Focus
Ukraine

Scope
Economics

Analyst
Alexander Valchyshen

Quarterly Report

Militarism fronts economic faults

1 OCTOBER 2015

READ FIRST THE DISCLOSURES SECTION FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

Contents

RESEARCH TEAM

Alexander Valchyshen
Head of Research
alexander.valchyshen@icu.ua
Kyiv, +38 044 2200120 Ext 721

PUBLICATION DATE

1 October 2015 9:10

Executive summary

This is an updated and condensed summary of our macro view for rest of 2015 and 2016-18.

Ukraine's domestic politics. The most recent developments in the parliament show that the incumbents, President Poroshenko and PM Yatsenyuk, despite retaining much criticism from the opponents, are capable of passing the required laws (ones that implement the Minsk 2 agreement or the external debt restructuring deal) by a hefty margin above the required majority of PMs. In our view, the regional elections scheduled on October 25 will not redraw Ukraine's political landscape dramatically. Indeed, although politics remains extremely competitive if not bloodthirsty, the macroeconomic setup of the future developments would prevent the mainstream political parties from changing the course (i.e. making reforms, while having the IMF and other official donors as a FX backstop). Many socially painful changes remain to be implemented. Yatsenyuk, who burned his public approval rating over the past year, remains a suitable candidate to lead the government in socially painful reforms over at least the next 12-month period. As the upcoming regional elections this fall could strengthen the power of the incumbents led by President Poroshenko, this is our base-case scenario.

Geopolitics: New militarism as a long-term factor. The Kremlin's military aggressiveness has been a relatively new factor that has arisen since early 2014. However, it has already cost Ukraine 8,000 fatalities, 16,000 seriously wounded, 1.2m internally misplaced persons, and two sizable territories effectively taken over by the Kremlin. Even if the Minsk 2 agreement is implemented by all sides under the full terms, the Kremlin's new militarism is set to remain a risk factor while assessing Ukraine's future macroeconomic situation. ICU's base-case scenario definitely includes this. Under this scenario, authorities understand that Ukraine must spend more on its defence capabilities (hence, having an impact on the fiscal balance). While this also implies there is a high risk of the Kremlin renewing its pressure on Ukraine via military means, conversely, Ukraine could evolve over the intermediate term (the next five years) into a more military-capable nation that defends itself. Hence, the nation's self-confidence could catalyze, albeit gradually, positively affecting business confidence.

More details on these viewpoints are in the section "Why new militarism is a front for a time-worn economic model" on page 6.

Global economy: Gradual slowdown, weak demand for Ukraine's exports. Global economic conditions are negative for Ukraine's economy over next one to two years. Foreign demand is characterised globally by slowing growth. The US economy is growing below expectations, partially due to tightened financial conditions as markets have been anticipating the Fed rate hike from the middle of this year. A sizable share of emerging market nations found themselves in recession as the flight of capital intensified and prices on commodities dropped. Russia's economy is in transition with authorities desperately trying to determine what kind of economic model will suit their interest best. We argue that Russia's new militarism that covers up the economic transition is a long-term development that is expected to span through 2018. Hence, Ukraine's share of Russian imports should remain subdued during this period (staying at the current 3% after halving since 2012). In

China, its economic transition affects the global economy by reducing commodity prices. China’s industrial sector has been experiencing deflation of prices on its produce since 2012. Deflation accelerated in August to nearly 6% YoY, supporting our view that the Chinese currency is dear and subject to further weakening not against the US dollar but against the euro, too. Hence, as the yuan’s near 3% devaluation in August is not a singular event, there should be more weakness in the Chinese currency.

For more details, please refer to the section "Global economy" on page 13.

Ukraine's economy: Stabilizes in 4Q15, a low-growth environment afterwards. The economy is set to recover in seasonally adjusted and on-quarter terms since 4Q15, two quarters later than we had previously anticipated. However, the 2015 full-year contraction is still estimated at a bit more than 13% YoY. Next year, a 2.7% rebound in real GDP should occur followed by +2% yearly growth each year in 2017-18. In our view, it is an optimistic proposition, which made by Ukraine authorities and IFIs, that Ukraine's future real GDP growth rate stabilizes at around +4.0% YoY. Our base-case scenario instead envisages a more prudent forecast of growth stabilizing at +2.0% YoY.

There are more details explaining that view in the section "Economic activity: recovery in 2H15, low-growth environment after" on page 20.

Fiscal performance: There are signs of prudence, politics is a risk. The government has been prudent this year by adhering to a balanced budget. This stance helped to stabilize the country's finances after February’s financial crisis characterised by devaluation and a spike in inflation. As of July, the month for which the latest data is available, the consolidated budget’s primary surplus rose to 2.5% of GDP on a trailing 12-month basis, which is the tightest fiscal stance of the government since January 2006 (the first month for which statistical records became publicly available). The recent relaxation of this stance (for which MPs passed the law on the budget that allows an increase in social payments) suggests that populist politicians are pressuring the government to spend more. Incumbents yielded to these demands just recently while they also try to sweeten the public stance over them. However, the above-mentioned prudence should continue by the government adhering to a balanced budget in primary terms. As a result, the primary surplus could decline during 2H15 to below 1%, albeit staying in a surplus territory, per IMF program mandates. Going forward, and given our assumption that Yatsenyuk retains his PM post through next year at least, the balanced state budget policy (in primary terms) should continue well into 2016-18 despite the likelihood of numerous attacks by populist politicians. This policy, alongside the external debt restructuring agreement approved by the parliament on September 17, should result in a gradual reduction of public debt from this year's more than 90% toward 80% over the period of forecast and further toward 70% by 2020.

Monetary conditions: Super tight stance to be eased. This year, out of the past 15 years, has been unprecedented in terms of the domestic credit contraction. Flow-based data indicates that domestic credit contracted by UAH194bn at current prices in January-July 2015, while in the recession of 2014 it shrank by only UAH3bn at current prices for the entire year. This sharp contraction was due to factors: an elimination of failed banks from the system, continued deleveraging by businesses and households, as well as a tight fiscal stance. This was accompanied by a corresponding sharp drop in money supply growth. See "Monetary conditions: Creeping stabilisation ", p.25.

Going forward, such a tight monetary stance is economically unsustainable. It should reverse. The NBU has already cut its policy rate twice in 2H15 from 30% to 27% and to

22% most recently. This step will be followed by additional easing steps, albeit undertaken in a cautious manner given the unfavourable external conditions for Ukraine's economy and domestic high inflation that sends the hryvnia appreciating in real trade-weighted terms.

External balance: A near-balanced current account should be short-lived. In our view, the current account is likely to be balanced in 2015. However, in 2016-18, a return to modest current account deficits is very likely and, in fact, this view is a part of ICU's base-scenario. The economy does not have the social and macroeconomic set-up to run sustainable current account surpluses. It would require very tight fiscal and monetary policies from the authorities which would have only resulted in an economic depression and very explosive social response. Ukraine's authorities should refrain from this approach and instead pursue a moderately tight fiscal policy and relative easy monetary policy that would aim at macroeconomic stability, including a price stabilization that would eventually spur growth. This said, current capital controls are to be phased out, albeit in a slow and risk-averse manner.

Our modelling yielded no sizable change in the FX reserves' forecast that was published in the previous macro report. Thus, for year-end 2015, they are likely to be at US$12bn, increasing up to US$21bn in 2016, US$24.0bn in 2017, and then subsiding back to US$21bn in 2018.

UAH: Commitment to FX flexibility to be confirmed. In our view, this year's financial stabilization produced a kind of unofficial FX band supported by the authorities. The NBU executed several FX market interventions at 21-23/USD and launched FX auctions to accumulate FX reserves by buying USD 21.7 UAH). This policy is set to be short-lived as high inflation (>50% YoY) has rapidly eroded the UAH's competitiveness. Our data suggests that the UAH turns from undervalued to overvalued in 2H15. This would require Ukraine's authorities to allow more FX flexibility to prevent the hryvnia from an extended real appreciation that would create conditions negative to economic growth. This means the UAH should weaken at the end of 2015 through 2016, and then stabilize in 2017-18 when the US Fed monetary policy cycle turns from tightening to loosening. More details are in the section "View on the UAH: An implicit peg to be abandoned cautiously" on page 31.

Domestic politics & geopolitics

In our view, the Kremlin's military aggressiveness is a kind of new normal that will remain an important factor. This refers particularly to Ukraine's macroeconomic perspectives, even if the Minsk 2 agreement is implemented fully by all sides. This implies that Ukraine must spend more on its defence capabilities (this has been acceptable by the authorities). While this also implies that the risk of the Kremlin renewing pressure on Ukraine via military and other means aiming at political and economic destabilization is reasonably high, the positive side of this factor is that Ukraine will evolve over the medium term (the next five years) into a more military-capable nation that defends itself. Hence, gradually the nation's self-confidence is being cemented, affecting business confidence positively as well.

Why new militarism is a front for a time-worn economic model

In our view, the recent rise of militarism in both Russia and China has a macroeconomic foundation.

While we do not dismiss the widely held view by the Western developed nations that these two global nuclear superpowers are eager (as so-called hawks would admit) to challenge the established balance of power after World War 2 or (as so-called doves would admit) to become more responsible stakeholders of global affairs.

What this widely-held view has been missing is the connection between increasingly assertive geopolitics carried out by the leaders of these countries and worsening economic performance by these economies observed over past several years.

By our observations, modern militarism as practised by the Kremlin and Beijing has been accelerating since at least 2012. In hindsight, 2012 marked a turning point in the economic fortunes of a number of emerging markets as the economic cycle following the 2008 global financial crisis shifted from economic expansion towards a global slowdown. The signs of economic unease were different in China and Russia. At the same time, the magnitude of economic uncertainty was sufficient to alarm authorities to take action.

The incumbents in both the Kremlin and Beijing have chosen assertive geopolitical policies largely to distract public attention from domestic economic difficulties and consolidate public opinion around the incumbents against external foes. These nationalistic policies have the power to provide authorities with room to manoeuvre that would be simply risky or completely impossible otherwise.

China's new militarism

In September 2012, China saw a spike of anti-Japan public protests over the disputed islands of Senkakus, as the Japanese call them, or Diaoyu, as referred to by the Chinese. At that time, those protests received implicit official endorsement as Chinese patrol boats entered Japanese waters as the protests occurred near the disputed islands. While these developments had been observed under the watch of departing President Hu Jintaio, his successor had already been chosen and was effectively preparing himself to deal with the situation.

The incumbent President Xi Jinping, who formally assumed leadership in March 2013, took the development to a new level. The Chinese government under President Xi had been promoting "a more assertive approach in territorial disputes that it regards as part of its 'core national interests'"[1], as referred in the West. It has been constructing artificial islands[2] in the disputed sea waters that China's neighbours saw as a military confrontation. China was also reportedly constructing large floating platforms that could "become part of China's naval armada"[3]. While the most recent sign of the extended reach of Chinese military might was on display just recently when its navy ships were spotted just off the Alaskan coast[4]. Coincidentally or not, US President Obama happened to be on a visit to Alaska when those ships were passing by.

China's recent military parade, commemorating the 70th anniversary of its WW2 victory on September 3, raised the concerns of its Asian neighbours despite the fact that the Chinese president announced a 300,000 cut in the 2.3 million-strong military personnel that same day. That parade, fully displaying the highly-disciplined, well-organised and well-equipped army, was just the 15th military parade held in China since 1949. Moreover, it was the first large-scale military parade held in Beijing in nearly six years, according to FT's editorial published on the same date of the parade[5].

While China's president was issuing peaceful statements on the day of the military parade, stressing that China's goal is to "safeguard peace", smaller neighbouring nations that found themselves in territorial disputes with China were soberly sceptical.

While China was increasing its military capabilities to display its power, it so far has managed to distance itself from the active military operations of its nuclear counterpart in the north, namely Russia (see upcoming subsection "Russia's new militarism"). The troubling sign is that Russia, under sanctions from the West for its military aggression in Ukraine, has not only become a frequent visitor to China because of the developing economic ties and fostering investments from China, but has also found in China's leadership the people who at least are willing to listen to the Kremlin's ideas and lessons on how to undermine the perceived threat from the West by acting more aggressively.

While this development is hardly coincidental with China's economic issues, which have been uncovering domestic economic faults with increased occurrence, in 2012, the Chinese economy began to post an annual growth rate well below the near 10% growth rate that was a normal through 2011. At the time of near-10%-a-year growth, China was adhering to an unsustainable growth model (investments plus net exports fuelled through massive debt increase) and even outgoing President Hu Jintaio acknowledged that to sustain "social harmony", the leadership should guide the economy through a transition towards a more sustainable growth model. Since then, there have been indications that Chinese authorities have pushed the economy toward a more balanced structure (more consumption, fewer

---

[1] See *Financial Times* op-ed by Gideon Rachman "Militarism is a risky temptation for Beijing", 31 August 2015 (short hyperlink: http://on.ft.com/1KnB8vZ).

[2] See *Financial Times* article "China's island building enters new phase", 31 August 2015 (short hyperlink: http://on.ft.com/1IJqF76).

[3] See *Financial Times* article "Chinese launch floating fortress project", 14 August 2015 (short hyperlink: http://on.ft.com/1IQpa8d).

[4] See *Financial Times* article "Chinese navy ships spotted off Alaska as Obama visits Arctic", 3 September 2015 (short hyperlink: http://on.ft.com/1Qa8rBG).

[5] See *Financial Times* editorial "China's parade sends an unmistakable message", 3 September 2015 (short hyperlink: http://on.ft.com/1L7Ioqu).

investments). However, that transition path has been proving to be quite tricky as the foreign economy, relatively to China, has been more dynamically transforming itself. Thus, its industrial sector has been in deflation since late 2012 as evidenced by its declining producer price index since July that year. The latest data on this macroeconomic indicator over 2015 through this July showed that a deflationary trend in fact accelerated in the industrial part of the economy – PPI was minus 5.4% YoY. In our view, the development of deflation was caused by a tightly managed FX policy by the authorities which produced a massive 20% real trade-weighted appreciation of the Chinese currency from January 2013 through July 2015, according to BIS data on real effective exchange rates[6]. In August, when Chinese authorities decided to allow more FX flexibility that yielded a 2.17% depreciation of the currency, PPI deflation worsened towards 5.9% from near 5% few months ago. As a result, this year the Chinese economy has found itself caught in economic troubles stemming from its deflationary industrial sector. For China, there is still a long way ahead for rebalancing its economy from investments to consumption. Its currency has a strong potential to weaken further (more details in "China reveals its rebalancing not smooth" on p.15).

Overall, in our view, China's militarism is not going to subside in the medium-term. It is not only because of China's military plans *per se*, but also because its economy is in transition and domestic dissent has to be restrained to a large extent via inflating external threat risk.

Russia's new militarism

With the power of hindsight, one would say that Russia's short-lived military invasion of neighbouring Georgia in August 2008 was only a warm-up prior to its aggressive stand-off with the West over the Kremlin's intervention into Ukraine that has been lasting since early 2014.

However, the birth of the truly new wave of the Russia's militarism really began in early 2012 when then Prime Minister Putin launched his second presidential election campaign amid emerging signs of economic troubles. At that time, domestic industrial enterprises were just starting to feel the impact of the slowdown in demand for their produce and had been complaining to the Kremlin over the rising difficulties and unsustainability of their payroll.

Putin's presidential campaign at the beginning of 2012 (with the election scheduled in March) featured a publication of essays in the Russian mainstream printed media (reaching the most voters) on the issues as perceived by Putin's circle that would be his immediate post-election priorities. Written in a soft-spoken tone and a refined language, Putin expressed his views on a broad array of issues, from domestic concerns like supporting the birth rate, developing health care and education, to foreign affair priorities.

Those essays as a whole were Putin's primer implicitly indicating that during his next two-term presidency[14] he would double down on the policies initiated during his first two-term presidency. As a note, Putin *de-facto* ruled during Medvedev's presidency. The implicit message in the essays was his extreme focus on foreign policy, particularly to promote and defend the Kremlin's "lawful national interests".

---

[6] See http://www.bis.org/statistics/eer/index.htm

[14] There is little doubt that then (before the March 2012 presidential elections) Putin and his inner circle were aiming to stay in power as long as possible and under the current constitution, meaning another two presidential terms.

Following the election, in April 2013, when Putin's second two-term presidency was just about one year old[15], Putin urgently summoned the government, top central bank officials, and top administrative officials to discuss specific economic issues[16], and opened the meeting on concerns over the contraction of the global economy. Andrey Belousov, the economic minister at that time who is now the chief economic adviser to Putin, in an insightful, yet bitterly honest, speech, stated that the Russian economy faced economic difficulties primarily because of domestic factors, implying that foreign factors were secondary. He particularly stressed that the economic slowdown was due to internal issues. The mere fact that Belousov spoke immediately following Putin's opening remarks, in our view, indicates that his version of the economic issues and how to address them from the macroeconomic standpoint was most likely the prevailing consensus of that gathering of people. (At the time, the Russian media, which as a rule follows Putin's speech and does not delve into details, retained the perfect shellac of a refined press release.)

In May 2013, Alexey Ulyukaev, who became the economic minister in place of Belousov[17], in a speech at the St Petersburg International Economic Forum, a Russian clone of the World Economic Forum in Davos, echoed his predecessor by saying that internal factors are at the core of the ongoing slowdown of Russia's economy. He particularly stressed that one of the factors was that the Russian economy has lost control over costs[18] (in terms of competitiveness).

These two public announcements underline that the Kremlin did realize the core issues that derailed Russia's economy from growing at least 4% every year into the future. However, as we explained in our past note[19], in terms of execution, the Kremlin decided to rely on military force to steer the economy through the unfavourable and lengthy conditions. Fully cognizant of plummeting public support at the time in late 2013, the Kremlin devised a policy that exploited the basic pre-occupations of the Russian populace.

