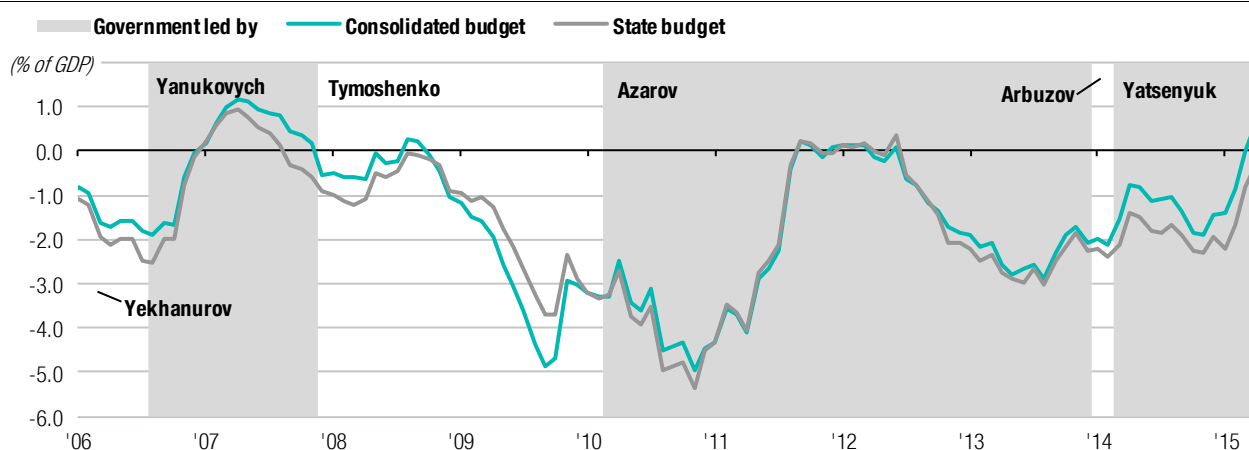
The above indicator is worthwhile as it reveals the underlying condition of the budget. These very two items of the state budget have performed not in the favor of PM Yatsenyuk's administration in 2014-15. Debt service expenditures have grown 74% YoY in April, up from 50.9% at the end of 2014 and from 33.2% at the end of 2013 (see Chart 55, p.36). At the same time, the NBU drastically reduced transfers.

On fiscal prudence: Primary balance

Another indicator on fiscal policy prudence we follow is the primary balance. In March-April, the consolidated state budget²³ turned positive for the first time since mid-2013. As described above, the self-imposed fiscal prudence by the government is likely to be affected by political considerations on the eve of regional elections in October. Nevertheless, our base case scenario forecast for FY 2015 is a near zero primary balance of 0.3% of GDP while the total state budget deficit is forecast at 3.3% of GDP.

Chart 54. Primary balance (% of GDP)

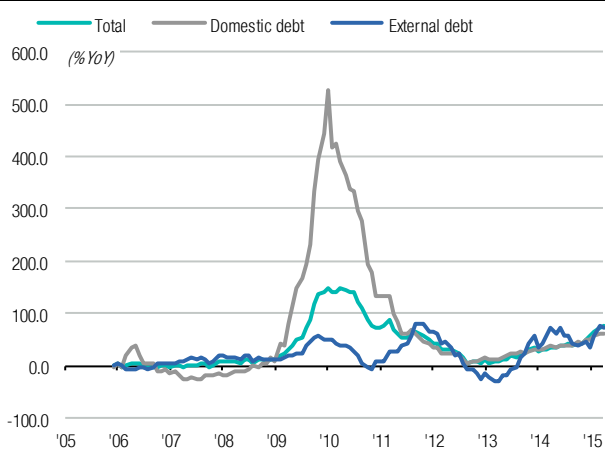
Monthly history from January 2006 through April 2015. Charts are based upon the 12-month rolling volumes of state budget revenues and expenditures.



Source: Ministry of Finance of Ukraine, ICU.

Chart 55. Growth rates of debt service expenditures (%YoY)

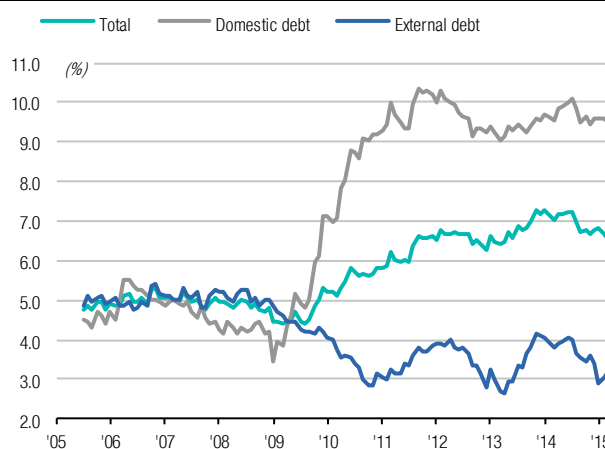
Monthly history from January 2006 through April 2015. Charts are based upon the 12-month rolling volumes of debt service expenditures



Source: Ministry of Finance of Ukraine, ICU.

Chart 56. Effective cost of debt as implied by debt stock and debt service expenditures (% per year)

Monthly history from January 2006 through April 2015. Charts are based upon the 12-month rolling volumes of debt service expenditures



Source: Ministry of Finance of Ukraine, ICU.

²³ Based on 12-month volume of budget revenues and expenditures.

The above Chart 54 on p.36 underlines our narrative maintained throughout this report – that since this February, when an acute financial crisis struck the economy, authorities have shifted towards more prudent policies aiming to reduce the public deficit and avoid any inflationary financing of this deficit.

Sizable devaluation and high inflation, as ugly as they are, helped the government by accelerating the growth of state budget revenues. In this regard, the government's prudence is observed in maintaining the expenditures restrained from populist demand to increase social spending right away. It appears that Yatsenyuk administration has been rejecting these requests during 2Q when the fiscal surplus just began to be reported, and it appears committed to sustain this track record through this summer. After that moment, the government should relax its stance somewhat to meet President Poroshenko's call to increase social spending this fall. From our perspective, this plan ultimately will result in a balanced budget (in primary terms).

External debt operation: Assessment of the macro environment and the outcome

Our macroeconomic model that began as a three-year forecast has been extended outward to 2018-25 to assess IMF specific targets to be met by the external debt operation:

- 1) To generate US\$15.3bn savings in public sector financing during the IMF programme period, assumed to be 2015-18.
- 2) To reduce public debt²⁴ in terms of debt-to-GDP to under 71% of GDP by 2020.
- 3) To contain the budget's gross financing needs²⁵ to an average of 10% of GDP in 2019-25 (maximum of 12% of GDP in any given year).

Our macro model is constructed upon these assumptions:

- 1) Real GDP growth rates in 2015-17 are as described above in this section: a deep and protracted recession in 2015 of a 13.1% decline is followed by a 2.5% rebound in 2016 and growth normalisation in 2017 at 2.0%. In 2018-2025, a 2% annual growth rate is assumed, in line with a low growth environment globally and lack of domestic stimulus as fiscal and monetary policies are restrained.
- 2) Inflation is projected to be in the double digits in 2015-17 and should decrease to single digits by 2018 as a result of a sluggish global economy.
- 3) Fiscal policy should be restrained from the domestic populace in reaction to economic austerity, as they experience yet another lost decade, and from creditors who will withhold from lending if creditworthiness is not assured (via fiscal primary surplus). We believe the government will try to target a small primary surplus.
- 4) Exchange rate: due to inflation, the UAH is on course for a prolonged future weakening toward 31/USD (on average) in 2016 and 34/USD in 2017. This will have an impact on the future debt level. For more details on the FX rate issue, see the section below "View on UAH: High inflation destroys competitiveness" on p.42.

Chart 57, Chart 58 and Chart 59 on p.39 depict the model's results in regard to target #2 and target #3 which are essential for the debt metrics which are calculated. It is assumed that target #1 is met as it is archived by extending the maturities of the debt securities into equal amortisations of principal during 2020-29.

²⁴ Direct and guaranteed debt.

²⁵ Includes financing needs of entities that depend directly on the Ukrainian state budget.

Under the scenario of simply adjusting the maturities and granting no coupon or principal haircuts (as depicted by the Chart 57), neither targets #2 nor #3 will be achieved.

Under a second scenario, when the coupon is reduced from the current average rate of 7.6% to 4.5% (likely to be targeted by Ukraine's government as it has historically paid an effective rate on external debt of no more than 5%, see Chart 56 on p.36) and the principal haircut is 20%, target #2 will not be achieved because public will be 75% of GDP by 2020, above the required "under 71%" to be met by that year. See Chart 58.

For the third scenario, with a 4.5% coupon and a 30% nominal haircut, both targets will be achieved (see Chart 59). This will result in a debt level at 66%, well under the targeted 71%, by 2020. Gross financing needs should be below the average 10% level in 2019-25.

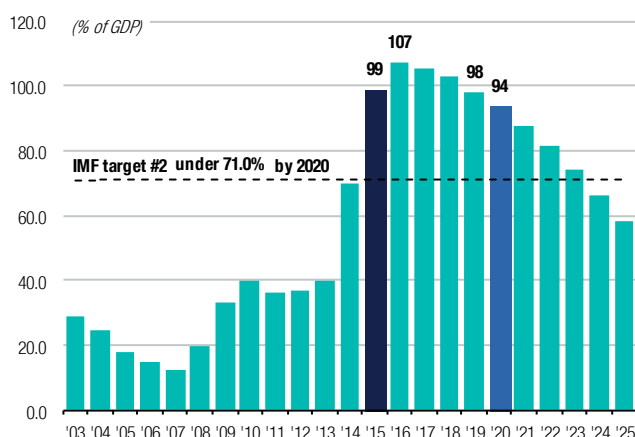
A scenario not depicted in the charts on the next page is one that requires a nominal haircut of 20%-30% (it requires a 25% reduction of nominal value of debt) that would fulfil both targets, according to our macroeconomic modelling.

According to the scenarios above, the forecast of Ukraine's public debt level projects that it will approach the 100% threshold by 2015-16 regardless of a successful external debt restructuring. For an economy like Ukraine's, public debt at that level will only result in protracted economic weakness because fiscal policy must focus on maintaining a surplus to restore creditworthiness. For an EM economy to be considered not prone to a debt crisis, the public debt level cannot exceed 60% of GDP. Maintaining fiscal surplus is a hefty task for any government as it implies a degree of austerity that political opponents will seek to derail.

