Focus
Ukraine

Scope
Economics

Analyst
Alexander Valchyshen

Quarterly Report

The patched road to reconstruction

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READ FIRST THE DISCLOSURES SECTION FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

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Executive summary

Below is a brief overview of our base case scenario of Ukraine's economy for rest of 2016 and 2017-18.

The economy: Growth momentum built in 2H15 receded in 1H16, amidst small fiscal stimulus. Based on our reading of key economic-sector performance statistics, the economy again experienced recessionary conditions in the first half of 2016. Real GDP contracted 0.7% in 1Q in seasonally adjusted, quarter-on-quarter, non-annualised terms (QoQ SA). In 2Q, according to official statistics, the economy rebounded by 0.6% QoQ SA, and, hence, escaped technical recession. In the first quarter of 2016, government reduced its consumption by 2.0% in QoQ SA terms after two previous quarters of expansion in spending. Amid weak household consumption and weak fixed investments, this restrained a potential recovery in very early 2016, and economy stumbled. In the second quarter, fixed investments rebounded by 9% QoQ SA after contracting in 1Q. Household consumption, which has been gradually recovering, was a bit stronger, and this propped up the economy over 1H16. In our view, PM Groysman's new government that assumed power in early 2Q has been moving toward a looser fiscal stance by spending slightly more actively than did the previous government. One key feature of Groysman's pro-growth fiscal stimulus has been the broad launch of civic road repairs that can be seen by all. Groysman's government is likely to continue such projects in 2H16 (and in 2017 as well). However, this stimulus is relatively small, as it is limited by the size of deficit allowed under current state budget law and also under the IMF programme. As was noted above, performance of the economy in 2H16 depends on further fiscal support—budget expenditures are set to increase in nominal and real terms both versus 2H15 and versus 1H16—as well as on whether recovery in household consumption and fixed investments takes hold. After a sluggish first half, we expect a more vibrant second half of the year, which would allow real GDP growth of 1.6% YoY for full-year 2016.

Fiscal balance: A turnaround from previous tight stance. The government has been relaxing the super-tight fiscal stance adopted by the previous cabinet, which had run a primary surplus of 2-3% in 2015 and 1Q16. During 2Q16, the consolidated state budget, excessive primary surplus fell to 2%. It is likely to be lower in 3Q16 and remain within the 0-0.5% range at the end of 2016 and continue at the same level through 2017-18. Given real GDP growth, even at our modest forecast, and a GDP deflator in the high single-digit area over 2016-18, public debt is set to decline gradually, as borrowing costs for the government are projected to slide thanks to low inflation and lower NBU key lending rates. As of the end of 1H16, public debt—comprised of local debt held by the central bank—was at 81%. It should decline to 80% by year-end and decline further during 2017-18 to 76-78%.

Cooperation with the IMF. IMF financing was resumed this September. It had been stalled for nearly a year, which had raised concerns over authorities' willingness to proceed within the IMF's guidelines. Despite the prolonged delay, the Groysman government has made the most vital step required to unlock the tranche flow: in April it raised regulated tariffs, which should appear in households' utility bills later this fall. At end 3Q16, a US$1bn tranche from the IMF is scheduled to be added to FX reserves (booked in NBU's accounts), which will be followed by a US$1bn, US-backed Eurobond issue (booked in the accounts of Ukraine's government). The government's eventual push for IMF funding was motivated by, among other reasons, a drop of its FX balance: as of July it was as low as US$1.3bn, a volume of FX that could only cover future government's external debt due through December and no more, and then only if the government had stopped borrowing FX from local banks (currently only entities wishing to exchange their own FX deposits for FX claims on own government). In our view, the IMF's next tranche will arrive next year, as required conditions (pensions system reform) will face what has become a ritual of delay.

Money in Ukraine's economy: Persistent debt deflation should reverse in 2H16. Bank lending was still very sluggish in 2Q16, as the flow of credit to the non-government (private) sector was still negative in 2Q. Moreover, credit contraction was even stronger in 2Q compared with the previous quarter (see Chart 49, p.33). The debt-deflation trend that began in 1Q14 has subsided, but it remains resilient. Although the economy has contracted, the gradual reduction of the NBU's refinancing rate should lower general lending rates and induce businesses to borrow. We expect private-sector credit to expand, helping the poor growth, eventually halting the 2.5-year trend of credit contraction.

Inflation & hryvnia interest rates: More NBU policy rate cuts ahead. Despite rapid disinflation in 1H16, headline CPI is set to edge higher in 2H16 after slowing to 7% this summer; it should end this year a bit below the 12% target set by the central bank. We attribute such a fast pace of disinflation over past year to weak domestic demand, which is likely to recover rather slowly, hence, the central bank is more likely than not to hit its inflation target of 8% set for next year. With the key policy rate currently at 15.0%, the NBU is expected to cut the rate further because of the following: (1) there is social, political pressure on the authorities (government as well as central bank) to turn around the economy rapidly after a lengthy recession, and lowering hryvnia borrowing costs would aid in this desired outcome, and (2) despite the rate cuts made over 9M16, the NBU has paid to banks (via increasing their reserves with central bank) a total of UAH8.6bn through instruments aimed at draining excess liquidity, which is more than UAH7.8bn paid over full year 2015 (p.32). This would put the NBU at risk of greater public scrutiny and subject it to criticism that it engaged in excessive, unproductive money creation.

External balance: Tight current-account balances expected in 2016-18. Based on a weaker global economy and global trade (see "Global trade conditions indicate deflationary bias", p.7) as well as domestic weakness, our trade projections yield a current-account deficit of less than 1% of GDP, enabling authorities to accumulate FX reserves given the slow-paced fulfillment of the IMF program in 2016.

UAH view: Current forecast eyes softer hryvnia weakness than previous forecast. This is based upon our real, trade-weighted analysis of two factors: (1) faster-than-expected disinflation caused by weak demand, and (2) US economy underperforming (with real GDP growth about 1% SAAR) for the third consecutive quarter through 2Q16. We forecast a UAH/USD rate at 27 as of the end of 2016, up from 288 (details are in "View on UAH: Again upward revision vs. previous call" on p.34 and "Quarterly forecast for 2016-18, base case scenario" on p.39).

Geopolitics & domestic politics

Despite routinely tense domestic politics, PM Groysman's government should continue through 2017 and resume the IMF programme. Russia will continue its occupation of Crimea and parts of Donbas through 2018.

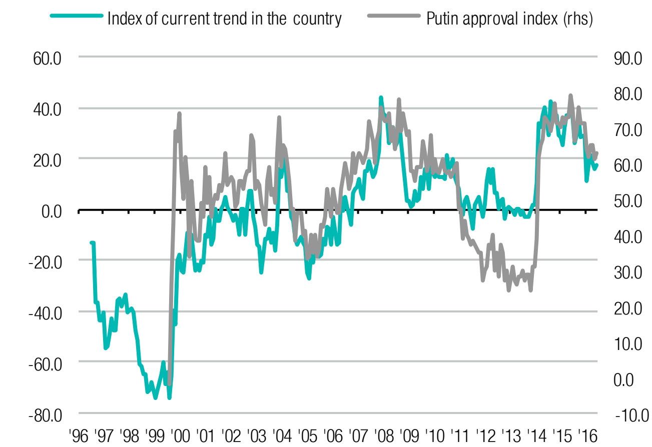
Minsk-2: Kremlin military posturing to continue

The *de-facto* control by the Russian military and state security services of Eastern Donbas should remain unresolved through 2018. The implementation of the Minsk-2 agreement has failed so far, because parliament refuses to legally acknowledge the self-proclaimed 'republics' and the Kremlin refuses to withdraw its military from the border. The occupied parts of Donbas are beginning to resemble the Transnistria enclave, also controlled by the Russian military, implying that they are *de-facto* lost and will be excluded from Ukraine's official statistics and economic metrics.

The Kremlin never planned to fulfil Minsk-2. This recent foreign intervention was merely meant to bolster Putin's approval index. Despite its success, Russian public sentiment (in regard to general social and consumer conditions) has plummeted quite noticeably over the past two years from the highs of late 2014-early 2015. We expect the Kremlin to reverse the current negative sentiment over domestic economic difficulties by resuming its foreign interventions of the occupied territories to fuel Russian nationalism.

Chart 1. Russian public view on current domestic developments* versus view on Putin's leadership**

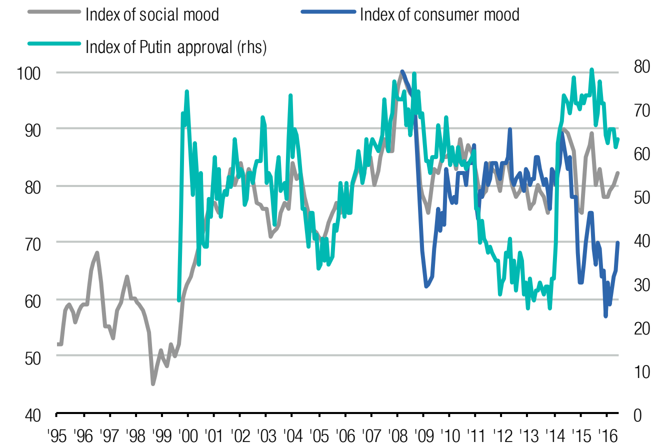
Monthly history from January 1996 through June 2016



Note: * difference between those who approve the current developments and those who disapprove them; ** difference between those who approve Putin and those who disapprove him. Source: Levada.ru

Chart 2. Russian public opinion of Putin* versus social and consumer sentiment

Monthly history from January 1995 through June 2016



Note: * Index of Putin approval – difference between those who approve Putin and those who disapprove him.
Source: Levada.ru

Ukraine's domestic politics: Team Poroshenko to avoid early elections in 2017

Team Poroshenko, a loose grouping of lawmakers and government officials that support President Poroshenko, should sustain the current parliamentary coalition of parties and the PM Groysman administration as long as possible, thus avoiding early elections in 2017 (as they were avoided in 2016).

The Groysman administration has immunity from a no-confidence vote through April 2017. While domestic political risks have not subsided, particularly as two ex-companions, the Tymoshenko Bloc and Radical Party, remain its fiercest critics, the opposition is manageable.

In regard to the IMF programme, Team Poroshenko is more likely to resume IMF reforms rather than abandon them despite the opposition.

Global economy

The post-Brexit environment provides evidence that the recovery, even in the developed market economies, has failed to meet the wider social needs of the respective societies. Moreover, in the emerging market economies, the still ongoing adjustments are creating fertile soil for renewed political risks. All in all, the Eurozone is now the weakest area of the global economy. We expect commodity prices to remain generally calm over next 6-12 months, recovering just modestly through 2018.

Global trade conditions indicate deflationary bias

Global trade volume grew 0.6% in April from the previous month, according to the CPB World Trade Monitor[1] April 2016, after it had contracted by the same amount in March 2016. In year-on-year terms, global trade volume rose 1.4% in April, the fastest rate of expansion since August 2015 and the last nine-month period. However, the current pace of global trade expansion fades in comparison with rates seen in 2009-2015, or post Global Financial Crisis (GFC), and before it, i.e. in 2002-2008. See Chart 3, p.10. This performance underlines the stagnation in which global trade occurred after adjustments seen over 2015 in the economies that used to depend on commodities and external demand.

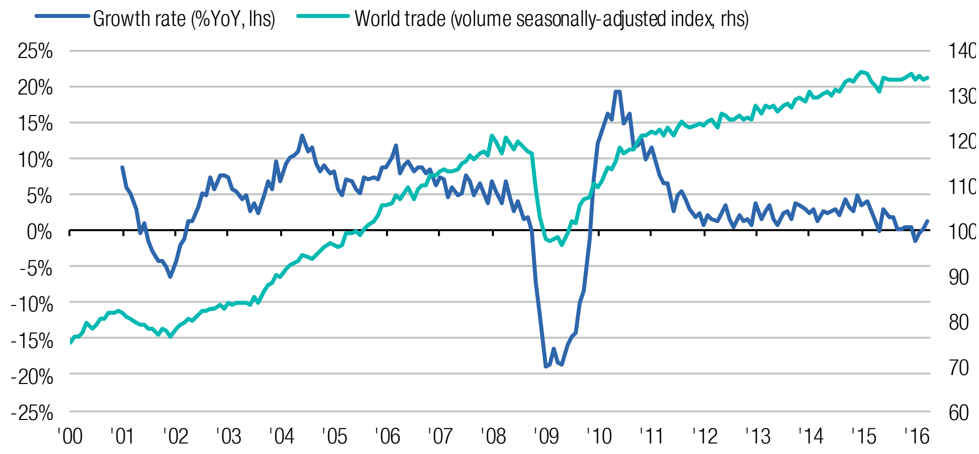
Going forward, we do not expect a repetition of the buoyant recovery of 2010-12, but rather a continuation of the sluggish conditions over the rest of 2016 into early 2017. Reflecting the post-Brexit world, which happened to be a widely unexpected event to the financial markets, there is even more foundation that a slowing of the recovery in the UK, Japan, and the Eurozone's largest economies of Germany and France has taken hold[2]. We even argue in our Eurozone economy review (see section "Eurozone" p.19) that this economic area is becoming the next issue in global economy as the chronic underperformance of the non-core and highly indebted economies (aka the PIGS) feeds into the ECB monetary policy stance that eventually (albeit partially) supports a weak euro and German exports, eventually producing a larger German current account surplus, which was 8.5% of GDP as of end-1Q16 and representing an increase of one percentage point over the past twelve months.

[1] http://www.cpb.nl/en/figure/cpb-world-trade-monitor-april-2016

[2] This is in line with just issued outlook updated by IMF on global economy, for more details http://www.imf.org/external/pubs/ft/weo/2016/update/02/

Chart 3. Global trade*: volume size and year-on-year growth rate

Monthly history from January 2000 through April 2016



Note: developed and emerging economies. Source: CPB Netherlands Bureau for Economic Policy Analysis.

Chart 4 and Chart 5 on p.10 indicate that emerging markets underperformed in both imports and exports over 2015 and early 2016. These countries' demand for imported goods and services (as depicted by the grey line in Chart 4) has contracting since January 2015 through the latest reported period (April 2016), except for the summer of 2015 when EM imports as a whole were expanding at 0.4-0.8% YoY. In exports, emerging markets have been lagging behind developed market economies in terms of year-on-year growth most of the time since late 2014[3]. This underlines the reality of current macroeconomic conditions, where, in a post-Brexit world, expectations of weaker recovery in the key developed market economies have emerged at a time when emerging market economies have been weak, and they in many cases underwent painful devaluations of their own currencies partially in a bid to be more competitive and eyeing for bigger demand from DM nations.

Chart 4. Breakdown of YoY growth rate of global imports*

Monthly history from January 2001 through April 2016

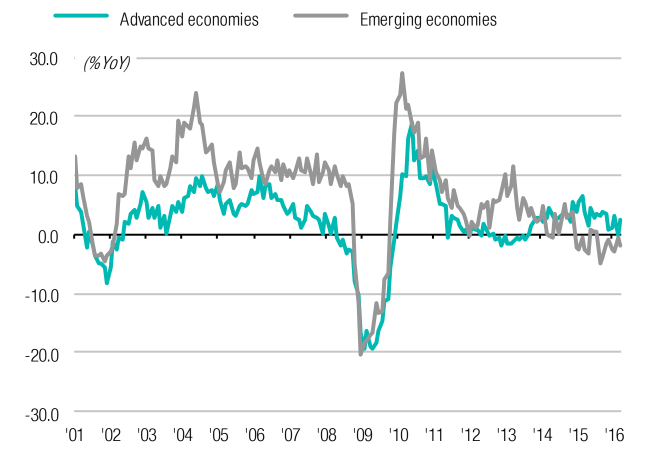
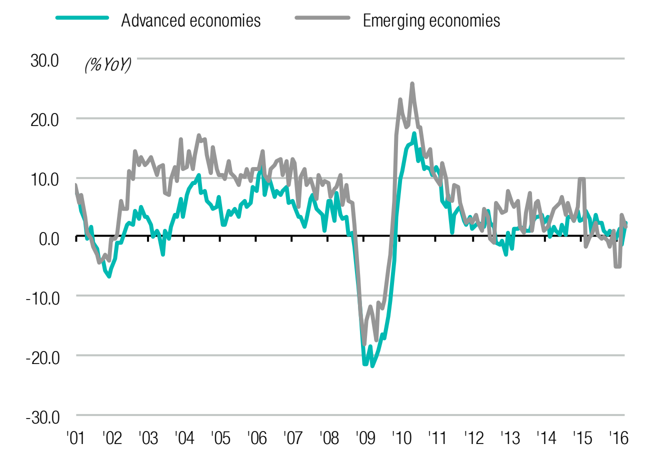


Chart 5. Breakdown of YoY growth rate of global exports*

Monthly history from January 2001 through April 2016



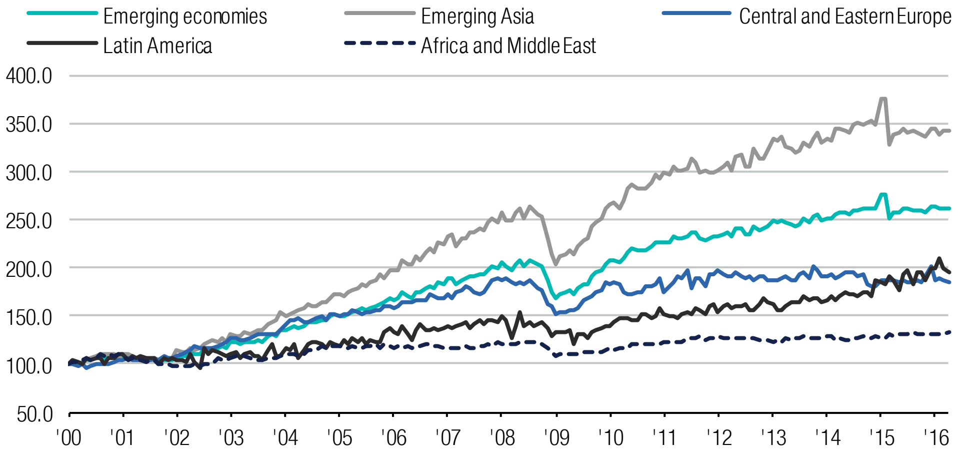
Note: developed and emerging economies. Source: CPB Netherlands Bureau for Economic Policy Analysis.

[3] Monthly history shows that the DM export growth rate was above the one experienced by EMs in 14 months out of the last 19-month period, starting October 2014 to April 2016. Source: CPB World Trade Monitor.

Global trade exports by emerging market economies (see the chart below) have shown a striking divergence in performance between the emerging nations of Asia and the rest of the EM universe. Although Latin American nations have stepped up the pace of export volume increases since 2013 while Asia's were rather flat, Central and Eastern Europe (CEE) has experienced nearly flat export growth since 2012. Russia, the largest economy in the CEE, has shaped the performance of the entire group.

Chart 6. Global exports by emerging economies: volume index (seasonally adjusted)

Monthly history from January 2000 through April 2016. Rebased at 100 points as of January 2000



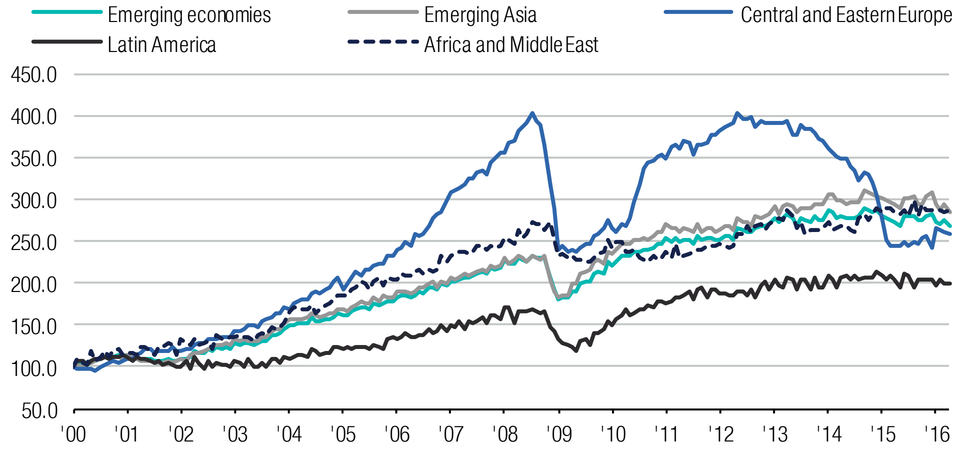
Note: Central and Eastern Europe – the group of countries that comprises Russia, Kazakhstan, Ukraine, Belarus, Armenia.
Source: CPB Netherlands Bureau for Economic Policy Analysis.