That policy essentially was a reversal from the official assurance of "stability" (the most popular official word in Russia from 2000 through 2012) toward "instability" that is "around us". In practical terms, that policy involves the increased the use of militarism, confrontation with the West, fanning the flames of nationalism that is advertised as patriotism, and primarily pushing a near abroad country into a protracted and well-televised period of instability and then invading it under the false pretext. Ukraine long ago has become such a target for the Kremlin's last resort policy.

Conclusion

Since 2012, every passing year (2015 included) has shown that the emerging market slowdown is going be protracted as past growth engines of EMs have slowed.

The new militarism and associated increase of domestic nationalism in Russia as well as in China are difficult to nullify over a short period of time as the risk of loss of credibility among the local populace by the incumbents is perceived as pretty high. That is why a protracted

[15] His inauguration took place on 7 May 2012.

[16] See details of the meeting here http://www.kremlin.ru/events/president/news/17947.

[17] Andrey Belousov went to become Putin's economic advisor (who speak rarely on the public however his viewpoints are sensible and should be treated core ones for the Kremlin understanding of the economy and future policy choices.

[18] See http://forumspb.com/en/2014/sections/30/materials/229/sessions/763.

[19] See *Economic Insight* "Minsk 2: Macroeconomic background", 13 February 2013 (hyperlink: http://www.icu.ua/download/1126/ICUMacroInsight-20150213.pdf).

EM slowdown and their transition towards new model of growth makes new militarism a permanent feature of the global economic conditions, in our view. The risk of escalation of tensions from the current *status quo* is reasonably high.

Currently, Russia's new militarism is much more serious than China's as it has been spawning death, destruction, casualties and refugees. So far the Donbas war has resulted in 7,962 fatalities just in the Donbas war as well as about 16,000 wounded and 1.2m people internally displaced, according to recent UN report[26]. This does not include the respective numbers after Crimea's annexation by the Russian military, which were albeit far less than in Donbas.

One would challenge our view by asking why Russian militarism turned so deadly. Are there other explanations of the Kremlin's behaviour rather than economic reasons like "what about the NATO threat?" or "It is like Russia's invasion of Georgia in 2008?", etc.

Our rationale is the following. The Kremlin has been desperate in the face of mounting economic challenges that progressively created more and more Russians who were deeply dissatisfied with the incumbents' record. The opinion polls by a respected Moscow-based pollster Levada Centre recorded record lows of Putin's approval rating in 2013 twice, first in January and then in November, or just before the "Ukrainian crisis" and subsequent operation to annex Crimea that was launched in February of 2014. Moreover, the Kremlin has been fierce in reacting to mass protests in the neighbouring countries that saw incumbents stepping down, dubbing them 'coloured revolutions' plotted by Western interests (implying not genuine) and doomed to failure. The Kremlin's fierce reaction to public protests revealed that the Kremlin was trying to avert Russian public protests that, given our own history, would result in the messy overthrow of incumbents.

Since 2012 in Russia, industrial enterprises had been laying workers off or cutting down both working hours and salaries. The Kremlin's inner circle's economic analysis and projections likely paid a gloomy picture ahead, given the notoriously high dollarization of Russian businesses' financial liabilities and looming "normalisation" of the US Fed monetary policy and its global impact (which, as a rule, is negative for commodities and for net-commodity-exporter economies). Hence, to reverse the 2012-13 Kremlin-negative public view trend and avoid future deterioration arising from macroeconomic challenges, the Kremlin turned to the option of last resort, namely the new militarism.

Hence, our conclusion is that Russia's new militarism is the means that allow the Kremlin to adapt the Russian economy to the changing global environment. The latter is driven by the global economy or by its key epicentres, namely the US economy, which is recovering and has been preparing to normalise its monetary policy, and the Chinese economy, which is slowing as it is trying to rebalance from investments to consumption, a process that 2015 proves is not that smooth in practice. Hence, as long as the global economy is shaky and the Russian economy tries and tests new growth models, the Kremlin will exploit its new militarism.

[26] See http://www.ohchr.org/Documents/Countries/UA/10thOHCHRreportUkraine.pdf.

Ukrainian warfare in that context

In our view, there is a wrongly and widely held view in the West on modern-day Ukraine. It repeatedly concentrates on the uncertainties of the war/conflict in the east (in the eastern part of Donbas), implying that it is in Ukraine's power to calm the war or "conflict" (that some call it). The Minsk 2 agreement has a list of obligations that Ukraine should deliver and has been delivering.

President Poroshenko undertook an amendment to the constitution that allows greater self-rule to the oblasts. The process is likely to be finalised over the next six-months. His tactics under the Minsk 2 agreement are about biding with the Kremlin's obligations to withdraw its military from Donbas and re-impose control over the border. The West controls the Kremlin via sanctions, which has been effective in terms of restraining the Kremlin from taking more land.

However, even if the Kremlin does withdraw from Donbas, it is likely to keep stationing its 50,000-strong army at Ukraine's border, explicitly signalling its readiness for a new intervention[27]. This is just one element of the ongoing Kremlin policy.

Russia's new militarism, the background of which is described above on pp.8-9, has many faces that could spread to meddling in or/and military invasions of other neighbouring nations, including Moldova (Transnistria), Georgia (yet again), Kazakhstan, Azerbaijan, and the Baltic countries.

It employs substantial propaganda not only at home but in on the foreign soil as a means of spawning and spreading fabricated information. In Ukraine, a free newspaper widely believed to be funded by the Kremlin is handed to every pedestrian at most crowded subway stations. Moreover, the Kremlin uses corruption (a quite easy way of confusing Ukraine's politics via webbing the political party with vested interests) and extremism (via funding of marginalised politicians or/and parties that have been spotted in televised violence).

Domestic politics: Poroshenko set to strengthen his position

The respected pollsters have been saying this year that public opinion has been very critical of PM Yatsenyuk, who unleashed sizable increase in tariffs on home utilities, natural gas and electricity on consumers. His public approval rating as of now is miserable, implying that he could lose the upcoming election. At the same time, Poroshenko's political approval rating has been stable in relation to others, as explained by Poroshenko's soft-toned public speeches during which he stresses on his peace-making credentials.

The regional elections scheduled for 25 October are considered by the main political forces in Ukraine to be equivalent to the general elections. Politicians are positioning the public to believe that these election results will be (as never before in the history of regional elections in the country) a political milestone.

[27] Like as discussed in this article at CBC News web site "Russia building military base near Ukraine border" 10 September 2015 (hyperlink: http://www.cbc.ca/news/world/russia-military-base-ukraine-border-1.3222002).

In our view, Poroshenko's party should lead the elections in 4Q15 while others (from Tymoshenko's party to the party that collected ex-Party of Regions heavyweights) will re-affirm their current parliamentary representation. Whether PM Yatsenyuk will prevail is uncertain. He proved to be politically straightforward in absorbing public anger over tariffs and, until recently, the lack of indexation of public wages and pensions. He nearly lost his political capital. It is hard to believe that he did not assure his stay at the top of politics with President Poroshenko before executing the ambitious IMF program for which he received just recently great praise by IMF head Christine Lagarde in Kyiv. Hence, PM Yatsenyuk should remain PM and continue a "dirty job" of pushing socially painful changes in the economy.

Global economy

In our view, global economic conditions are negative to the Ukrainian economy over the next one to two years. Foreign demand is characterised by slow growth globally. The US economy is growing below expectations, partially due to tightened financial conditions as financial markets have been anticipating the Fed rate increase in the middle of this year. Due to this market- driven tightening, there is a sizable share of nations among the emerging market economies that found themselves in recessions as the capital flight intensified while commodity prices dropped. Russia's economy is in transition with authorities desperately trying to figure out what kind of economic model will suit their demands best (the Kremlin's key interest, in our view, is the preservation of power for as long as possible, making all other considerations secondary). We argue that Russia's new militarism that masks its economic transition is a long-term development that should continue at least through 2018 (see pp.8-9). Hence, Ukraine's share in Russian imports should remain subdued during this period (staying at the current 3% after halving since 2012). China's economic transition affects the global economy by causing commodities' prices to plummet as its industrial sector has been experiencing deflation of the prices on its production since 2012. Deflation accelerated in August to nearly 6% YoY, indicating that the Chinese currency is overvalued and subject to further weakening against not just the US dollar but the euro, too. Hence, the yuan's near 3% devaluation in August is not an extraordinary event, but we expect the Chinese currency to weaken even further.

More evidence of stagnant conditions in the global economy

As of early September of 2015, there have been early warning signs of a protracted integrated global economic slowdown, particularly developed economies with key global reserve currencies and emerging ones epitomised by the BRIC nations[28].

In the developed economies, despite extended monetary stimulus, inflation rates are still well below targets of the central banks and real GDP growth rates fell short of expectations. The new wave of declining commodities prices—which, in our view, have been reflecting market expectations over US monetary policy tightening and China's slowdown—were contributing to a sustained trend of low inflation.

In the emerging markets, the macroeconomic conditions have been worsening again because of expectations of the US monetary tightening due to the associated capital flight amid fears that increased US dollar indebtedness would be costlier to refinance.

This year, the IMF more often downwardly revised expectations of the performance of the global economy for 2015 and 2016. In July, it reduced expected world output for 2015 by 0.2ppt just few months after April's review. In April it held put, but in January's review, the Fund cut world output for 2015 down by 0.3ppt. Hence, the overall reduction in expected growth of the global economy in 2015 amounted to 0.5ppt from 3.8% as of the end of last year to 3.3% as of this July.

The key contributors to the revisions were developed economies—US, UK, Japan, Canada—where past expectations were overly optimistic. In reality, their performance was

[28] An acronym that stands for Brazil, Russia, India and China.

restrained by the marked slowdown of the emerging and developing economies. Their aggregate growth rate was subsiding from 5.0% in 2013 to 4.6% in 2014 and to the expected 4.2% in 2015.

The US monetary ultimate "normalisation" to be postponed

Over past two months, the market expectations shifted from September to December when the US Fed would start increasing its policy rate. Despite headline unemployment rate improving further to 5.1% after the August jobs data report, the last monthly jobs report was short of market expectations over new employment hires.

Among those who argue against the Fed's rate action, the key arguments are that inflation is a concern and that the economy continues to be weak as evidenced by growth rates in 1Q15 and 2Q15 that were below expectations as the current 3Q15 weak pace of real GDP growth of just +1.5% YoY was forecast by the Federal Reserve Bank of Atlanta[29].

In our view, the arguments against September's rate increase were weak. Our understanding of the evolution of the macroeconomic conditions over 1H15 and prior to that in 2H14 yield the following. Market expectations of the "normalisation" were so strong and concentrated that monetary conditions in the US dollar-based financial markets have tightened even without the official increase of the Fed's rate from the current low of 0.25%.

This monetary tightening over 2H14 and YTD in 2015 was evidenced by:

- 20% appreciation of the US dollar in trade-weighted terms as measured by DXY index[30];
- 17-28bp increase in the yields of US Treasuries with of one-, two- and three-year maturities. (However, yields on the US Treasuries with longer maturities declined in the 11-40bp range.)
- 217bp increase in risk premium (spread over the government bond) of USD-denominated below-investment grade corporate debt issued in the US domestic market[31].
- US domestic oil producing sector saw WTI crude oil price decline 54%.

Financial markets have already priced-in their expectations over the future path of US Fed decision-making. This year's slowdown of the real GDP growth rate has been partially due to a sizable USD appreciation that took place from June 2014 through March 2015. There was also a negative impact coming from the EM capital flight which prevented EM nations' ability to sustain their imports, including from DM nations and the US in particular. Since this April, it has been flat lining. The USD currently has limited appreciation potential as our FX trade-weighted indices suggest that over 2016 the dollar is likely to become an overpriced currency, a condition that would be corrected by the markets.

Overall, September's rate increase would be appropriate and would change neither the markets nor the economy as feared by many. The prevailing market view is different from

---

[29] See https://www.frbatlanta.org/cqer/research/gdpnow.aspx.

[30] As of 8 September 2015, DXY index was at 95.985 points or 20.3% up from end of 1H14.

[31] As measured by The BofA Merrill Lynch US High Yield Index, which was 342bp as of 16 June 2014 and 559bp as of 9 September 2015. Source: CBonds.info.

our rationale. A rate increase by the Fed, as our base-case scenario, is taking place this December at the earliest.

China reveals its rebalancing not smooth

There was also an indirect impact on the US economy via the so-called Chinese channel. The Chinese FX policy of tightly-managing the yuan (CNY), which has been *de-facto* a peg to the US dollar, resulted in the sizable appreciation of the CNY alongside the USD over the same period of time. Eventually, as a 2.7% CNY snap devaluation occurred this August, Chinese authorities decided to lean against the wind by testing the domestic market with a new FX policy framework that eventually allowed more FX flexibility.

This new FX approach is a positive development for China over the long-term; however, it is negative to the US economy and global economy as a whole over the short-term as it shows that China is unable to sustain its current pace of imports (albeit which have been stagnating alongside exports). Chinese demand for imports should subside alongside the inevitable adherence of the Chinese authorities to FX flexibility.

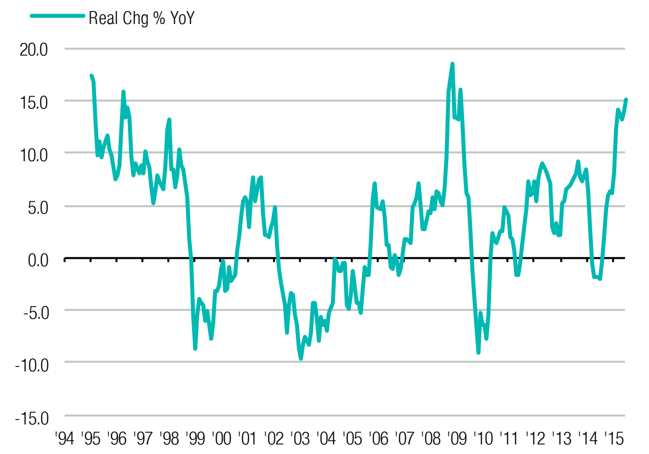
As shown in our charts below, China has been running quite an inflexible FX policy that resulted in a steep appreciation of its currency in real trade-weighted terms (see Chart 1). Thus, when major developed market economies experienced unprecedented monetary stimuli that resulted in the weakness of their currencies, China remained on the other side of the equation as it was absorbing this impact by allowing its currency to become dearer month by month and year by year. In Asia, China has been on the extreme negative side (via losing competitiveness), while Japan, for instance, was on the opposite extreme side (by gaining competitiveness, see Chart 2). Hence, export performance has been stagnating in China since 2012. China's fast growth story--seen before the 2008 financial crisis and in 2010-11 when a debt-financed and investment-led recovery took place (see Chart 3)—has come to an end.

Going forward, China will undertake more monetary easing and bring (as a by-product) devalue weakening of its currency because it is uncompetitive. The almost 3% devaluation of the currency versus the US dollar in last August was just a small (and initial) step into that path which is likely to be protracted. Chinese currency has to regain competitiveness, possibly at 7/USD. Chinese currency weakening from the current level of near 6.4/USD toward 7/USD and a bit beyond is our base-case scenario for the period of forecast through 2018.

Despite the above-mentioned trajectory of the FX rate, China's economy will remain rebalancing from fixed investments towards consumption. As China will not create another commodities boom, with commodities' markets are projected to remain deflated and current low market prices for commodities should stabilise.

Chart 1. Appreciation of the China's REER* (%YoY)

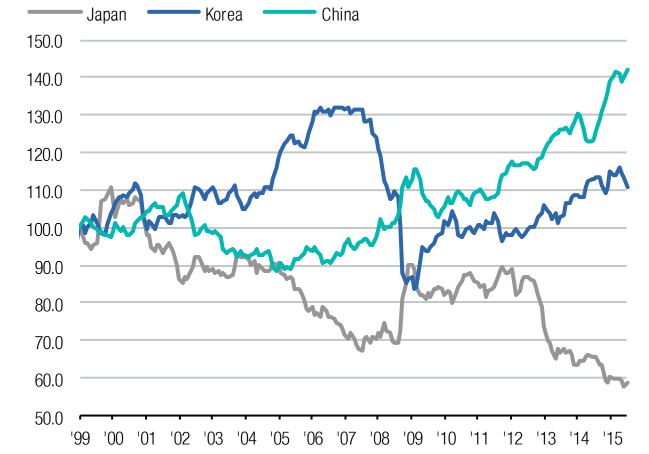
Monthly history from January 1994 through July 2015



Note: real effective exchange rate. Source: BIS, ICU.

Chart 2. Real FX rates: China versus neighbours Japan & S.Korea

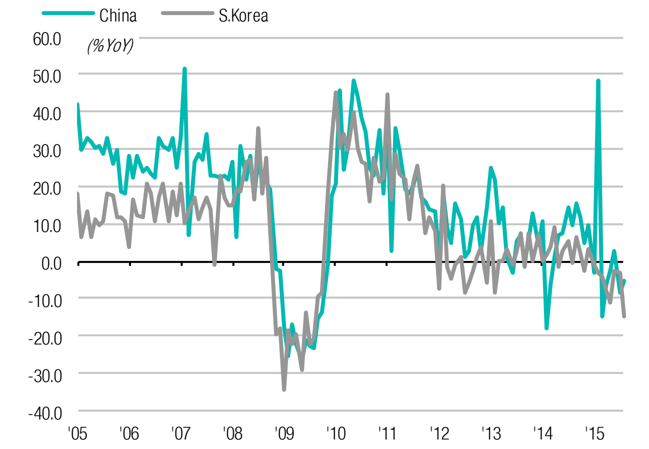
Monthly history from January 1999 through July 2015.
Rebased at 100 points as of January 1999



Source: BIS, ICU.