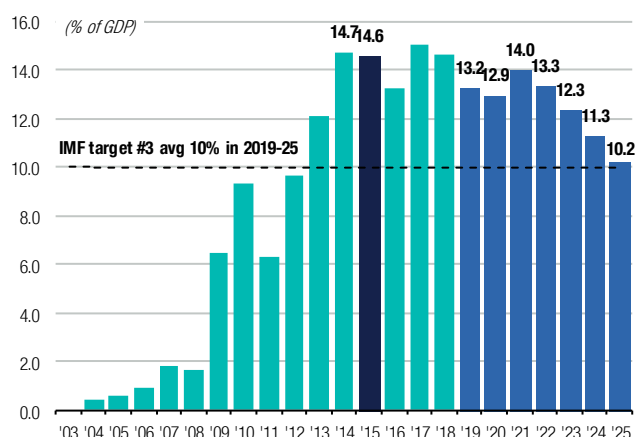
Ukraine's current administration should exploit this argument in discussions about those political opponents/populists who would rather undermine the incumbents using a likely popular backlash to austerity. The argument is this: if the opponents are successful in toppling the incumbents, they would demand new talks with creditors to negotiate yet another restructuring, and possibly with worse terms and conditions.

In the meantime, the talks held on June 5 between Ukraine's government and creditors yielded no progress. Their active phase is likely to span from mid-June (when Ukraine's prime minister and finance minister are scheduled to visit the US for a in person talks with interested parties) to mid-September, a week before the 23 September 2015 US\$500m Eurobond matures.

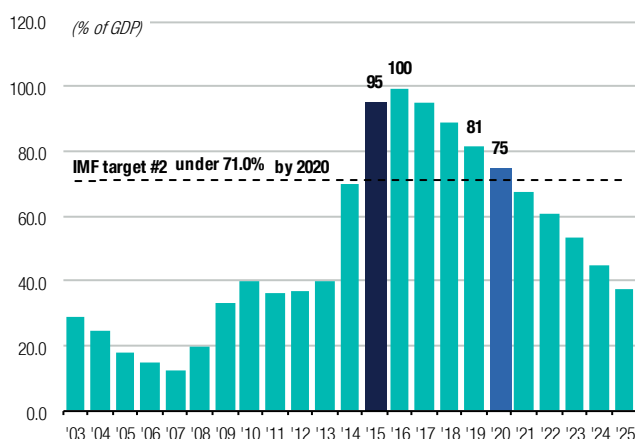
Our base case scenario envisages that talks reach a negotiated agreement through this summer, allowing Ukraine to reach the IMF targets, which implies at least 25% nominal haircut.

Chart 57. Outcome of external debt operation if there is no coupon haircut and no nominal haircut**Target #2** – Public debt level under 71.0% by 2020

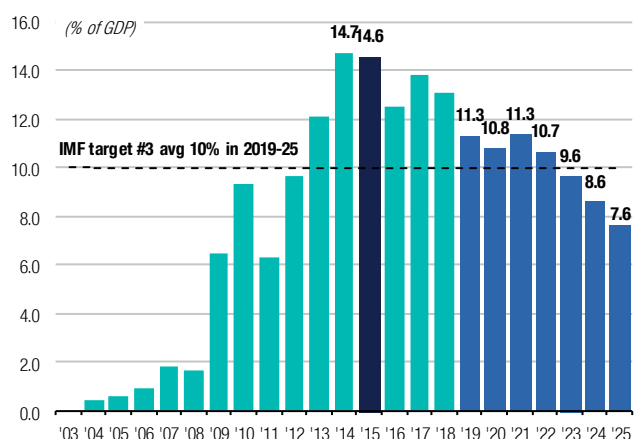
Source: Ministry of Finance of Ukraine, ICU.

Target #3 – Gross financing needs at an average of 10% of GDP in 2019-25

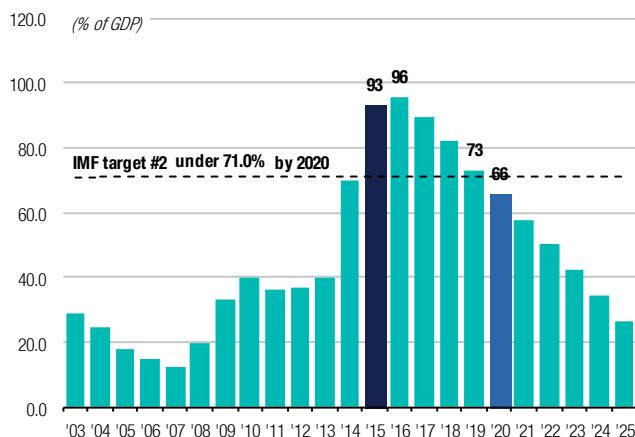
Source: Ministry of Finance of Ukraine, ICU.

Chart 58. Outcome of external debt operation if there is coupon haircut (from 7.6% to 4.5%) and 20% nominal haircut**Target #2** – Public debt level under 71% by 2020

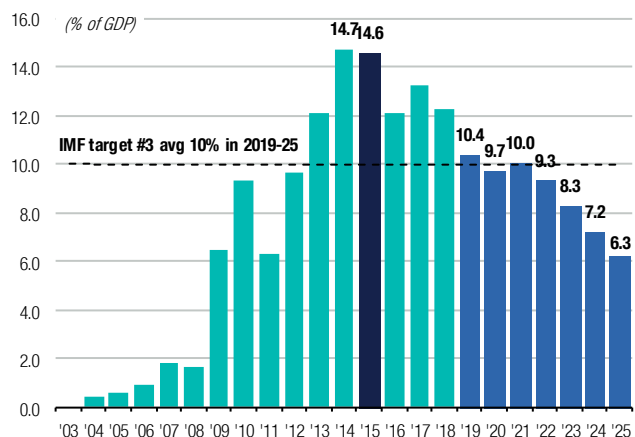
Source: Ministry of Finance of Ukraine, ICU.

Target #3 – Gross financing needs at an average of 10% of GDP in 2019-25

Source: Ministry of Finance of Ukraine, ICU.

Chart 59. Outcome of external debt operation if there is coupon haircut (from 7.6% to 4.5%) and 30% nominal haircut**Target #2** – Public debt level under 71% by 2020

Source: Ministry of Finance of Ukraine, ICU.

Target #3 – Gross financing needs at an average of 10% of GDP in 2019-25

Source: Ministry of Finance of Ukraine, ICU.

External balance: Current account surplus due to recession

Due to a more severe recession in 2015 than was previously forecast, there is more ground to assume that the full-year current account deficit should be more balanced than previously thought. According to our assessment, the current account should record a small surplus of 0.1% of GDP, or US\$51m. On the back of an economic rebound in 2016, and then steady growth from 2017 going forward, the current account is again projected to slip into a deficit of US\$1-2bn in 2016-18, which is manageable given the FDI forecast of US\$3.0-4.6bn during the same period, see Table 2 on p.41.

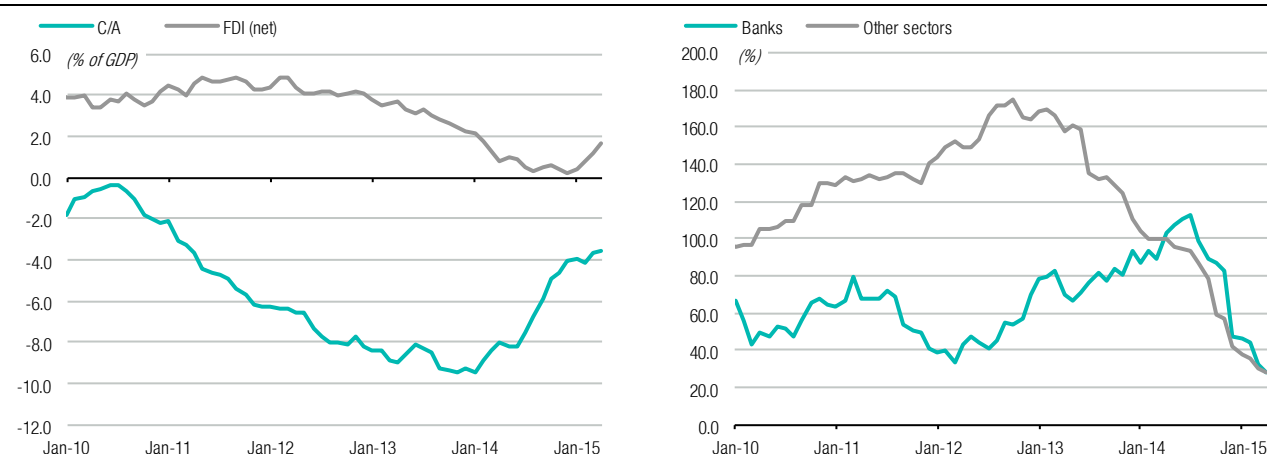
We anticipate that authorities will be under pressure to privatize sectors or companies, generally luring FDI to attract foreign capital. Hence, a sizable US\$3bn recovery in FDI is forecast in 2015 (for 4M15, net FDI amounts to US\$0.5bn). FDI underperformance below the full-year level poses a risk to our base case scenario. Also, the capital controls implemented to prevent a currency run is likely to contain domestic demand for cash FX, which is lowered from our previous forecast of US\$4bn to US\$0.5bn. However, it is projected to recover back to US\$3-4bn.

Another risk to our balance of payments projection is a recovery of non-government rollover ratios (depicting net borrowings by banks and corporations²⁶ on a trailing 12-month basis), which have been on a steady downward trend through April, according to the latest statistics. For instance, April's rollover ratio was 28% for both banks and corporations. Our 2015 forecast assumes that a full-year recovery of rollover ratios occurs through the rest of 2015 recovering to 74% for banks and 61% for corporations. If these indicators underperform, then they, too, pose a risk to our base case scenario.

Overall, our base case scenario forecast of balance of payments results in a US\$5bn FX recovery of reserves to US\$12.5bn this year, to be followed by a US\$8bn increase in 2016 to US\$21.1bn.

Chart 60. Net FDI and other capital (% of GDP, left) and rollover ratio* for external borrowings by banks and other sectors (% , right)

Both charts depict the data on trailing 12-month indicators



Source: National Bank of Ukraine, ICU.

Note: * >100% means leveraging by the sector; <100% means deleveraging by the sector. Source: National Bank of Ukraine, ICU.

²⁶ For all type of borrowings from bank loans to trade loans as well as intercompany loans.