However, the next chart (see below) shows that Asia, Africa and the Middle East have been expanding their imports. As their domestic demand was relatively stable since the GFC, this development contrasts with the visible stagnation of domestic demand for imports by Latin America and the CEE region's sizable swings in the domestic demand for imports. Over the past ten-year period, CEE experienced two episodes of sizable expansion of domestic demand followed by sharp downward reversals: (1) in 2005-08 (peaking in summer 2008 just on the eve of the GFC), and (2) in 2011-12 (when commodity prices recovered helping oil-producing countries like Russia and Kazakhstan, imbuing a false sense of 'normality [of 2007-08 boom]' returning). During both episodes, the volume of imports peaked at an unprecedented 4.0x the level seen in 2000 before reversing.

However, the CEE economies experienced macro adjustments in 2014-15 via sharp devaluations of their currencies and the consequent collapsed domestic demand for imported goods and services. Now, the group's level of domestic demand for imports, as of April 2016 at 2.5x the 2000 level, is close to the demand levels of emerging Asia, Africa and the Middle East, and EMs as a whole at 2.3-3.0x. In comparison, Latin America's domestic demand for imports now stands at 2.0x the 2000 level (doubled).

Chart 7. Global imports by emerging economies: volume index (seasonally adjusted)

Monthly history from January 2000 through April 2016. Rebased at 100 points as of January 2000

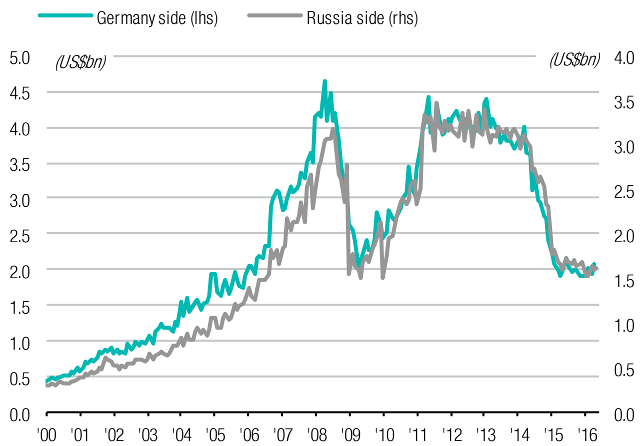


Note: Central and Eastern Europe – the group of countries that comprises Russia, Kazakhstan, Ukraine, Belarus, Armenia.
Source: CPB Netherlands Bureau for Economic Policy Analysis.

Going forward, the CEE, with Russia as the largest member economy, will never again experience a recovery in demand for imports that would retouch 4.0x the 2000 level. Instead, there is plenty of evidence that authorities of Russia and Kazakhstan as well as of Azerbajan, which is not accounted by CPB World Trade Monitor, all abandoned their FX policies of a tight peg (Kazakhstan, Azerbaijan) or heavily managed float (Russia). Instead, they adopted FX flexibility as a long-term monetary policy stance to reduce the unsustainable level of domestic demand for imports and prevent domestic demand from growing too much as occurred in the past when commodity prices peaked.

Chart 8. Russia imports from Germany as proxy Russia demand evolution (US$bn)

Seasonally-adjusted data. History from January 2000 through May 2016



Source: Bloomberg, Customs Service of Russia, ICU.

Chart 9. Growth rates of monthly imports by CEE countries* and Russia (%YoY)

Seasonally-adjusted data. History from January 2000 through May 2016

Note: * the group of countries that comprises Russia, Kazakhstan, Ukraine, Belarus, Armenia.
Source: CPB Netherlands Bureau for Economic Policy Analysis, Bloomberg, Customs Service of Russia, ICU.

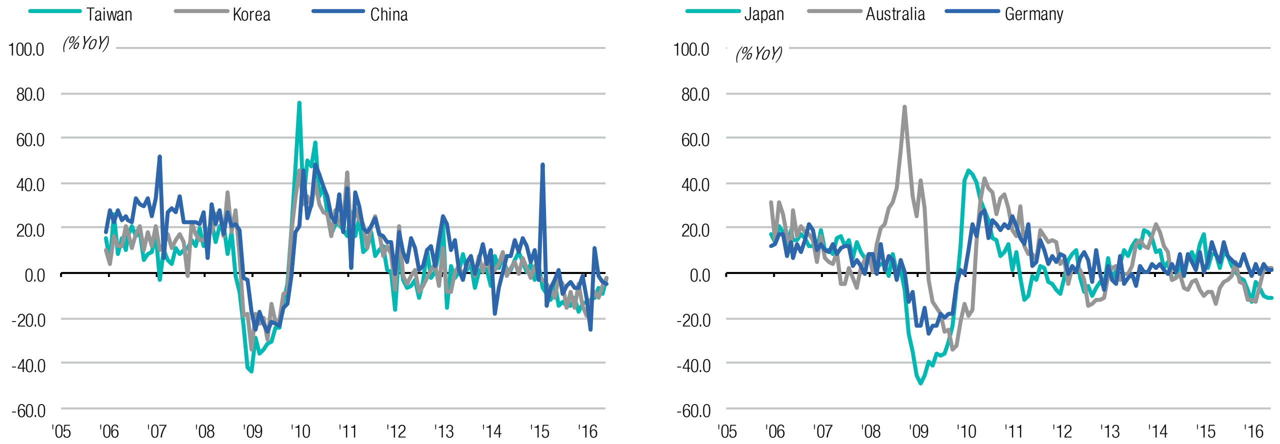
There are several insights that are relevant to Ukraine's economy. Russia's domestic demand, for example, is not going to expand sizably going forward. Historically one of the biggest buyers of Ukraine's produce, Russia staged trade wars with Ukraine that were both political and macroeconomic in nature. Despite a widely propagated view about Russia’s motivations, a plausible argument exists that if Ukraine and Russia resolve their conflict over Crimea and eastern Donbas, which were de-facto annexed by the Russian military, then Ukraine's trade flows could normalize as Russia resumes importing Ukrainian products.

We believe that Russian demand was reduced by a profound macroeconomic adjustment enabled by Kremlin authorities that will not return to peak demand levels seen in 2007-08 and 2011-12. Even under a best case scenario, where Ukraine and Russia politically agree to a mutual settlement of the military conflict, trade volumes would recover marginally at best.

The broader issue is of the current global economy being deflationary. Ukraine's main trading partners, namely the EU and CIS, with Russia as the largest player, are economically stagnant. In the EU, the euro crisis continues as evidenced by the following: the growing current account surplus of Germany and the negative yields of German government bonds; by the ECB's failure to hit its inflation target, its monetary policy stance that embraces negative interest rates, and the promise to continue QE through March 2017 or beyond, if needed. In Russia and throughout the CIS, recent recessions and sharp devaluations produced economies that brace themselves for a new reality of lower commodity prices and subdued future growth rates of the economy hat contrast dramatically with rebounds seen in the past.

Chart 10. Selected group of nations that are bellwether of global trade: percentage change over a year ago (%YoY)

Monthly history from January 2006 through June 2016



Source: Bloomberg.

The impact of the Brexit

Only a few days after the UK's national referendum on its EU membership, referred to as the Brexit, as a slim majority voted in favor of departing, there is a great deal of market and media guessing as to the UK's next move and its implications. The following is our take on the Brexit's impact on Ukraine's economy.

The Brexit's political economy

It is widely accepted that the Brexit was a protest vote against the immigrant crisis in Europe, Brussels' bureaucracy, and the ever-growing powers that the EU imposed on member states. We believe that this is just a part of the story. The backbone of the Brexit fundamentally signals that the slow-growth environment and fiscal austerity measures implemented by both EU member states and the UK have failed to resolve the nearly chronic issue of high unemployment and stagnant incomes. In macroeconomic terms, the UK's move provides little gain: it was not a full EU member and was sovereign in purely monetary terms. In theory, it may enjoy greater sovereignty over fiscal policy, foreign trade and immigration, but the UK's Conservative party-led administration has been adhering to an austerity stance from the very first day in office and does not differ from the fiscal stance propagated by Brussels' EU officials. In terms of fiscal sovereignty, the Brexit appears to be a pointless exercise. It may be different if the next general elections in the UK bring forward politicians that abandon austerity in favor of a more simulative fiscal policy, but this option is quite distant. In terms of foreign trade sovereignty, rising trade flows are far less likely than a growing tide of trade protectionism as domestic demand for goods is shrinking, rather than expanding, in many areas of the global economy. The same appears to be occurring in services as well. While global trade flows are anticipated to be recovering soon, the onset of this happening is repeatedly postponed. Because of this, over the short-term, the Brexit has much more of a political than a macroeconomic impact, but over the medium- to long-term, the Brexit has a further reaching impact that goes beyond the UK's borders.

The Brexit as a minor event uncovering bigger issues

The Brexit was more about British domestic economic dissatisfaction over employment and stagnant incomes than over the EU immigrant crisis and Brussels' "notorious bureaucracy that limits national sovereign powers". Following the GFC, growth rates have been sub-par and many nations continue to experience stagnant growth or endure multi-year recessions. Such a popular outburst of dissatisfaction amid poor economic conditions may spread to other countries if authorities allow referendum votes to occur. The *Financial Times* column by Wolfgang Münchau "Italy may be the next domino to fall" as of June 15 outlines Italy's referendum schedule which in October may produce yet another fracture within the EU[4]. On top of this, the core nations of the EU—Germany and France—are having general elections within the next fifteen months, with federal elections in Germany in October 2017 and the presidential election in France in May 2017.

In our view, general public dissatisfaction with post-GFC economic conditions is widespread. In the developed economies, elections and referendum votes allow the public to express their sentiment. However, in EM economies, authorities are more often accused of corruption (prime examples include Ukraine and Brazil, with Argentina as a less clear example of this) or they survive by exploiting nationalism and foreign military interventions (as exemplified by Russia's waging a military intervention into Ukraine's territories of Crimea and Donbas).

All in all, the Brexit underlines a post-GFC pandemic economic malaise. The UK's departure from the EU has created an internal (home-grown) shock to the economies which could be cured by more monetary policy remedies (low interest rates for longer, more QE if needed).

What financial markets tell us post-Brexit

The financial market reaction was particularly wild in the FX market as the British pound's nominal rate to the US dollar declined to a multi-year low of 1.32 early this week and recovered to 1.34.

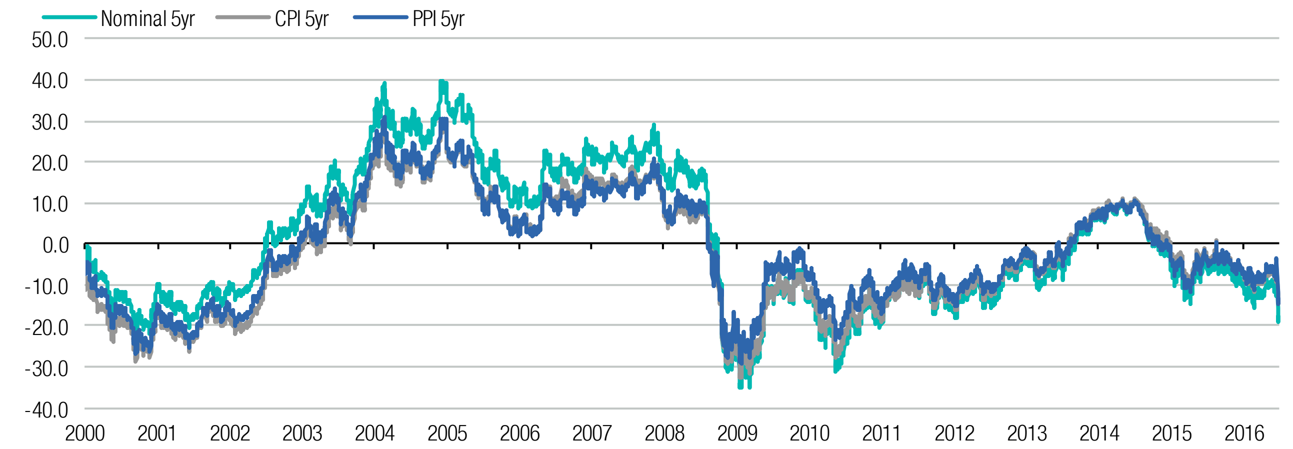
Our FX analysis of the British pound's performance based upon real trade-weighted indices says that the GBP's devaluation in the wake of Brexit was not dramatic (see chart below). In the past, GBP devaluations yielded by far greater misalignments – namely, from late 2000

[4] https://next.ft.com/content/009468b0-3b89-11e6-8716-a4a71e8140b0

and early 2001 years and over 2002, in late 2008 and early 2009, and in 2010. While there could be more FX market pressure on the GBP, it is unlikely to produce a greater misalignment by real TWIs than now. As Chart 8 and Chart 9 (on pp.6-7) show, the GBP's current misalignment is less than some EM currencies suffered over the course of 2014-15 when the USD strengthened on the back of expectations over monetary policy normalization by the US Federal Reserve. Quite noteworthy, the US dollar index (DXY) appreciated in the wake of the Brexit to 95 points, which is still not a dramatic move for the dollar as its important threshold of strength would be DXY appreciation above the 100-point threshold. We believe that if the DXY would have broken the 100-point threshold, it would become an emergency to the Fed. Hence, our base macro scenario does envisage the DXY at 100 or higher going forward.

Chart 11. ICU's real TWI-based analysis of British pound (GBP): misalignment of the currency*

Daily history from 1 January 2000 through 29 June 2016



Note: Difference between trade-weighted index and its five-year moving average. Source: ICU.

The sovereign bond market reaction to the Brexit was noteworthy, too. Despite credit rating agencies downgrading the UK government, yield declines underlined investors' demand for UK government bonds: the 2-year bond yield dropped as low as 0.10% on Thursday from 0.52% before the referendum; the 10-year bond yield declined to 0.86% from 1.37%. In the Eurozone, German bond yields also dropped, albeit into negative territory (see the charts below): its 2-year bond yield has been negative since late 2014, while its 10-year bond yield dropped below zero for the first time post-Brexit. This means that bond markets treat UK government debt as default-free and its economy as monetary sovereign – this stance will not change any time soon unless the UK loses its sovereignty in monetary terms (which is unrealistic). Hence, UK gilts should yield low single digit and even move closer to zero as the economic malaise persists. In the Eurozone, German bonds are considered to be default-free despite the fact that all EU member states are not monetary sovereign (but rather are subject to the ECB). However, the rest of the EU members, especially the so-called PIGS (Portugal, Italy, Greece, Spain), have no privilege of the German economy and hence their 10-year sovereign bond yields have a tendency to tilt up during economic shocks. However, ECB assurances that it would support the bond markets allow PIGS government bond yields to stay within the single-digit area, but the risk of macroeconomic conditions deteriorating further could push their bond yields higher again.

All in all, financial market sentiment indicates prevailing expectations that central banks (BoE, ECB, the Fed, BoJ, etc.) will provide liquidity support to their financial systems if needed. This may provide liquidity spillovers to EM FX by creating some appreciation pressure on them (especially on FX deemed as undervalued, see Chart 8 and Chart 9 on pp.6-7).

Macro issues remain

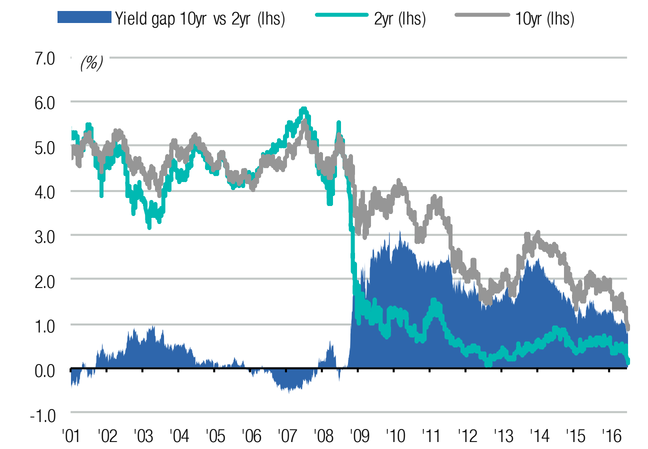
In our view, Brexit underlines the macro issues of the core Eurozone member states. While not sovereign in monetary terms, they are constrained by Brussels' fiscal rules. UK-related issues are minor in relation to the Eurozone. Its unemployment is low, like in Germany. While its current account deficit is too large, Germany's surplus is also too large (see Chart 6). The UK's trade balance is not a huge issue as its currency (GBP) is a natural buffer. In contrast, weak EU members with high unemployment rates recently turned their economies from external deficits (in terms of current account balance) to surplus economies. They achieved this via internal devaluations as sizable domestic demand contraction was highly painful for the public. Low growth is a more serious risk for the Eurozone than for the UK.

Ukraine: Low growth expected

For Ukraine, the Brexit marks sluggish economic conditions. Eurozone issues have particularly had an impact on Russia and Turkey which depend on trade flows from the EU. For Ukraine's economy, it will be quite difficult to grow higher than 3-4% in real terms going forward, which could be unfortunate for the holders of Ukraine's VRIs issued under the sovereign debt restructuring. The Brexit pushed key central banks (Fed, BoE, ECB, BoJ) for renewed cautiousness, implying that the USD is likely to weaken, which is positive for EM FX for the rest of 2016 and early 2017. Most likely, ICU will review its USD/UAH forecast for a slightly better hryvnia during the next macro update. Disinflation should take hold globally, including in EM economies, alongside low-growth trends and Ukraine's economy will experience the same. Hence, we expect UAH interest rates to decline gradually.

Chart 12. UK government 2- and 10-year bond yields (%)

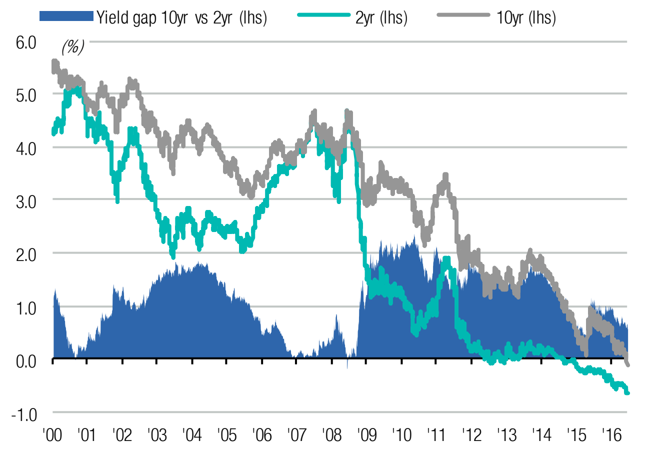
Daily history through 30 June 2016



Source: Bloomberg.

Chart 13. Germany government 2- and 10-year bond yields (%)

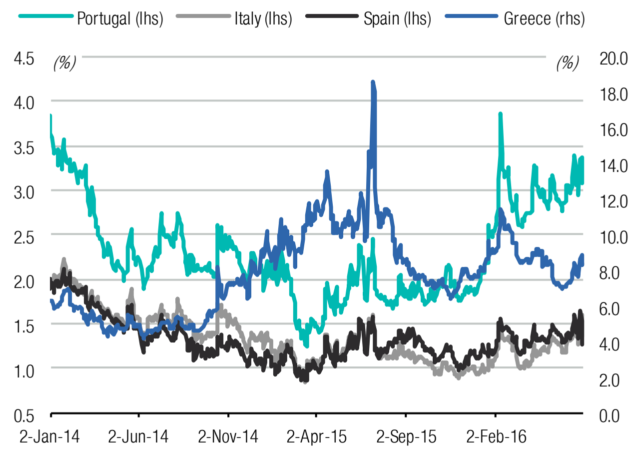
Daily history through 30 June 2016



Source: Bloomberg.

Chart 14. PIGS bond yield spread over German bond yield (ppt)

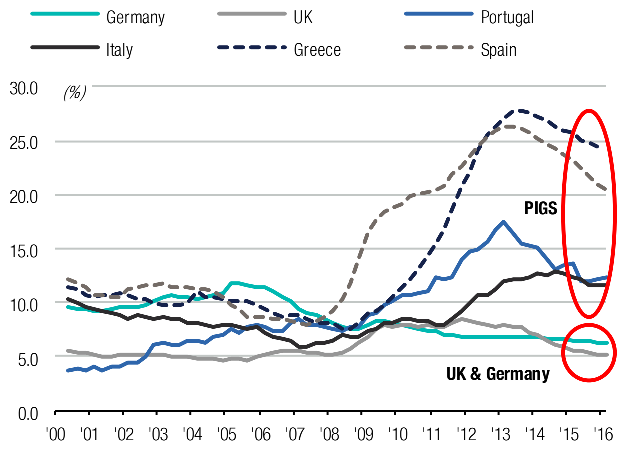
Daily history from 1 january 2014 through 30 June 2016



Source: Bloomberg.