Chart 3. Exports growth: China and South Korea (%YoY)

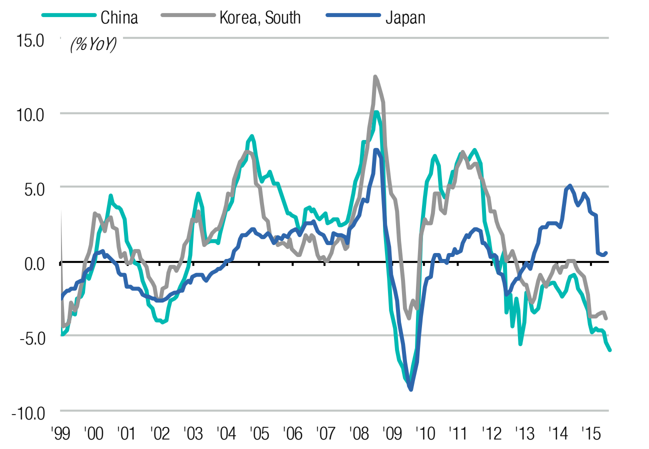
Monthly history from January 2005 through July 2015



Note: real effective exchange rate. Source: BIS, ICU.

Chart 4. PPI rates: China versus neighbours Japan & S.Korea

Monthly history from January 1999 through July 2015.



Source: BIS, ICU.

Russia on expected course, in recession

Russia's economy, in our view, has been a victim of the Kremlin-led initiative to mitigate the upcoming economic transition under the mask of new militarism (as discussed above, see "Why new militarism is a front for a time-worn economic model" on p.6). In this regard, this maverick behaviour should be regarded as an integral part of the Kremlin's new militarism strategy in which Western sanctions were actually sought after or largely self-imposed. This said, however, it should be noted that MH17 was a black swan event for the Kremlin. Other human tragedies as suffered by both Ukrainians and Russians were all anticipated and accepted by the strategy.

As shown in the charts below, domestic demand as epitomised by Russia's imports from Germany (which show Russian businesses' and consumers' appetite for high-quality equipment, machinery and cars), has contracted nearly to the bottom seen at the trough of the previous steep recession. These charts with data through July 2015 are also hinting that monthly seasonally-adjusted volumes of imports were rebounding in June and July.

However, August turbulence in the FX markets caused by China's devaluation and expectations over the US Fed's first move on interest rate increase could push the Russian economy to be hit by a renewed currency weakness, accelerated inflation, and a delay in its central bank's policy rate decrease.

The current recession in Russia is going to be lengthier than that in 2008-09. We downwardly revised our view of the real GDP contraction in 2015 from our previous macroeconomic publication from 3.2% to 3.5%. For next year, it lowered to zero increase (no growth) and in 2017-18 should increase 1.5% each year.

The FX flexibility, which was introduced into the economy in very early 2014 under the cover of a confrontation with the West and its sanctions regime, should assist the economy to adapt sooner rather than later to this new environment where low commodities' prices have become the new norm globally. Our view on the RUB is that it would be fluctuating around 70/USD in the forecast period (see Chart 7 and Chart 8 on p.). These charts on the projected future value of the RUB imply that Russian authorities are eagerly embracing a weak ruble policy and not defending its value versus the dollar.

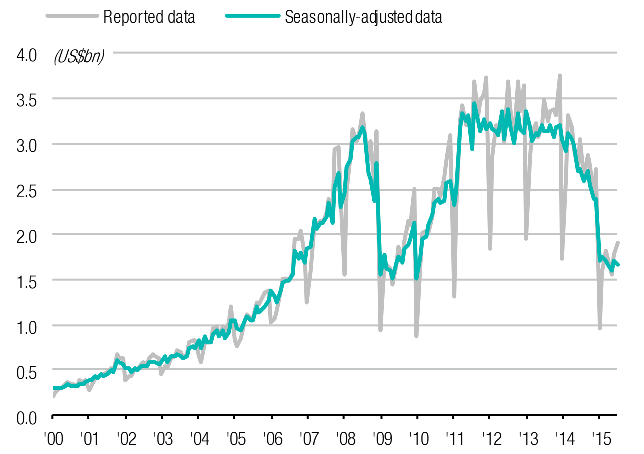
This fits into the Kremlin's announcement earlier this year that it would aim to rebuild FX reserves to US$500bn: it will not support the ruble's convertibility into US dollars at some predetermined rate (just on the market rate). The Kremlin is much concerned about the strength of the balance sheet of the public sector, which is why there is so much hesitation in the government to run an easier fiscal policy. Such fear of losing financial strength of the Russian public sector supports the Kremlin's demand for unorthodox approaches to shape Russia's new economic model. In this regard, recent Russian media leaks of a document on new economic model proposals[32] as developed by one of Putin's economic advisers, Sergey Glaziev, indicates Kremlin's desperation to find one. Indeed, it needs one as soon as possible, because the global economy is near being stagnation, own economy's helpless state that has been unfolding over the past few years threatens the Kremlin's incumbents who are in power as the prosperity of Russians continues to be visibly shrinking.

Hence, for Ukraine, these developments do not promise return to the business as usual in trade relations with Russia anytime soon (as they were before 2014). One should expect that Ukraine's share in Russian imports would not recover from the current 3% (before 2014, it was 5%, albeit declining from 6.6% at the end of 2011). Our base-case scenario envisages that it would stay at this level going forward. Largely, it has nothing to do with the Minsk 2 agreement implementation, but instead with the Russian economy's transition toward a new economic model, which is still being defined by the Kremlin's inner circle.

[32] See http://www.kommersant.ru/doc/2805251 (in Russian)

Chart 5. Monthly volume of Russia's imports from Germany

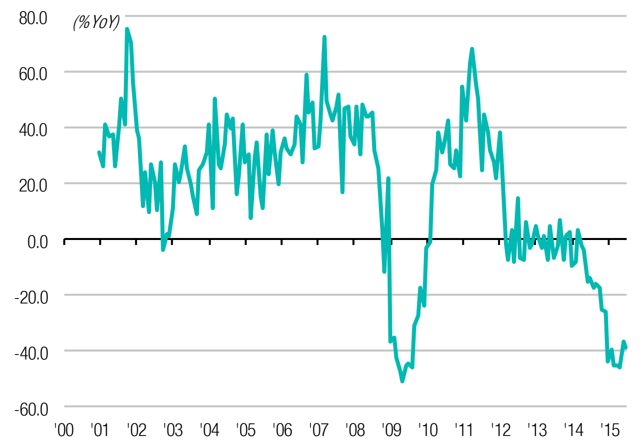
Seasonally-adjusted data. Monthly history from January 2000 through July 2015



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

Chart 6. On-year growth rate of Russia's imports from Germany

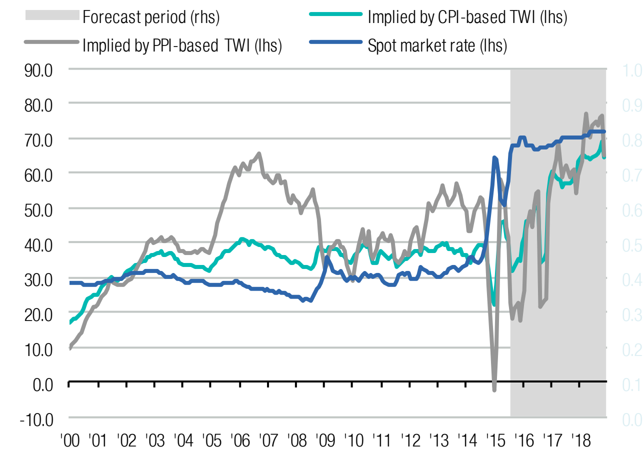
Seasonally-adjusted data. Monthly history from January 2000 through July 2015



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

Chart 7. History and forecast of the Russian ruble (RUB) market rate against the FX rates implied by RUB's real TWIs*

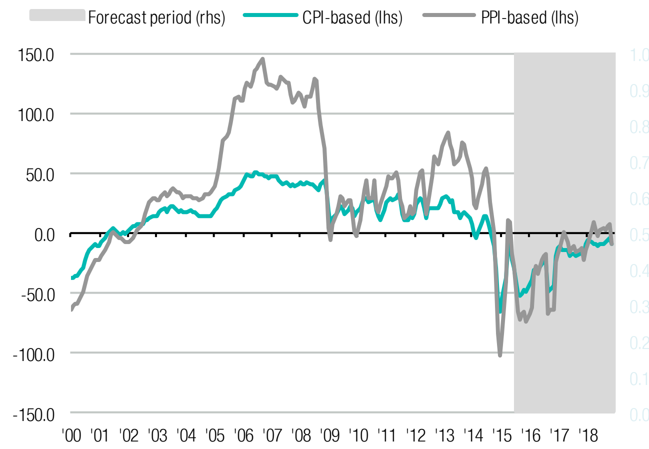
Monthly history from January 2000 through August 2015.
Forecast for 2H15 and 2016-18



Note: CPI- and PPI-based real trade-weighted indices. Source: ICU.

Chart 8. Misalignment of the Russian ruble (RUB) market rate versus its fundamental values as implied by RUB's real TWIs*

Monthly history from January 2000 through August 2015.
Forecast for 2H15 and 2016-18



Note: CPI- and PPI-based real trade-weighted indices. Source: ICU.

Key indicators vital for Ukraine's economy

Growth assumptions

Our base-case scenario envisages a real GDP growth rate of the global economy at 3.3% this year and 3.8% in the next one, which are derived from July's update into the IMF World Economic Outlook[33]. For the Russian economy, it assumes a 3.5% contraction in 2015 and then flat real GDP in 2016 and then an annual recovery in 2017 appears with +1.5% real GDP increase yearly.

Commodities

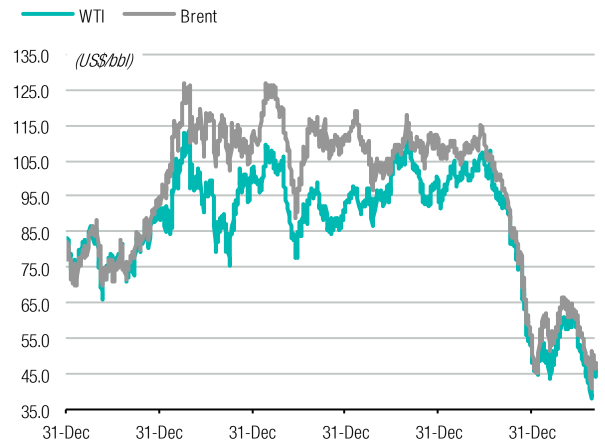
The table and charts below provide our base-case scenario on the key commodities that are vital for Ukraine: crude oil and steel. The recent decline of commodities prices in great

[33] See http://www.imf.org/external/pubs/ft/weo/2015/update/02/

part are due to expected monetary tightening by the US Fed and Chinese slowing down upon the rebalancing of growth drivers. Both factors' impact on global demand accelerated over the course of this year. Going forward, as these two continue to unfold, in our view, commodities are to stay depressed relative to just few years ago, when crude oil exporters enjoyed a market price of over US$100/bbl at the same time that oil importers suffered under its weight.

Chart 9. Crude oil price (US$ per barrel)

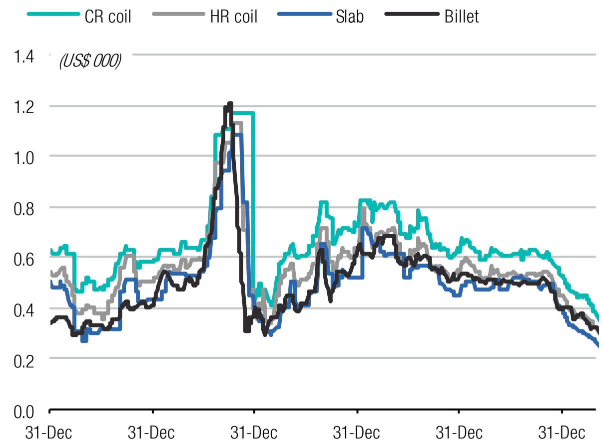
Spot and futures market daily quotations



Sources: Bloomberg, ICU.

Chart 10. CIS export steel prices (US$ 000s per tonne)

Quarterly averages



Sources: Bloomberg, ICU.

Table 1. ICU's 3-year quarterly and yearly forecast for the global economy's key indicators vital to Ukraine's economy, according to our base-case scenario for the rest of 2015 and 2016-18

	Quarterly forecast														Annual forecast			
	3Q15E	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F	4Q17F	1Q18F	2Q18F	3Q18F	4Q18F	2015F	2016F	2017F	2018F
World real GDP (%YoY)	3.3	3.3	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.3	3.8	3.8	3.8
Russia real GDP (%YoY)	-4.0	-3.0	-1.0	0.0	0.5	0.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	-3.5	0.0	1.5	1.5
Crude oil (US$/bbl, avg)	47.0	47.0	47.8	48.6	49.4	51.0	51.8	52.6	53.4	55.0	55.4	55.8	56.2	57.0	47.4	49.2	53.2	56.1
Steel (US$/tonne, avg)	339.0	298.0	313.0	328.0	343.0	358.0	359.0	361.0	362.0	363.0	363.0	363.0	363.0	363.0	353.0	335.5	361.3	363.0
EUR in US$ (eop)	1.12	1.11	1.10	1.07	1.50	1.05	1.08	1.10	1.11	1.12	1.13	1.13	1.14	1.15	1.11	1.05	1.12	1.15
US$ in RUB (eop)	67.00	70.00	68.00	67.00	67.50	68.00	69.00	70.00	70.50	70.00	71.00	72.00	72.00	72.00	70.00	68.00	70.00	72.00

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

Source: ICU.

Ukraine's economy brief

The economy should recover in seasonally adjusted and on-quarter terms from 4Q15, two quarters later than previously expected in our forecast. Still due to a sizable collapse of output in 1Q, the 2015 full-year contraction is still estimated to come in slightly above 13% YoY. Next year, a 2.7% rebound in real GDP takes place to be followed by +2% yearly growth each year in 2017-18.

Economic activity: recovery in 2H15, low-growth environment after

Our call from the previous macroeconomic report[34] on stabilisation of economic activity (in seasonally adjusted and quarter-on-quarter terms) at the end of the first half of this year failed to materialise after the steep 6.5% QoQ SA contraction in 1Q15 was followed by another on-quarter contraction, albeit a much smaller one, of 0.9%.

However, because of the evident stabilisation of economic activity in some key sectors like cargo transport, industries, agriculture and retail trade, as evident from the monthly data through August (see Chart 11-Chart 16 on p.22), we shifted over the expectation of stabilisation to 4Q15.

Overall, a full-year real GDP contraction of 13.1% YoY in 2015, a call made in the previous macroeconomic report, is retained. Hence, with reported data on real GDP in the first half of the year, which turned out to be weaker than anticipated (-16.2% YoY vs -15.8% YoY), our estimates produced a bit better recovery of the economy than previous envisaged (-7.4% YoY vs -10.2% YoY). This implies that on-quarter real GDP rates in 3Q and 4Q of this year amount to -0.3% and +0.2,% respectively.

In 2016, in our view, there will be a 2.7% rebound in economic growth thanks to the macroeconomic stabilization achieved this year after the February financial storm, relative stabilisation of the domestic security situation on the back of a sizable scaling back of Ukraine's defensive activities in the Donbas war area against Russian army aggression. Another factor that is going to aid to the rebound in 2016 is an increase in bank lending on the back of declining interest rates and a general restoration of the creditworthiness of the banks and businesses they deal with.

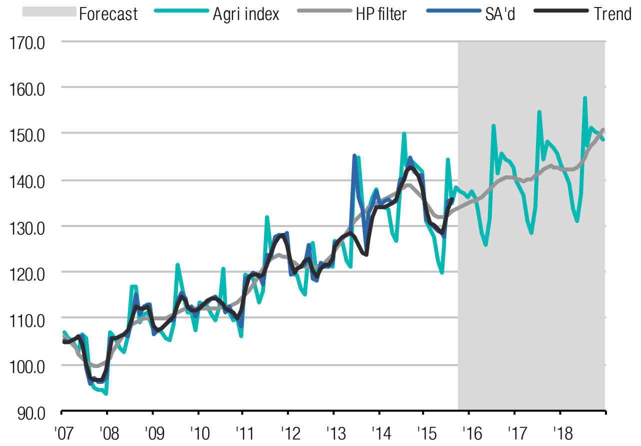
From 2017, the annual growth rate of the Ukrainian economy is projected to settle at 2% in real terms, a reflection of the potential growth rate. In our view, Ukraine's economic potential growth rate has declined over the past few years because of chronic underinvestment (a low level of fixed investments in relation to GDP), which put a kind a natural restraint on the future growth of domestic output. Business confidence has been shaken by the Russian military aggression on Ukraine, which resulted in the Crimean annexation and military occupation of parts of Donbas. As risk of further escalation was kept high, private businesses have been on alert over their operations and were cutting

[34] See *Quarterly Report* "Since the storm last February", 17 June 2015 (hyperlink: https://www.icu.ua/download/1245/ICUQtlyReport-20150617.pdf)

back. This behaviour will be difficult to reverse and moreover to streamline into a business boom.

Chart 11. Agriculture production index

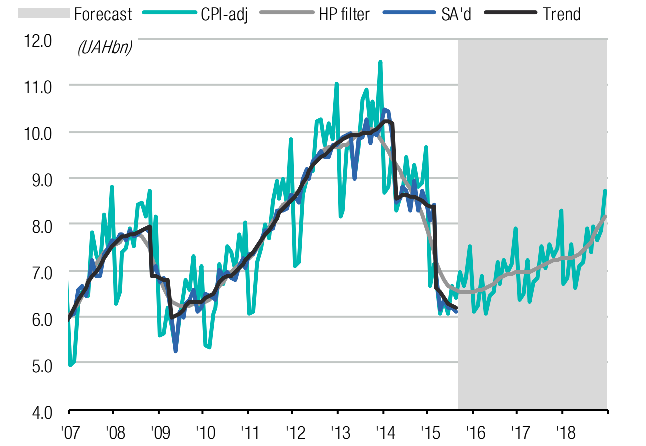
History (from January 2007 through August 2015), forecast for the rest of 2015 and 2016-18



Source: State Statistics Office of Ukraine, ICU.