Table 2. Balance of payments projections for 2015-18 (US\$m)

	Forecast period				Rollover ratios				Comment
	2015	2016	2017	2018	2015	2016	2017	2018	
Current account balance	51	-1,289	-2,162	-2,000					
Short-term debt due	-43,938	-25,728	-21,875	-19,918					
Government									
Official lenders	-688	0	0	0	1123%	0%	0%	0%	Official lending by IMF, donors
Russian banks	0	0	0	0	0%	0%	0%	0%	
Eurobonds	0	0	0	0 means to be restructured
Domestic FX bonds	-2,327	-1,459	0	-200	100%	100%	100%	0%	To be rolled over w local banks
Other	0	0	0	0	0%	0%	0%	0%	
Central bank									
Official lenders (IMF)	-440	0	0	0	1783%	0%	Borrowings from IMF
Other	0	0	0	0	0%	0%	0%	0%	
Banks									
Eurobonds	0	0	0	0	0%	0%	0%	0%	No access to the market
Other lenders	-9,883	-7,295	-6,566	-5,909	74%*	100%	100%	100%	Rollover ratios recovers to 100%
Corporations									
Eurobonds	0	0	0	0	0%	0%	0%	0%	No access to the market
Loans	-6,960	-3,861	-3,482	-3,141	61%*	100%	100%	100%	Rollover ratios recovers to 100%
Trade loans	-16,148	-8,957	-8,079	-7,287	61%*	100%	100%	100%	Rollover ratios recovers to 100%
Other	-7,490	-4,155	-3,747	-3,380	61%*	100%	100%	100%	Rollover ratios recovers to 100%
Domestic demand for cash FX	-500	-2,000	-3,000	-4,000					Assumed to be \$4bn/yr
Total financing needs	-44,387	-29,017	-27,036	-25,918					
FDI, inflows	3,060	4,000	4,198	4,574					According to ICU BoP proj'ns
Borrowings									
Government	12,207	1,459	0	0					
Central bank	8,000	8,640	5,000	0					
Banks	7,295	6,566	5,909	5,318					
Corporations	18,817	16,973	15,309	14,499					
Total financing	49,380	37,638	30,417	24,391					
Use of reserves	+4,993	+8,621	+3,380	-1,526					
FX reserves									
At the start of year	7,533	12,526	21,147	24,527					
At the end of year	12,526	21,147	24,527	23,001					
Change (%YoY)	66.3	68.8	16.0	-6.2					
FX reserves (% of GDP)									
At the start of year	5.7	13.4	24.1	26.6					
At the end of year	13.4	24.1	26.6	24.4					
Change (ppt)	7.7	10.7	2.5	-2.2					
FX res imp cov (months)									
At the start of year	1.2	2.8	4.5	5.0					
At the end of year	2.8	4.5	5.0	4.5					
Change (months)	1.6	1.7	0.4	-0.5					

Note: * rollover ratios assumed for 2015 are at the average level seen in the last 12 month period from May 2014 through April 2015, see the right-hand part of the Chart 60 on p.40. Source: ICU.

View on UAH: High inflation destroys competitiveness

Ukraine's currency has been suffering tremendously from high inflation since 1H14.

After the recent currency devaluation, a wave of inflation boosted headline CPI from near zero at the beginning of the year to 12.5% YoY by mid-year. By the end of 3Q14, consumer inflation hit 17.5% YoY (while PPI was at 26.9% YoY). The positive impact of the devalued currency's competitiveness was quickly eliminated by the inflation spike. In our view, this lack of competitiveness as of early 4Q14 was one of the many factors that caused new pressure on the FX rate in the market.

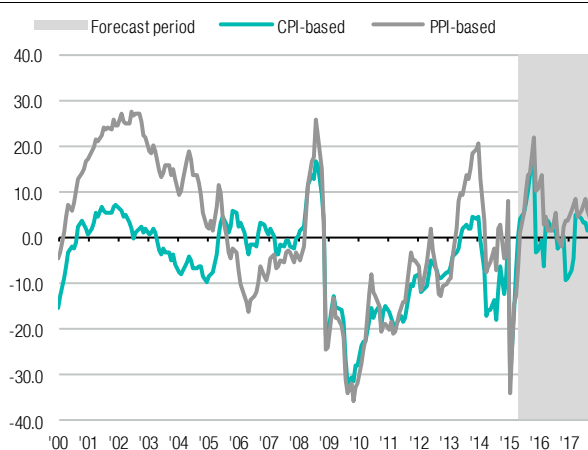
In 2015, the pattern of the past year will probably repeat itself as the currency devaluation of 1Q15 produced a lasting impact on consumer prices (notwithstanding April's jump in inflation on the back of the tariff increase on utilities and natural gas) which in itself has eroded the significant competitive advantage (in real terms) provided by the currency devaluation from 15.66/USD at year-end 2014 to 23.04/USD at the end of 1Q15.

As our calculations of the hryvnia's real-trade weighted indices show that the competitive gains of the 1Q15 devaluation have been swiftly wiped out by inflation, which stands now at 58% YoY, well above inflation in Ukraine's key trade partners. While authorities have been keeping capital controls in place, albeit slightly relaxing them to appease public anxiety, their priority is to defend the hryvnia from weakening too much. The summer lull in the FX market could easily allow the UAH to hold steady at 21-22/USD through September. However, this would cause a real appreciation of the hryvnia, which is undesirable from a macroeconomic stance. This appreciation is negative for growth in general and for exports' in particular. Hence, the UAH's FX rate will probably weaken further.

This is included in our base case scenario forecast. As long as inflation remains double-digit and well ahead of our trading partners' inflation rates, the hryvnia value is on the path of protracted weakness, as depicted below.

Chart 61. Misalignment of the UAH's FX rate as implied by the UAH real trade-weighted indices

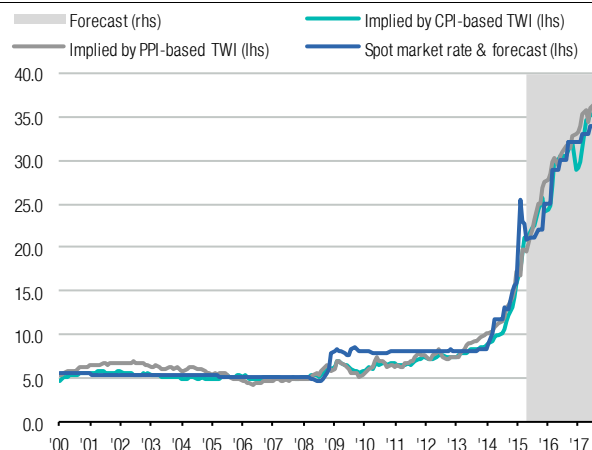
History 2000-5M15 and forecast for 2H15-2017



Source: ICU.

Chart 62. UAH's FX rate versus the rates implied by the UAH real trade-weighted indices

History 2000-5M15 and forecast for 2H15-2017



Source: ICU.

Forecast for 2015-17

The following two pages of statistics are our yearly and quarterly key macroeconomic indicators with forecasts to 2017.

Yearly forecast for 2015-17, base case scenario

Table 3. Forecast of key macroeconomic indicators for 2015-17 (annual)

	Historical data for 2004-12										Forecast by ICU		
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014E	2015F	2016F	2017F
Activity													
Real GDP (%YoY)	2.7	7.3	7.9	2.3	-14.8	4.1	5.2	0.2	-0.1	-6.7	-13.1	2.7	2.0
Nominal GDP (UAHbn)	441	544	721	948	913	1,083	1,302	1,409	1,455	1,551	2,110	2,719	3,177
Nominal GDP (US\$bn)	87	108	143	184	114	136	163	174	178	130	94	88	93
GDP per capita (US\$, ann)	1,850	2,319	3,091	3,986	2,474	2,978	3,572	3,823	3,920	3,017	2,198	2,077	2,188
Unemployment rate (%)	7.2	6.2	6.4	6.4	8.8	8.1	7.9	7.5	7.2	8.7	11.0	9.8	9.8
Prices													
CPI headline (%YoY, eop)	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	52.7	23.6	16.7
CPI headline (%YoY, average)	13.6	9.1	12.8	25.3	16.0	9.4	8.0	0.6	-0.3	12.1	51.3	30.2	19.2
PPI (%YoY, eop)	9.6	15.4	23.2	21.1	15.3	18.8	17.4	0.4	1.7	31.8	39.8	19.6	5.3
PPI (%YoY, average)	17.0	9.6	20.5	33.6	7.4	21.4	19.9	6.0	-0.1	17.0	42.0	23.4	11.0
Fiscal balance													
Consolidated budget bal. (UAHbn)	-7.5	-3.5	-6.1	-11.3	-34.4	-63.3	-18.3	-46.9	-63.0	-67.1	-33.3	4.4	-14.0
Consolidated budget bal. (% of GDP)	-1.7	-0.6	-0.8	-1.2	-3.8	-5.9	-1.4	-3.3	-4.3	-4.3	-1.6	0.2	-0.4
Budget balance (UAHbn)	-7.9	-3.8	-9.8	-12.5	-35.5	-64.3	-23.6	-53.4	-64.7	-78.1	-69.7	-46.5	-70.1
Budget balance (% of GDP)	-1.8	-0.7	-1.4	-1.3	-3.9	-5.9	-1.8	-3.8	-4.4	-5.0	-3.3	-1.7	-2.2
External balance													
Exports (US\$bn)	44.4	50.2	64.0	85.6	54.3	69.3	88.8	90.0	85.3	68.8	53.5	54.3	56.6
Imports (US\$bn)	43.7	53.3	72.2	100.0	56.2	73.2	99.0	104.4	100.8	74.1	53.9	56.2	59.4
Trade balance (US\$bn)	0.7	-3.1	-8.2	-14.4	-2.0	-4.0	-10.2	-14.3	-15.5	-5.3	-0.4	-1.9	-2.8
Trade balance (% of GDP)	0.8	-2.8	-5.7	-7.8	-1.7	-2.9	-6.2	-8.2	-8.7	-4.1	-0.4	-2.1	-3.1
Current account balance (US\$bn)	2.5	-1.6	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	-5.2	0.1	-1.4	-2.3
Current account balance (% of GDP)	2.9	-1.5	-3.7	-6.9	-1.5	-2.2	-6.3	-8.2	-9.2	-4.0	0.1	-1.6	-2.4
Net FDI (US\$bn)	7.5	5.7	9.2	9.9	4.7	5.8	7.0	7.2	4.1	0.4	3.1	4.0	4.2
Net FDI (% of GDP)	8.7	5.3	6.4	5.4	4.1	4.2	4.3	4.1	2.3	0.3	3.3	4.5	4.5
C/A bal. + net FDI (% of GDP)	11.6	3.8	2.8	-1.6	2.6	2.0	-2.0	-4.1	-6.9	-3.7	3.3	3.0	2.1
External debt (US\$bn, eop)	39.6	54.5	80.0	101.7	103.4	117.3	126.2	134.6	142.1	134.1	136.5	142.9	144.8
External debt (% of ann'd GDP, eop)	45.6	50.4	55.8	55.3	90.9	86.1	77.4	77.3	79.7	103.1	145.9	162.3	156.5
FX reserves (US\$bn, eop)	19.4	22.3	32.5	31.5	26.5	34.6	31.8	24.5	20.4	7.5	12.5	21.1	24.4
FX reserves (% of ann'd GDP, eop)	22.3	20.6	22.6	17.2	23.3	25.4	19.5	14.1	11.4	5.8	13.4	23.9	26.3
External debt / FX reserves (x, eop)	2.0	2.4	2.5	3.2	3.9	3.4	4.0	5.5	7.0	17.8	10.9	6.8	5.9
FX reserves imports cov (months)	5.3	5.0	5.4	3.8	5.7	5.7	3.9	2.8	2.4	1.2	2.8	4.5	4.9
Interest rates													
Central bank key rate (% eop)	9.50	8.50	8.00	12.00	10.25	7.75	7.75	7.50	6.50	14.00	25.00	20.00	15.00
3-month rate (% eop 4Q)	11.46	9.90	7.58	21.60	17.59	6.12	19.72	25.52	11.71	18.37	25.00	25.00	25.00
Exchange rates													
UAH trade-weighted index (nominal)	77.84	70.90	64.93	45.89	46.09	53.28	56.87	54.63	49.59	32.62	19.65	19.48	18.95
UAH trade-weighted index (real)	129.21	123.61	120.06	100.21	90.26	97.73	98.76	94.72	100.84	84.90	59.45	64.46	67.40
UAH/US\$ (eop)	5.05	5.05	5.05	7.80	8.00	7.94	8.00	8.05	8.24	14.45	25.00	32.00	35.00
UAH/US\$ (average)	5.10	5.03	5.03	5.25	8.03	7.94	7.99	8.08	8.16	12.00	22.50	30.75	34.25
UAH/€ (eop)	5.97	6.66	7.36	10.90	11.45	10.63	10.37	10.62	11.32	18.06	27.50	35.20	42.70
UAH/€ (average)	6.05	6.64	7.32	7.10	11.70	10.51	10.50	10.60	11.17	15.95	24.94	33.83	41.44
US\$/€ (eop)	1.18	1.32	1.46	1.40	1.43	1.34	1.30	1.32	1.37	1.25	1.10	1.10	1.22
US\$/€ (average)	1.19	1.32	1.46	1.35	1.46	1.32	1.32	1.31	1.37	1.33	1.11	1.10	1.21
Population													
Population (million, eop)	47.0	46.6	46.4	46.1	46.0	45.8	45.6	45.6	45.5	43.1	42.6	42.4	42.3
Population (%YoY)	-0.8	-0.7	-0.6	-0.5	-0.4	-0.4	-0.3	-0.2	-0.1	-5.2	-0.5	-0.4	-0.2