Chart 15. Unemployment rate (%): PIGS vs. UK, Germany

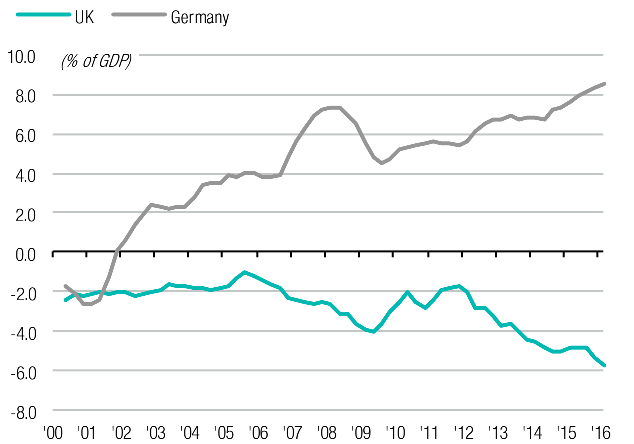
Quarterly data



Source: Bloomberg.

Chart 16. Current account deficits: UK vs. Germany (% of GDP)

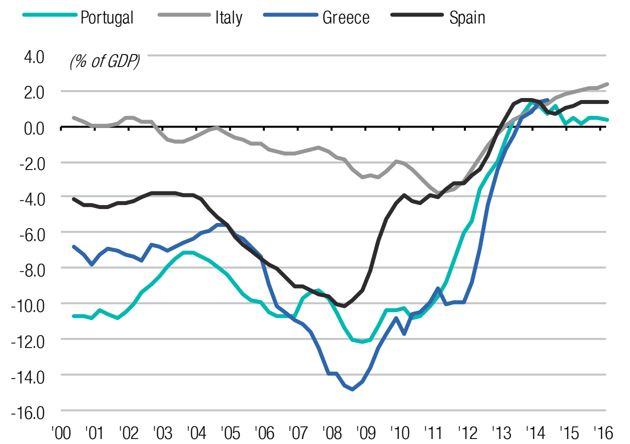
Quarterly data



Source: Bloomberg.

Chart 17. Current account deficits: PIGS (% of GDP)

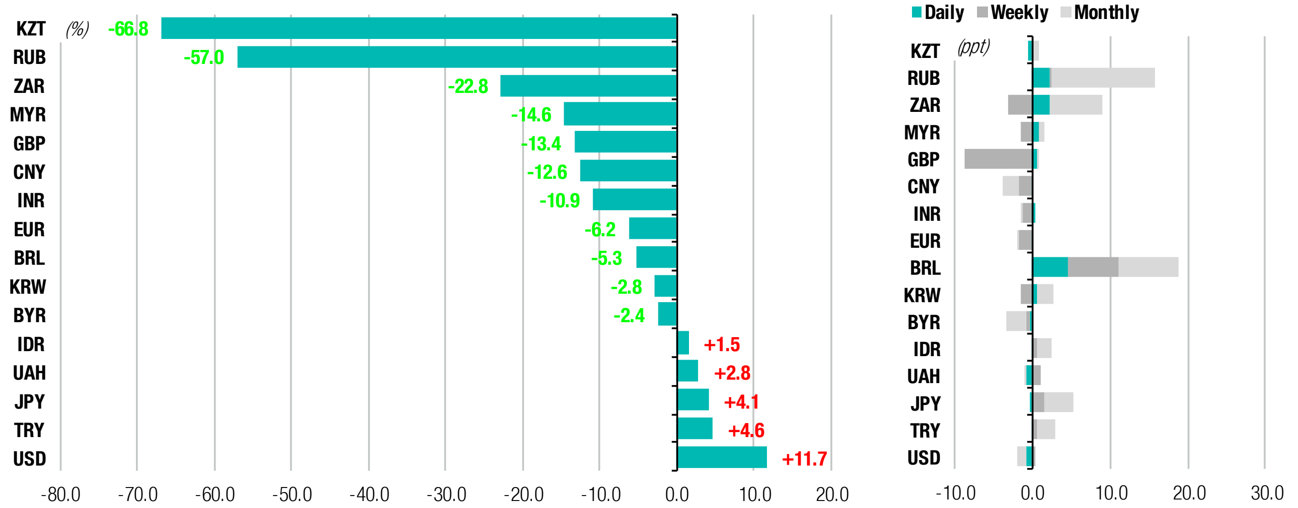
Quarterly data



Source: Bloomberg.

Chart 18. ICU's TWI analysis of the selected range of currencies

Data is as of 29 June 2016, data based on PPI-based real trade-weighted indices, see Table 1



Source: ICU.

Table 1. ICU's TWI analysis of the selected range of currencies

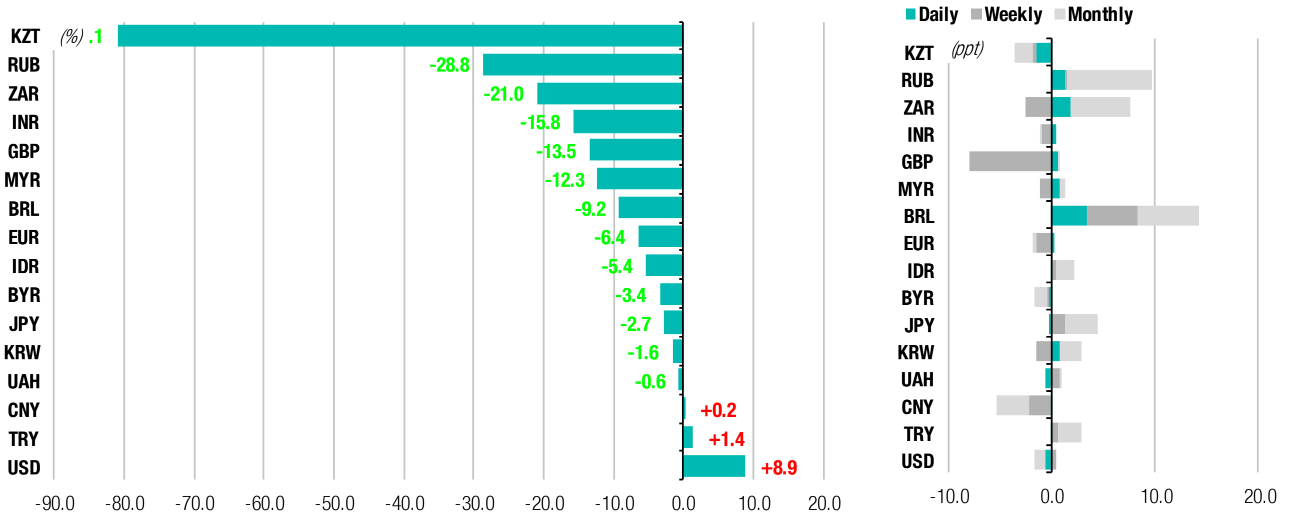
Country	Currency	Currency text ID	FX rate to US dollar	PPI-based misalignment of the currency as of 29 June	Daily[1]	Weekly[2]	Monthly[3]
United States	840	USD	1	11.70294	-0.73	0.42	-1.23
Turkey	792	TRY	2.89	4.613954	0.18	0.56	2.21
Japan	392	JPY	102.83	4.092657	-0.17	1.57	3.64
Ukraine	980	UAH	24.92	2.804787	-0.77	1.04	-0.01
Indonesia	360	IDR	13157	1.476243	0.17	0.45	1.97
Belarus	974	BYR	20041	-2.43171	-0.34	-0.48	-2.37
Korea, South	410	KRW	1160.04	-2.79432	0.76	-1.38	1.93
Brazil	986	BRL	3.2206	-5.34487	4.54	6.58	7.69
Eurozone	978	EUR	1.1125	-6.18395	0.30	-1.66	-0.24
India	356	INR	67.685	-10.9421	0.45	-1.20	-0.25
China	156	CNY	6.6368	-12.5768	0.06	-1.66	-2.14
United Kingdom	826	GBP	1.3429	-13.3599	0.66	-8.59	0.21
Malaysia	458	MYR	4.0405	-14.6312	0.91	-1.41	0.67
South Africa	710	ZAR	14.7927	-22.8209	2.29	-3.13	6.87
Russia	643	RUB	63.7187	-57.0371	2.25	0.25	13.32
Kazakhstan	398	KZT	339.25	-66.8479	-0.42	0.16	0.78

Notes: [1] daily change versus the value as of 28 June 2016; [2] weekly change less daily change; [3] monthly change less weekly and daily changes

Sources: ICU.

Chart 19. ICU's TWI analysis of the selected range of currencies

Data is as of 29 June 2016, data based on PPI-based real trade-weighted indices



Source: ICU.

Table 2. ICU's TWI analysis of the selected range of currencies

Country	Currency	Currency text ID	FX rate to US dollar	CPI-based misalignment of the currency: as of 29 June	Daily[1]	Weekly[2]	Monthly[3]
United States	840	USD	1	8.858416	-0.63	0.37	-0.99
Turkey	792	TRY	2.89	1.371059	0.17	0.53	2.10
China	156	CNY	6.6368	0.194934	0.05	-2.16	-3.11
Ukraine	980	UAH	24.92	-0.62026	-0.57	0.80	0.14
Korea, South	410	KRW	1160.04	-1.62789	0.83	-1.51	2.05
Japan	392	JPY	102.83	-2.69729	-0.13	1.30	3.11
Belarus	974	BYR	20041	-3.40292	-0.19	-0.26	-1.28
Indonesia	360	IDR	13157	-5.36795	0.14	0.38	1.67
Eurozone	978	EUR	1.1125	-6.39857	0.28	-1.56	-0.20
Brazil	986	BRL	3.2206	-9.16463	3.39	4.94	5.88
Malaysia	458	MYR	4.0405	-12.2783	0.74	-1.15	0.50
United Kingdom	826	GBP	1.3429	-13.5256	0.61	-7.90	0.20
India	356	INR	67.685	-15.817	0.42	-1.03	-0.01
South Africa	710	ZAR	14.7927	-21.0375	1.87	-2.55	5.66
Russia	643	RUB	63.7187	-28.756	1.35	0.20	8.10
Kazakhstan	398	KZT	339.25	-81.0717	-1.52	-0.38	-1.75

Notes: [1] daily change versus the value as of 28 June 2016; [2] weekly change less daily change; [3] monthly change less weekly and daily changes

Sources: ICU.

G4 economies: Eurozone as next concern despite resilient PMIs

Eurozone

In the post-Brexit environment, among the G4 economies[5] the Eurozone (excluding Germany) is the weakest spot. Subpar growth of the peripheral member economies further

[5] G4: USA, Eurozone, UK and Japan.

leads to public debt accrual and sustained high unemployment rates in the double-digits (Chart 15 on p.17 and Chart 22 on p.21). Recent PMI data for the Eurozone was upbeat indicating that the economy as a whole was expanding in July (Chart 20 and Chart 21 on p.21). However, the German economy's trade balance reaching a record surplus hides the issues of weaker members, like Italy's stagnant performance (see Chart 23 on p.21).

EU policymakers' current approach toward restoring health in the crisis-stricken economies of the EU and within the entire Eurozone via austerity is in itself deflationary. This makes the ECB's mandate to guide inflation towards 2% or lower over the medium term is increasingly difficult to implement. Rhetoric of German policymakers[6] signals that the Eurozone's prevailing policymaking stance will not change soon. It will not abandon the austerity imposed on the allegedly profligate nations of PIGS and fix the inefficiencies of the Eurozone's economic set-up. Instead, it will try to sustain the Eurozone's economy via a zero refinancing rate, a negative rate on deposits facility (-0.4%), and QE of EUR80bn/month through March 2017 or beyond[7].

Combined with the UK's economic deterioration due to the Brexit decision (detailed in the next paragraph), the euro has potential to weaken albeit not sizable one as it would result in further US dollar appreciation (beyond the 100-point threshold in terms of the DXY index). Such a move would cause a further imbalance among the already stretched FX valuations of currencies of these two largest global economies and eventually stall them. Hence, we project the EUR/USD to weaken to 1.00-1.05 over the next 12-months.

UK

In the UK, there is controversy over the Brexit's impact. The new government led by PM Theresa May reportedly stuck to a previous government pledge to achieve a zero state budget deficit by 2020[8]. Although this pledge in itself was applauded by the UK government the other day, most likely that UK economy, facing a "sharp downturn" due to the Brexit as revealed by July PMI data, saw the manufacturing and services purchasing managers' index fall from 52.4 a month ago to July's 47.7 points, hitting an 87-month low[9]. This fresh reading of the index indicates that 2H 2016 will be much weaker for the UK than the previous half of the year. As the Eurozone is the UK's largest trade partner, a sizable slowdown coupled with a balanced state budget approach would be deflationary to EU members that depend on UK demand. Hence, there has been a macroeconomic loop between the UK and EU that Brexit, where economic policies dealing with post GFC recovery (or rather low visibility of one) were quite similar[10], does not cue at all.

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[6] Read a *Wall Street Journal* op-ed "Resist the Siren Song of 'Cheap' Government Spending" 20 July 2016 by Dr. Ludger Schuknecht, chief economist and director-general for strategy, international financial monetary policy at Germany's Ministry of Finance, http://www.wsj.com/articles/resist-the-siren-song-of-cheap-government-spending-1469043140

[7] See https://www.ecb.europa.eu/press/pr/date/2016/html/pr160721.en.html

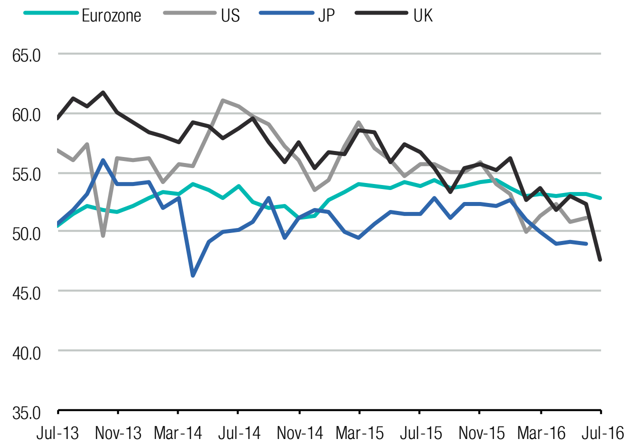
[8] Financial Times 20 July 2016 "Theresa May commits to a balanced budget" https://next.ft.com/content/df2160f6-4e76-11e6-8172-e39ecd3b86fc

[9] More details are here: https://www.markiteconomics.com/Survey/PressRelease.mvc/b68c3686a48c40198505b81e4e55cd81

[10] Both UK government and EU's officials have turned to austerity and pledged zero balance budget in order to keep public debt in check.

Chart 20. Composite PMIs* of G4 economic areas: Euro zone, USA, Japan and UK

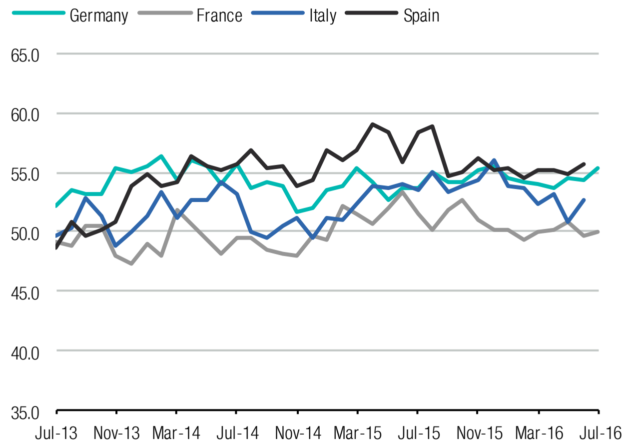
Monthly history from July 2013 through July 2016



Note: * a composite PMI for a nation is an aggregate of manufacturing and services PMIs. Source: Bloomberg.

Chart 21. Composite PMIs* of largest economies of Eurozone

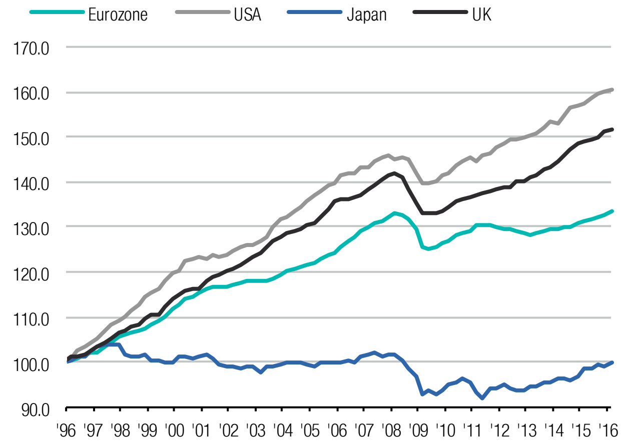
Monthly history from July 2013 through July 2016



Note: * a composite PMI for a nation is an aggregate of manufacturing and services PMIs. Source: Bloomberg.

Chart 22. Real GDP index of G4 economic areas: Euro zone, USA, Japan and UK

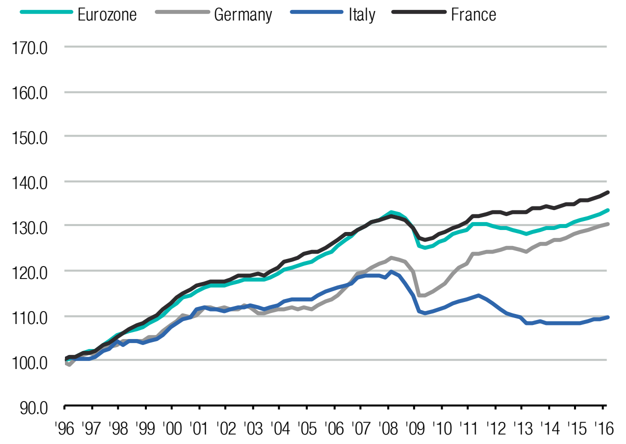
Quarterly history from 1Q of 1996 through 1Q of 2016



Source: Bloomberg.

Chart 23. Real GDP index of largest economies of Eurozone

Quarterly history from 1Q of 1996 through 1Q of 2016



Source: Bloomberg.

US

In the US, there is still a case for another Fed decision to raise its policy rate by 25bp to 0.75%, most likely in September. Following this, the Fed's interest policy stance should remain unchanged at least through mid-2017. The economy has picked up after a slowdown seen in 1Q16 as two major providers of high-frequency GDP trackers of the US economy, the Atlanta Fed[11] and New York Fed[12], see 2Q16 growth at 2.4% and 2.2%, respectively.

With economic issues present within the EU as well as Japan, and an evident and managed slowdown of China—these are all major trading partners to the US outside of the

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

[12] See https://www.newyorkfed.org/research/policy/nowcast

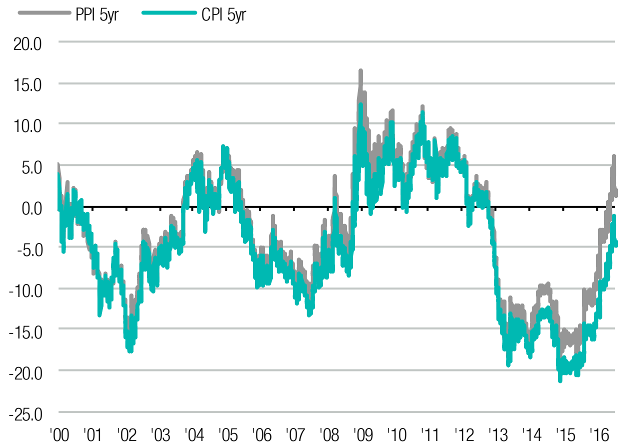
Americas—there is a serious risk that the recent rebound in the dollar value (as measured by DXY) may last for a while and result in a dollar appreciation trend through 2H16.

Japan

As Chart 22 on p.21 shows, the economy has been recovering from the GFC slump albeit it is still well below the pre-2008 size. One of the key elements of the 2012-15 recovery was the impact of ultra loose monetary policy that produced as a by-product a weaker JPY. The currency weakness was eliminated over 1H16 due to JPY's sharp appreciation, which in its turn was inspired by financial market perception that the US slowdown in 1Q16 was a quite serious matter. As of now, when the US economy has passed the slowdown phase and aims at a growth rate of slightly over 2% YoY in 2016, the JPY could experience a new episode of undervaluation following the severe devaluation of 2012-15. The JPY could weaken to 110-120/USD over the next 6-12 months.