Chart 12. Retail trade (UAHbn, at constant prices of Dec-1999)

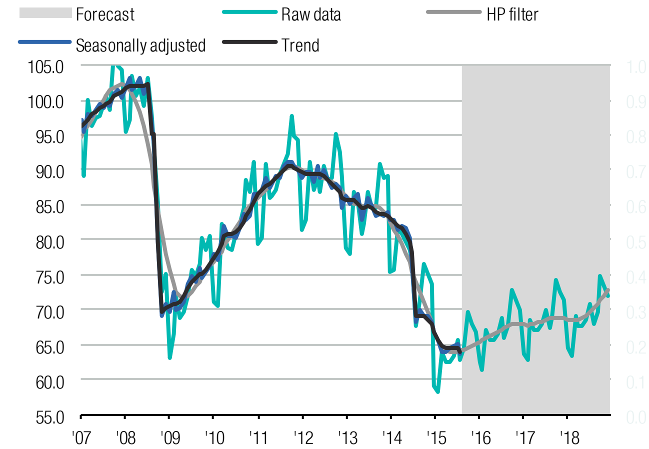
History (from January 2007 through August 2015), forecast for the rest of 2015 and 2016-18



Source: State Statistics Office of Ukraine, ICU.

Chart 13. Industrial production index

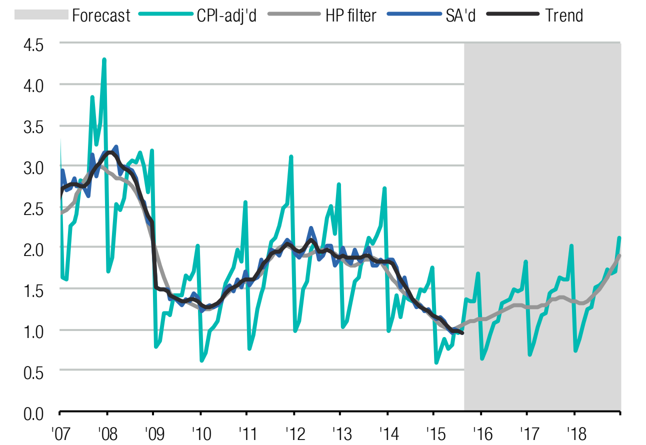
History (from January 2007 through August 2015), forecast for the rest of 2015 and 2016-18



Source: State Statistics Office of Ukraine, ICU.

Chart 14. Construction (UAHbn, at constant prices of Dec-2001)

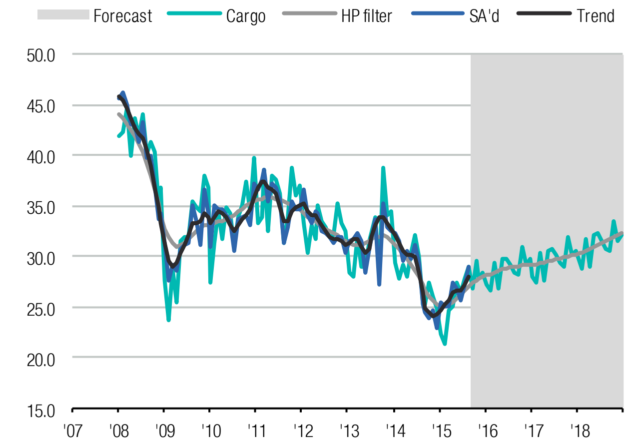
History (from January 2007 through August 2015), forecast for the rest of 2015 and 2016-18



Source: State Statistics Office of Ukraine, ICU.

Chart 15. Cargo transportation turnover (m tonne * km)

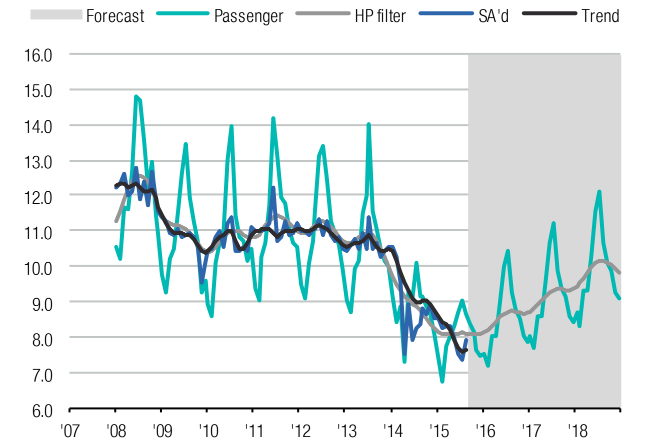
History (from January 2007 through August 2015), forecast for the rest of 2015 and 2016-18



Source: State Statistics Office of Ukraine, ICU.

Chart 16. Passenger transportation turnover (m * km)

History (from January 2007 through August 2015), forecast for the rest of 2015 and 2016-18



Source: State Statistics Office of Ukraine, ICU.

In addition, the whole set-up of the financial system remains the same as it was in the past, except with more thorough oversight over banks by the NBU.

In our view, the great fault of the domestic system is that it retains the established *status-quo* when local-currency credit remains dearer versus the foreign–currency providers. By addressing the most urgent task, which is to achieve macro stabilisation of the economy, authorities are not wasting any effort to increase FX reserves, which (if increased up to a sufficient safe level of at least three months of future imports cover) are perceived as a buffer against future shocks.

However, such an approach contains a major flaw – Ukraine is accumulating FX reserves now thanks to net FX borrowing and mainly from the IMF and other official lenders. Current account surpluses, if they appear this year or in the next few years (not our base-case scenario), are not going to be sizable enough to become the sole contributor to the desired build-up of FX reserves. Moreover, the public sector's current indebtedness does not allow the future build-up of FX reserves via public FX borrowing. Hence, there is a temptation from the side of the authorities to rush after FX reserves via encouraging private sector FX borrowing (if macro stabilisation is achieved) that would increase FX supply on the domestic market, which eventually would be bought out by the central bank.

Aside of this future concern, Ukraine's authorities, currently buried under the weight of implementing reforms in numerous areas, are forgoing the fact that the corporate sector has been continuing building up FX risk on its balance sheet as creditworthy companies (those that have established exports sales) are borrowing in foreign currencies abroad via IFIs[35]. In our view, the slow recovery of the domestic banking sector and its inherited low capacity to match foreign lenders' lending capacity in terms of volume, maturity and relative costs is a risk for future financial stability. Slow accumulation of FX financial liabilities by the corporate sector, local currency lending is limited, pose a systematic risk in the medium term future, making future economic growth undermined by new financial crisis.

From the foreign demand viewpoint, Ukraine's economy is going to be operating in the environment of slow growth of its key trade partners. This is true for nearly every region that the Ukrainian economy deals with in foreign trade – from the EU to Russia to China.

The EU has been recovering recently from a profound debt crisis, and its policy mix has been and is to remain deflationary for the near future as it disciplines Eurozone members (and the rest of the EU) for tight fiscal balances and lower current account deficits (better turning current account deficit economies into current account surplus ones).

In Russia, as previously discussed, authorities have been busy with defining a suitable model of economic growth. Since 2013 and very much increasingly since early 2014, this policy resulted in deflationary tendencies that the Russian economy was imposing on domestic economic agents (businesses and consumers) and on its trading partners that saw the Kremlin imposing trade barriers and launching trade wars, particularly on Ukraine under the auspices of the latter's EU association. Devaluations of the domestic currencies has been a norm in the major nations of ex-Soviet Union, except Russia itself, like Belarus, Kazakhstan and Ukraine.

In China, as developments of this August show, authorities are tackling with the excesses of past accumulation of economic flaws. As an example, ripe equity market activity that went from boom to bust over just a few months, combined with an inflexible FX policy, produced a strong currency that required a relaxation of that regime. These examples

[35] International financial institutions like EBRD.

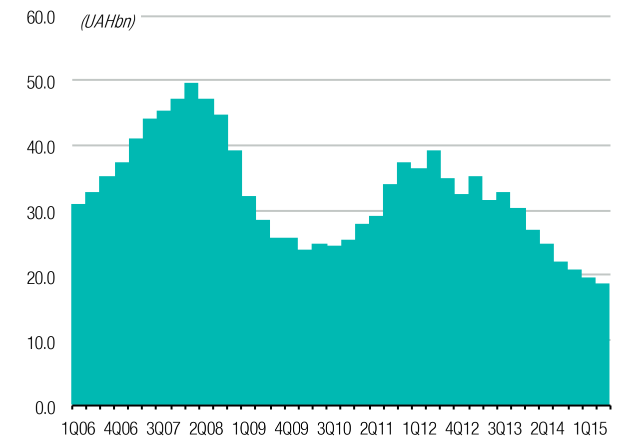
underscore that the Chinese economy has been facing a challenge of a growth slowdown which requires extraordinary undertakings from the authorities. Eventually, China's slowdown has become a serious factor this year and its impact will be deflationary on the global economy for at least the next couple of years.

The future potential growth rate of the Ukrainian economy is also constrained by the chronic underinvestment following the 2008-09 financial crisis. During 2014 and through 1Q15, the share of fixed investment dropped from the already low level of 15% toward an even lower level of 11.6%[36] (see Chart 19). In 2Q15, fixed investments were mediocre as fixed investment spending for 2Q yielded yet another contraction of 4.5% QoQ (or by 25% YoY) in both price- and seasonally-adjusted terms (see Chart 17-Chart 18). As retained earnings have remained a key source of investments (69% of total in 2Q15[37]), there is little hope that a future boost of fixed investments could arrive from the domestic financial system because of its unfavourable setup.

Another element of the slow growth environment that has embraced Ukraine's economy is industrial stagnation as shown through new industrial order statistics (see Chart 21-Chart 23 on page 26). The latest data available through June 2015 suggests that the deep currency devaluation failed to spur foreign demand for local exports. In price-adjusted terms, new industrial orders rose 13.2% MoM[38] in June though, at the same time they are down by 23.8% YoY from the same month a year ago. Cumulative orders for 2Q of this year were noticeably lower in both on-quarter and on-year terms. This development suggests that the steep devaluation and followed a spike in inflation did not fuel domestic economic competitiveness. We expect further weakness of the exchange rate.

Chart 17. Quarterly volume of investments in the economy*

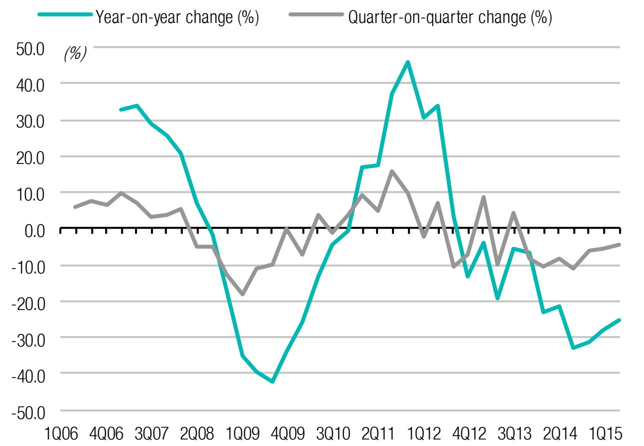
Seasonally adjusted data, history from 1Q of 2006 through 2Q of 2015



Note: * at constant prices of December 2005, adjusted by CPI. Source: State Statistics Service of Ukraine, ICU.

Chart 18. Growth rates of investments (%YoY)

Seasonally & price-adjusted adjusted data, history from 2Q06 through 1Q15



Source: State Statistics Service of Ukraine, ICU.

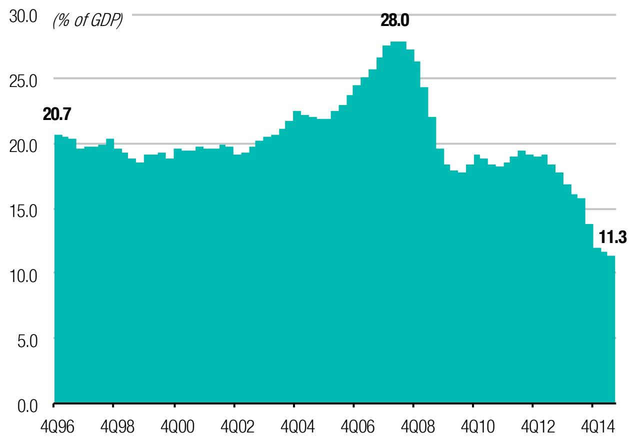
[36] Ratio is calculated upon the GDP data for last 12-month period, ie from 2Q of 2014 through 1Q of 2015. In 2Q of 2015, this ratio slipped further down to 11.3%

[37] In boom years of 2005-07, level of fixed investments was nearly 60% of total.

[38] Not seasonally adjusted.

Chart 19. Level of fixed investments in the economy (% of GDP)

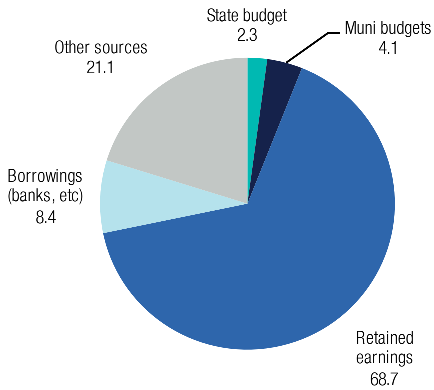
History from 1Q of 1996 through 2Q of 2015



Source: State Statistics Service of Ukraine, ICU.

Chart 20. Fixed-interments spending by source of financing (%)

Data for 2Q of 2015. 100% = UAH54.0bn



Source: State Statistics Service of Ukraine, ICU.

Monetary conditions: Creeping stabilisation

The most recent monetary statistics data from the NBU indicates fragile stabilisation occurring after the turbulent 1Q15 (see Chart 24-Chart 29 on page 27). Although there has been a modest UAH4.5bn increase of UAH deposits by commercial banks during June-July, foreign currency deposits have continued to decline. From the assets side of the banks' books, lending to the non-government sector has not revived yet as the banks' loan portfolio has been shrinking through July, the latest month for which the statistical data is available.

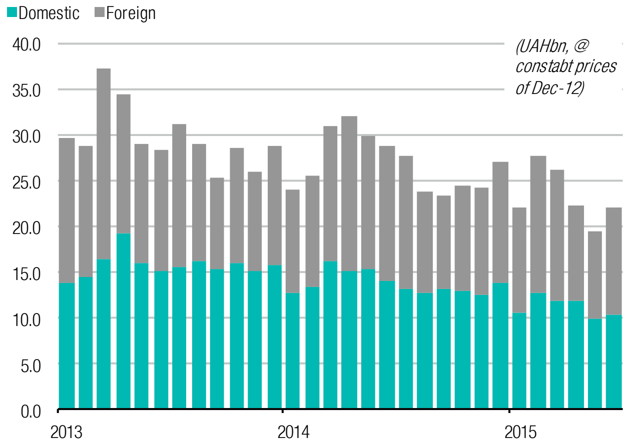
2015 so far has been more devastating for the economy in relation to monetary conditions. The flow of domestic credit in January-July contracted by UAH194bn while it contracted by only UAH3bn during full year 2014.

This was mainly due to the banking sector restructuring (where insolvent banks were eliminated) and corporate sector deleveraging with local banks. Secondly, the government budget surplus that eliminated accumulations of claims by banks on government also were a factor. The contraction of domestic credit of such dimension is indeed extraordinary and should subside through 2H15.

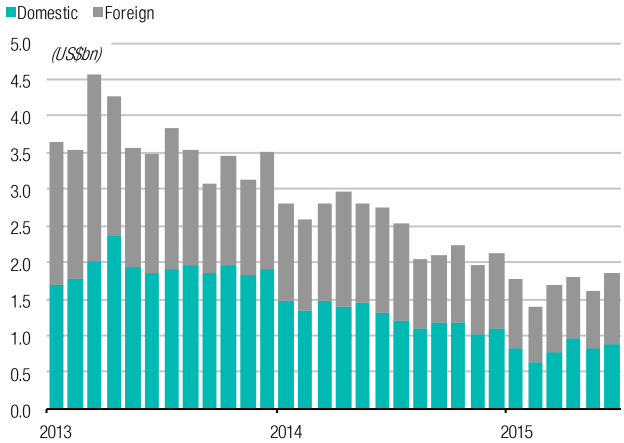
There is political pressure on the authorities to increase spending and eventually engineer economic growth following two years of deep recession. The reversal in growth is likely to be spurred by an increase in both government and business borrowings. We anticipate an increase in domestic credit flow, accompanied by a money supply recovery through the end of 2015 and into 2016.

Chart 21. New orders in the industrial sector: CPI-adjusted volume[1] (UAHbn, left) and FX-adjusted volume[2] (US$bn, right)

Monthly volumes. History from January 2013 through April 2015

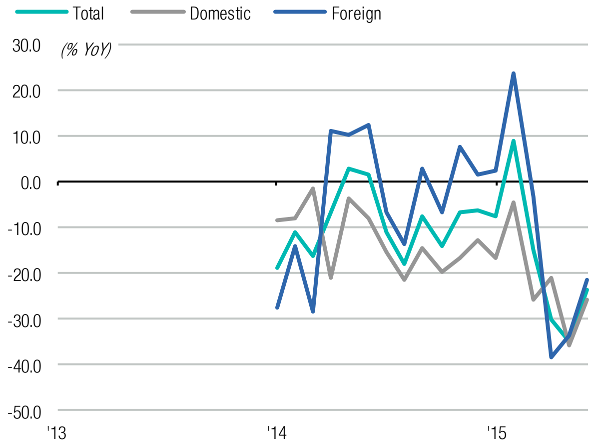


Note: [1] In constant prices of December 2012, adjusted by CPI.
Source: State Statistics Committee of Ukraine, ICU.