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

Quarterly forecast for 2015-17, base case scenario

Table 4. Forecast of key macroeconomic indicators for 2015-17 (quarterly)

	Forecast by ICU											
	1Q15F	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F	4Q17F
Activity												
Real GDP (%YoY)	-17.6	-14.0	-10.7	-9.7	2.5	2.5	2.7	3.0	2.0	2.0	2.0	2.0
Nominal GDP (UAHbn)	382.3	518.3	600.5	608.8	530.5	660.6	763.6	764.5	655.5	776.5	876.1	868.9
Nominal GDP (US\$bn)	17.8	23.8	27.3	24.4	18.3	22.0	23.9	23.9	19.9	22.8	25.0	24.8
GDP per capita (US\$, ann)	2,678	2,492	2,328	2,183	2,197	2,157	2,078	2,070	2,108	2,128	2,157	2,180
Unemployment rate (%)	9.7	10.7	10.9	11.0	11.0	9.7	9.7	9.8	9.8	9.8	9.8	9.8
Prices												
CPI headline (%YoY, eop)	45.8	57.9	55.3	52.7	36.8	26.2	25.4	23.6	21.1	18.6	18.0	16.7
CPI headline (%YoY, average)	36.3	59.1	56.3	53.6	44.0	26.5	25.9	24.3	22.3	18.9	18.4	17.2
PPI (%YoY, eop)	51.6	41.9	40.8	39.8	18.7	23.8	21.7	19.6	19.5	9.2	5.8	5.3
PPI (%YoY, average)	42.3	44.2	41.2	40.2	27.9	22.8	22.4	20.3	20.3	11.6	6.5	5.5
Fiscal balance												
Consolidated budget bal. (UAHbn)	14.2	-17.4	0.2	-30.4	2.4	-2.0	21.1	-17.2	9.6	-5.4	15.3	-33.5
Consolidated budget bal. (% of GDP)	3.7	-3.4	0.0	-5.0	0.5	-0.3	2.8	-2.2	1.5	-0.7	1.7	-3.9
Budget balance (UAHbn)	4.2	-26.3	-10.8	-36.8	-7.7	-13.4	3.5	-28.9	-4.1	-18.3	-3.4	-44.3
Budget balance (% of GDP)	1.1	-5.1	-1.8	-6.0	-1.4	-2.0	0.5	-3.8	-0.6	-2.4	-0.4	-5.1
External balance												
Exports (US\$bn)	12.1	13.8	13.8	13.8	12.2	13.6	14.1	14.4	13.1	14.0	14.6	14.9
Imports (US\$bn)	12.7	13.0	14.8	13.3	13.6	12.9	14.7	15.1	14.4	13.7	15.8	15.5
Trade balance (US\$bn)	-0.6	0.8	-1.0	0.5	-1.3	0.7	-0.6	-0.7	-1.3	0.2	-1.2	-0.6
Trade balance (% of GDP)	-3.5	3.2	-3.8	1.9	-7.4	3.4	-2.5	-2.8	-6.5	1.0	-4.7	-2.4
Current account balance (US\$bn)	-0.5	0.8	-1.0	0.7	-1.2	0.8	-0.5	-0.5	-1.1	0.4	-1.1	-0.4
Current account balance (% of GDP)	-2.5	3.5	-3.8	2.9	-6.5	3.9	-2.3	-2.0	-5.7	1.6	-4.3	-1.7
Net FDI (US\$bn)	0.5	0.6	0.8	1.2	1.0	1.0	1.0	1.0	1.0	1.0	1.1	1.1
Net FDI (% of GDP)	2.6	2.5	2.9	4.9	5.5	4.5	4.2	4.2	5.2	4.6	4.2	4.3
C/A bal. + net FDI (% of GDP)	0.0	6.1	-0.9	7.8	-1.1	8.4	1.9	2.2	-0.5	6.2	-0.1	2.6
External debt (US\$bn, eop)	134.7	135.3	135.9	136.5	138.1	139.7	141.3	142.9	144.8	144.8	144.8	144.8
External debt (% of ann'd GDP, eop)	117.4	126.8	136.5	146.4	147.3	151.9	159.6	162.3	161.6	160.1	158.1	156.5
FX reserves (US\$bn, eop)	8.8	10.0	11.3	12.5	14.7	16.8	18.9	21.1	21.9	22.7	23.5	24.4
FX reserves (% of ann'd GDP, eop)	7.7	9.4	11.3	13.4	15.6	18.3	21.4	23.9	24.4	25.1	25.7	26.3
External debt / FX reserves (x, eop)	15.3	13.5	12.0	10.9	9.4	8.3	7.5	6.8	6.6	6.4	6.2	5.9
FX reserves imports cov (months)	1.6	2.0	2.3	2.8	3.2	3.7	4.2	4.5	4.6	4.7	4.8	4.9
Interest rates												
Central bank key rate (% eop)	30.00	30.00	30.00	25.00	25.00	25.00	25.00	20.00	15.00	15.00	15.00	15.00
3-month rate (% eop 4Q)	21.85	26.24	30.00	25.00	25.00	25.00	25.00	18.00	18.00	18.00	18.00	18.00
Exchange rates												
UAH trade-weighted index (nominal)	19.38	19.36	19.88	19.65	19.59	19.52	19.54	19.48	19.50	19.48	19.50	18.95
UAH trade-weighted index (real)	52.14	55.40	58.44	59.45	60.35	63.04	63.79	64.46	65.42	68.19	68.71	67.40
UAH/US\$ (eop)	23.49	0.00	22.00	25.00	29.00	30.00	32.00	32.00	33.00	34.00	35.00	35.00
UAH/US\$ (average)	21.50	21.78	22.00	25.00	29.00	30.00	32.00	32.00	33.00	34.00	35.00	35.00
UAH/€ (eop)	25.20	0.00	24.20	27.50	31.90	33.00	35.20	35.20	39.60	40.80	42.70	42.70
UAH/€ (average)	23.28	23.77	24.31	27.50	31.90	33.00	35.20	35.20	37.95	40.80	42.35	42.70
US\$/€ (eop)	1.07	1.11	1.10	1.10	1.10	1.10	1.10	1.10	1.20	1.20	1.22	1.22
US\$/€ (average)	1.08	1.09	1.11	1.10	1.10	1.10	1.10	1.10	1.15	1.20	1.21	1.22
Population												
Population (million, eop)	42.73	42.78	42.77	42.55	42.58	42.63	42.61	42.40	42.48	42.52	42.51	42.30
Population (%YoY)	-0.5	-0.5	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.2	-0.2	-0.2	-0.2

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

Appendices: Research details, thematic charts & tables

The following pages contain the data charts and tables as referenced in this report.