Chart 24. JPY misalignment* as measured by ICU in-house real trade-weighted analysis

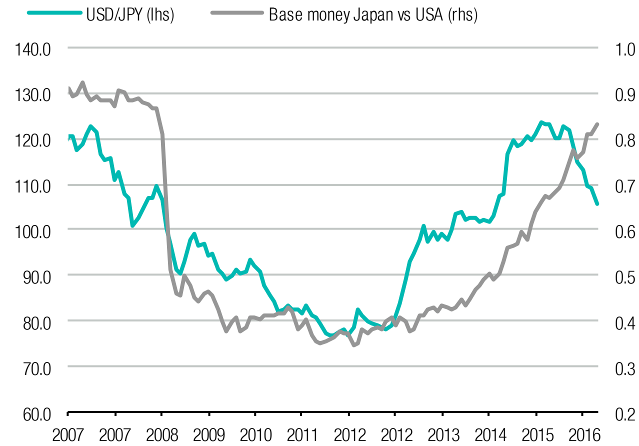
Daily history from 1 January 2000 through 24 July 2016



Note: * difference between JPY's CPI- or PPI-based real trade-weighted index and five-year rolling average of the index. Negative values mean undervaluation of the currency, while positive ones mean overvaluation. Source: ICU.

Chart 25. Monthly history of JPY FX rate* against the background of relative size of banking reserves in Japan vs USA**

Monthly history from January 2007 through June 2016



Note: * USD/JPY (left axis); ** banking reserves – reserves held by banks on their accounts in the central bank. Source: Bloomberg, ICU.

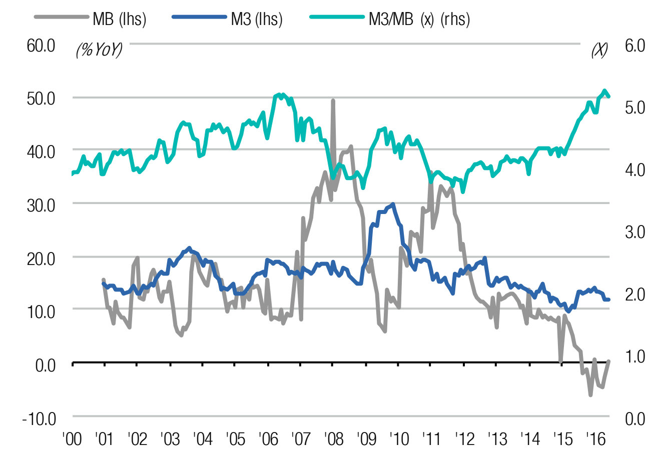
BRICS economies: A diverse picture

China

The Chinese authority-managed macroeconomic adjustment is exemplified by the slow and persistent devaluation of the local currency in real trade-weighted terms, which is deemed to be pro-growth. At the time of managed real devaluation of the currency, authorities are sustaining demand in the economy via continued money supply expansion that runs well above 10%, according to the most recently available data of June 2016, while base money growth has been restrained since mid-2015 for the first time since 2000, when available data starts (Chart 26, p.23). Hence, domestic credit availability is the key to sustaining a smoother (hence, lasting) transition of the Chinese economy from investments and exports towards more consumption. Moreover, the Chinese currency is no more dear by our metrics both in CPI and PPI-based terms (Chart 27, p.23). Concerns about devaluation risks early this year were overly critical and are likely to subside going forward, allowing financial markets to re-focus their concerns from a Chinese slowdown toward the negative spillover effects that the managed weakening of the CNY would have on other EM economies. Still, we project the CNY to hit 6.8-6.9/USD over the next 6-12 months.

Chart 26. Growth rate of key monetary aggregates, base and broad money (MB and M3, left axis), and base money leverage* (right axis) in China

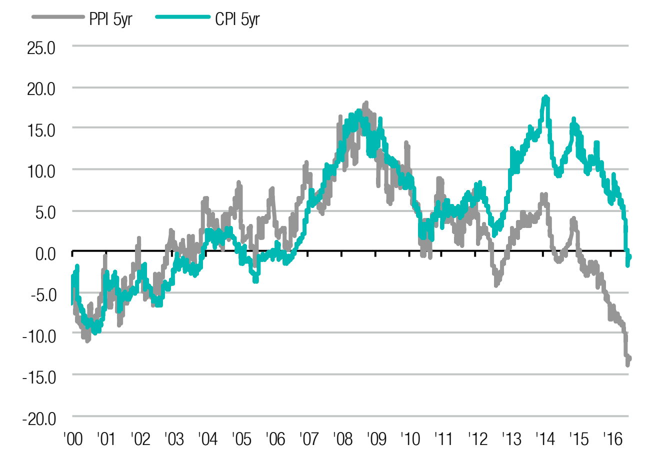
Monthly history from January 2000 through June 2016



Note: * coefficient of broad money to base money, which measures banks' ability of leveraging reserves into earning assets (loans). Source: Bloomberg, ICU.

Chart 27. CNY misalignment* as measured by ICU in-house real trade-weighted analysis

Daily history from 1 January 2000 through 25 July 2016



Note: * difference between CNY's CPI- or PPI-based real trade-weighted index and five-year rolling average of the index. Negative values mean undervaluation of the currency, while positive ones mean overvaluation. Source: ICU.

Russia

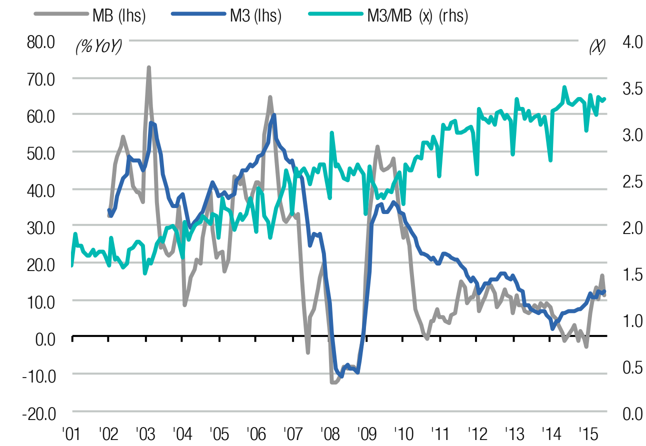
In Russia, the economy is likely to proceed with a recession this year before staging a modest recovery next year. We largely retain our previous call made in May's *Quarterly Report* "A quiet recovery"[13] that this year's recession is to be larger than 1% and now estimated at 1.3% YoY, followed by a recovery of 1.5% 2017. Our "static" stance on this economy stems from the observation of its established mode of economic policymaking. Due to the prolonged slowdown in 2012-15 of the Russian economy, the entire region that borders the country (the CIS or ex-Soviet Union nations) was affected via slower growth of exports or—in the case of Ukraine—via an outright trade war that imposed punitive measures on some imports entering Russia's market. Moreover, as Russia had been sliding into an imminent recession over several years, its leadership turned to the military and intelligence apparatus (with the annexation of Crimea and Donbas invasion in early 2014) to consolidate public support that had faltered already at that time. During most of 2016, the Kremlin's approach to policymaking was deflationary (quite similar to the approach championed by the UK and Germany) as state budget spending cuts mounted on the devalued currency, resulting in a severe recessionary trend within the CIS since late 2012-early 2016. We doubt that there will be any meaningful change in Russian politics after parliamentary elections this September. The result is largely predetermined. There are ongoing talks in the Kremlin of finding a new economic model for Russia that would create a fast-growing economy. However, the Kremlin fears the risk of trying an outright new model that could fail and result in public discontent. More likely, the Kremlin will compromise by implementing half-measures in economic policymaking only to prolong the already static economy. Although we remain skeptical of Russia’s economic prospects, the RUB could enjoy flexibility in the FX markets. Given the elevated level of inflation in Russia, the RUB is projected to erase its current (and quite sizable) competitiveness fairly quickly (by 2H of 2017) because its main trading partners (the Eurozone and China) are projected

[13] Published on 24 May 2016 (https://www.icu.ua/download/1621/ICUQtlyReport-20160524.pdf)

to have a far lower level of domestic inflation relative to Russia's. We see the RUB hitting 65-70/USD.

Chart 28. Growth rate of key monetary aggregates, base and broad money (MB and M3, left axis), and base money leverage* (right axis) in Russia

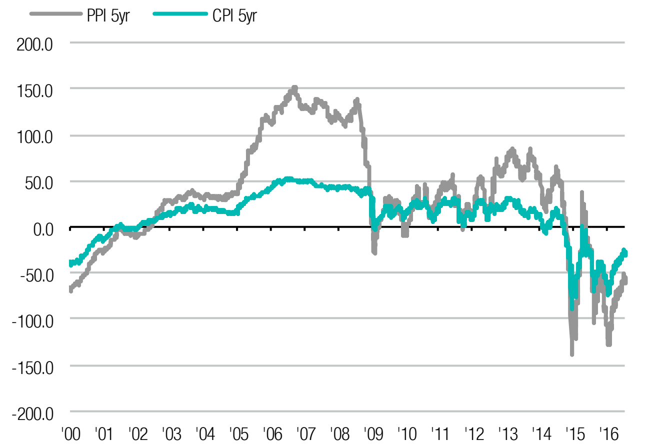
Monthly history from January 2000 through June 2016



Note: * coefficient of broad money to base money, which measures banks' ability of leveraging reserves into earning assets (loans). Source: Bloomberg, ICU.

Chart 29. RUB misalignment* as measured by ICU in-house real trade-weighted analysis

Daily history from 1 January 2000 through 25 July 2016



Note: * difference between CNY's CPI- or PPI-based real trade-weighted index and five-year rolling average of the index. Negative values mean undervaluation of the currency, while positive ones mean overvaluation. Source: ICU.

Key indicators vital for Ukraine's economy

Growth assumption

Our global growth assumptions are based upon IMF projections from the July 2016 update of the World Economic Outlook[14]. This year's world output is seen at 3.1% YoY instead the previously thought 3.2% YoY real increase. Next year's was lowered to 3.4% YoY from 3.5%. For 2018, we forecast a 3.5% YoY increase. As far as Russia is concerned, our projection is largely retained from previous publication (as discussed in section "Russia" on p.23).

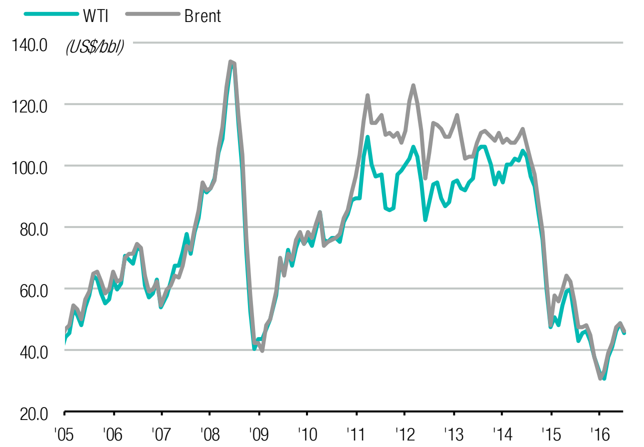
Commodities

In our previous Quarterly Report, we explained that the commodity rally was about to fade followed by a period of stabilisation. In general this was correct, as prices for crude oil and steel declined recently (post-Brexit), see charts below. Going forward, we reiterate that commodity prices should recover only mildly with no steady rally. See details on the commodity price projections on the table on the next page.

[14] See details of the update here: http://www.imf.org/external/pubs/ft/weo/2016/update/02/

Chart 30. Crude oil price (US$ per barrel)

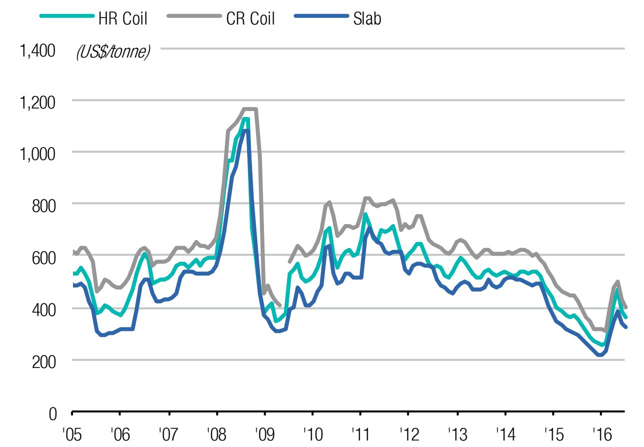
Monthly averages since January 2005 through April 2016



Sources: Bloomberg, ICU.

Chart 31. CIS export steel prices (US$ per tonne)

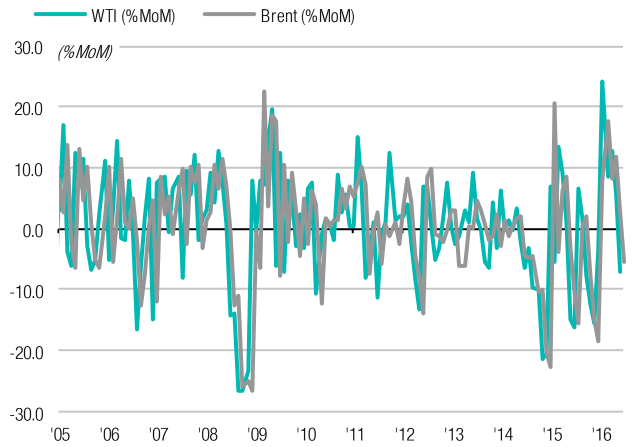
Monthly averages since January 2005 through April 2016



Sources: Bloomberg, ICU.

Chart 32. Monthly changes in crude oil prices: WTI, Brent (% MoM)

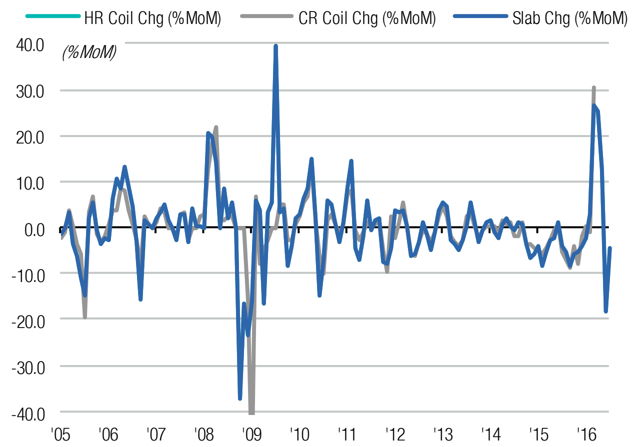
Monthly averages since January 2005 through April 2016



Sources: Bloomberg, ICU.

Chart 33. Monthly changes in CIS steel prices (% MoM)

Monthly averages since January 2005 through April 2016



Sources: Bloomberg, ICU.

Table 3. 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 2016-18

	Quarterly forecast												Annual forecast		
	1Q16	2Q16F	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F	4Q17F	1Q18F	2Q18F	3Q18F	4Q18F	2016F	2017F	2018F
World real GDP (%YoY)	3.1	3.1	3.1	3.1	3.4	3.4	3.4	3.4	3.5	3.5	3.5	3.5	3.1	3.4	3.5
Russia real GDP (%YoY)	-1.2	-2.0	-1.0	-1.0	1.0	2.0	1.0	1.5	2.0	2.0	2.0	2.0	-1.3	1.4	2.0
Crude oil (US$/bbl, avg)	33.4	48.0	49.0	50.0	49.0	48.0	47.0	45.0	46.0	47.0	48.0	50.0	45.1	47.3	47.8
Steel (US$/tonne, avg)	282.0	416.0	327.0	352.0	365.0	377.0	390.0	402.0	402.0	402.0	402.0	402.0	344.3	383.5	402.0
EUR in US$ (eop)	1.10	1.14	1.10	1.09	1.08	1.08	1.10	1.10	1.10	1.11	1.12	1.13	1.09	1.10	1.13
US$ in RUB (eop)	66.90	66.00	65.00	66.00	67.00	68.00	69.00	70.00	70.00	70.00	70.00	70.00	66.00	70.00	70.00

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: quarterly update of the outlook

In 1H16, the economy has been flirting with recession again as official data revealed that the economy contracted by 0.7% in 1Q16 from the previous quarter in seasonally adjusted terms. Our own assessment of the monthly data on the key sectors of the real economy in 2Q16 indicates that quarter-on-quarter growth appears flat. However, 2H16 appears to be a bit brighter as our full-year growth assessed at +1.4% YoY (albeit revised down from the previous +2.1% YoY forecast in May).

Key sectors of the real economy in 2Q16

After a 1Q16 decline of 0.7% QoQ SA was registered, growth in 2Q16 should be muted. As the table below shows, raw monthly reported data on the key sectors of the real economy into seasonal adjusted series data yields quite a poor picture. The combined key sectors of the economy in 2Q16 are down on a quarter-on-quarter basis (-4.2% QoQ for seasonally adjusted data and -0.4% QoQ for the trend data). Assuming that state spending increased in 2Q16 and the shadow part of the economy benefited from the general financial stability seen throughout 1H16, on-quarter growth rate could likely be zero, translating into an up to 1% year-on-year increase in real GDP.

Table 4. Performance of key sectors of Ukraine's economy in June and April-August

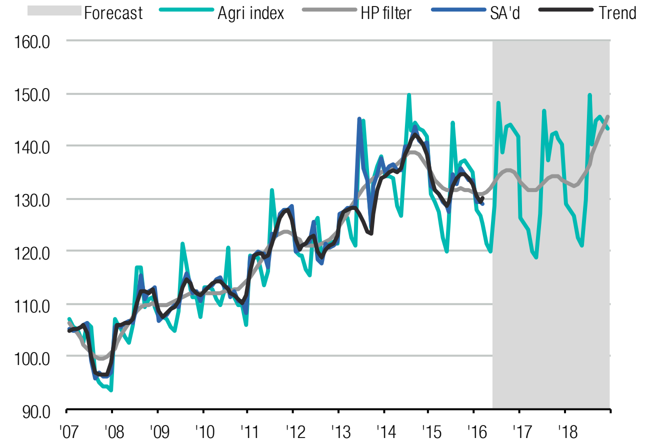
Sector's Indicator	Seasonally adjusted*			Trend*		
	Change[1] (%MoM)	Change[2] (%QoQ)	Change[3] (%YoY)	Change[1] (%MoM)	Change[2] (%QoQ)	Change[3] (%YoY)
Agriculture index	+0.3	-0.5	+0.01	+0.6	-0.5	-1.0
Retail trade, retailers (UAHm, CPI-adj)	+9.3	-11.6	+3.4	+1.3	+2.2	+9.2
Transport turnover, cargo (tonne*km)	-5.4	-0.05	-1.6	-2.7	-0.4	-2.4
Transport turnover, passenger (passenger*km)	+2.9	+1.0	+7.5	+0.3	+1.0	+5.7
Industrial production index	-1.8	-3.2	-3.9	-1.1	-2.4	-2.2
Construction (UAHm, CPI-adj)	-1.4	+5.7	+8.0	-1.3	+2.50	+10.0
Composite index	+1.1	-4.2	-0.3	-0.2	-0.4	+1.3

Notes: * adjusted by Demetra using adjustment method of Tramo-Seats; [1] month-on-month change of June of 2016 to May 2016; [2] quarter-on-quarter change of April-June of 2016 to January-March of 2015; [3] year-on-year change of June of 2016 to June of 2015.
Source: State Statistics Service of Ukraine, ICU.

The most visible correction to downside was registered in the industrial sector and cargo transportation, which in part underlines the interdependence of these two sectors. New processing industry order statistics that appear on a monthly basis and with a near two-month lag was sluggish in April and May—respectively, the price-adjusted volume of orders was down 25% and 0.9% in month-on-month terms—and that was after a two-month spike in February and March of 24% MoM and 46% MoM, respectively. In the consumer-related sector, gasoline retail sales, all months of 2Q posted on-year declines, albeit in single digits. All this provides another layer of doubt regarding decent growth in 2Q16. However, in 2H16 we bet on a harvesting season and more bank lending that would support the economy from slipping into recession. Hence, our projections eye a quickening of on-quarter growth in 3Q and 4Q of 2016 of 0.5-1.0%, resulting in a 1.4% YoY real GDP increase in 2016. For 2017 and 2018, our view on full-year real GDP stays intact, i.e. +2.3% and +2.8%, respectively.

Chart 34. Agriculture production index

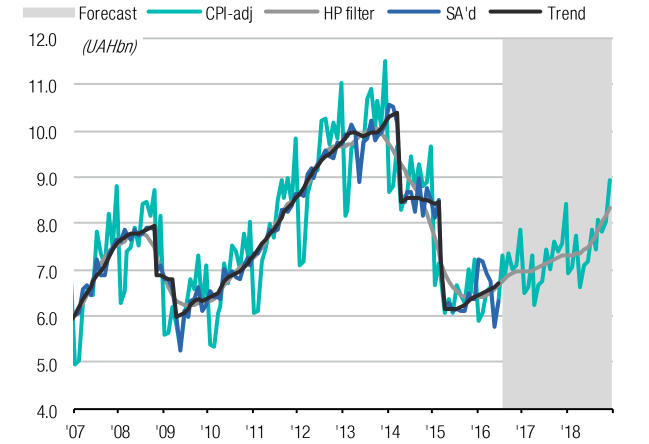
History (from January 2007 through June 2016), forecast for the rest of 2016 and 2017-18



Source: State Statistics Service of Ukraine, ICU.