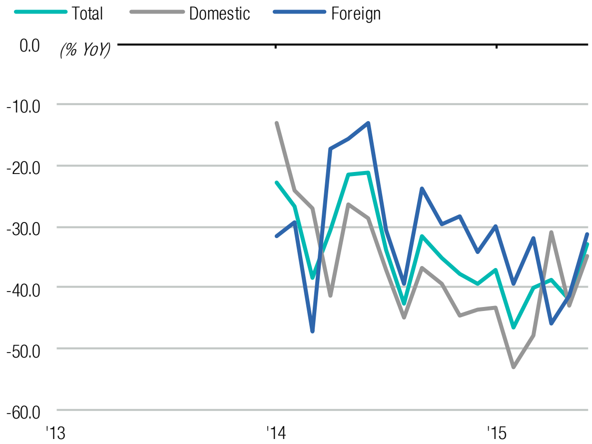


Note: [2] Adjusted by market FX rate.
Source: State Statistics Committee of Ukraine, Bloomberg, ICU.

Chart 22. On-year growth rates of new orders in the industrial sector: CPI-adjusted volume[1] (left) and FX-adjusted volume[2] (right)

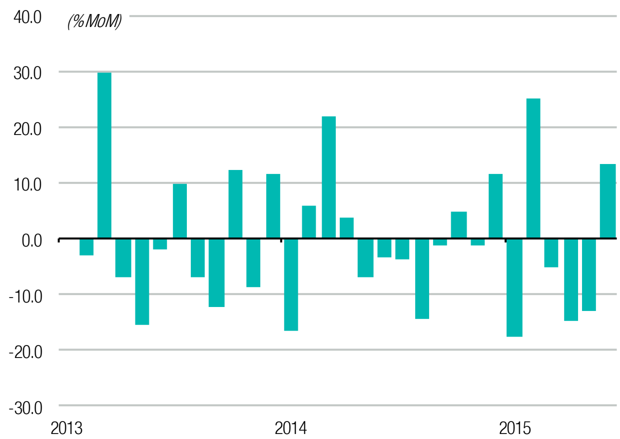


Source: State Statistics Committee of Ukraine, ICU.

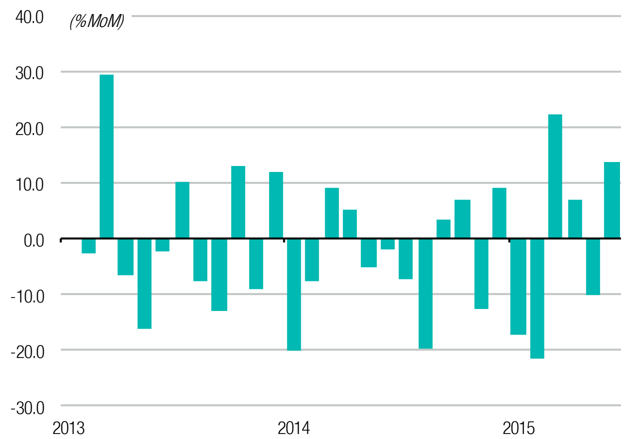


Source: State Statistics Committee of Ukraine, ICU.

Chart 23. On-month growth rates of new orders in the industrial sector: CPI-adjusted volume[1] (left) and FX-adjusted volume[2] (right)



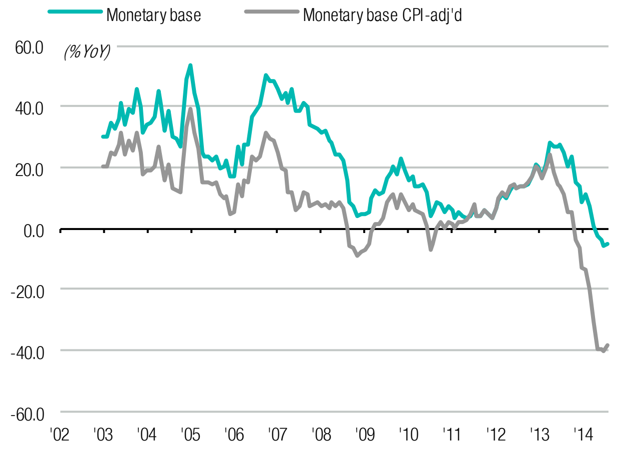
Source: State Statistics Committee of Ukraine, ICU.



Source: State Statistics Committee of Ukraine, ICU.

Chart 24. Base money (BM): growth rates of raw and inflation adjusted volume (%YoY)

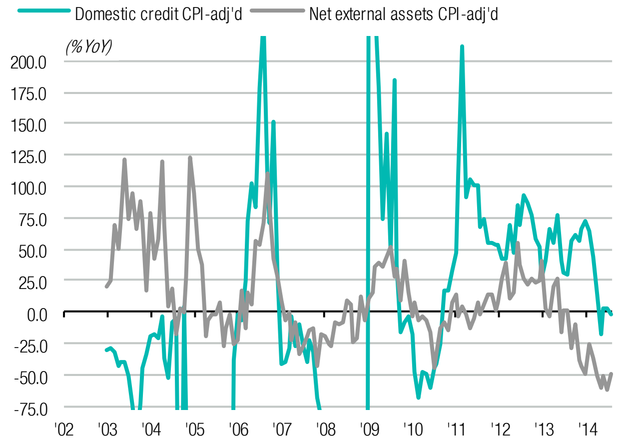
Monthly history from January 2004 through July 2015



Source: National Bank of Ukraine, ICU.

Chart 25. Counterparts of base money: growth rates of inflation adjusted volume (%YoY)

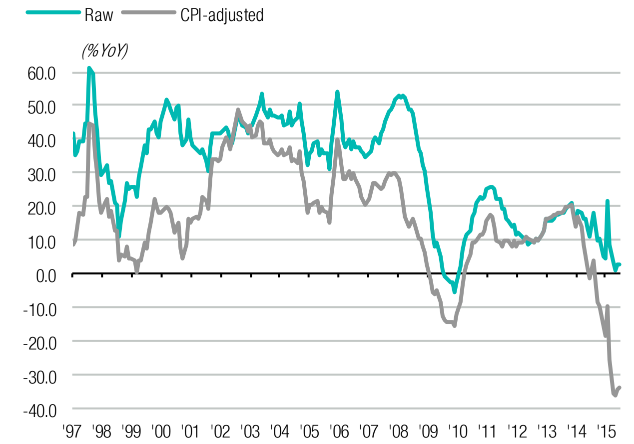
Monthly history from January 2004 through July 2015



Source: National Bank of Ukraine, ICU.

Chart 26. Broad money (M3): growth rates of raw and inflation adjusted volume (%YoY)

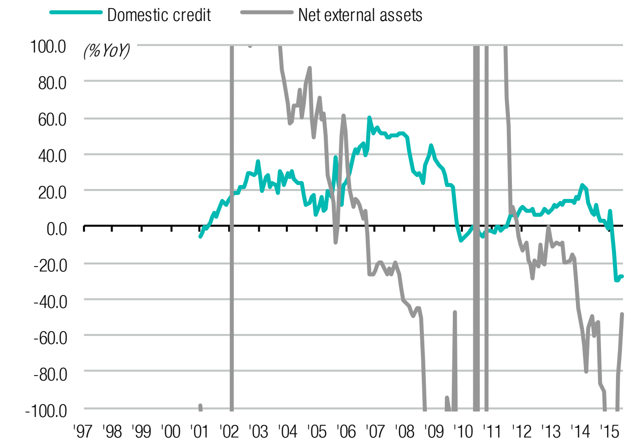
Monthly history from January 1997 through July 2015



Source: National Bank of Ukraine, ICU.

Chart 27. Counterparts of broad money: growth rates of inflation adjusted volume (%YoY)

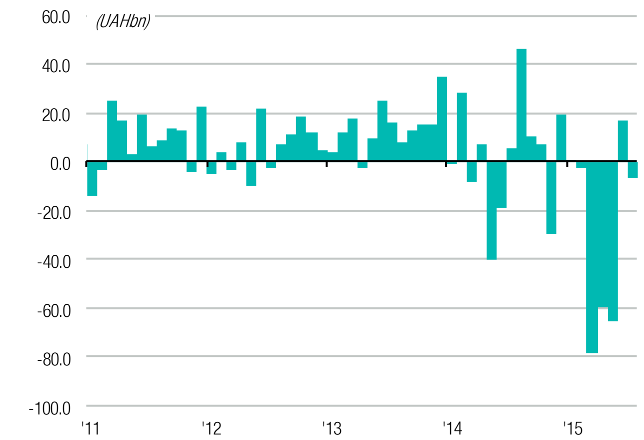
Monthly history from January 2001 through July 2015



Source: National Bank of Ukraine, ICU.

Chart 28. Domestic credit monthly flows (UAHbn)

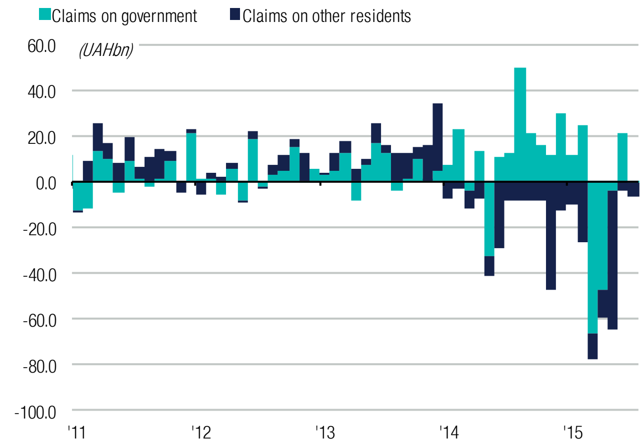
Monthly history from January 2011 through July 2015



Source: National Bank of Ukraine, ICU.

Chart 29. Breakdown of domestic credit monthly flows (UAHbn)

Monthly history from January 2011 through July 2015



Source: National Bank of Ukraine, ICU.

Inflation: Trending downwards, albeit not that fast

In our view, high inflation peaked this summer at above 50% YoY and should subside, albeit gradually. There is domestic political pressure on the incumbent politicians in power to increase public wages, pensions and other spending by the state on social services. Under such political pressure, the risk that government spending could be rationalised toward consumption-related spending while investment-related spending is neglected is inflationary.

Headline consumer price inflation is to slow from its annual average rate of 50.2% in 2015 to 29.2% YoY in 2016 and then 19.2% and 8.4% in 2017 and 2018, respectively. This is our base-case scenario. In our worst-case scenario where state spending is directed by populist parties that could assume power, higher inflation rates are projected that assure double-digit rates stay over the period of forecast through 2018.

Public finances: Balanced stance is there

The monthly statistics on the fiscal performance during 2015 indicate that, the Yatsenyuk government has adopted a quite strident balanced-budget policy. For the first time in the history of state budget statistics since January 2006, there was a 2.5% primary surplus on the consolidated budget as of July, the latest month for which data is available. Chart 30 shows that the incumbent government has become the most prudent out of the previous five governments that served over the past 10 years.

Moreover, the incumbent government has been effectively adhering to the path that maintained the growth of revenues, net of NBU transfers, ahead of growth in expenditures (see Chart 31, p.29). Despite the fact that NBU transfers should hit UAH60bn, the largest annual amount ever seen at current prices, this year state budget law in relative terms have deemed these transfers less significant. For instance, at the end of this year, the ratio of NBU transfers to debt service expenditures will be 73%, well below the 2008-14 monthly average of 94% (Chart 32-Chart 33, p.30). In relation to revenues, the share of NBU transfers should be 12.0% this December or just 0.5ppt short of the historical high share of 12.5% seen in April and May 2014.

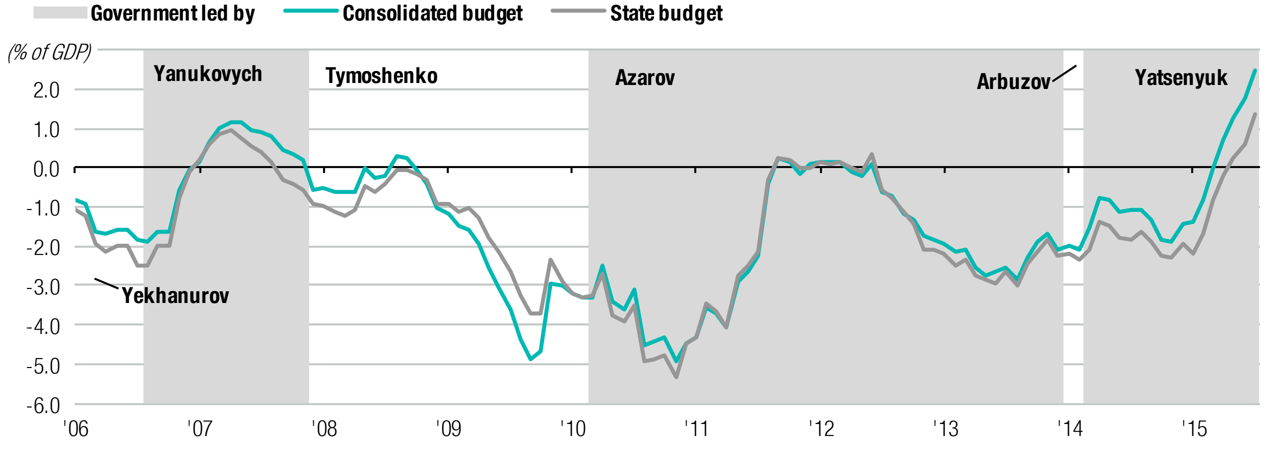
The debt operation (restructuring) which was agreed upon between Ukraine's government and private creditors is to be completed by year-end 2015. There is a risk that MPs who have been critical of the government on this issue (especially after news that the debt deal has GDP-linked securities embedded) would try to derail it. Our base-case scenario envisages that these MPs are bound to fail[39]. In our worst-case scenario, the debt deal fails to be adopted by MPs from their first attempt and this causes another couple of months of delay of the deal to be eventually adopted in early 2016 and NBU's tight capital controls will be retained longer than previously envisaged and the IMF's and other donors' financial assistance will be delayed.

[39] In fact, they did fail as the debt restructuring legislation was passed by a sizable majority of MPs.

In our view, the debt deal (with a 20% nominal reduction, 7.75% coupon and with our other macro assumptions used for the modelling the outcome[40]) is going to miss the IMF targets albeit by a relatively slim margin (Chart 34-Chart 35, p.30). In reality, Ukraine's government will be forced to exploit other tools—primarily by running a bigger primary surplus than previously envisaged—that effectively would reduce public debt level over time.

Chart 30. Primary balance (% of GDP)

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



Source: Ministry of Finance of Ukraine, ICU.

Chart 31. Divergence of growth rates between budget revenues[1] and primary expenditures[2] (ppt)

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

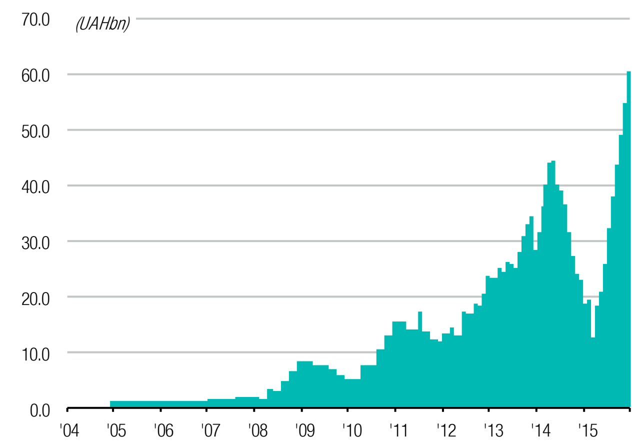
Note: [1] excluding NBU transfers, [2] total expenditure less interest payments. Source: Ministry of Finance of Ukraine, ICU.

[40] Our research relied on the assumption that government will run state budget at modest primary surpluses starting 2015, which are of 0-1.5% of GDP.

See details in ICU's research report *Bond Market Insight* "Sensitivity analysis of future public debt" https://www.icu.ua/download/1266/ICUDebtInsight-20150710.pdf

Chart 32. NBU's transfer to state budget revenues (UAHbn)

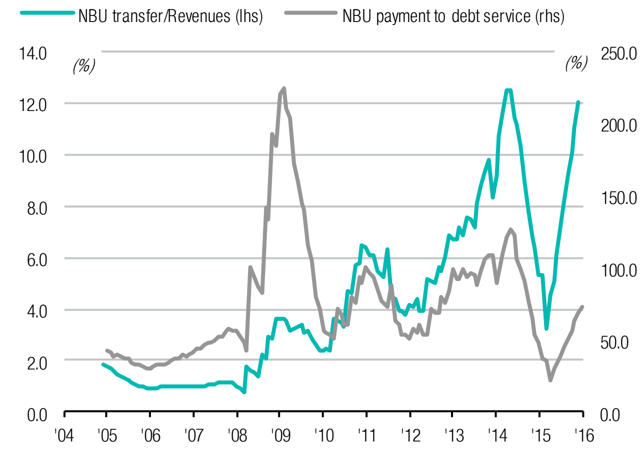
Monthly history from January 2004 through July 2015



Source: National Bank of Ukraine, ICU.

Chart 33. Ratios of NBU's transfer to revenues and debt service (%)

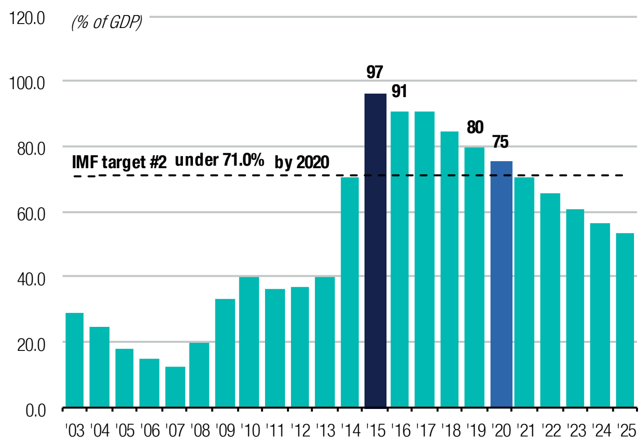
Monthly history from January 2004 through July 2015



Source: National Bank of Ukraine, ICU.