Comparative analysis of FX flexibility in 1995-2015

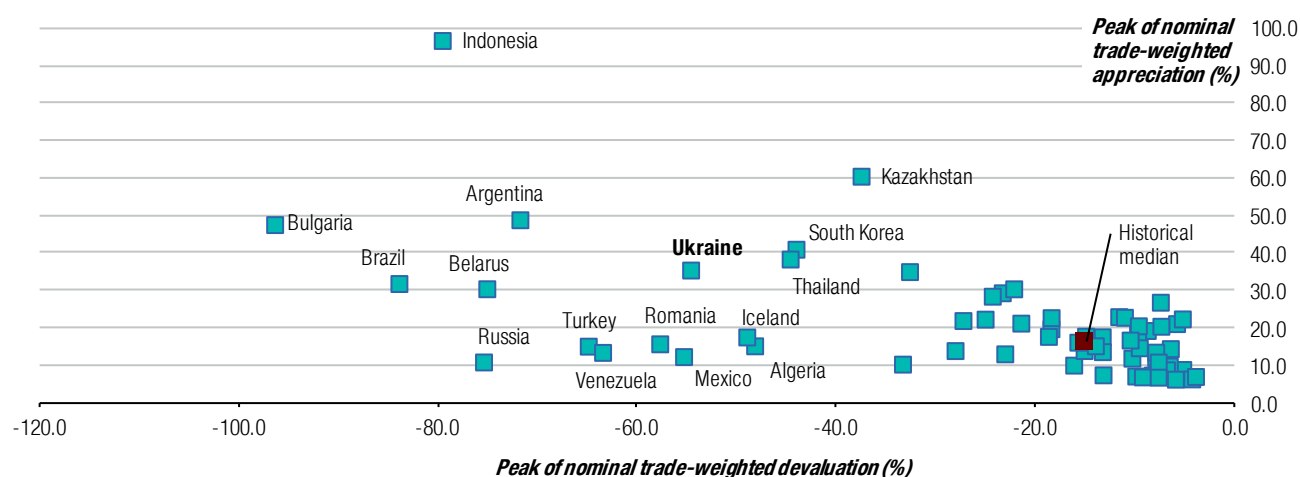
This analysis charts sizable devaluations of the hryvnia in 2014-15 versus its own past and that of other nations' FX crises that have occurred since the 1990s.

Nominal trade-weighted change in currency values

Chart 63. Charting 64 economies on their largest appreciation/devaluation move over 1994-2015 in trade-weighted terms (%YoY)

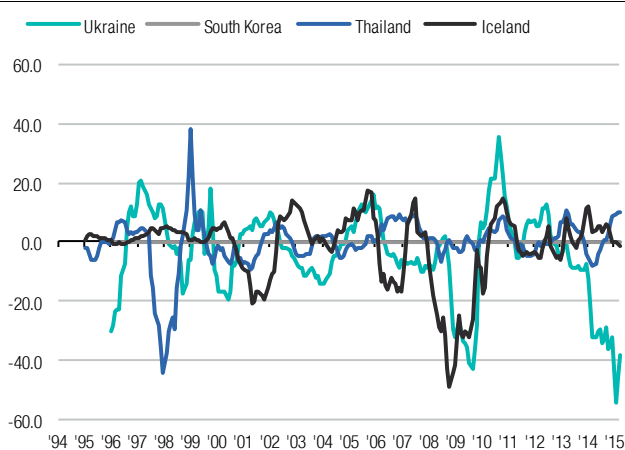
Historical median for appreciation change = 16.4% YoY; median for devaluation change = 15.0% YoY

Based upon the monthly historical data, January 1994 - April 2015



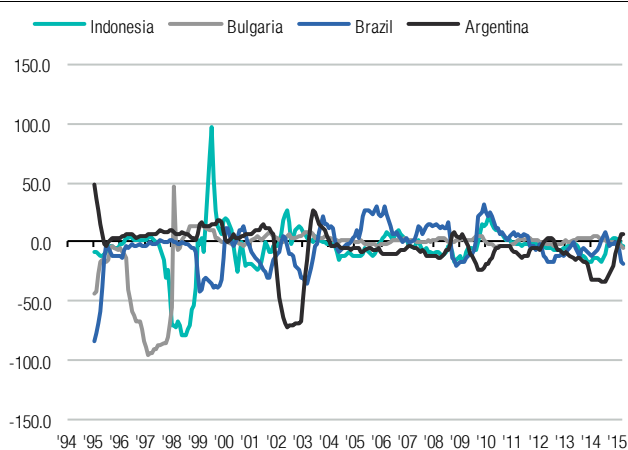
Source: BIS, ICU.

Chart 64. History of nominal TWI growth rate of economies that experienced FX moves similar to Ukraine (%YoY)



Source: BIS, ICU.

Chart 65. History of nominal TWI growth rate of economies that experienced most acute FX crises in 1994-2015 (%YoY)



Source: BIS, ICU.

Real trade-weighted change in currency values

Chart 66. Charting 64 economies on their largest appreciation/devaluation move in 1994-2015 in real trade-weighted terms (%YoY)

Historical median for appreciation change = 19.0% YoY; median for devaluation change = 14.3% YoY

Based upon the monthly historical data in January 1994-April 2015

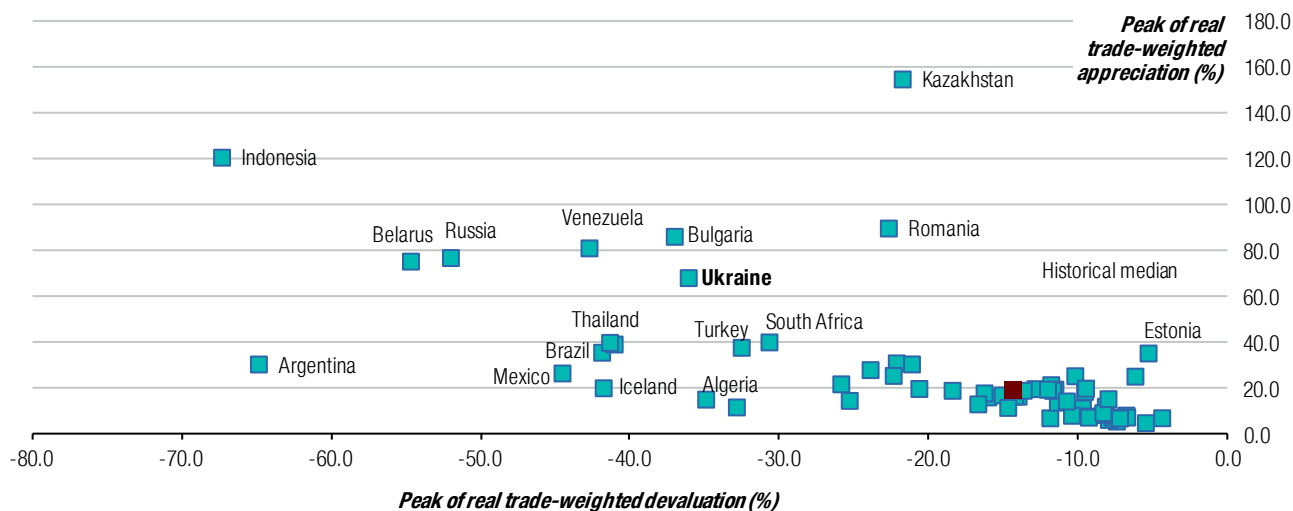


Chart 67. History of real TWI growth rate of economies that experienced FX moves similar to Ukraine (%YoY)

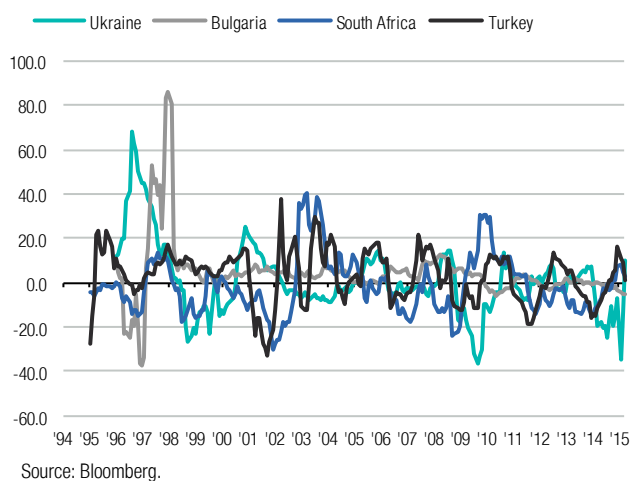
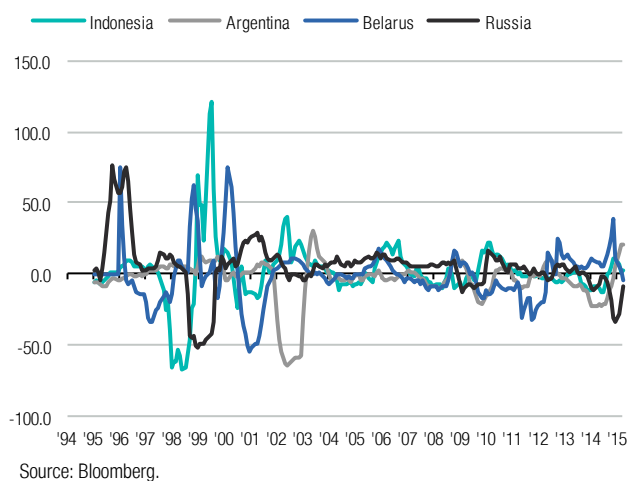


Chart 68. History of real TWI growth rate of economies that experienced most acute FX crises in 1994-2015 (%YoY)

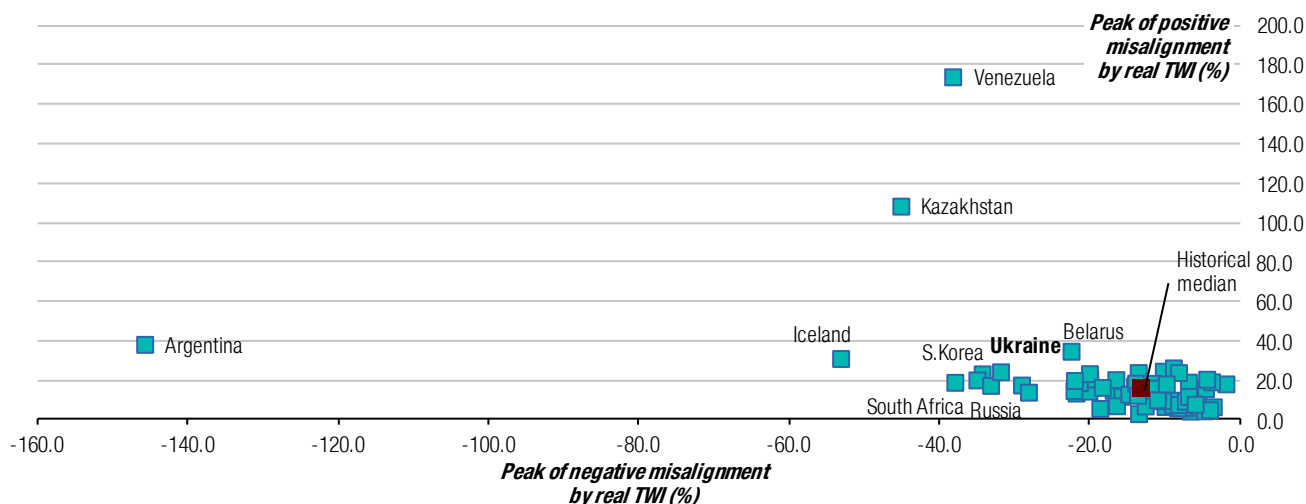


Currency misalignment as implied by real trade-weighted indices

Chart 69. Charting 64 economies on their largest appreciation/devaluation move over 1994-2015 in real trade-weighted terms (%YoY)