Chart 35. Retail trade (UAHbn, at constant prices of Dec-1999)

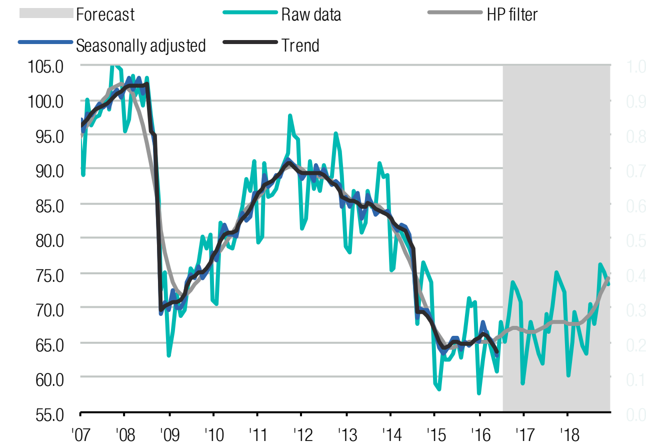
History (from January 2007 through June 2016), forecast for the rest of 2016 and 2017-18



Source: State Statistics Service of Ukraine, ICU.

Chart 36. Industrial production index

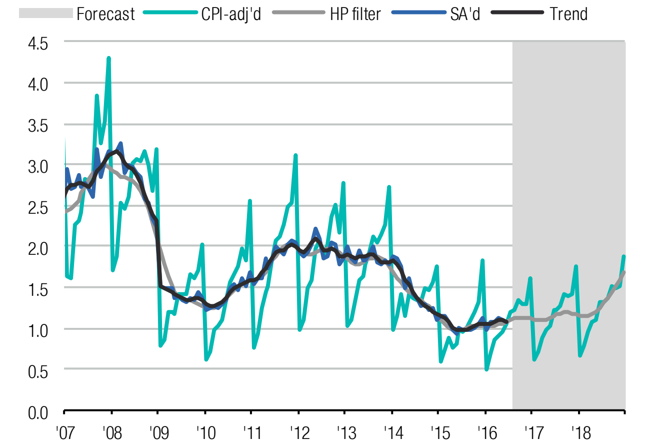
History (from January 2007 through June 2016), forecast for the rest of 2016 and 2017-18



Source: State Statistics Service of Ukraine, ICU.

Chart 37. Construction (UAHbn, at constant prices of Dec-2001)

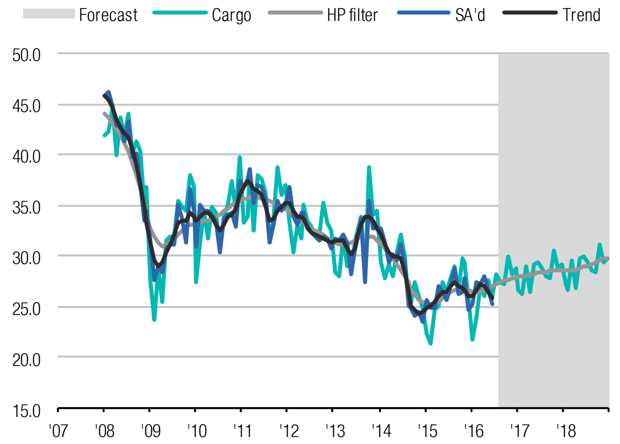
History (from January 2007 through June 2016), forecast for the rest of 2016 and 2017-18



Source: State Statistics Service of Ukraine, ICU.

Chart 38. Cargo transportation turnover (m tonne * km)

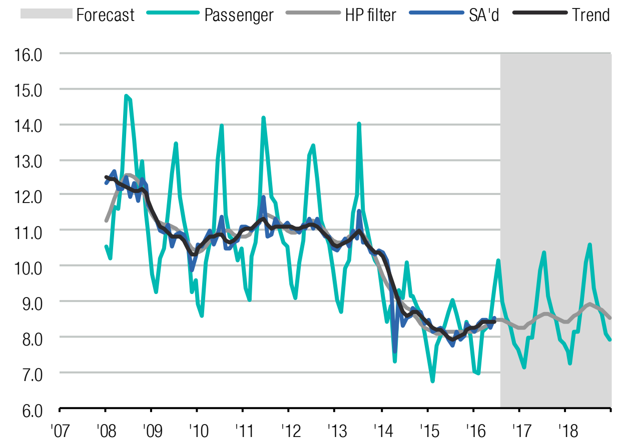
History (from January 2007 through June 2016), forecast for the rest of 2016 and 2017-18



Source: State Statistics Service of Ukraine, ICU.

Chart 39. Passenger transportation turnover (m * km)

History (from January 2007 through June 2016), forecast for the rest of 2016 and 2017-18



Source: State Statistics Service of Ukraine, ICU.

Sector balances: Decoding their evolution in 1H16

Our assessment of the sector balances for 2Q16 yield the following picture.

The government quarterly balance hit a higher deficit than in the previous quarter: 4.5% versus 2.1% in 1Q16. A looser quarterly state budget deficit took place against the background of a nominal increase in state budget expenditures of UAH158bn in 2Q versus UAH140bn in 1Q ,representing a 12.9% QoQ rate of increase. At the same time, taxes and other payments into the state budget from other economic units rose too from UAH129bn in 1Q to UAH136bn in 2Q, or by 5.7% QoQ. Hence, this relative change in state budget revenues and expenditures explain the looser fiscal outcome.

The external sector had a much smaller surplus in 2Q of 0.4% of GDP relative to Ukraine's economy[15] versus the previous period (7.2% in 1Q16[16]).

In effect, the non-government domestic sector has turned its balance into a surplus of 4.1% in 2Q16 after running a record high deficit (between revenues and expenditures) since 3Q13 of 5.1% of GDP.

In our view, deficits of the non-government domestic sector lasting more than two consecutive quarters are more likely to result in a recession. Examples are as follows: (1) four quarters in a row from 4Q07 through 3Q08, (2) seven consecutive quarters during 3Q11 through 1Q13, and (3) two quarters of deficits during 3Q13 and 4Q13. All of these episodes ended with quite severe recessions. In the future, this rule should prove itself once again as simultaneous sizable deficits of the non-government sector against sizable trade deficits (flip side of this is external sector runs surpluses against Ukraine's economy, implying that domestic non-government incurs foreign currency debt, further increasing its already substantial FX leverage).

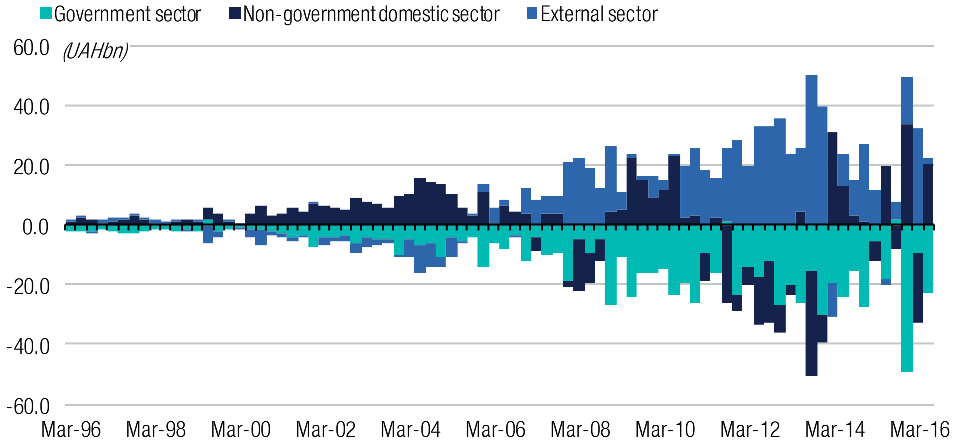
[15] From Ukraine's economy point of view it is current account balance with a negative sign – thus, in the 2Q of 2016 current account deficit was 0.4% of quarterly GDP.

[16] Indeed, trade deficit (in goods and services) in the 1Q amounted to US$1.27bn, while it was US$0.15bn in the 2Q of 2016.

Hence going forward, in 2H16, our projections say that the current account deficit should be tight (running to zero or be balanced), with budget deficits in 3Q and 4Q running in the range of 3-6% relative to quarterly GDP. This is likely to coincide with currency flexibility allowed by the authorities, implying a weakening currency that would undercut domestic demand for imports.

Chart 40. Ukraine's sectoral balances: quarterly volumes (UAHbn)

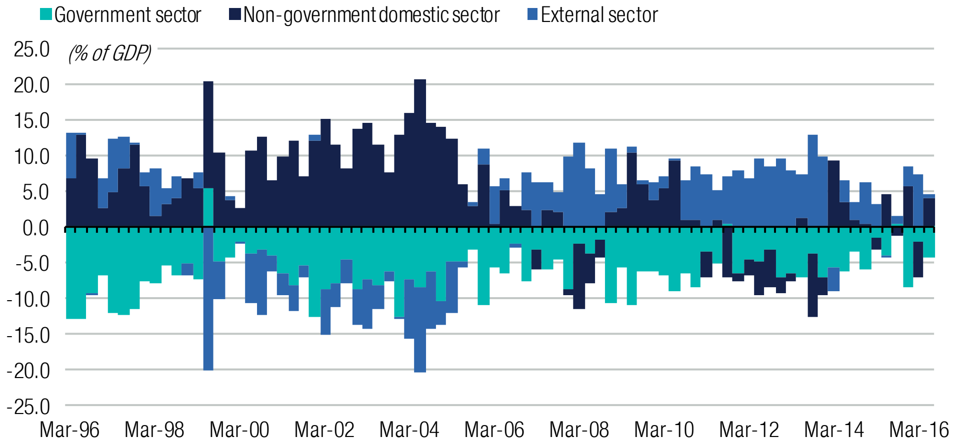
History from 1Q of 1996 through 2Q of 2016, at current prices



Source: State Statistics Service of Ukraine, ICU.

Chart 41. Ukraine's sectoral balances: quarterly volumes (% of GDP)

History from 1Q of 1996 through 2Q of 2016, as percentage of quarterly GDP



Source: State Statistics Service of Ukraine, ICU.

Fiscal stance: Second quarter weakness requires steady loosening course

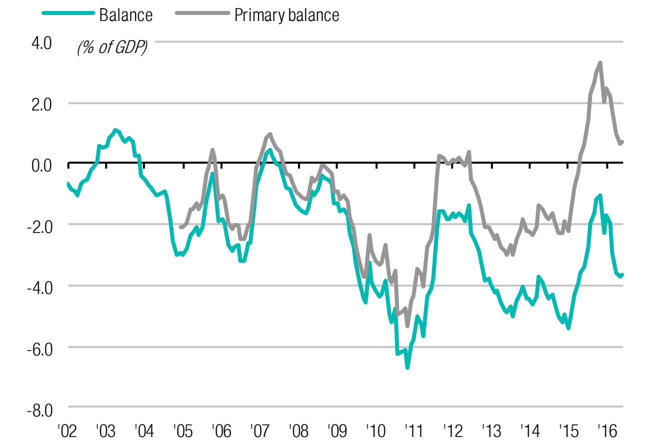
Volodymyr Groysman becoming Ukraine's prime-minister early 2Q16 produced an expected loosening of the fiscal stance which was unusually restrictive under PM Yatsenyuk during most of 2015, except 4Q15, and early 2016 (Chart 44, p.31).

Effectively, the historically high primary surplus of more than 3% of GDP (in terms of the central government's budget) started subsiding toward 0.7% as of May. As of the end of 2016, we project a small primary surplus of 0-0.5%, an element of the authorities' strategy to reduce public debt from 80% as of May 2016.

On a quarterly basis, budget primary expenditures[17] increased by 6.9% in nominal terms in 2Q16; but in inflation-adjusted terms, they rose 15.7%, according to our assessments. In 3Q and 4Q of this year, expenditures are seen up 7.5% and 10.8% YoY in nominal terms, respectively. But in inflation-adjusted terms, the increase was uneven – resulting in a 20.6% increase in 3Q16 while contracting 7% in 4Q16. Overall, state budget primary expenditures rose 17.4% this year overall and 5.9% in real terms, contrasting with the previous year's budget that occurred in an inflation spike of 2015 primary expenditures up by 28.9% YoY in nominal terms and down by 14.2% YoY in real terms.

Chart 42. Central government budget balance (% of GDP)

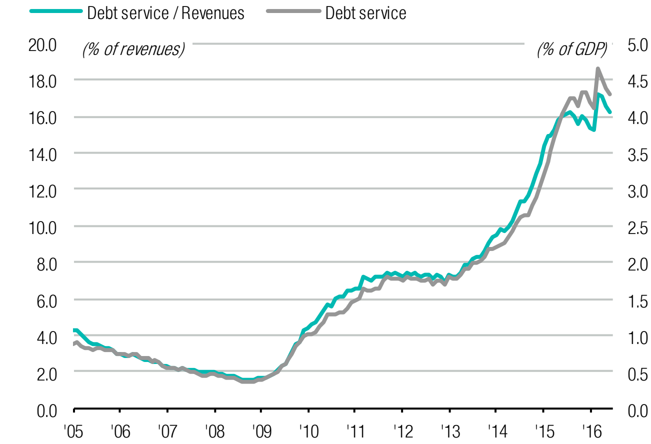
Monthly history from January 2002 through March 2016



Source: Ministry of Finance of Ukraine, ICU.

Chart 43. Debt service expenditure as share of budget revenues and GDP size (%)

Monthly history from January 2005 through March 2016



Source: Ministry of Finance of Ukraine, ICU.

The macroeconomic stabilization brought about by PM Yatsenyuk's tight fiscal stance enables the government and the NBU to lower the UAH interest rate. As a consequence, the ratio of debt service expenditures to revenues should decline from 16% to 15% by the end of 2H16, down 1ppt.

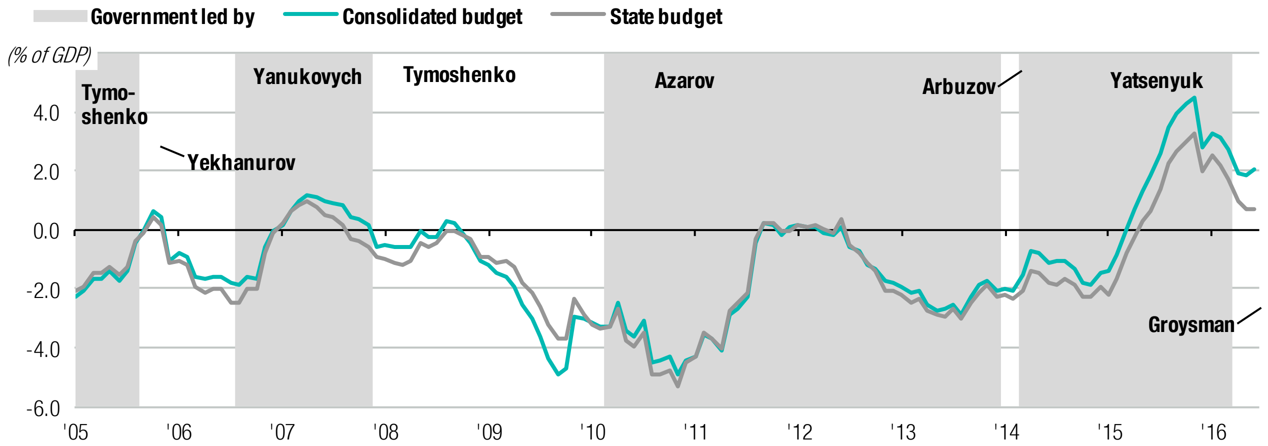
Thanks to last year's external debt restructuring, Ukraine's FX liabilities due over the next 12-months was reduced to as low as US$2.06bn as of June 2016. Meanwhile, the FX balance at the government's account with Ukraine's central bank is US$1.7bn.

Overall, the government's FX financial liabilities (interest and principal on FX-denominated debt, domestic and foreign) that fall due in 2H16 is US$1.6bn, of which just US$0.1bn is

[17] Primary expenditures – total expenditures less projected expenditures on debt servicing.

due to the IMF and US$0.5bn is due to Eurobond investors, while up to US$1.0bn (the largest share) is due to the domestic holders[18] of FX-denominated bonds. This makes Ukraine's government deplete FX deposits by this December, assuming no new FX borrowing. We believe that Ukraine's authorities will unlock IMF funding this fall, eventually raising FX from official donors (including the US Treasury guaranteed bond of US$1bn).

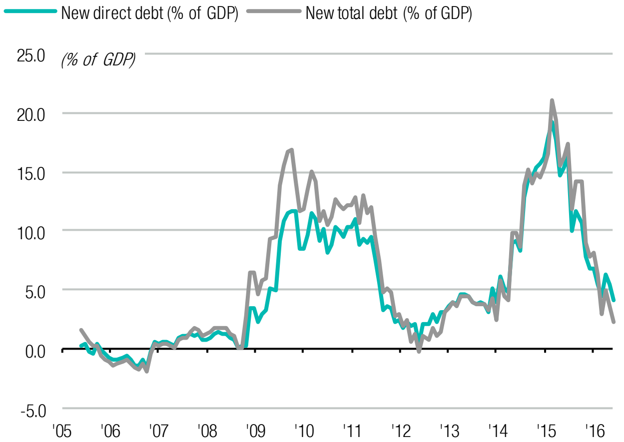
Chart 44. Primary balance of the state budget: consolidated state budget and central government budget (% of GDP)



Source: Ministry of Finance of Ukraine, ICU.

Chart 45. Pace of public debt level change* (% of GDP)

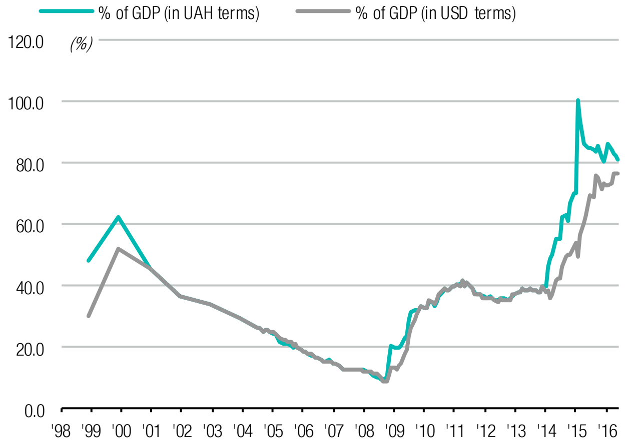
History from January 2005 through December 2015



Note: * 12-month rolling volume debt increase adjusted for FX rate changes. Source: Ministry of Finance of Ukraine, ICU.

Chart 46. Public debt level (% of GDP)

History from January 1998 through February 2016



Source: Ministry of Finance of Ukraine, ICU.

Monetary stance: A fast-paced loosening

Inflation this year proved difficult to project as our past forecasts did not foresee such fast-paced taming of price changes, i.e. from about 40% YoY last year toward single-digits in early 2Q16. As of June, headline CPI moved down to 6.9% YoY, allowing for year-end inflation to be at about 11% - slightly better than the NBU's own target of 12% YoY. Our price projections for 3Q16 suggest that year-on-year headline CPI is likely to start climbing up, albeit quite gradually and peaking at 11% in 4Q16. Overall, our year-end CPI projection yields 10.8% YoY while the yearly average level slows to 14.5% YoY from the previous

[18] These are mostly state-owned banks, by our assessments.

year's 48.5% YoY. Our previous macro report contained a projection of the NBU's refinancing rate at the end of 2015 of 15%. We now forecast 12.5%, suggesting that the NBU is going to continue rate cuts of 1ppt at every policy meeting throughout 2H16 (with three meetings left in the current year).

Money: Debt deflation extends

Domestic credit

One explanation for the fast-paced disinflationary environment in Ukraine's economy is the ongoing depressed demand for credit from the non-government sector. As our charts below show—Chart 49 and Chart 51 on p.33—the flow of credit was still negative in net terms (UAH24bn) and even accelerated from UAH16.3bn in 1Q16. In inflation-adjusted terms, the net credit flow pointed to the continued trend of debt deflation in the banking sector (as Chart 49 reveals this process has been alive from 1Q14 onwards). This tendency was also reflected in the monetary aggregates that were growing quite sluggishly (see details below). Meanwhile, credit flow to the government turned positive in 2Q16 after a 1Q16 contraction (see Chart 50 on p.33) underlying our call that PM Groysman's government is becoming less restrictive in terms of budget expenditures and started spending more than his predecessor. In our view, bank credit contraction (in flow terms) to the private (non-government sector) in 2Q16 has aided to the weakness and underperformance of the economy during this period. High nominal interest rates charged by banks on loans (more than 20% per year[19]) most likely were the disincentives (among other ones) for the company's applying for new loans in domestic currency. In 2H16, we retain our view that the authorities are interested in an economic revival and should push for bank lending, i.e. via lower borrowing costs. Hence, the NBU is set to resume policy rate cuts through year-end 2016 and possibly in 2017.