Chart 34. Public debt to GDP (% of GDP)

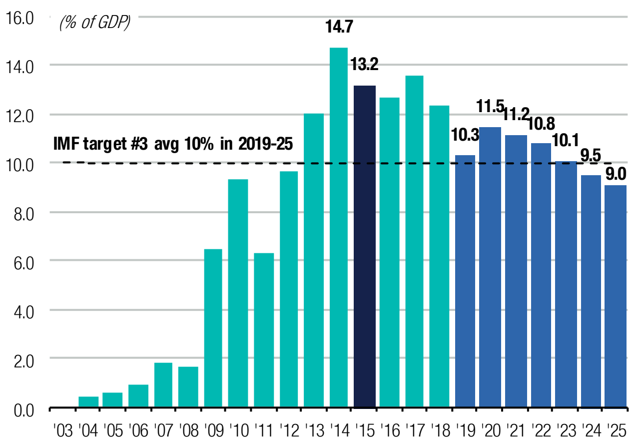
Forecast for 2015-25 under ICU's base-case scenario



Source: State Statistics Service of Ukraine, ICU.

Chart 35. Gross financial needs (% of GDP)

Forecast for 2015-25 under ICU's base-case scenario



Source: State Statistics Service of Ukraine, ICU.

External balance: A near balanced current account as short-term phenomenon

This year's collapse in foreign trade is yielding a near balanced current account. This development also underscores the fact that Ukraine's economy has faced an abrupt interruption of foreign private capital inflows into the country.

Our forecast for the 2015 current account balance is a surplus of US$0.6bn, or 0.7% of GDP, versus our previous macro report forecasted surplus of US$0.1bn or 0.1% of GDP.

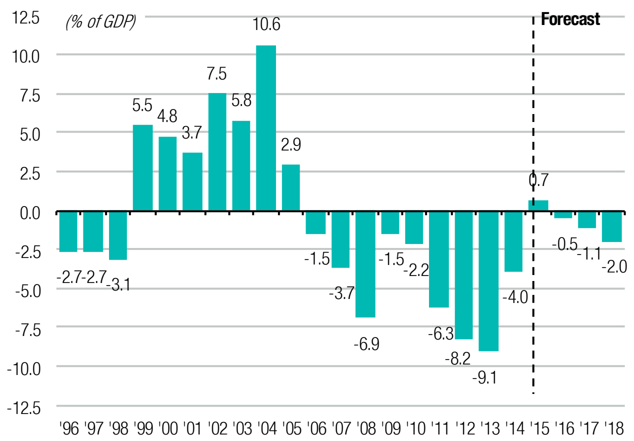
In our view, this is a temporary phenomenon as Ukraine's economy is not in a position to run sustained external surpluses (as measured by current account balance). There are prospects of weak foreign demand for Ukraine's exports, resulting from the deflationary Chinese economy as well as the recessions in the Russian economy and stagnant EU, where macroeconomic adjustment pushes member states to run current account surpluses. In order to run a current account surplus, Ukrainian authorities should carry out such policies that would have depressed domestic demand to yield a foreign trade surplus. This kind of policy is depressive and hence not sustainable going forward. In our view, Ukraine's government is going to support domestic demand, still being wary of inflation risk to avoid an extended recession or depression.

Hence, in 2016-18, our base-case scenario envisages that the current account slips back into a deficit and progresses annually over the range of 0.5-2.0% of GDP. Capital account inflows should be tilted toward non-debt financing (mostly FDI and later equity portfolio investments). This is due to the fact that debt financing (with a sizable share of FX debt) was excessive prior to the current recession (as well as the previous one in 2008-09) and subject to constant risk of default with regard to FX debt. Going forward, external debt deleveraging by state, banks and (to a lesser extent) corporations is one of the main themes of Ukraine's economic external balance.

As far as FX reserves are concerned, we retain our view expressed in the previous macro report of this July that their volume would be US$12.2bn below the official target. In 2016, they should increase toward US$20.5bn, peak at US$24.0bn in 2017, and subside back to US$21.2bn in 2018.

Chart 36. Current account balance history and forecast (% of GDP)

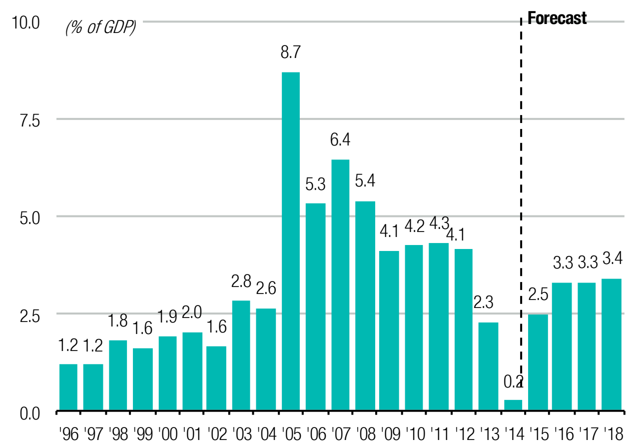
History 2000-7M15 and forecast for full year of 2015-2018



Source: NBU, ICU.

Chart 37. Foreign direct investments (% of GDP)

History 2000-7M15 and forecast for full year of 2015-2018



Source: NBU, ICU.

View on the UAH: An implicit peg to be abandoned cautiously

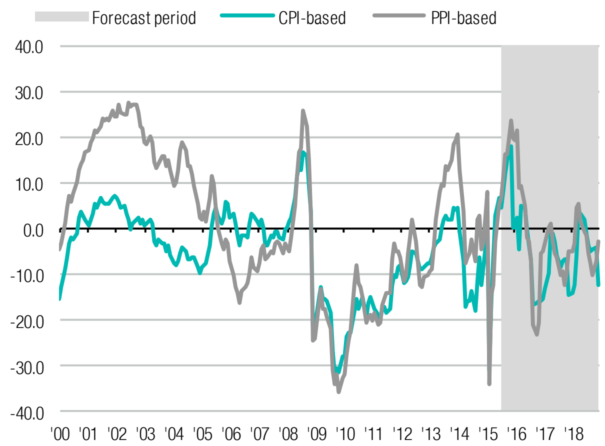
Due to the inflationary spike of late 2014 and early 2015 that currently is running above 50% YoY threshold, the UAH's fundamental value has been shifting from undervalued to overvalued in 2H15 (see Chart 38, p.32). Because of the risk that currency inflexibility (in nominal, or FX market, terms) results in growth-negative development, a loss of competitiveness, Ukraine's authorities are likely to abandon the current policy of maintaining its unofficial FX band[41]. This is likely to happen after regional elections scheduled on October 25.

[41] This has been between 21-23/USD.

During 2016, the hryvnia is set to weaken alongside its fundamental value as measured by ICU's CPI- and PPI-based real trade-weighted indices (see Chart 39, p.32). By year-end, the hryvnia should be 25/USD, moving to 32/USD at the end of next year and in the end of 2017 and 2018, the currency's pace of the weakening subsides sizably to 33 and 34/USD, respectively. In our base-case scenario, UAH stabilisation occurs in 2017-18 on the back of inflation moderation toward single-digit territory and reversing of the current trend of a strong dollar into a new trend when US monetary policy becomes more easy (after a period of tightening that gathers pace now).

Chart 38. Misalignment of the UAH's FX rate as implied by the UAH real trade-weighted indices

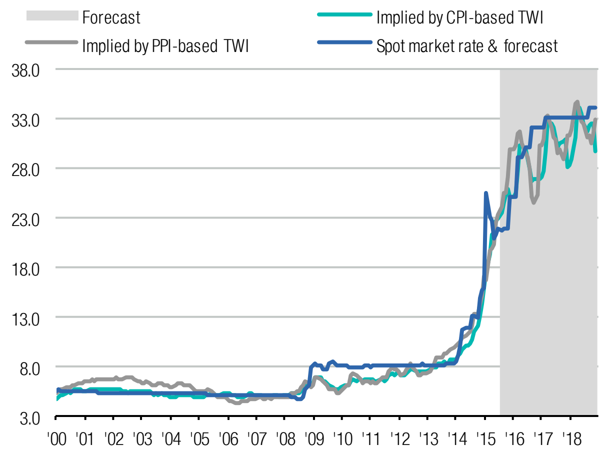
History 2000-7M15 and forecast for 2H15-2018



Source: ICU.

Chart 39. UAH's FX rate versus the rates implied by the UAH real trade-weighted indices

History 2000-7M15 and forecast for 2H15-2018



Source: ICU.

Forecast for 2015-18

The following two pages of statistics are our yearly and quarterly key macroeconomic indicators with forecasts through 2018.

Yearly forecast for 2015-18, base case scenario

Table 2. Forecast of key macroeconomic indicators for 2015-18 (annual)

	Historical data for 2004-14									Forecast by ICU			
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015F	2016F	2017F	2018F
Activity													
Real GDP (%YoY)	7.3	7.9	2.3	-14.8	4.1	5.2	0.2	-0.1	-6.6	**-13.1**	**2.7**	**2.0**	**2.0**
Nominal GDP (UAHbn)	544	721	948	913	1,083	1,302	1,409	1,465	1,567	**2,061**	**2,631**	**3,071**	**3,342**
Nominal GDP (US$bn)	108	143	184	114	136	163	174	180	131	**91**	**85**	**93**	**100**
GDP per capita (US$, ann)	2,319	3,091	3,986	2,474	2,978	3,572	3,823	3,962	3,069	**2,143**	**2,009**	**2,200**	**2,359**
Unemployment rate (%)	6.2	6.4	6.4	8.8	8.1	7.9	7.5	7.2	9.3	**11.0**	**9.8**	**9.8**	**9.8**
Prices													
CPI headline (%YoY, eop)	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	**50.5**	**23.6**	**16.7**	**4.9**
CPI headline (%YoY, average)	9.1	12.8	25.3	16.0	9.4	8.0	0.6	-0.3	12.1	**50.2**	**29.2**	**19.2**	**8.4**
PPI (%YoY, eop)	15.4	23.2	21.1	15.3	18.8	17.4	0.4	1.7	31.8	**35.5**	**19.6**	**5.3**	**5.3**
PPI (%YoY, average)	9.6	20.5	33.6	7.4	21.4	19.9	6.0	-0.1	17.0	**39.5**	**21.7**	**11.0**	**5.3**
Fiscal balance													
Consolidated budget bal. (UAHbn)	-3.5	-6.1	-11.3	-34.4	-63.3	-18.3	-46.9	-63.0	-67.1	**-22.1**	**-18.9**	**-42.2**	**-42.3**
Consolidated budget bal. (% of GDP)	-0.6	-0.8	-1.2	-3.8	-5.9	-1.4	-3.3	-4.3	-4.3	**-1.1**	**-0.7**	**-1.4**	**-1.3**
Budget balance (UAHbn)	-3.8	-9.8	-12.5	-35.5	-64.3	-23.6	-53.4	-64.7	-78.1	**-53.2**	**-64.0**	**-91.2**	**-96.3**
Budget balance (% of GDP)	-0.7	-1.4	-1.3	-3.9	-5.9	-1.8	-3.8	-4.4	-5.0	**-2.6**	**-2.4**	**-3.0**	**-2.9**
External balance													
Exports (US$bn)	50.2	64.0	85.6	54.3	69.3	88.8	90.0	85.3	68.8	**53.0**	**52.7**	**55.1**	**57.0**
Imports (US$bn)	53.3	72.2	100.0	56.2	73.2	99.0	104.4	100.8	74.1	**52.9**	**53.7**	**56.7**	**59.4**
Trade balance (US$bn)	-3.1	-8.2	-14.4	-2.0	-4.0	-10.2	-14.3	-15.5	-5.2	**0.1**	**-1.0**	**-1.7**	**-2.4**
Trade balance (% of GDP)	-2.8	-5.7	-7.8	-1.7	-2.9	-6.2	-8.2	-8.6	-4.0	**0.2**	**-1.2**	**-1.8**	**-2.4**
Current account balance (US$bn)	-1.6	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	-5.2	**0.6**	**-0.5**	**-1.1**	**-2.0**
Current account balance (% of GDP)	-1.5	-3.7	-6.9	-1.5	-2.2	-6.3	-8.2	-9.1	-4.0	**0.7**	**-0.5**	**-1.1**	**-2.0**
Net FDI (US$bn)	5.7	9.2	9.9	4.7	5.8	7.0	7.2	4.1	0.3	**2.3**	**2.8**	**3.1**	**3.4**
Net FDI (% of GDP)	5.3	6.4	5.4	4.1	4.2	4.3	4.1	2.3	0.2	**2.5**	**3.3**	**3.3**	**3.4**
C/A bal. + net FDI (% of GDP)	3.8	2.8	-1.6	2.6	2.0	-2.0	-4.1	-6.8	-3.7	**3.1**	**2.7**	**2.2**	**1.4**
External debt (US$bn, eop)	54.5	80.0	101.7	103.4	117.3	126.2	134.6	142.1	134.1	**136.5**	**142.9**	**144.8**	**141.1**
External debt (% of ann'd GDP, eop)	50.4	55.8	55.3	90.9	86.1	77.4	77.3	79.1	102.2	**149.6**	**167.8**	**155.6**	**141.6**
FX reserves (US$bn, eop)	22.3	32.5	31.5	26.5	34.6	31.8	24.5	20.4	7.5	**12.3**	**20.5**	**23.9**	**21.2**
FX reserves (% of ann'd GDP, eop)	20.6	22.6	17.2	23.3	25.4	19.5	14.1	11.4	5.7	**13.5**	**24.1**	**25.7**	**21.2**
External debt / FX reserves (x, eop)	2.4	2.5	3.2	3.9	3.4	4.0	5.5	7.0	17.8	**11.1**	**7.0**	**6.1**	**6.7**
FX reserves imports cov (months)	5.0	5.4	3.8	5.7	5.7	3.9	2.8	2.4	1.2	**2.8**	**4.6**	**5.1**	**4.3**
Interest rates													
Central bank key rate (%, eop)	8.50	8.00	12.00	10.25	7.75	7.75	7.50	6.50	14.00	**25.00**	**20.00**	**15.00**	**0.00**
3-month rate (%, eop 4Q)	9.90	7.58	21.60	17.59	6.12	19.72	25.52	11.71	18.37	**25.00**	**25.00**	**25.00**	**25.00**
Exchange rates													
UAH trade-weighted index (nominal)	70.90	64.93	45.89	46.09	53.28	56.87	54.63	49.59	32.29	**20.50**	**16.19**	**15.46**	**14.83**
UAH trade-weighted index (real)	123.61	120.06	100.21	90.26	97.73	98.76	94.72	100.84	85.40	**93.57**	**76.37**	**74.97**	**74.10**
UAH/US$ (eop)	5.05	5.05	7.80	8.00	7.94	8.00	8.05	8.24	15.82	**25.00**	**32.00**	**33.00**	**34.00**
UAH/US$ (average)	5.03	5.03	5.25	8.03	7.94	7.99	8.08	8.16	12.01	**22.53**	**30.75**	**33.00**	**33.50**
UAH/€ (eop)	6.66	7.36	10.90	11.45	10.63	10.37	10.62	11.32	19.14	**27.75**	**33.60**	**36.96**	**39.10**
UAH/€ (average)	6.64	7.32	7.10	11.70	10.51	10.50	10.60	11.17	14.79	**25.12**	**36.29**	**36.38**	**38.11**
US$/€ (eop)	1.32	1.46	1.40	1.43	1.34	1.30	1.32	1.37	1.21	**1.11**	**1.05**	**1.12**	**1.15**
US$/€ (average)	1.32	1.46	1.35	1.46	1.32	1.32	1.31	1.37	1.23	**1.11**	**1.18**	**1.10**	**1.14**
Population													
Population (million, eop)	46.6	46.4	46.1	46.0	45.8	45.6	45.6	45.3	42.8	**42.6**	**42.4**	**42.3**	**42.2**
Population (%YoY)	-0.7	-0.6	-0.5	-0.4	-0.4	-0.3	-0.2	-0.5	-5.7	**-0.5**	**-0.4**	**-0.2**	**-0.1**

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

Quarterly forecast for 2015-18, base case scenario

Table 3. Forecast of key macroeconomic indicators for 2015-18 (quarterly)