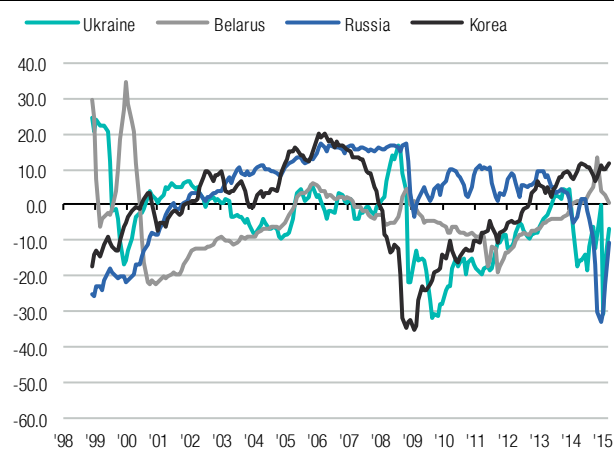
Historical median for positive misalignment = 16.2% YoY; median for negative misalignment = 13.1% YoY

Based upon the monthly historical data spanning from January 1994 through April 2015



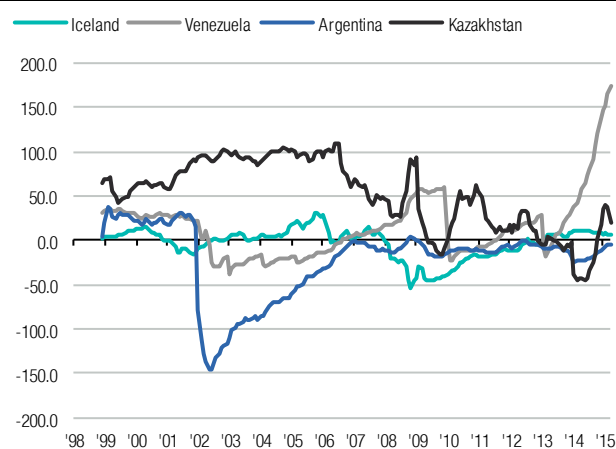
Source: Bloomberg, ICU.

Chart 70. History of FX misalignment of economies that experienced FX moves similar to Ukraine (%YoY)



Source: Bloomberg.

Chart 71. History of FX misalignment of economies that experienced most acute FX crises in 1994-2015 (%YoY)



Source: Bloomberg.

Quarterly GDP: Reported statistics and ICU's calculations

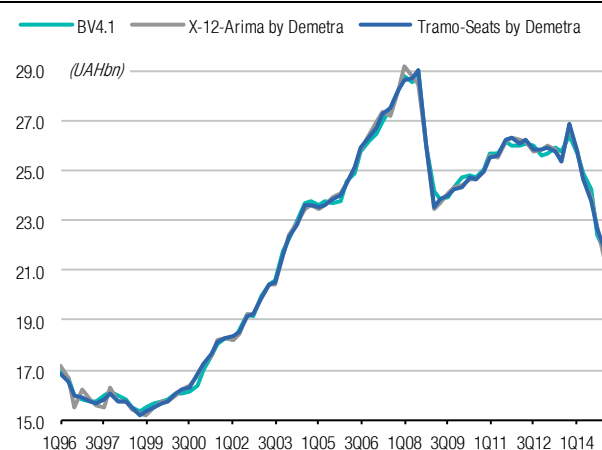
Chart 72. Ukraine's economy from the perspective of quarterly GDP volumes (left) and on-quarter growth rates (right)

1Q96-1Q15

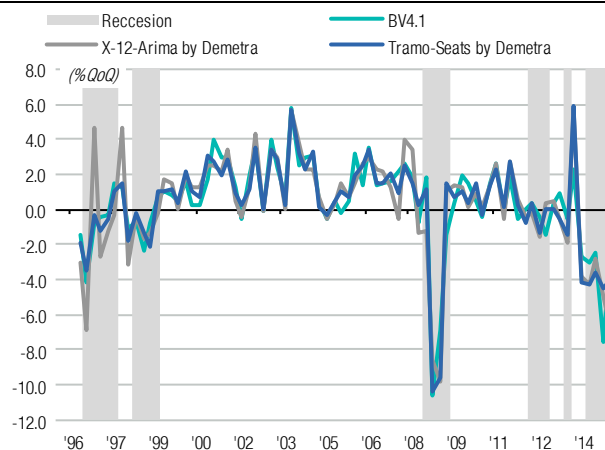
Data is adjusted for inflation and seasonal factors; seasonally adjusted by three methods BV4.1, X-12 Arima and Tramo-Seats

Quarterly GDP size in constant prices of Dec-95

Quarterly GDP growth rates (% QoQ)



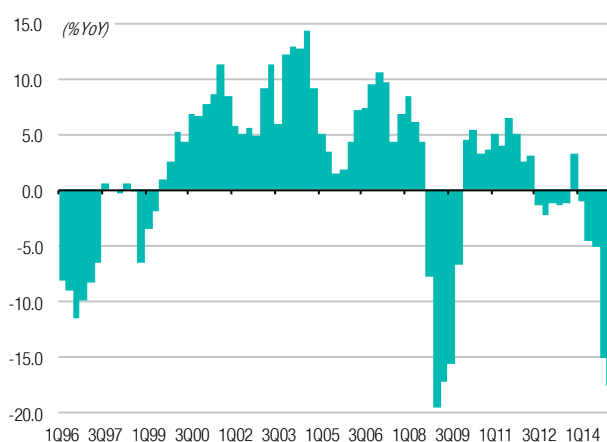
Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.



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

Chart 73. Reported on-year quarterly GDP growth (% YoY)

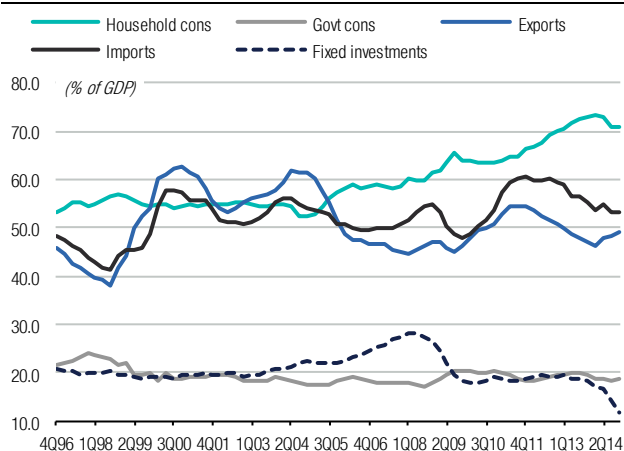
1Q96-1Q15



Source: State Statistics Service of Ukraine.

Chart 74. Demand-side components of GDP (% of total, LTM)

1Q96-1Q15



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

Table 5. Ukraine quarterly GDP size: History from 4Q96 till 1Q15 (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, qtlly)	Real growth (% QoQ, SA)	Deflator (% YoY)	Real growth (% YoY, ann'd)	GDP at cons prices¹ (UAHm, NSA)	GDP at cons prices¹ (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
...
1Q07	139,444	10.6		18.6	8.7	24,253	26,509	26,972	26,734	1.5	2.1	1.5
2Q07	166,869	9.7		20.4	9.3	25,260	26,940	27,310	27,293	1.6	1.3	2.1
3Q07	199,535	4.4		25.4	8.5	30,592	27,533	27,158	27,538	2.2	-0.6	0.9
4Q07	214,883	6.9		26.4	7.9	29,558	28,244	28,234	28,219	2.6	4.0	2.5
1Q08	191,459	8.5		26.6	7.4	26,303	28,755	29,205	28,643	1.8	3.4	1.5
2Q08	236,033	6.2		33.2	6.5	26,824	28,539	28,812	28,697	-0.8	-1.3	0.2
3Q08	276,451	4.3		32.9	6.5	31,892	29,059	28,465	29,011	1.8	-1.2	1.1
4Q08	244,113	-7.8		23.3	2.6	27,233	25,985	26,034	25,991	-10.6	-8.5	-10.4
1Q09	189,028	-19.6		22.8	-4.8	21,148	24,184	23,465	23,506	-6.9	-9.9	-9.6
2Q09	214,103	-17.3		9.7	-10.6	22,181	23,824	23,717	23,865	-1.5	1.1	1.5
3Q09	250,306	-15.7		7.4	-15.2	26,886	23,909	24,049	24,016	0.4	1.4	0.6
4Q09	259,908	-6.7		14.1	-15.0	25,412	24,365	24,337	24,273	1.9	1.2	1.1
1Q10	217,286	4.5	0.7	10.7	-9.2	21,959	24,716	24,378	24,348	1.4	0.2	0.3
2Q10	256,754	5.4	1.4	15.1	-3.5	23,110	24,819	24,609	24,698	0.4	0.9	1.4
3Q10	301,251	3.3	0.4	17.5	1.5	27,539	24,698	24,633	24,614	-0.5	0.1	-0.3
4Q10	307,278	3.7	0.7	15.6	4.2	25,989	25,058	24,968	24,962	1.5	1.4	1.4
1Q11	257,682	5.1	2.0	12.9	4.4	23,066	25,705	25,630	25,526	2.6	2.7	2.3
2Q11	311,022	3.9	0.3	16.6	4.0	24,009	25,665	25,487	25,570	-0.2	-0.6	0.2
3Q11	369,818	6.5	2.5	15.2	4.8	29,347	26,137	26,191	26,272	1.8	2.8	2.7
4Q11	363,557	5.0	0.3	12.6	5.1	27,309	25,998	26,347	26,329	-0.5	0.6	0.2
1Q12	293,493	2.5	-0.8	11.4	4.5	23,584	26,012	26,245	26,109	0.1	-0.4	-0.8
2Q12	349,212	3.1	0.5	9.0	4.3	24,731	26,112	26,184	26,200	0.4	-0.2	0.3
3Q12	387,620	-1.3	-1.5	6.2	2.3	28,963	25,990	25,762	25,859	-0.5	-1.6	-1.3
4Q12	378,564	-2.3	-0.8	6.6	0.5	26,681	25,617	25,849	25,872	-1.4	0.3	0.0
1Q13	302,864	-1.2	0.6	4.4	-0.4	23,301	25,704	25,982	25,888	0.3	0.5	0.1
2Q13	353,025	-1.3	0.4	2.4	-1.5	24,409	25,937	25,824	25,740	0.9	-0.6	-0.6
3Q13	394,731	-1.2	-0.1	3.1	-1.5	28,616	25,788	25,329	25,358	-0.6	-1.9	-1.5
4Q13	404,311	3.3	2.1	3.4	-0.1	27,561	26,364	26,796	26,853	2.2	5.8	5.9
1Q14	313,568	-1.1	-2.0	4.7	-0.1	23,044	25,643	25,756	25,738	-2.7	-3.9	-4.2
2Q14	375,903	-4.6	-2.3	11.6	-0.9	23,287	24,871	24,642	24,634	-3.0	-4.3	-4.3
3Q14	434,166	-5.1	-2.1	15.9	-1.9	27,156	24,256	23,944	23,746	-2.5	-2.8	-3.6
4Q14	443,091	-15.2	-3.8	29.2	-6.7	23,372	22,416	22,755	22,685	-7.6	-5.0	-4.5
1Q15	382,343	-17.6	-6.5	48.0	-10.8	18,988	21,676	21,268	21,767	-3.3	-6.5	-4.0

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.