Monetary aggregates

With practically no new lending created by banks, M3 growth has been depressed as has been money base growth, which was depressed as the NBU routinely withdrew excess reserves from banks' accounts into high-yields CDs. As of June, the NBU created this year nearly the same volume of reserves (paid as interest on withdrawn excess reserves) as in the whole year of 2015 (see Chart 52, p.33). To soften public concerns over this money creation, the NBU is destined to reduce its policy rate and its pace of reserves creation (the NBU itself was vocal against unproductive money creation on monetizing public debt[20]). Overall, the eventual push for bank lending is likely to be evident in 2H16.

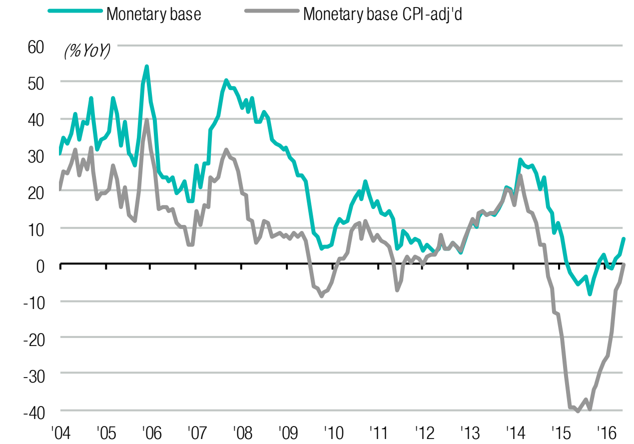
---

[19] An aggregate for corporate and household loans.

[20] Over June-July 2016, NBU was paying interest to banks on certificates of deposits in the amount of UAH39.5m per calendar day. While over January—May, it was UAH34.5m/day. In 2015, it was UAH21.3m/day. Hence, daily volume of reserves creation increased despite policy rate cuts over 1H16.

Chart 47. Monetary base growth (%YoY)

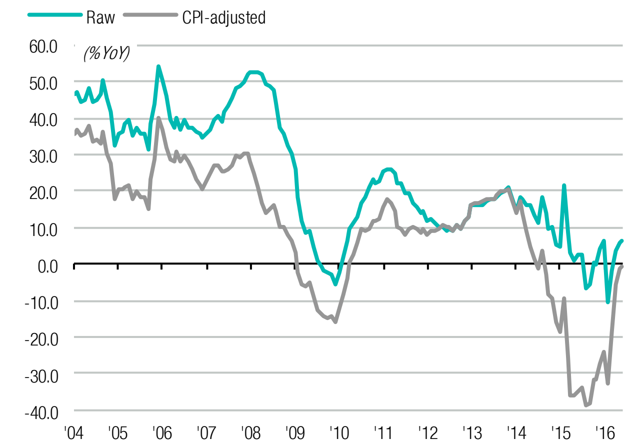
Monthly history from January 2004 through March 2016



Source: National Bank of Ukraine, ICU.

Chart 48. Money supply* growth (%YoY)

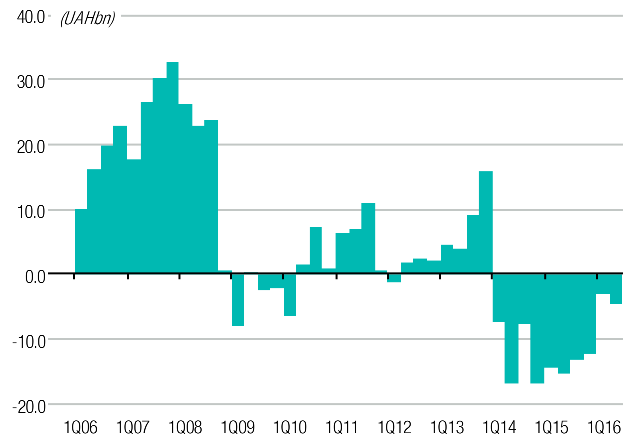
Monthly history from January 2004 through March 2016



Note: monetary aggregate M3. Source: National Bank of Ukraine, ICU.

Chart 49. Bank credit net flow to private sector (UAHbn)

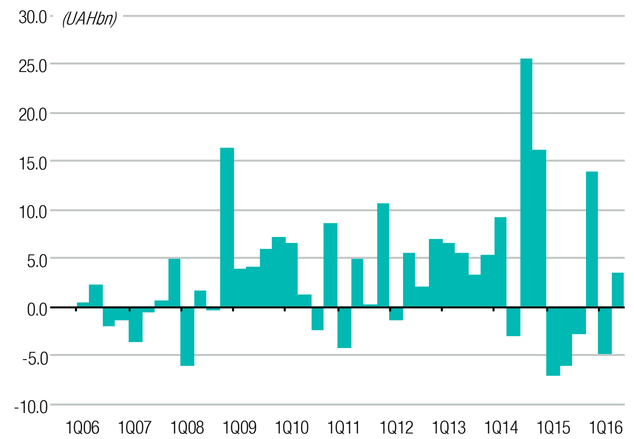
Quarterly history from 1Q of 2003 through 1Q of 2016. CPI-adjusted volume



Source: National Bank of Ukraine, ICU.

Chart 50. Bank credit net flow to government sector (UAHbn)

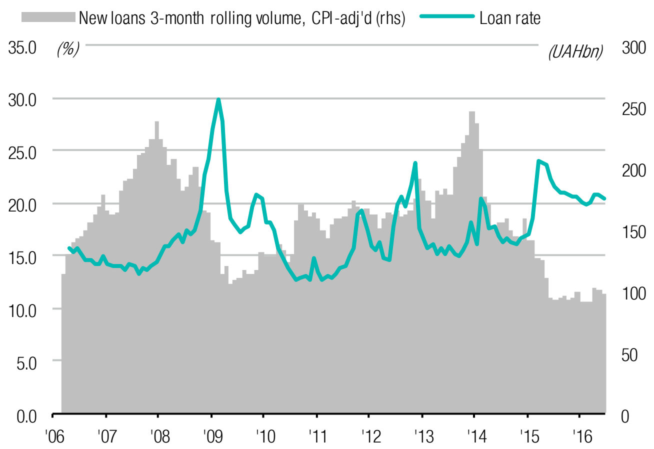
Quarterly history from 1Q of 2003 through 1Q of 2016. CPI-adjusted volume



Source: National Bank of Ukraine, ICU.

Chart 51. New bank lending: volume and rate* (UAHbn)

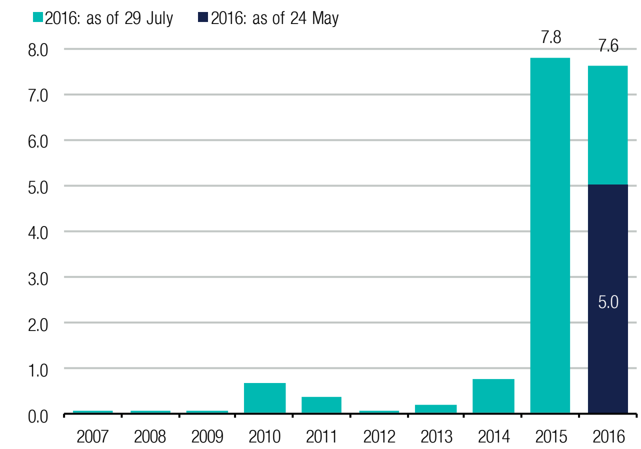
Quarterly history from January of 2006 through March of 2016



Note: * volume comprises all loans in UAH and FX, interest rate is for UAH loans only. Source: National Bank of Ukraine, ICU.

Chart 52. NBU's creation of bank reserves via CDs* (UAHbn)

Yearly nominal volumes for 2007-15, January-July for 2016



Note: CDs – certificates of deposit, a short-term security issued by NBU to absorb excess reserves from banks' accounts at the central bank. Source: National Bank of Ukraine, ICU.

External balance: Bottom seen

Foreign trade should hit bottom in 1H16 after a two-year period of continued decline in exports as well as imports. The left-hand chart below depicts that the year-on-year change of foreign trade monthly flows in goods and services has effectively stopped contracting, implying that on a quarterly basis the trade volumes have stabilized and likely (our base case scenario) should recover off the bottom, albeit slowly.

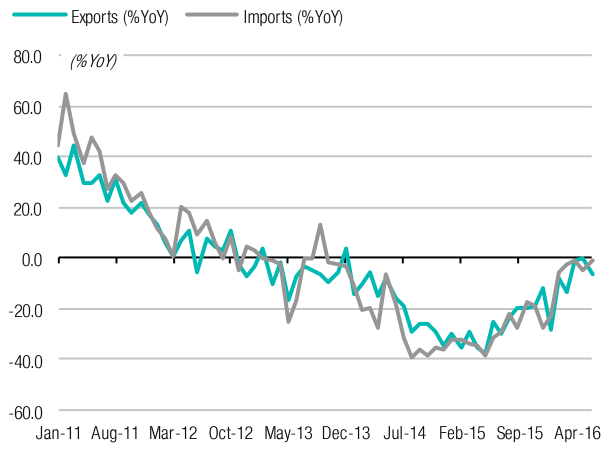
Foreign direct investments have recovered to just below US$4bn in the last 12-months, largely shaped by foreign commercial banks (see the right-hand chart below) that were recapitalizing their subsidiaries operating in Ukraine. Still, non-banking FDI has been shallow so far. In 2017-18, our projections eye FDI inflow recovering slightly beyond the US$4bn/year threshold and, in terms of composition, non-banking direct investments increasing their share in the total.

Other financial inflows (ex-FDI) are visible in the economy as 2Q16 saw central bank accumulation of FX reserves via buying excess FX from the market. This happened even in the absence of the IMF tranches which were postponed well into the end of 3Q16. Our base case scenario now envisages that Ukraine's authorities will get just one IMF tranche of US$1bn and another US$1bn from a US-guaranteed Eurobond.

This year, the current account is projected to be nearly balanced: a US$0.23bn deficit is expected, just 0.3% of GDP. This allows authorities to record another year of FX reserve build up. Following 2015, from a record low of US$7bn to grow to US$13bn, they are seen at US$15bn at year end. However, this is below of our previous projection that relied on the expectation of sizable IMF funding to achieve reserves of US$20bn, which now appears too elevated. In 2017-18, FX reserves should recover further to US$15-17bn thanks to resumed IMF funding and a still nearly balanced current account balance.

Chart 53. Growth rates of monthly export and imports* (%YoY)

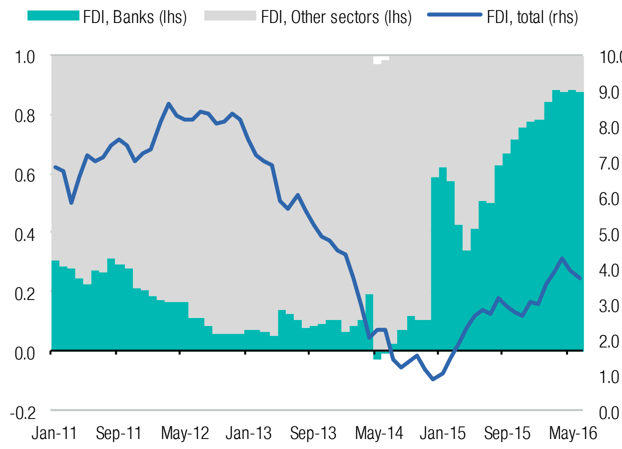
Monthly history from January 2011 through June 2016



* goods and services. Source: National Bank of Ukraine, ICU.

Chart 54. Gross FDI into Ukraine, breakdown by destination

12-month rolling volumes, history from January 2011 through June 2016



Source: National Bank of Ukraine, ICU.

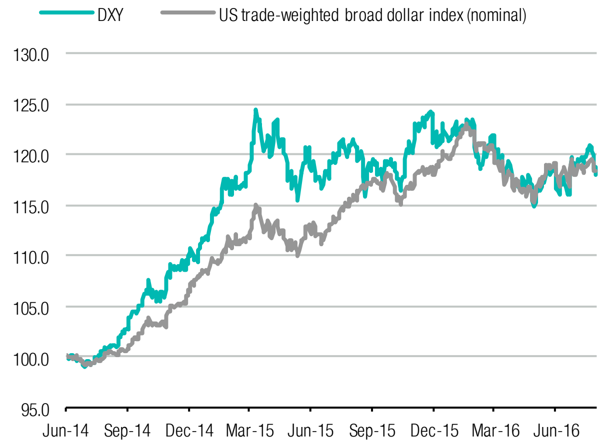
View on UAH: Again upward revision vs. previous call

- **Domestic inflation.** Faster than expected disinflation that has been unfolding in Ukraine's economy amid stagnant economic conditions. This spells a low inflation environment in the forecast due to the following: (1) weak external demand, (2) domestic weakness that is restrained by tight monetary conditions, (3) a rather timid fiscal stance by the government which is restrained by a future promise of regaining an access to the Eurobond market. The logic is as follows: the government limits deficits and restrained expenditure for the sake of fiscal prudence to win private lenders' praises via Eurobond placements in 2017-18. Lower inflation than previously projected enables an upward revision of UAH's FX rate.

- **US Dollar & Fed monetary stance.** Another element of our analysis is most recent data on the US economy and its currency. In 1H16, the US economy underperformed and in both quarters posted growth rates closer to 1% SAAR than 2-2.5%, a subdued pace of expansion. This pace of real GDP change increased expectations of recession risks recently. Some media reports provide evidence that US companies cite the strong US dollar as one of the reasons for their operations' underperformance[21]. Hence, strong momentum will prevent the US dollar from further appreciation and it will more likely trade sideways or a bit lower. Because of this, the market is more favourable toward EM currencies, but tere are exceptions, including USD peg break-ups over the past few weeks have included Egypt and Nigeria[22,23].
- **Conclusion.**. Our update of FX projections based upon the real trade-weighted analysis yields the following upgrade: 26/USD by end-3Q16 and 27/USD by year-end 2016 (up from 28 by end-2016 from our previous forecast made on 24 May 2016).

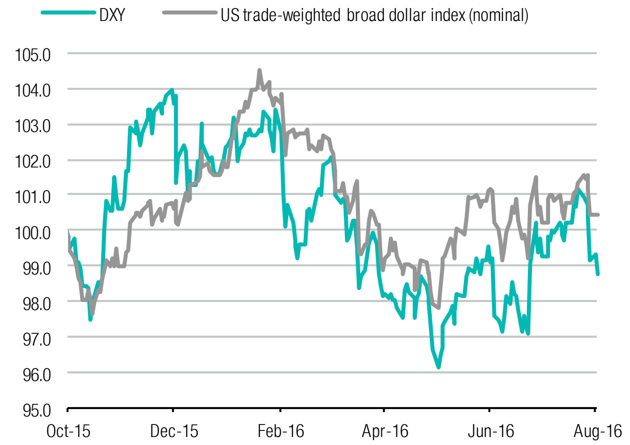
Chart 55. US dollar value as measured versus: (1) a basket of currencies of major DM market economies (DXY or narrow index); and (2) a basket of currencies of DM and EM economies (broad index)

*Rebased at 100 points at **1 June 2014.** History through 1 July 2016*



Source: Bloomberg, ICU.

*Rebased at 100 points at **1 October 2015**. History through 1 July 2016*



Source: Bloomberg, ICU.

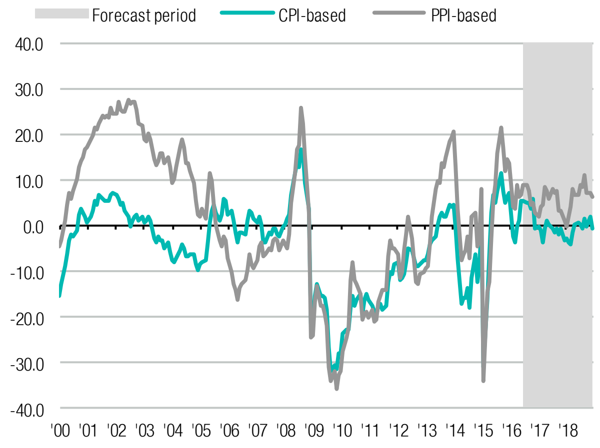
[21] *Wall Street Journal* article " U.S. GDP Grew a Disappointing 1.2% in Second Quarter", 29 July 2016 http://www.wsj.com/articles/u-s-economy-grew-at-a-disappointing-1-2-in-2nd-quarter-1469795649

[22] *Wall Street Journal* article on Egypt's peg: http://www.wsj.com/articles/egypt-says-imf-loan-talks-to-start-in-days-1469612745

[23] *Wall Street Journal* article on Nigeria's peg: http://www.wsj.com/articles/nigerian-central-bank-raises-interest-rate-1469543320

Chart 56. Misalignment of the UAH's FX rate, as implied by the UAH real trade-weighted indices

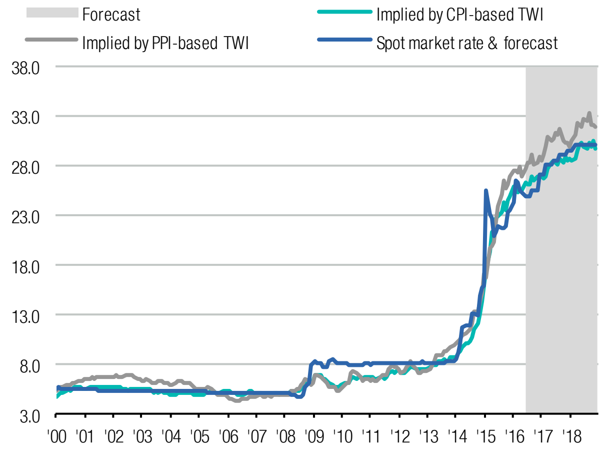
History 2000-15 and forecast for 2016-2018



Source: ICU.

Chart 57. UAH's FX rate versus rates implied by the UAH real trade-weighted indices

History 2000-15 and forecast for 2016-2018



Source: ICU.