	Forecast by ICU													
	3Q15E	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F	4Q17F	1Q18F	2Q18F	3Q18F	4Q18F
Activity														
Real GDP (%YoY)	-10.7	-9.7	2.5	2.5	2.7	3.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Nominal GDP (UAHbn)	586.0	594.1	498.6	562.6	744.5	745.7	615.8	661.0	853.7	846.9	691.4	717.8	921.2	910.4
Nominal GDP (US$bn)	26.9	23.8	17.2	18.8	23.3	23.3	18.7	20.0	25.9	25.7	21.0	21.8	27.1	26.8
GDP per capita (US$, ann)	2,232	2,073	2,078	2,031	1,948	1,939	1,975	2,006	2,068	2,125	2,180	2,221	2,251	2,278
Unemployment rate (%)	10.9	11.0	11.0	9.7	9.7	9.8	9.8	9.8	9.8	9.8	0.0	0.0	0.0	0.0
Prices														
CPI headline (%YoY, eop)	53.0	50.5	34.8	24.7	25.4	23.6	21.1	18.6	18.0	16.7	12.8	6.4	5.7	4.9
CPI headline (%YoY, average)	54.1	51.3	41.9	24.7	25.8	24.3	22.3	18.9	18.4	17.2	14.8	7.5	6.1	5.3
PPI (%YoY, eop)	36.5	35.5	15.0	23.3	21.7	19.6	19.5	9.2	5.8	5.3	5.3	5.3	5.3	5.3
PPI (%YoY, average)	36.8	35.8	24.0	20.1	22.4	20.3	20.3	11.6	6.5	5.5	5.3	5.3	5.3	5.3
Fiscal balance														
Consolidated budget bal. (UAHbn)	-4.0	-31.6	-10.4	-27.1	16.5	-21.9	-6.4	-35.0	9.9	-38.9	-0.2	-37.7	9.5	-44.5
Consolidated budget bal. (% of GDP)	-0.7	-5.3	-2.1	-4.8	2.2	-2.9	-1.0	-5.3	1.2	-4.6	0.0	-5.2	1.0	-4.9
Budget balance (UAHbn)	-13.6	-37.5	-17.4	-32.4	0.0	-32.4	-16.1	-40.7	-7.4	-48.4	-12.4	-43.9	-9.0	-54.2
Budget balance (% of GDP)	-2.3	-6.3	-3.5	-5.8	0.0	-4.3	-2.6	-6.2	-0.9	-5.7	-1.8	-6.1	-1.0	-6.0
External balance														
Exports (US$bn)	13.7	13.5	11.7	13.1	13.7	14.1	12.7	13.6	14.2	14.6	13.3	14.0	14.7	15.1
Imports (US$bn)	14.4	12.8	13.0	12.4	13.9	14.3	13.8	13.3	14.9	14.7	14.3	13.6	15.9	15.7
Trade balance (US$bn)	-0.7	0.7	-1.3	0.7	-0.1	-0.2	-1.1	0.3	-0.7	-0.2	-0.9	0.4	-1.2	-0.6
Trade balance (% of GDP)	-2.7	3.0	-7.7	3.8	-0.6	-1.0	-5.9	1.5	-2.7	-0.6	-4.4	1.7	-4.4	-2.4
Current account balance (US$bn)	-0.7	0.9	-1.2	0.8	-0.1	0.0	-0.9	0.4	-0.6	0.0	-0.8	0.5	-1.0	-0.4
Current account balance (% of GDP)	-2.7	3.9	-6.8	4.4	-0.3	-0.2	-5.1	2.1	-2.3	0.1	-3.7	2.4	-3.8	-1.7
Net FDI (US$bn)	0.6	0.6	0.6	0.6	0.6	1.0	0.7	0.8	0.7	0.9	0.8	0.9	0.8	0.9
Net FDI (% of GDP)	2.2	2.5	3.5	3.2	2.6	4.3	3.9	3.8	2.7	3.5	3.9	3.9	3.0	3.4
C/A bal. + net FDI (% of GDP)	-0.5	6.5	-3.3	7.6	2.2	4.1	-1.2	5.9	0.4	3.6	0.2	6.3	-0.8	1.8
External debt (US$bn, eop)	135.9	136.5	138.1	139.7	141.3	142.9	144.8	142.0	142.0	142.0	140.0	140.0	140.0	140.0
External debt (% of ann'd GDP, eop)	142.4	154.1	155.7	161.3	170.3	173.2	172.4	166.6	161.6	157.4	151.3	148.6	146.7	145.0
FX reserves (US$bn, eop)	11.1	12.3	14.3	16.4	18.5	20.5	21.4	22.2	23.0	23.9	23.2	22.5	21.8	21.1
FX reserves (% of ann'd GDP, eop)	11.6	13.9	16.2	18.9	22.2	24.9	25.4	26.0	26.2	26.4	25.0	23.9	22.9	21.9
External debt / FX reserves (x, eop)	12.2	11.1	9.6	8.5	7.7	7.0	6.8	6.4	6.2	6.0	6.0	6.2	6.4	6.6
FX reserves imports cov (months)	2.3	2.8	3.2	3.7	4.2	4.6	4.7	4.8	4.9	5.0	4.9	4.7	4.5	4.3
Interest rates														
Central bank key rate (%, eop)	27.00	25.00	25.00	25.00	25.00	20.00	15.00	15.00	15.00	15.00	10.00	10.00	10.00	10.00
3-month rate (%, eop 4Q)	25.00	25.00	25.00	25.00	25.00	18.00	18.00	18.00	18.00	18.00	10.00	10.00	10.00	10.00
Exchange rates														
UAH trade-weighted index (nominal)	22.96	20.50	17.62	17.11	14.89	16.19	15.68	15.68	15.70	15.46	15.53	15.59	15.16	14.83
UAH trade-weighted index (real)	105.12	93.57	88.60	93.22	76.37	76.37	81.38	88.05	82.91	74.97	82.91	90.13	82.43	74.10
UAH/US$ (eop)	21.97	25.00	29.00	30.00	32.00	32.00	33.00	33.00	33.00	33.00	33.00	33.00	34.00	34.00
UAH/US$ (average)	21.81	25.00	29.00	30.00	32.00	32.00	33.00	33.00	33.00	33.00	33.00	33.00	34.00	34.00
UAH/€ (eop)	24.60	27.75	31.90	32.10	48.00	33.60	35.64	36.30	36.63	36.96	37.29	37.29	38.76	39.10
UAH/€ (average)	24.37	27.88	32.05	32.55	41.12	40.80	35.15	35.97	36.47	36.80	37.13	37.29	38.59	38.93
US$/€ (eop)	1.12	1.11	1.10	1.07	1.50	1.05	1.08	1.10	1.11	1.12	1.13	1.13	1.14	1.15
US$/€ (average)	1.12	1.12	1.11	1.09	1.29	1.28	1.07	1.09	1.11	1.12	1.13	1.13	1.14	1.15
Population														
Population (million, eop)	42.77	42.55	42.58	42.63	42.61	42.40	42.48	42.52	42.51	42.30	42.42	42.47	42.46	42.25
Population (%YoY)	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.2	-0.2	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1

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

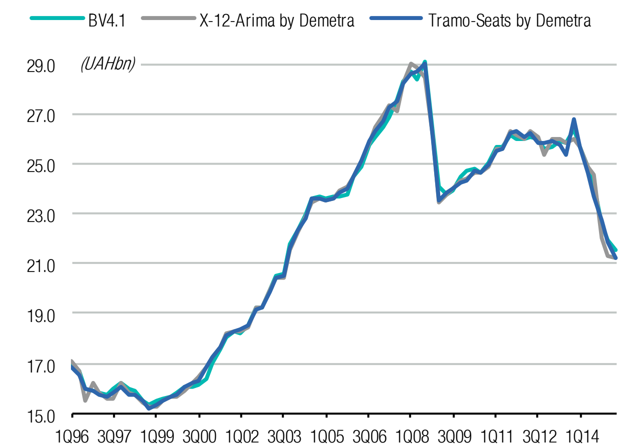
Appendices: Research details, thematic charts & tables

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

Quarterly GDP: Reported statistics and ICU's calculations

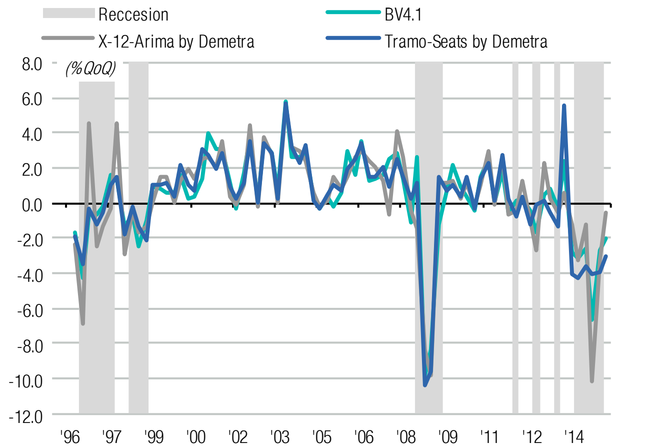
Chart 40. Ukraine's economy from the perspective of quarterly GDP volumes (left) and on-quarter growth rates (right)
1Q96-1Q15
Data is adjusted for inflation and seasonal factors; seasonally adjusted by three methods BV4.1, X-12 Arima and Tramo-Seats

Quarterly GDP size in constant prices of Dec-95



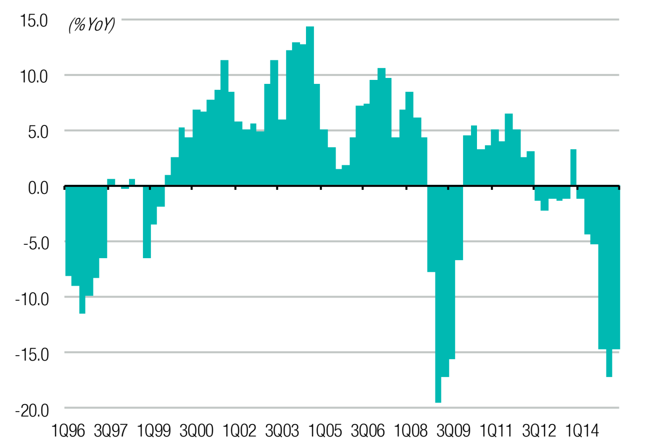
Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Quarterly GDP growth rates (% QoQ)



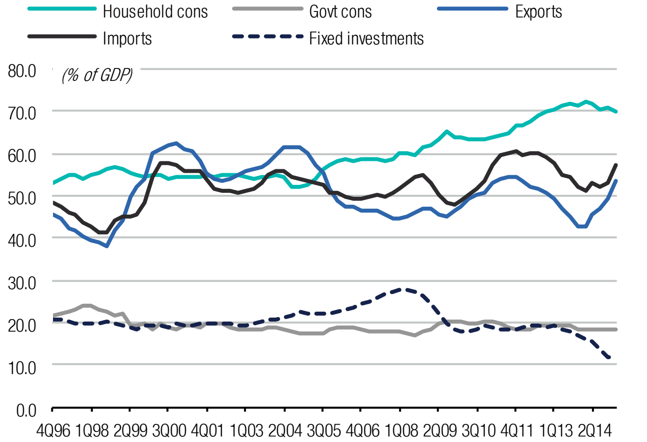
Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 41. Reported on-year quarterly GDP growth (% YoY)
1Q96-1Q15



Source: State Statistics Service of Ukraine.

Chart 42. Demand-side components of GDP (% of total, LTM)
1Q96-1Q15



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

Table 4. 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, qtly)	Real growth (% QoQ, SA)	Deflator (% YoY)	Real growth (% YoY, ann'd)	GDP at cons prices[1] (UAHm, NSA)	GDP at cons prices[1] (UAHm, SA)			Real GDP growth (%QoQ, SA)		
							BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra	BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra
4Q96	24,454	-10.0		40.1	-9.7	17,404	16,075	16,228	**15,824**	0.8	4.6	0.8
1Q97	18,728	-8.3		22.3	-9.8	14,114	15,777	15,780	**15,779**	-1.9	-2.8	-0.3
2Q97	20,485	-6.6		22.7	-9.1	14,117	15,758	15,586	**15,750**	-0.1	-1.2	-0.2
3Q97	26,076	0.5		15.3	-6.2	17,544	16,049	15,531	**15,687**	1.8	-0.4	-0.4
4Q97	28,076	0.0		14.8	-3.7	17,405	16,122	16,258	**15,984**	0.5	4.7	1.9
1Q98	20,871	-0.3		11.8	-1.6	14,068	16,011	15,744	**15,762**	-0.7	-3.2	-1.4
2Q98	23,367	0.5		13.5	0.2	14,188	15,795	15,701	**15,724**	-1.4	-0.3	-0.2
3Q98	28,908	-0.1		10.9	0.0	17,538	15,379	15,435	**15,479**	-2.6	-1.7	-1.6
4Q98	29,447	-6.6		12.3	-1.7	16,256	15,177	15,236	**15,165**	-1.3	-1.3	-2.0
…	…	…	…	…	…	…	…	…	**…**	…	…	**…**
2Q07	166,869	9.7		20.4	9.3	25,260	26,880	27,342	**27,293**	1.6	1.3	2.1
3Q07	199,535	4.4		25.4	8.5	30,592	27,549	27,150	**27,539**	2.5	-0.7	0.9
4Q07	214,883	6.9		26.4	7.9	29,558	28,335	28,252	**28,218**	2.9	4.1	2.5
1Q08	191,459	8.5		26.6	7.4	26,303	28,711	28,981	**28,642**	1.3	2.6	1.5
2Q08	236,033	6.2		33.2	6.5	26,824	28,404	28,854	**28,697**	-1.1	-0.4	0.2
3Q08	276,451	4.3		32.9	6.5	31,892	29,132	28,430	**29,011**	2.6	-1.5	1.1
4Q08	244,113	-7.8		23.3	2.6	27,233	26,268	26,048	**25,990**	-9.8	-8.4	-10.4
1Q09	189,028	-19.6		22.8	-4.8	21,148	24,071	23,487	**23,506**	-8.4	-9.8	-9.6
2Q09	214,103	-17.3		9.7	-10.6	22,181	23,781	23,762	**23,865**	-1.2	1.2	1.5
3Q09	250,306	-15.7		7.4	-15.2	26,886	23,948	24,028	**24,017**	0.7	1.1	0.6
4Q09	259,908	-6.7		14.1	-15.0	25,412	24,455	24,328	**24,273**	2.1	1.2	1.1
1Q10	217,286	4.5	0.7	10.7	-9.2	21,959	24,686	24,392	**24,348**	0.9	0.3	0.3
2Q10	256,754	5.4	1.4	15.1	-3.5	23,110	24,776	24,681	**24,698**	0.4	1.2	1.4
3Q10	301,251	3.3	0.4	17.5	1.5	27,539	24,665	24,640	**24,615**	-0.4	-0.2	-0.3
4Q10	307,278	3.7	0.7	15.6	4.2	25,989	25,034	24,897	**24,961**	1.5	1.0	1.4
1Q11	257,682	5.1	2.0	12.9	4.4	23,066	25,652	25,636	**25,526**	2.5	3.0	2.3
2Q11	311,022	3.9	0.3	16.6	4.0	24,009	25,654	25,600	**25,571**	0.0	-0.1	0.2
3Q11	369,818	6.5	2.5	15.2	4.8	29,347	26,120	26,302	**26,274**	1.8	2.7	2.8
4Q11	363,557	5.0	0.3	12.6	5.1	27,309	25,988	26,132	**26,325**	-0.5	-0.6	0.2
1Q12	293,493	2.5	-0.8	11.4	4.5	23,584	26,025	26,006	**26,110**	0.1	-0.5	-0.8
2Q12	349,212	3.1	0.5	9.0	4.3	24,731	26,099	26,339	**26,200**	0.3	1.3	0.3
3Q12	387,620	-1.3	-1.5	6.2	2.3	28,963	25,996	26,085	**25,870**	-0.4	-1.0	-1.3
4Q12	378,564	-2.3	-0.8	6.6	0.5	26,681	25,571	25,375	**25,853**	-1.6	-2.7	-0.1
1Q13	303,753	-1.2	0.6	4.8	-0.4	23,301	25,702	25,961	**25,892**	0.5	2.3	0.1
2Q13	354,814	-1.3	0.4	2.9	-1.5	24,409	25,902	26,015	**25,741**	0.8	0.2	-0.6
3Q13	398,000	-1.2	-0.1	3.9	-1.5	28,616	25,804	25,870	**25,398**	-0.4	-0.6	-1.3
4Q13	408,631	3.3	2.1	4.5	-0.1	27,561	26,426	26,016	**26,803**	2.4	0.6	5.5
1Q14	313,568	-1.2	-1.1	4.5	-0.1	23,018	25,677	25,696	**25,713**	-2.8	-1.2	-4.1
2Q14	375,903	-4.5	-4.4	11.1	-0.9	23,277	24,853	24,846	**24,611**	-3.2	-3.3	-4.3
3Q14	434,166	-5.4	-3.1	15.4	-2.0	27,050	24,205	24,534	**23,718**	-2.6	-1.3	-3.6
4Q14	443,091	-14.8	-3.9	27.2	-6.6	23,495	22,583	22,048	**22,747**	-6.7	-10.1	-4.1
1Q15	367,577	-17.2	-5.3	41.5	-10.7	19,069	21,965	21,328	**21,860**	-2.7	-3.3	-3.9
2Q15	512,985	-14.7	-0.9	60.0	-13.1	19,855	21,519	21,220	**21,193**	-2.0	-0.5	-3.1

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

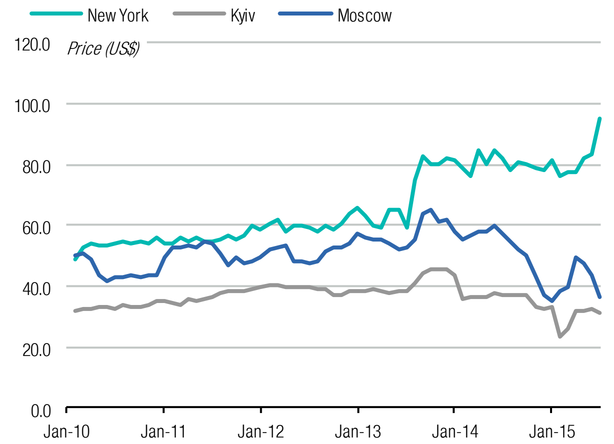
Table 5. ICU consumer basket as of end of August 2015
Prices of consumer goods in Kyiv, New-York, and Moscow

Item of the basket	Description	Kyiv, central district 7-Sep-15 Price (UAH)	New York metro-politan area 30-Aug-15 Price (US$)	Moscow, central district 7-Sep-15 Price (RUB)
Consumer goods				
Coca-cola (0.5 litre, plastic bottle)	Non-alcohol beverages	7.87	2.50	51.90
Beer Corona Extra (0.33 litre, glass bottle)	Alcoholic beverages	20.65	1.66	94.90
Bunch of fresh bananas (1 kg)	From Ecuador	17.45	1.74	64.90
Pack of milk (1 litter)	Locally produced, soft package, i.e., not glass bottle	10.67	1.69	68.90
Chicken meat (1 kg pack)	Locally produced and branded package, boneless breast	61.80	13.18	179.00
Canned pineapple (0.85 kg, can)	Pineapple circles, Dole brand	57.19	4.50	170.00
Pasta (0.5 kg)	Soft package, produced in Italy	38.60	2.65	87.00
Sugar (1 kg)		16.20	4.94	54.90
Package of table salt (0.5 kg)		9.60	0.88	16.80
Chicken eggs (10 units pack)	White eggs, standard size	26.15	3.60	95.90
Chocolate (100 g)	Made by Craft Foods Corp, Milka brand	26.19	1.26	81.90
Toothpaste (100ml package)	Colgate	46.03	5.19	170.00
Shampoo (200ml package)	Head & Shoulders brand, for normal hair	58.75	3.31	240.00
Toilet paper (4 rolls package)	Kleenex Cottonelle brand, white paper, Regular toilet tissue	28.12	4.49	98.90
Magazine	Men's Health, local edition, A4 format (standard one, not a pocket book format)	36.45	5.99	140.00
Gasoline (1 litre)	Lukoil, regular	21.49	0.73	38.00
Batteries (AA x 4 pack)	A 4-pack of AA Duracell batteries, Alkaline	62.80	3.99	150.00
Coffee (250 g, vacuum pack)	Jacobs Monarch, brick-like vacuum pack	75.60	15.09	220.00
Services				
Underground commute ticket	Within the central part of the city	4.00	2.75	40.00
Cinema ticket	Thursday's night price for the seat with good location, Hollywood film	55.00	15.25	450.00
Total basket value (in local currency)		**680.61**	**95.39**	**2,513.00**
Exchange rate versus US dollar at spot market as of date of observation		22.000	1.000	69.124
Total basket value (in US$)		**30.94**	**95.39**	**36.35**
Overvalued "+" / undervalued "-" (%)				
UAH vs. USD		**-67.57**		
UAH vs. RUB		**-14.90**		
Fair value in the long-run as of observation date				
UAH per USD		**7.135**		
UAH per RUB		**0.271**		

Source: ICU.