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

Table 6. ICU consumer basket as of end of May 2015

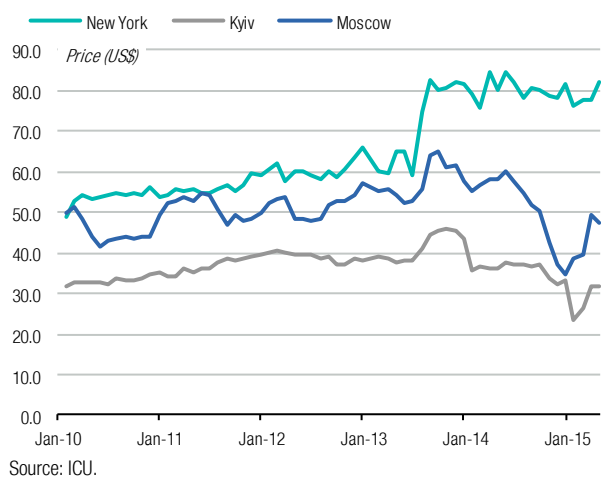
Prices of consumer goods in Kyiv, New-York, and Moscow

Item of the basket	Description	Kyiv, central district 30-May-15 Price (UAH)	New York metro- politan area 30-May-15 Price (US\$)	Moscow, central district 30-May-15 Price (RUB)
Consumer goods				
Coca-cola (0.5 litre, plastic bottle)	Non-alcohol beverages	7.20	2.50	51.90
Beer Corona Extra (0.33 litre, glass bottle)	Alcoholic beverages	18.70	1.66	83.25
Bunch of fresh bananas (1 kg)	From Ecuador	33.65	1.74	69.90
Pack of milk (1 litre)	Locally produced, soft package, i.e., not glass bottle	10.67	1.69	66.90
Chicken meat (1 kg pack)	Locally produced and branded package, boneless breast	59.55	12.08	169.00
Canned pineapple (0.85 kg, can)	Pineapple circles, Dole brand	49.98	3.00	170.00
Pasta (0.5 kg)	Soft package, produced in Italy	38.60	2.12	89.70
Sugar (1 kg)		14.90	3.88	44.90
Package of table salt (0.5 kg)		10.60	0.88	16.80
Chicken eggs (10 units pack)	White eggs, standard size	27.95	3.20	93.90
Chocolate (100 g)	Made by Craft Foods Corp, Milka brand	22.60	2.55	110.00
Toothpaste (100ml package)	Colgate	46.45	3.62	170.00
Shampoo (200ml package)	Head & Shoulders brand, for normal hair	63.85	3.31	240.10
Toilet paper (4 rolls package)	Kleenex Cottonelle brand, white paper, Regular toilet tissue	24.05	4.49	98.90
Magazine	Men's Health, local edition, A4 format (standard one, not a pocket book format)	36.45	5.99	140.00
Gasoline (1 litre)	Lukoil, regular	22.35	0.79	36.25
Batteries (AA x 4 pack)	A 4-pack of AA Duracell batteries, Alkaline	52.80	5.99	140.00
Coffee (250 g, vacuum pack)	Jacobs Monarch, brick-like vacuum pack	74.53	5.69	220.00
Services				
Underground commute ticket	Within the central part of the city	4.00	2.75	40.00
Cinema ticket	Thursday's night price for the seat with good location, Hollywood film	50.00	13.99	450.00
Total basket value (in local currency)		668.88	81.92	2,501.50
Exchange rate versus US dollar at spot market as of date of observation		21.000	1.000	52.715
Total basket value (in US\$)		31.85	81.92	47.45
Overvalued "+" / undervalued "-" (%)				
UAH vs. USD		-61.12		
UAH vs. RUB		-32.88		
Fair value in the long-run as of observation date				
UAH per USD		8.165		
UAH per RUB		0.267		

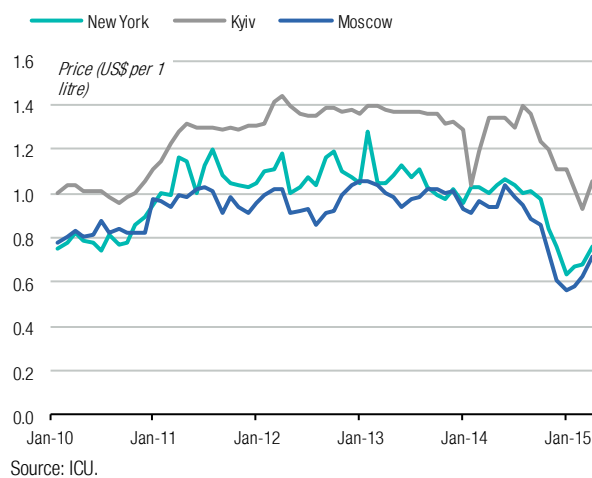
Source: ICU.

Chart 75. ICU consumer basket value (US\$)