Forecast for 2016-18

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

Yearly forecast for 2016-18, base case scenario

Table 5. Forecast of key macroeconomic indicators for 2016-18 (annual)

	Historical data for 2004-15										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	-10.3	**1.4**	**2.3**	**2.8**
Nominal GDP (UAHbn)	544	721	948	913	1,083	1,302	1,409	1,465	1,567	1,939	**2,295**	**2,612**	**2,905**
Nominal GDP (US$bn)	108	143	184	114	136	163	174	180	131	88	**87**	**91**	**97**
GDP per capita (US$, ann)	2,319	3,091	3,986	2,474	2,978	3,572	3,823	3,962	3,069	2,061	**2,055**	**2,134**	**2,283**
Unemployment rate (%)	6.2	6.4	6.4	8.8	8.1	7.9	7.5	7.2	9.3	9.0	**8.2**	**7.5**	**7.5**
Prices													
CPI headline (%YoY, eop)	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	41.8	**10.8**	**7.6**	**7.6**
CPI headline (%YoY, average)	9.1	12.8	25.3	16.0	9.4	8.0	0.6	-0.3	12.1	48.2	**14.5**	**11.1**	**7.6**
PPI (%YoY, eop)	15.4	23.2	21.1	15.3	18.8	17.4	0.4	1.7	31.8	24.0	**18.2**	**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	36.5	**15.1**	**8.5**	**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	-27.8	**-67.0**	**-97.9**	**-98.7**
Consolidated budget bal. (% of GDP)	-0.6	-0.8	-1.2	-3.8	-5.9	-1.4	-3.3	-4.3	-4.3	-1.4	**-2.9**	**-3.7**	**-3.4**
Budget balance (UAHbn)	-3.8	-9.8	-12.5	-35.5	-64.3	-23.6	-53.4	-64.7	-78.1	-45.4	**-81.8**	**-98.2**	**-100.0**
Budget balance (% of GDP)	-0.7	-1.4	-1.3	-3.9	-5.9	-1.8	-3.8	-4.4	-5.0	-2.3	**-3.6**	**-3.8**	**-3.4**
External balance													
Exports (US$bn)	50.2	64.0	85.6	54.3	69.3	88.8	90.0	85.3	68.8	47.4	**44.8**	**48.9**	**53.2**
Imports (US$bn)	53.3	72.2	100.0	56.2	73.2	99.0	104.4	100.8	74.1	48.6	**47.3**	**51.2**	**55.4**
Trade balance (US$bn)	-3.1	-8.2	-14.4	-2.0	-4.0	-10.2	-14.3	-15.5	-5.2	-1.2	**-2.5**	**-2.3**	**-2.1**
Trade balance (% of GDP)	-2.8	-5.7	-7.8	-1.7	-2.9	-6.2	-8.2	-8.6	-4.0	-1.3	**-2.9**	**-2.5**	**-2.2**
Current account balance (US$bn)	-1.6	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	-5.2	-0.2	**-0.2**	**-0.6**	**-0.3**
Current account balance (% of GDP)	-1.5	-3.7	-6.9	-1.5	-2.2	-6.3	-8.2	-9.1	-4.0	-0.2	**-0.3**	**-0.7**	**-0.4**
Net FDI (US$bn)	5.7	9.2	9.9	4.7	5.8	7.0	7.2	4.1	0.3	-3.1	**4.3**	**4.2**	**4.2**
Net FDI (% of GDP)	5.3	6.4	5.4	4.1	4.2	4.3	4.1	2.3	0.2	-3.5	**4.9**	**4.7**	**4.4**
C/A bal. + net FDI (% of GDP)	3.8	2.8	-1.6	2.6	2.0	-2.0	-4.1	-6.8	-3.7	-3.7	**4.6**	**4.0**	**4.0**
External debt (US$bn, eop)	54.5	80.0	101.7	103.4	117.3	126.2	134.6	142.1	134.1	145.2	**137.7**	**137.8**	**136.2**
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	164.9	**157.4**	**152.0**	**140.6**
FX reserves (US$bn, eop)	22.3	32.5	31.5	26.5	34.6	31.8	24.5	20.4	7.5	14.4	**15.0**	**17.0**	**17.5**
FX reserves (% of ann'd GDP, eop)	20.6	22.6	17.2	23.3	25.4	19.5	14.1	11.4	5.7	16.3	**17.1**	**18.8**	**18.1**
External debt / FX reserves (x, eop)	2.4	2.5	3.2	3.9	3.4	4.0	5.5	7.0	17.8	10.1	**9.2**	**8.1**	**7.8**
FX reserves imports cov (months)	5.0	5.4	3.8	5.7	5.7	3.9	2.8	2.4	1.2	3.6	**3.8**	**4.0**	**3.8**
Interest rates													
Central bank key rate (%, eop)	8.50	8.00	12.00	10.25	7.75	7.75	7.50	6.50	14.00	22.00	**15.00**	**12.00**	**10.00**
3-month rate (%, eop 4Q)	9.90	7.58	21.60	17.59	6.12	19.72	25.52	11.71	18.37	23.86	**23.34**	**22.00**	**21.00**
Exchange rates													
UAH trade-weighted index (nominal)	70.90	64.93	45.89	46.09	53.28	56.87	54.63	49.59	32.29	20.86	**17.57**	**16.58**	**16.40**
UAH trade-weighted index (real)	123.61	120.06	100.21	90.26	97.73	98.76	94.72	100.84	85.40	99.67	**90.93**	**89.51**	**92.40**
UAH/US$ (eop)	5.05	5.05	7.80	8.00	7.94	8.00	8.05	8.24	15.82	24.03	**27.00**	**29.50**	**30.00**
UAH/US$ (average)	5.03	5.03	5.25	8.03	7.94	7.99	8.08	8.16	12.01	21.96	**26.17**	**28.75**	**30.00**
UAH/€ (eop)	6.66	7.36	10.90	11.45	10.63	10.37	10.62	11.32	19.14	26.10	**29.43**	**32.45**	**33.90**
UAH/€ (average)	6.64	7.32	7.10	11.70	10.51	10.50	10.60	11.17	14.79	23.91	**29.00**	**31.34**	**33.45**
US$/€ (eop)	1.32	1.46	1.40	1.43	1.34	1.30	1.32	1.37	1.21	1.09	**1.09**	**1.10**	**1.13**
US$/€ (average)	1.32	1.46	1.35	1.46	1.32	1.32	1.31	1.37	1.23	1.09	**1.11**	**1.09**	**1.12**
Population													
Population (million, eop)	46.6	46.4	46.1	46.0	45.8	45.6	45.6	45.3	42.8	42.7	**42.6**	**42.5**	**42.4**
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 2016-18, base case scenario

Table 6. Forecast of key macroeconomic indicators for 2016-18 (quarterly)

				Forecast by ICU										
	3Q15	4Q15	1Q16E	2Q16F	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F	4Q17F	1Q18F	2Q18F	3Q18F	4Q18F
Activity														
Real GDP (%YoY)	-7.2	-1.4	0.1	0.5	3.0	2.0	2.9	1.5	1.9	3.1	2.8	2.7	2.8	2.8
Nominal GDP (UAHbn)	555.0	584.8	453.2	509.8	642.8	689.1	538.2	576.2	725.9	771.3	598.5	640.8	807.7	858.3
Nominal GDP (US$bn)	25.5	25.4	17.6	20.2	24.7	25.5	19.2	20.2	25.0	26.1	20.0	21.4	26.9	28.6
GDP per capita (US$, ann)	2,195	2,076	2,090	2,077	2,061	2,065	2,103	2,105	2,114	2,130	2,148	2,175	2,220	2,301
Unemployment rate (%)	9.0	9.0	9.0	8.2	8.2	8.2	7.5	7.5	7.5	7.5	7.5	7.5	7.5	9.2
Prices														
CPI headline (%YoY, eop)	51.9	43.3	20.9	6.9	7.5	10.8	12.8	13.3	11.3	7.6	7.6	7.6	7.6	7.6
CPI headline (%YoY, average)	53.3	45.4	31.3	8.1	7.7	10.8	11.5	12.2	12.5	8.2	7.6	7.6	7.6	7.6
PPI (%YoY, eop)	32.5	24.0	10.1	15.3	13.4	18.2	12.9	5.6	5.8	5.3	5.3	5.3	5.3	5.3
PPI (%YoY, average)	34.2	26.5	16.0	13.7	13.8	16.8	16.2	6.7	5.6	5.5	5.3	5.3	5.3	5.3
Fiscal balance														
Consolidated budget bal. (UAHbn)	21.3	-62.6	3.4	-22.7	-16.2	-31.5	-13.9	-39.9	-6.0	-38.1	-13.6	-41.8	-4.3	-59.6
Consolidated budget bal. (% of GDP)	3.8	-10.7	0.8	-4.5	-2.5	-4.6	-2.6	-6.9	-0.8	-4.9	-2.3	-6.5	-0.5	-6.9
Budget balance (UAHbn)	10.9	-54.0	-10.6	-23.1	-17.1	-31.0	-14.7	-37.6	-8.7	-37.2	-14.6	-39.5	-7.5	-56.4
Budget balance (% of GDP)	2.0	-9.2	-2.3	-4.5	-2.7	-4.5	-2.7	-6.5	-1.2	-4.8	-2.4	-6.2	-0.9	-6.6
External balance														
Exports (US$bn)	12.1	12.2	9.8	11.3	11.4	12.3	11.0	11.8	12.5	13.7	12.6	12.7	13.4	20.5
Imports (US$bn)	12.4	12.9	11.1	11.4	12.4	12.4	12.3	11.2	14.0	13.7	13.2	12.1	15.0	15.1
Trade balance (US$bn)	-0.3	-0.7	-1.3	-0.1	-1.0	-0.1	-1.3	0.6	-1.5	-0.1	-0.6	0.6	-1.6	-0.6
Trade balance (% of GDP)	-1.2	-2.6	-7.2	-0.7	-4.0	-0.4	-6.8	2.8	-5.9	-0.2	-3.1	3.0	-5.8	-2.1
Current account balance (US$bn)	0.1	0.1	-1.1	0.9	-0.6	0.5	-1.0	0.9	-1.0	0.5	-0.2	1.1	-1.1	-0.1
Current account balance (% of GDP)	0.3	0.5	-6.2	4.5	-2.4	2.1	-5.3	4.7	-4.2	1.9	-1.2	5.0	-4.1	-0.2
Net FDI (US$bn)	0.9	0.7	1.4	1.0	1.0	0.9	1.2	1.0	1.1	1.0	1.1	1.0	1.1	1.0
Net FDI (% of GDP)	3.5	2.9	7.7	4.9	4.2	3.5	6.1	5.0	4.3	3.7	5.5	4.8	4.0	3.6
C/A bal. + net FDI (% of GDP)	3.8	3.4	1.4	9.4	1.8	5.6	0.8	9.6	0.1	5.6	4.3	9.8	-0.1	3.4
External debt (US$bn, eop)	136.7	137.8	137.7	137.7	137.7	137.7	137.8	142.0	142.0	142.0	140.0	140.0	140.0	140.0
External debt (% of ann'd GDP, eop)	145.3	155.1	154.1	155.2	156.5	156.4	153.7	158.3	157.8	156.7	153.3	151.4	148.3	143.2
FX reserves (US$bn, eop)	12.8	13.3	13.7	14.1	14.6	15.0	15.5	16.0	16.5	17.0	17.1	17.2	17.4	17.5
FX reserves (% of ann'd GDP, eop)	13.6	15.0	15.4	15.9	16.6	17.0	17.3	17.8	18.3	18.8	18.7	18.7	18.4	17.9
External debt / FX reserves (x, eop)	10.7	10.4	10.0	9.7	9.4	9.2	8.9	8.9	8.6	8.4	8.2	8.1	8.1	8.0
FX reserves imports cov (months)	2.9	3.3	3.4	3.6	3.7	3.8	3.8	4.0	4.0	4.0	3.9	3.9	3.9	3.8
Interest rates														
Central bank key rate (%, eop)	22.00	22.00	22.00	19.00	14.50	12.50	12.50	12.50	12.50	12.00	11.00	11.00	11.00	11.00
3-month rate (%, eop 4Q)	25.80	23.86	23.34	21.67	21.00	18.00	18.00	18.00	18.00	15.00	12.00	12.00	12.00	12.00
Exchange rates														
UAH trade-weighted index (nominal)	22.52	20.86	18.61	18.51	17.93	17.57	17.38	17.16	16.88	16.58	16.60	16.58	16.55	16.40
UAH trade-weighted index (real)	104.52	99.67	89.28	94.48	92.49	90.93	89.48	93.17	91.72	89.51	89.15	93.88	93.85	92.40
UAH/US$ (eop)	21.20	24.03	26.20	24.83	26.00	27.00	28.00	28.50	29.00	29.50	30.00	30.00	30.00	30.00
UAH/US$ (average)	21.77	22.99	25.69	25.25	26.00	27.00	28.00	28.50	29.00	29.50	30.00	30.00	30.00	30.00
UAH/€ (eop)	23.70	26.10	29.82	28.31	28.60	29.43	30.24	30.78	31.90	32.45	33.00	33.30	33.60	33.90
UAH/€ (average)	24.47	25.04	28.62	28.76	29.12	29.57	30.38	30.78	31.61	32.45	33.00	33.15	33.45	33.75
US$/€ (eop)	1.12	1.09	1.14	1.14	1.10	1.09	1.08	1.08	1.10	1.10	1.10	1.11	1.12	1.13
US$/€ (average)	1.12	1.09	1.11	1.14	1.12	1.10	1.09	1.08	1.09	1.10	1.10	1.11	1.12	1.13
Population														
Population (million, eop)	42.80	42.72	42.72	42.67	42.65	42.57	42.62	42.57	42.54	42.46	42.56	42.51	42.49	42.41
Population (%YoY)	-0.4	-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.

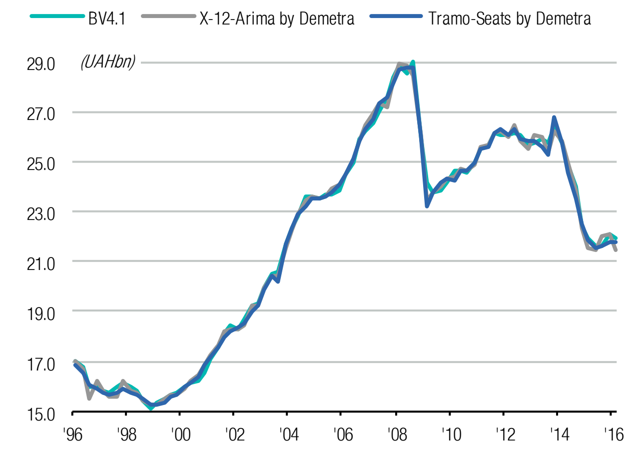
Appendices: Research details, thematic charts & tables

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

Quarterly GDP: Reported statistics and ICU's calculations

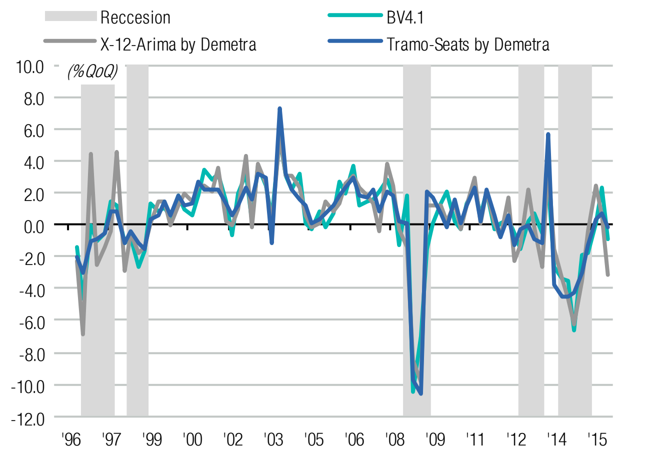
Chart 58. Ukraine's economy from the perspective of quarterly GDP volumes (left) and on-quarter growth rates (right)
1Q96-1Q16
Data is adjusted for inflation and seasonal factors; seasonally adjusted by three methods BV4.1, X-12 Arima and Tramo-Seats

Quarterly GDP size in constant prices of Dec-95



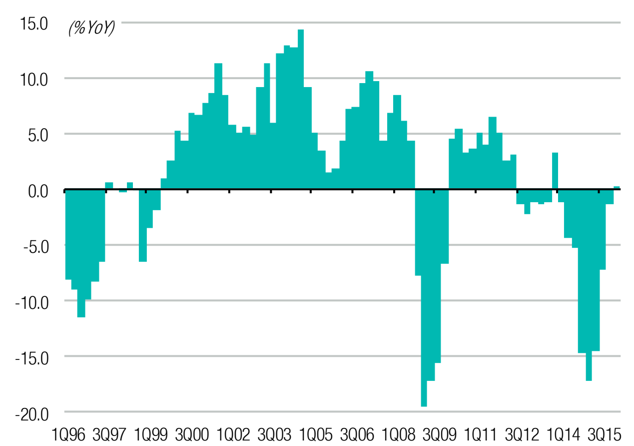
Sources: State Statistics Service of Ukraine, ICU.

Quarterly GDP growth rates (% QoQ)



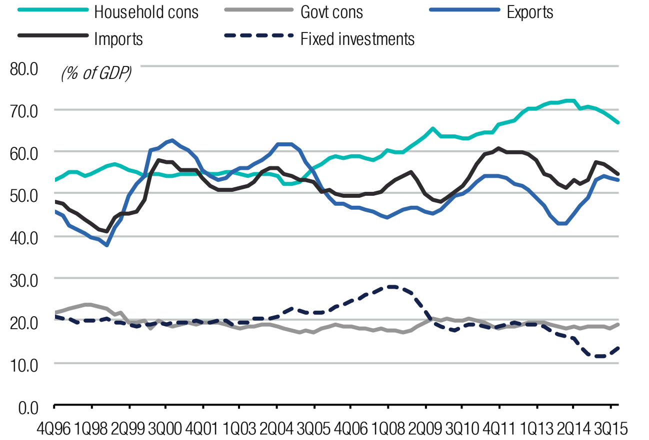
Sources: State Statistics Service of Ukraine, ICU.

Chart 59. Reported on-year quarterly GDP growth (% YoY)
1Q96-1Q16



Source: State Statistics Service of Ukraine.

Chart 60. Demand-side components of GDP (% of total, LTM)
1Q96-4Q15



Sources: State Statistics Service of Ukraine, ICU.

Table 7. Ukraine quarterly GDP size: History from 4Q96 till 4Q15 (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
…	…	…	…	…	…	…	…	…	**…**	…	…	**…**
1Q08	191,459	+8.5		26.6	+7.4	26,303	28,874	28,931	**28,703**	+1.8	+2.4	+1.9
2Q08	236,033	+6.2		33.2	+6.5	26,824	28,521	28,834	**28,782**	-1.2	-0.3	+0.3
3Q08	276,451	+4.3		32.9	+6.5	31,892	29,030	28,447	**28,800**	+1.8	-1.3	+0.1
4Q08	244,113	-7.8		23.3	+2.6	27,233	25,970	26,047	**26,009**	-10.5	-8.4	-9.7
1Q09	189,028	-19.6		22.8	-4.8	21,148	24,159	23,476	**23,244**	-7.0	-9.9	-10.6
2Q09	214,103	-17.3		9.7	-10.6	22,181	23,795	23,757	**23,734**	-1.5	+1.2	+2.1
3Q09	250,306	-15.7		7.4	-15.2	26,886	23,809	24,037	**24,145**	+0.1	+1.2	+1.7
4Q09	259,908	-6.7		14.1	-15.0	25,412	24,134	24,327	**24,326**	+1.4	+1.2	+0.8
1Q10	217,286	+4.5	+0.7	10.7	-9.2	21,959	24,626	24,378	**24,276**	+2.0	+0.2	-0.2
2Q10	256,754	+5.4	+1.4	15.1	-3.5	23,110	24,672	24,695	**24,670**	+0.2	+1.3	+1.6
3Q10	301,251	+3.3	+0.4	17.5	+1.5	27,539	24,597	24,616	**24,680**	-0.3	-0.3	+0.0
4Q10	307,278	+3.7	+0.7	15.6	+4.2	25,989	24,936	24,909	**24,969**	+1.4	+1.2	+1.2
1Q11	257,682	+5.1	+2.0	12.9	+4.4	23,066	25,507	25,637	**25,540**	+2.3	+2.9	+2.3
2Q11	311,022	+3.9	+0.3	16.6	+4.0	24,009	25,645	25,657	**25,592**	+0.5	+0.1	+0.2
3Q11	369,818	+6.5	+2.5	15.2	+4.8	29,347	26,169	26,191	**26,156**	+2.0	+2.1	+2.2
4Q11	363,557	+5.0	+0.3	12.6	+5.1	27,309	26,084	26,214	**26,298**	-0.3	+0.1	+0.5
1Q12	293,493	+2.5	-0.8	11.4	+4.5	23,584	26,105	26,004	**26,109**	+0.1	-0.8	-0.7
2Q12	349,212	+3.1	+0.5	9.0	+4.3	24,731	26,191	26,459	**26,275**	+0.3	+1.8	+0.6
3Q12	387,620	-1.3	-1.5	6.2	+2.3	28,963	26,059	25,843	**25,930**	-0.5	-2.3	-1.3
4Q12	378,564	-2.3	-0.8	6.6	+0.5	26,681	25,670	25,502	**25,868**	-1.5	-1.3	-0.2
1Q13	303,753	-1.2	+0.6	4.8	-0.4	23,301	25,733	26,058	**25,850**	+0.2	+2.2	-0.1
2Q13	354,814	-1.3	+0.4	3.8	-1.5	24,208	25,913	26,031	**25,611**	+0.7	-0.1	-0.9
3Q13	398,000	-1.2	-0.1	4.0	-1.5	28,595	25,760	25,346	**25,311**	-0.6	-2.6	-1.2
4Q13	408,631	+3.3	+2.1	4.3	-0.1	27,612	26,415	26,271	**26,753**	+2.5	+3.6	+5.7
1Q14	313,568	-1.2	-1.1	4.5	-0.1	23,018	25,722	25,872	**25,751**	-2.6	-1.5	-3.7
2Q14	375,903	-4.5	-4.4	11.1	-0.9	23,084	24,853	24,985	**24,591**	-3.4	-3.4	-4.5
3Q14	434,166	-5.4	-3.1	15.4	-2.0	27,031	23,990	23,817	**23,492**	-3.5	-4.7	-4.5
4Q14	443,091	-14.8	-3.9	27.2	-6.6	23,538	22,390	22,315	**22,502**	-6.7	-6.3	-4.2
1Q15	367,577	-17.2	-5.3	41.5	-10.7	19,069	21,975	21,544	**21,835**	-1.9	-3.5	-3.0
2Q15	449,575	-14.6	-0.5	40.1	-13.1	19,706	21,596	21,457	**21,563**	-1.7	-0.4	-1.2
3Q15	555,044	-7.2	+0.5	37.8	-13.5	25,077	21,628	21,988	**21,627**	+0.2	+2.5	+0.3
4Q15	584,781	-1.4	+1.4	32.7	-10.3	23,410	22,125	22,121	**21,778**	+2.3	+0.6	+0.7
1Q16E	431,506	+0.1	-0.7	17.3	-6.0	19,088	21,922	21,429	**21,749**	-0.9	-3.1	-0.1