Chart 43. ICU consumer basket value (US$)

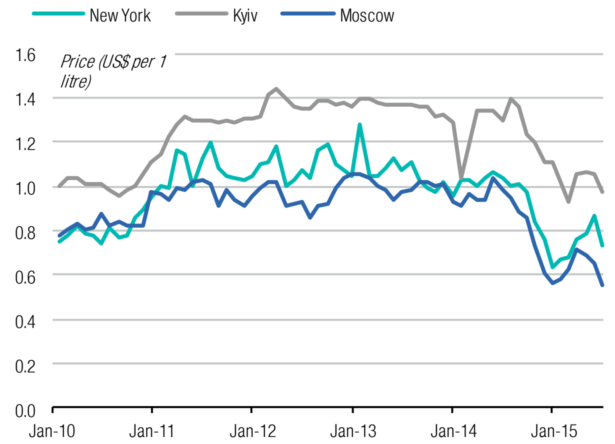
Price history February 2010 - August 2015



Source: ICU.

Chart 44. Gasoline A95 equivalent 1 litre (US$)

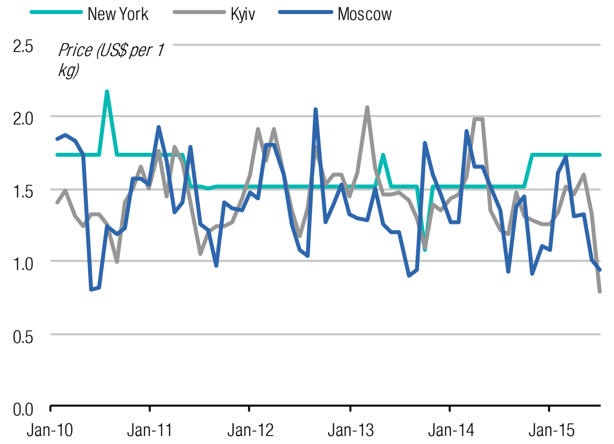
Price history February 2010 - August 2015



Source: ICU.

Chart 45. Fresh banana 1 kg bunch (US$)

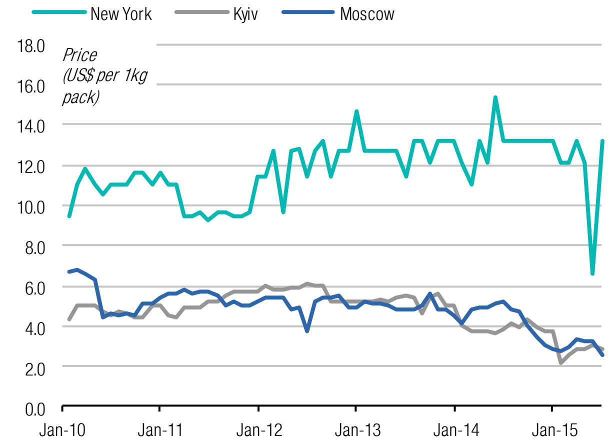
Price history February 2010 - August 2015



Source: ICU.

Chart 46. Chicken meat 1 kg pack of boneless breast (US$)

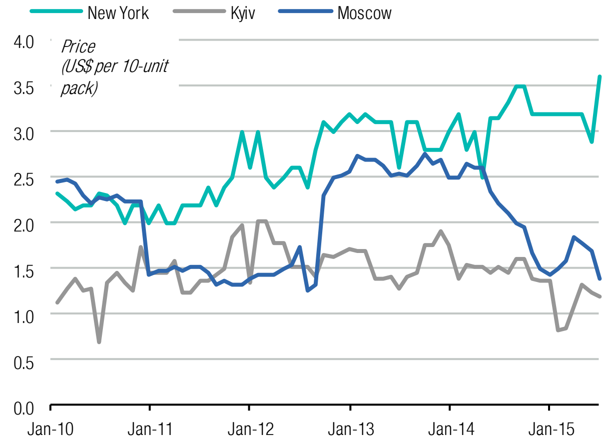
Price history February 2010 - August 2015



Source: ICU.

Chart 47. Chicken eggs 10-unit pack (US$)

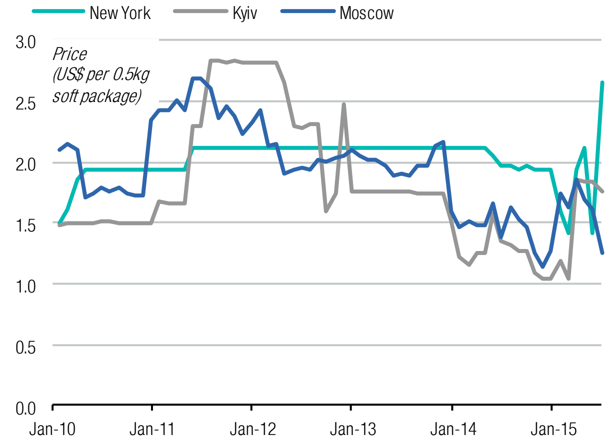
Price history February 2010 - August 2015



Source: ICU.

Chart 48. Pasta 0.5 kg soft package Italy-made (US$)

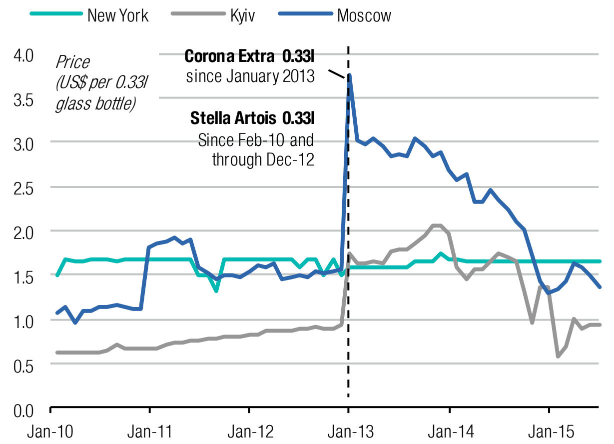
Price history February 2010 - August 2015



Source: ICU.

Chart 49. Beer Corona Extra 0.33 litre glass bottle (US$)

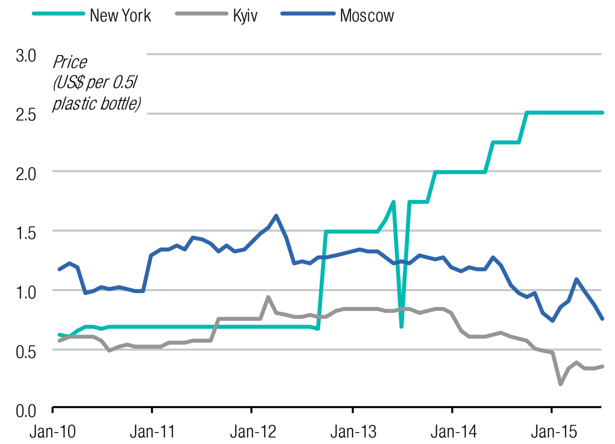
Price history February 2010 - August 2015



Source: ICU.

Chart 50. Coca-Cola 0.5 litre plastic bottle (US$)

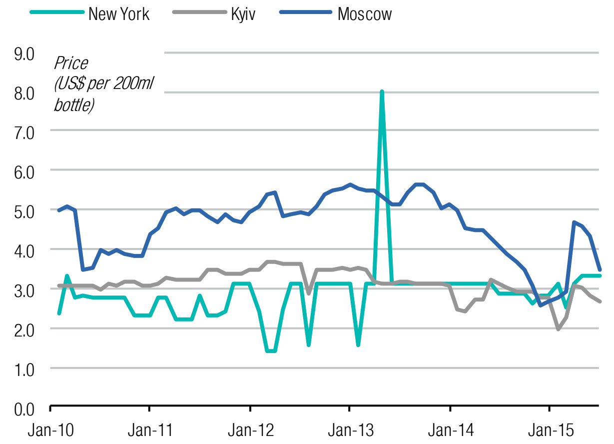
Price history February 2010 - August 2015



Source: ICU.

Chart 51. Shampoo 200ml bottle Head & Shoulders (US$)

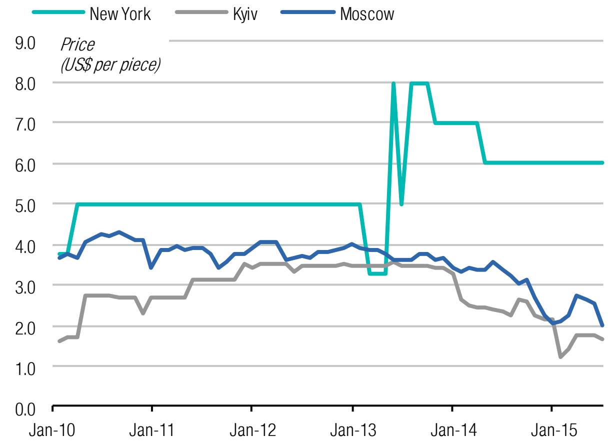
Price history February 2010 - August 2015



Source: ICU.

Chart 52. Magazine *Men's Health,* A4 format (US$)

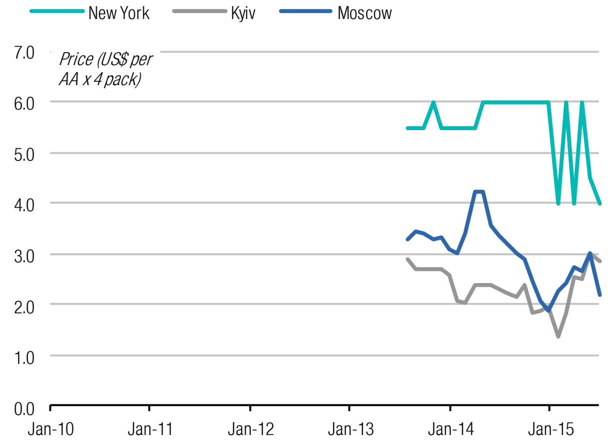
Price history February 2010 - August 2015



Source: ICU.

Chart 53. Duracell batteries (AA x 4 pack) (US$)

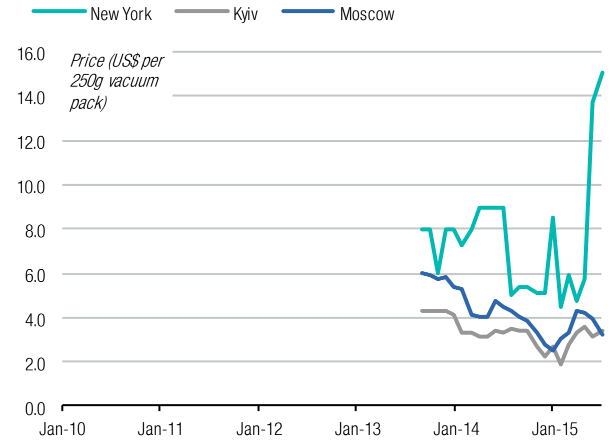
Price history February 2010 - August 2015



Source: ICU.

Chart 54. Jacobs Monarch coffee, 250 g vacuum pack (US$)

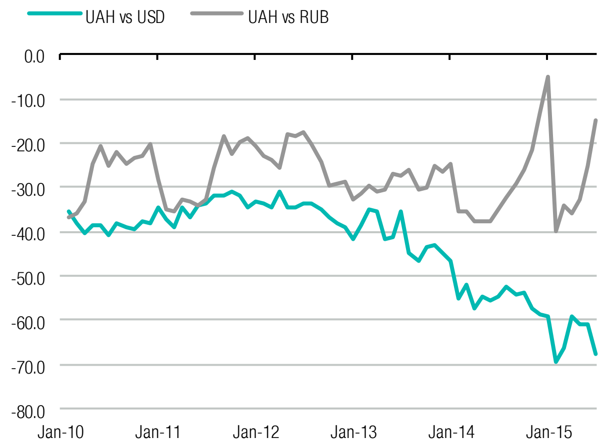
Price history February 2010 - August 2015



Source: ICU.

Chart 55. Value gap of ICU basket in UAH vs. USD and RUB (%)

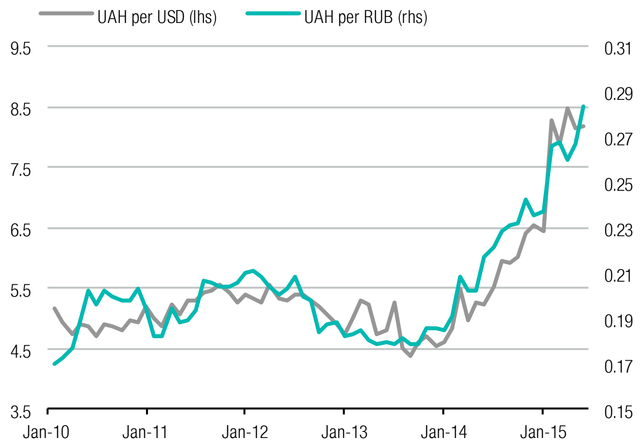
Price history February 2010 - August 2015



Source: ICU.

Chart 56. An exchange rate level of UAH per USD and UAH per RUB, which would eliminate the value gap of ICU basket

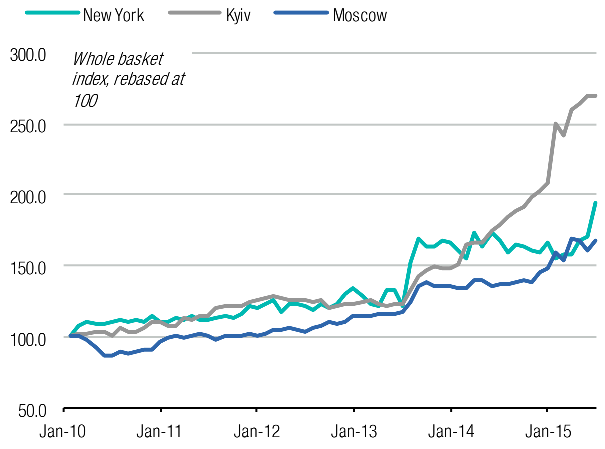
Price history February 2010 - August 2015



Source: ICU.

Chart 57. Index of the ICU consumer basket value in local currency (points, rebased at 100 as of February 2010)

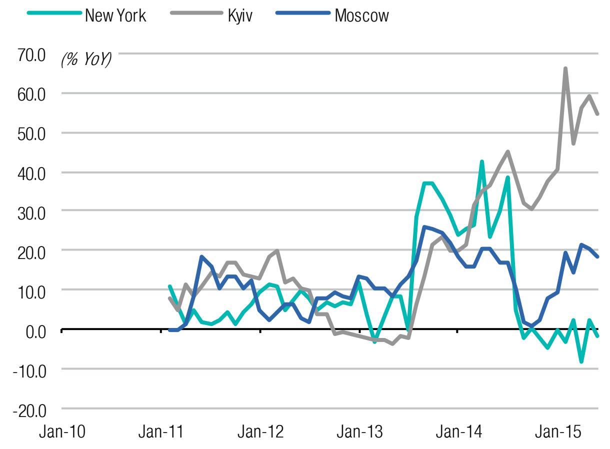
Price history February 2010 - August 2015



Source: ICU.

Chart 58. Growth rate of the index of the ICU consumer basket value in local currency (% YoY)

Price history February 2010 - August 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

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

WEB www.icu.ua @ICU_UA

CORPORATE FINANCE

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

Roman Nikitov, ACCA Director
roman.nikitov@icu.ua

Ruslan Kilmukhametov, Director
ruslan.kilmukhametov@icu.ua

Ivan Shvydanenko, Vice President
ivan.shvydanenko@icu.ua

Yuriy Kamarytskyi, Vice President
yuriy.kamarytskyi@icu.ua

Ruslan Patlavsky, Vice President
ruslan.patlavsky@icu.ua

STRATEGY AND CORPORATE DEVELOPMENT

Vlad Sinani, Director
vlad.sinani@icu.ua

SALES AND TRADING

Konstantin Stetsenko
Managing Director
konstantin.stetsenko@icu.ua

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

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

Liliya Kubytovych
Asset Management Product Sales
liliya.kubytovych@icu.ua

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

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

RESEARCH DEPARTMENT

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

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

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

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

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

Lee Daniels, Rolfe Haas
Editors

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

DISCLAIMER

Additional information is available upon request.