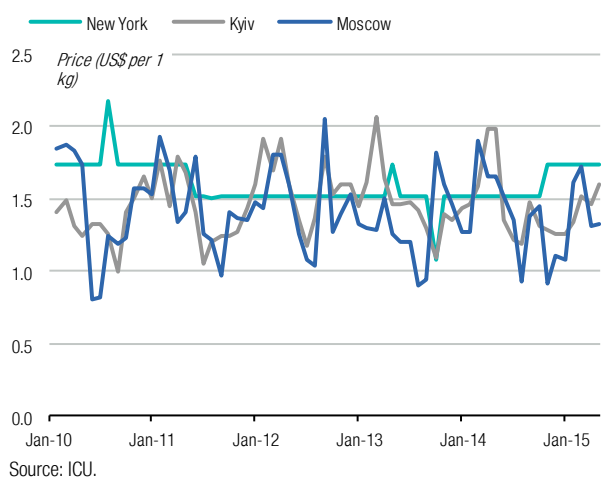
Price history February 2010 - May 2015

**Chart 76. Gasoline A95 equivalent 1 litre (US\$)**

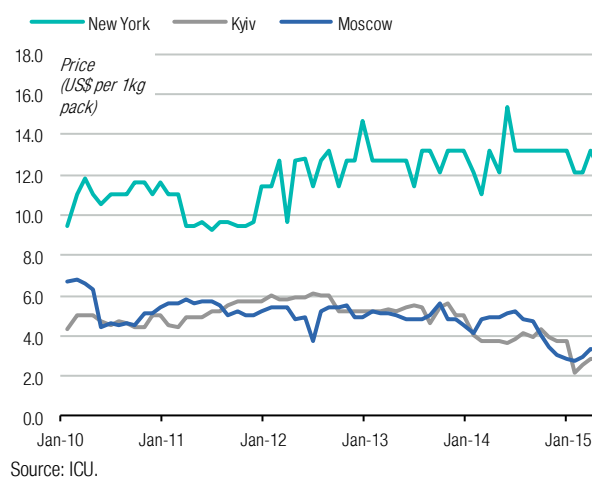
Price history February 2010 - May 2015

**Chart 77. Fresh banana 1 kg bunch (US\$)**

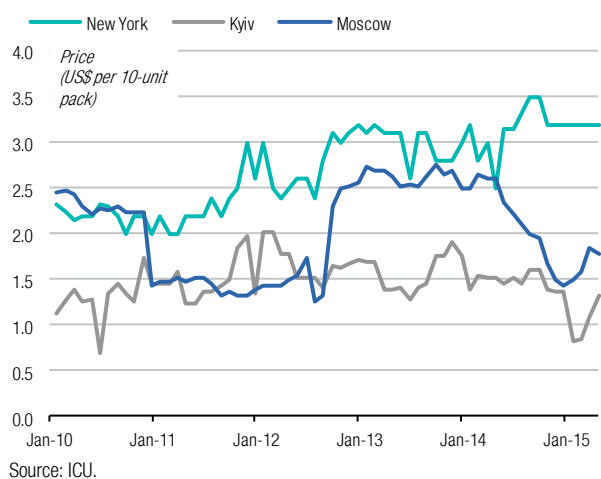
Price history February 2010 - May 2015

**Chart 78. Chicken meat 1 kg pack of boneless breast (US\$)**

Price history February 2010 - May 2015

**Chart 79. Chicken eggs 10-unit pack (US\$)**

Price history February 2010 - May 2015

**Chart 80. Pasta 0.5 kg soft package Italy-made (US\$)**

Price history February 2010 - May 2015

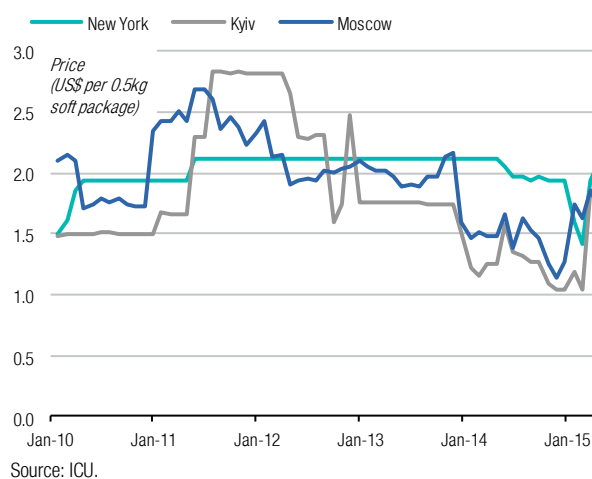
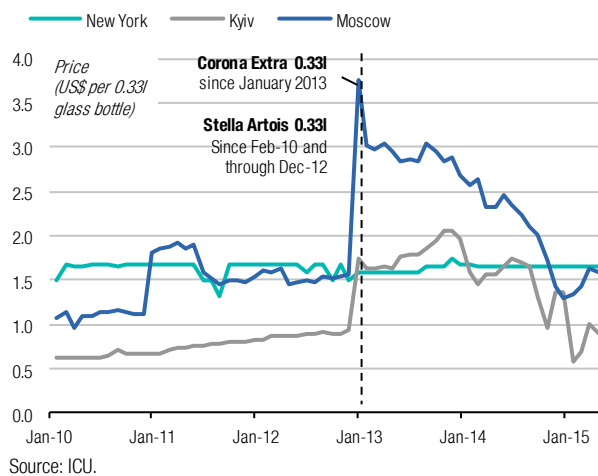
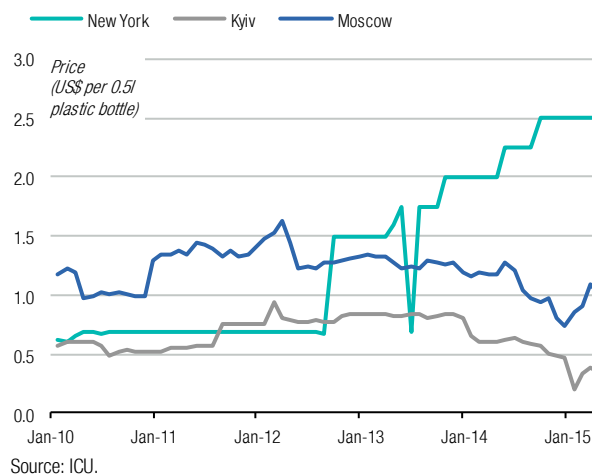


Chart 81. Beer Corona Extra 0.33 litre glass bottle (US\$)

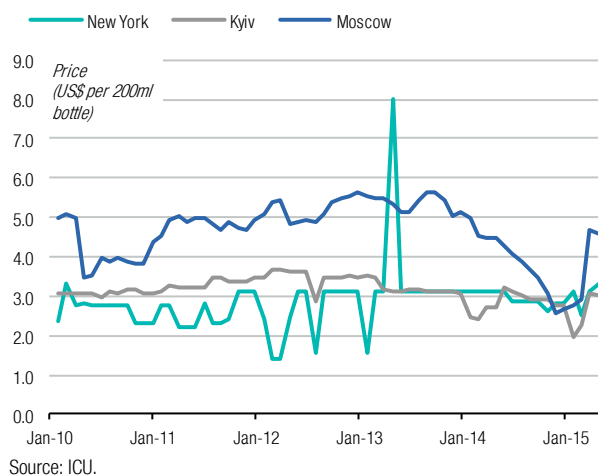
Price history February 2010 - May 2015

**Chart 82. Coca-Cola 0.5 litre plastic bottle (US\$)**

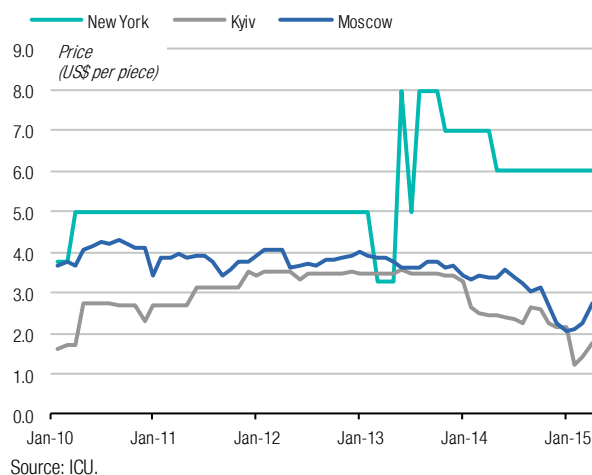
Price history February 2010 - May 2015

**Chart 83. Shampoo 200ml bottle Head & Shoulders (US\$)**

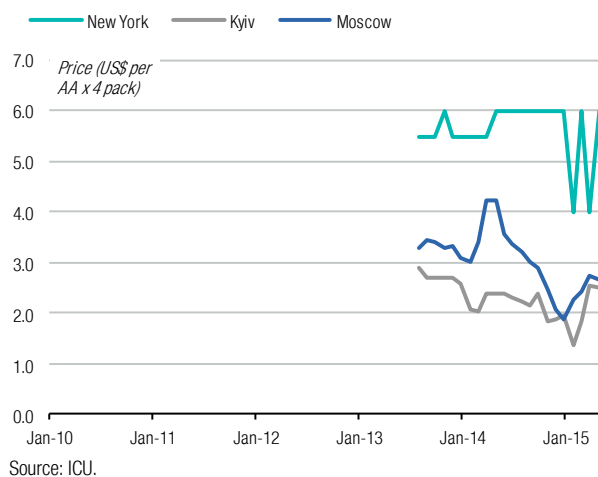
Price history February 2010 - May 2015

**Chart 84. Magazine Men's Health, A4 format (US\$)**

Price history February 2010 - May 2015

**Chart 85. Duracell batteries (AA x 4 pack) (US\$)**

Price history February 2010 - May 2015

**Chart 86. Jacobs Monarch coffee, 250 g vacuum pack (US\$)**

Price history February 2010 - May 2015

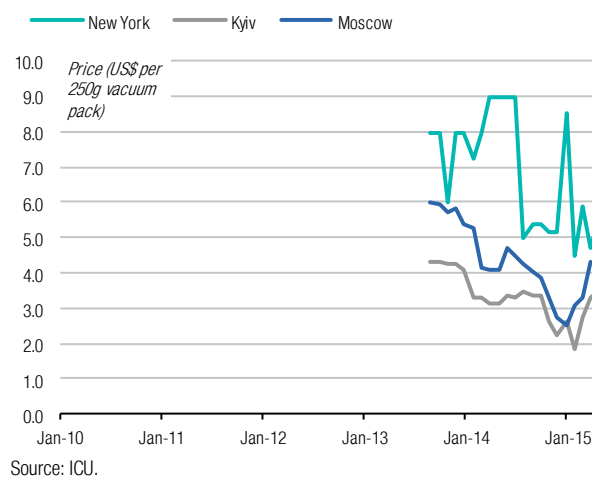
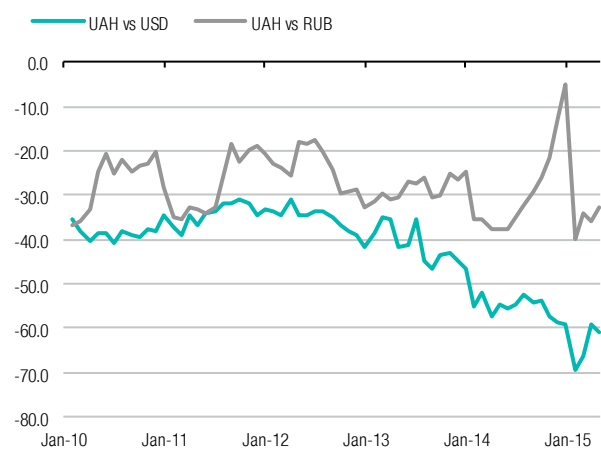


Chart 87. Value gap of ICU basket in UAH vs. USD and RUB (%)

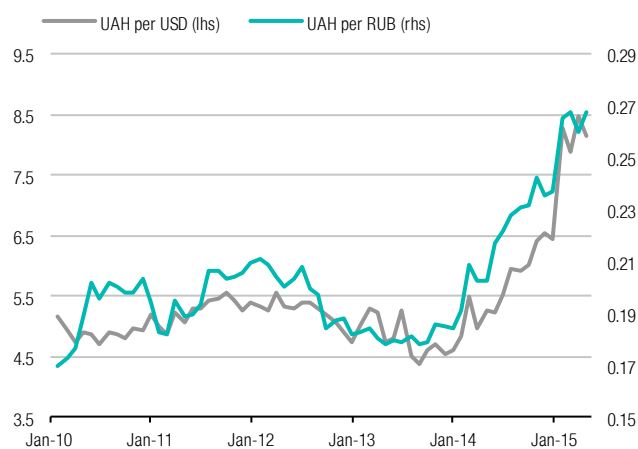
Price history February 2010 - May 2015



Source: ICU.

Chart 88. An exchange rate level of UAH per USD and UAH per RUB, which would eliminate the value gap of ICU basket

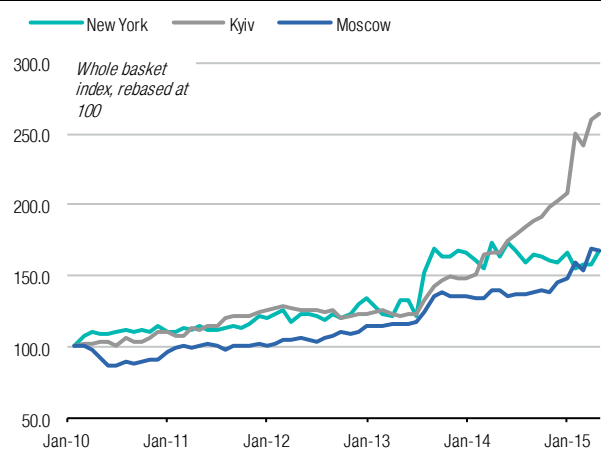
Price history February 2010 - May 2015



Source: ICU.

Chart 89. Index of the ICU consumer basket value in local currency (points, rebased at 100 as of February 2010)

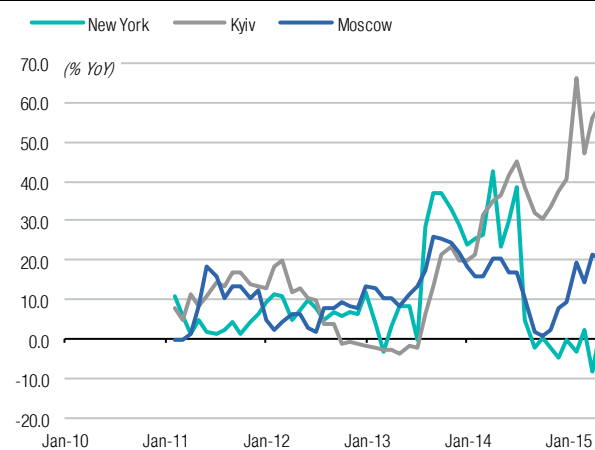
Price history February 2010 - May 2015



Source: ICU.

Chart 90. Growth rate of the index of the ICU consumer basket value in local currency (% YoY)

Price history February 2010 - May 2015



Source: 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



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