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

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

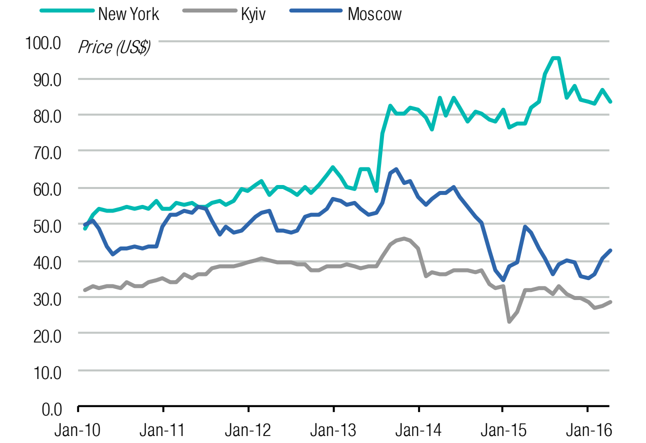
Table 8. ICU consumer basket as of end of January 2016
Prices of consumer goods in Kyiv, New-York, and Moscow

Item of the basket	Description	Kyiv, central district 29-Apr-16 Price (UAH)	New York metro-politan area 29-Apr-16 Price (US$)	Moscow, central district 29-Apr-16 Price (RUB)
Consumer goods				
Coca-cola (0.5 litre, plastic bottle)	Non-alcohol beverages	8.99	2.00	53.00
Beer Corona Extra (0.33 litre, glass bottle)	Alcoholic beverages	17.95	1.83	92.50
Bunch of fresh bananas (1 kg)	From Ecuador	33.35	1.94	95.00
Pack of milk (1 litter)	Locally produced, soft package, i.e., not glass bottle	14.61	1.57	79.00
Chicken meat (1 kg pack)	Locally produced and branded package, boneless breast	70.85	10.98	169.00
Canned pineapple (0.85 kg, can)	Pineapple circles, Dole brand	61.80	3.27	218.74
Pasta (0.5 kg)	Soft package, produced in Italy	34.56	1.75	108.00
Sugar (1 kg)		20.50	2.86	56.00
Package of table salt (0.5 kg)		12.35	0.80	20.80
Chicken eggs (10 units pack)	White eggs, standard size	24.75	3.07	105.00
Chocolate (100 g)	Made by Craft Foods Corp, Milka brand	28.49	2.00	89.30
Toothpaste (100ml package)	Colgate	49.95	3.54	222.00
Shampoo (200ml package)	Head & Shoulders brand, for normal hair	53.00	3.11	220.00
Toilet paper (4 rolls package)	Kleenex Cottonelle brand, white paper, Regular toilet tissue	21.10	3.43	132.00
Magazine	Men's Health, local edition, A4 format (standard one, not a pocket book format)	33.95	4.99	140.00
Gasoline (1 litre)	Lukoil, regular	21.99	0.63	38.90
Batteries (AA x 4 pack)	A 4-pack of AA Duracell batteries, Alkaline	53.99	4.99	188.00
Coffee (250 g, vacuum pack)	Jacobs Monarch, brick-like vacuum pack	90.40	13.65	251.00
Services				
Underground commute ticket	Within the central part of the city	4.00	2.75	50.00
Cinema ticket	Thursday's night price for the seat with good location, Hollywood film	65.00	14.59	450.00
Total basket value (in local currency)		**721.58**	**83.75**	**2,778.24**
Exchange rate versus US dollar at spot market as of date of observation		25.125	1.000	64.767
Total basket value (in US$)		**28.72**	**83.75**	**42.90**
Overvalued "+" / undervalued "-" (%)				
UAH vs. USD		**-65.71**		
UAH vs. RUB		**-33.05**		
Fair value in the long-run as of observation date				
UAH per USD		**8.616**		
UAH per RUB		**0.260**		

Source: ICU.

Chart 61. ICU consumer basket value (US$)

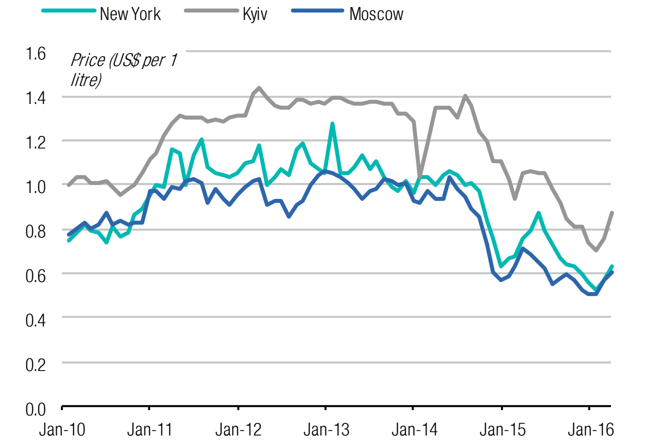
Price history February 2010 - April 2016



Source: ICU.

Chart 62. Gasoline A95 equivalent 1 litre (US$)

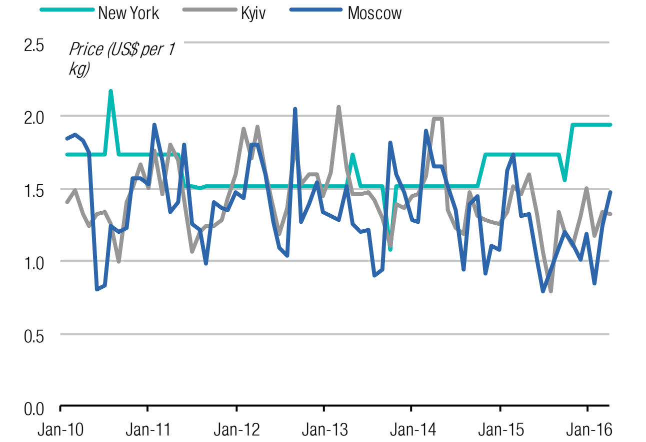
Price history February 2010 - April 2016



Source: ICU.

Chart 63. Fresh banana 1 kg bunch (US$)

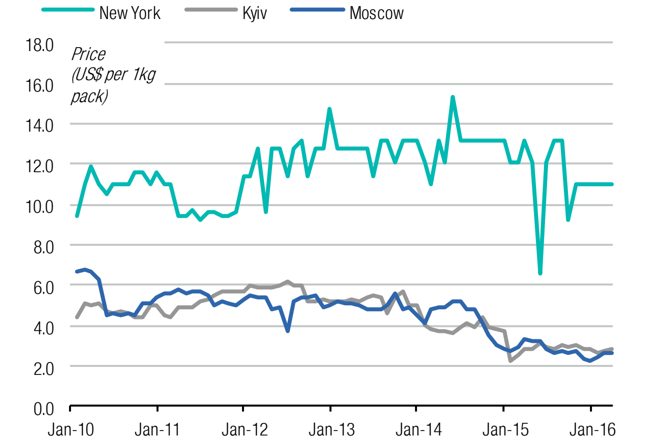
Price history February 2010 - April 2016



Source: ICU.

Chart 64. Chicken meat 1 kg pack of boneless breast (US$)

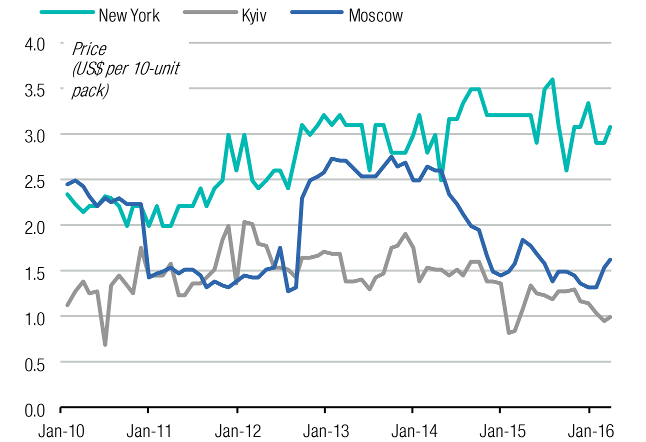
Price history February 2010 - April 2016



Source: ICU.

Chart 65. Chicken eggs 10-unit pack (US$)

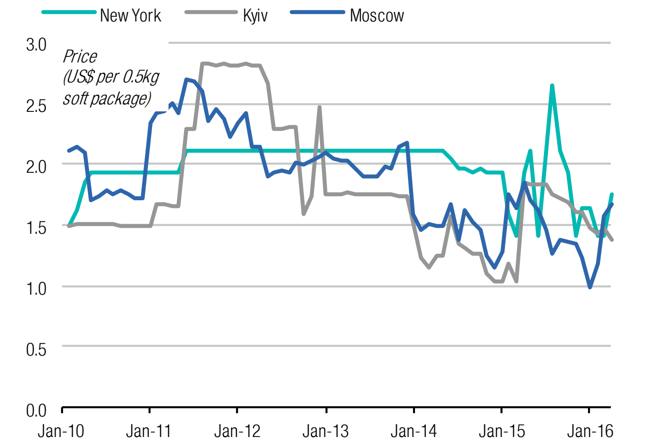
Price history February 2010 - April 2016



Source: ICU.

Chart 66. Pasta 0.5 kg soft package Italy-made (US$)

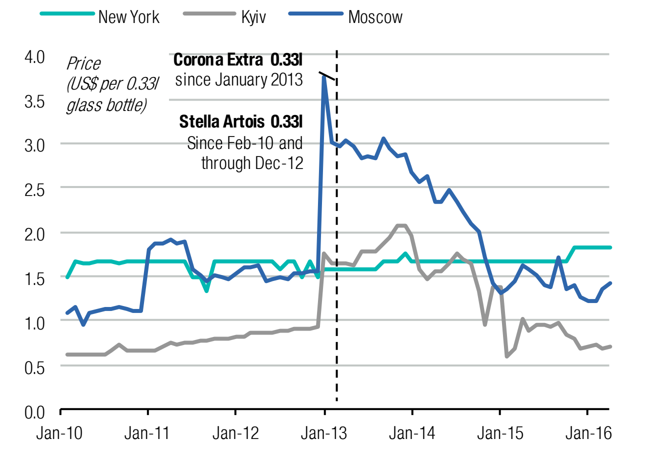
Price history February 2010 - April 2016



Source: ICU.

Chart 67. Beer Corona Extra 0.33 litre glass bottle (US$)

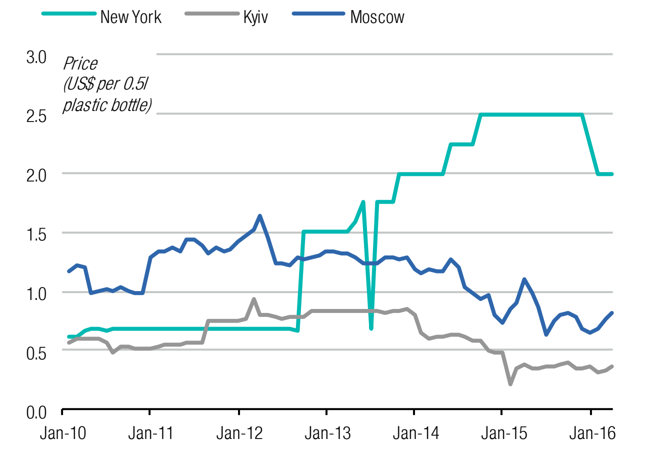
Price history February 2010 - April 2016



Source: ICU.

Chart 68. Coca-Cola 0.5 litre plastic bottle (US$)

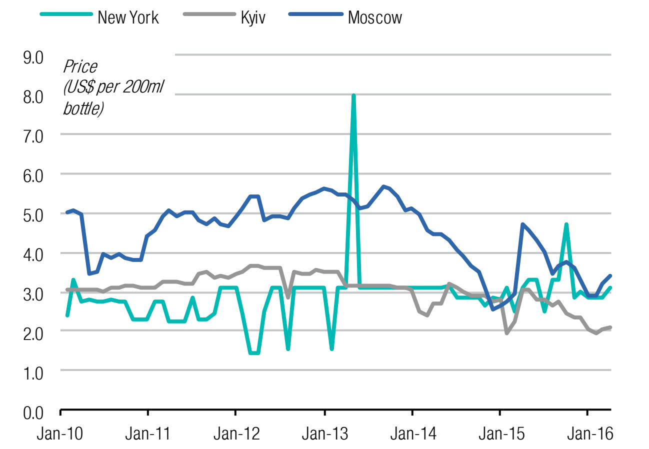
Price history February 2010 - April 2016



Source: ICU.

Chart 69. Shampoo 200ml bottle Head & Shoulders (US$)

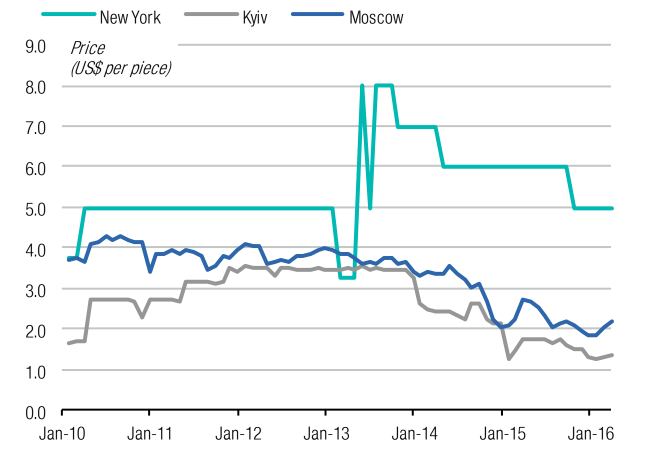
Price history February 2010 - April 2016



Source: ICU.

Chart 70. Magazine *Men's Health,* A4 format (US$)

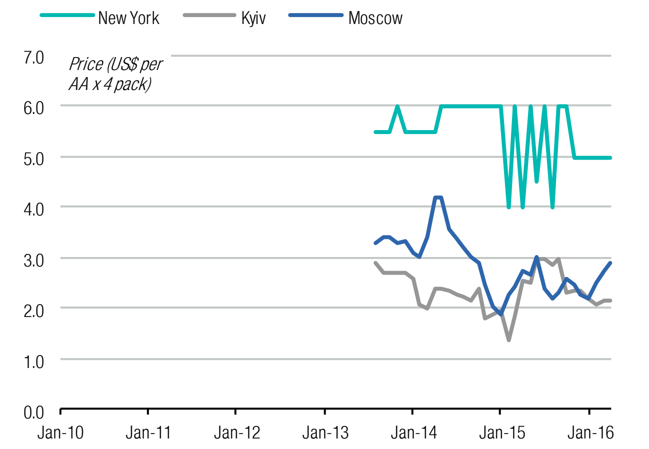
Price history February 2010 - April 2016



Source: ICU.

Chart 71. Duracell batteries (AA x 4 pack) (US$)

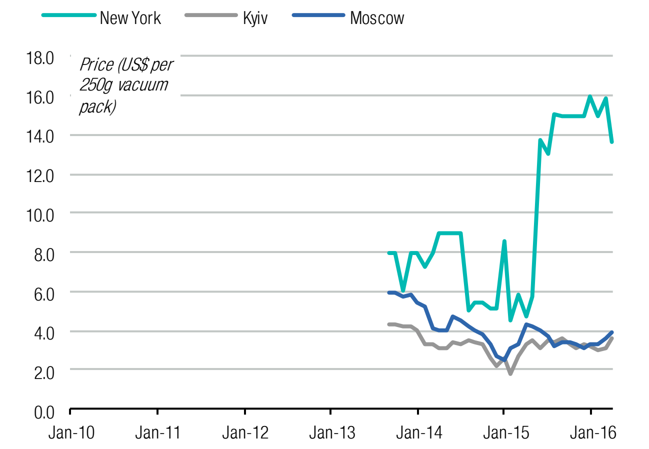
Price history February 2010 - April 2016



Source: ICU.

Chart 72. Jacobs Monarch coffee, 250 g vacuum pack (US$)

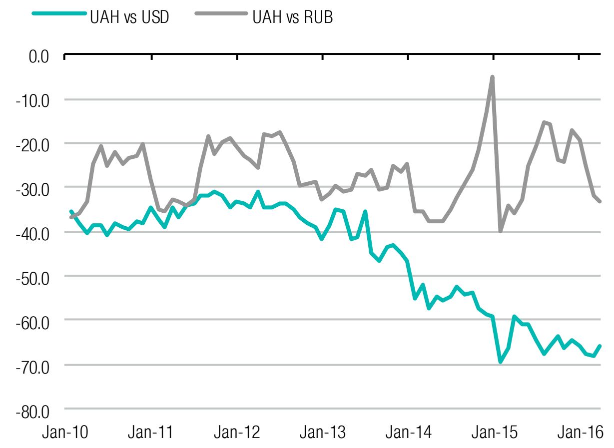
Price history February 2010 - April 2016



Source: ICU.

Chart 73. Value gap of ICU basket in UAH vs. USD and RUB (%)

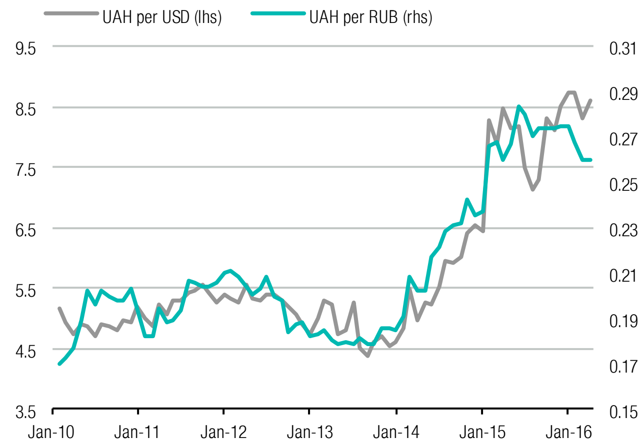
Price history February 2010 - April 2016



Source: ICU.

Chart 74. An exchange rate level of UAH per USD and UAH per RUB, which would eliminate the value gap of ICU basket

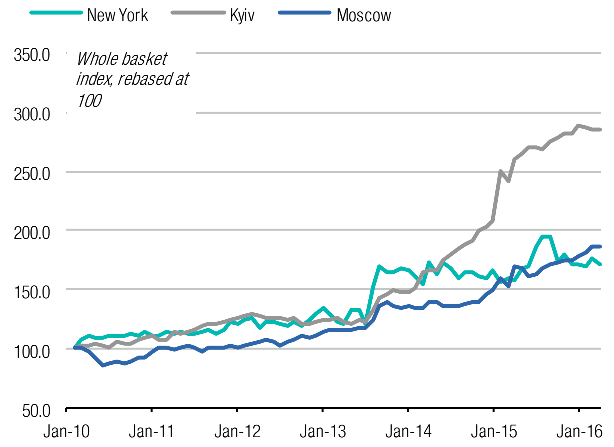
Price history February 2010 - April 2016



Source: ICU.

Chart 75. Index of the ICU consumer basket value in local currency (points, rebased at 100 as of February 2010)

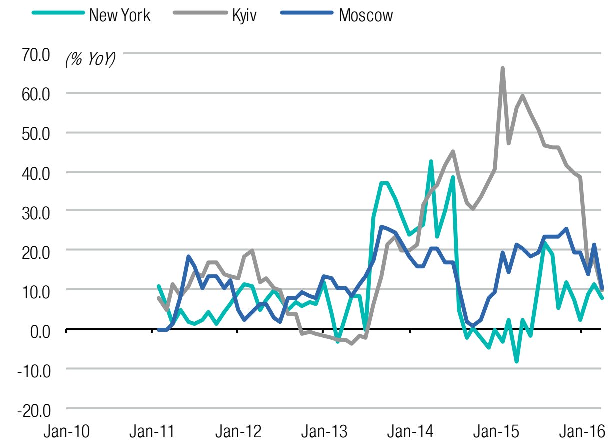
Price history February 2010 - April 2016



Source: ICU.

Chart 76. Growth rate of the index of the ICU consumer basket value in local currency (% YoY)

Price history February 2010 - April 2016



Source: ICU.

Disclosures

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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

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

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

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

CORPORATE FINANCE TEL. +38 044 2200120

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

Ruslan Kilmukhametov, Director
ruslan.kilmukhametov@icu.ua

SALES AND TRADING TEL. +38 044 2201621

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

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

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

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

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

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

RESEARCH DEPARTMENT TEL. +38 044 2200120

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

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

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

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

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

Lee Daniels, Rolfe Haas
Editors