| Focus | Scope | Analysts |
|---|---|---|
| **Ukraine** | **Economics** | **Alexander Valchyshen, Alexander Martynenko, Taras Kotovych, Mykhaylo Demkiv, Dmytro Dyachenko, Artem Gladchenko** |

Quarterly Report

# Embracing a Goldilocks economy?

**27 OCTOBER 2017**

# Contents

# Executive rundown

**Below is a brief overview of our base-case economic scenario for Ukraine vis à vis the global economy for the remainder of 2017 and over 2018–2019.**

**Why we are sceptical of the "Goldilocks" global economy.** Beginning in the summer of 2016, and increasingly since early 2017, there has been a widespread view among economists and analysts that the upbeat performance of the financial markets is a reflection of an overoptimistic "Goldilocks" economy. Headline macro parameters like growth and inflation are at just-right levels, or—as BIS put it in its recent quarterly report—"not too hot, while not too cold."

This development coincides with an across-the-board decline of the USD against several major currencies, most notably the euro (EUR) and the BRICS currencies (BRL, RUB, INR, CNY, ZAR). This lasting decline of the USD, which was interrupted by a correction this September, has supported commodity prices and boosted the fortunes of commodity-driven economies, which had faced collapsing currencies over the past few years, along with the prices of their key export commodities. Ukraine, too, has benefited from the Goldilocks economy. It has spurred economic growth and strengthened the hryvnia, which allowed a successful refinancing of external debt. However, in our view, this notion fails to acknowledge flaws in today's global economy that are quite similar to what eventually led to the global financial crisis of 2007–08. These flaws were also seen in the 1990s and early 2000s, when the US economy was run with troublesome structural imbalances, as evidenced by the lasting deficits of its private sector in 1998–2002 and 2005–08. During those periods, the US private sector dug itself into a financial hole, leveraging itself up until the crises brought it to an abrupt end.

Today, the US private sector is on the same path. With financial deregulation looming, repeating the mistakes of the past may be more likely, and the day of reckoning in terms of reconciling this may finally arrive faster. Ultimately, today's Goldilocks economy could be a harbinger of future financial troubles that could spread quickly across the global financial system. Previously, the Goldilocks economy persisted for several years. This time it really could be different. Our base-case scenario incorporates the assumption that the "Goldilocks scenario" is a medium-term phenomenon, and will last one more year.

**Ukraine's political cycle to benefit from Goldilocks economy.** As the prevailing sentiment has shifted perspectives from viewing the glass as half-full from half-empty, Ukraine's economy has benefitted. Improved prices for key commodities and easier access to FX funding has bolstered Ukraine's balance of payments, which is necessary to refinance existing sovereign and corporate foreign-currency denominated debt. The economy is therefore running smoothly, and speculation over political upheaval has softened. Also, important, the NBU has been able to effect a heavily managed float of UAH, and facilitate an orderly weakening of the domestic currency, which is misaligned, according to our assessment.

**Ukraine's economy: Steady recovery, improving outlook.** We revised our 2017 forecast upward towards +1.8% YoY real GDP growth from +1.2% YoY. In 2018, a +3% YoY increase of real GDP is forecast, as our base-case envisages that the government will raise the minimum wage again next year, since this practice paid off this year. Income distribution has shifted from a very acute preference to profits while neglecting wages (47% versus 36% in 2016) towards a less acute structure (see Chart 31 and Chart 32 on p.25). With household consumption accounting for 65% of GDP, this shift should extend, and is on a path to reach a more sustainable structure of 40-45% profits and 40-45% wages, with taxes accounting for the remaining 15%. This has been a natural shift, and one that produces stable growth, since it is not supported by credit. Growth is healthy when consumers spend their wages as opposed to using credit. Hence, consumer-related businesses are likely to benefit from this expected development. Another sector likely to extend double-digit growth is construction, as the government continues to fund civil infrastructure projects.

**Inflation: Last spike in headline CPI transitory, sliding towards 10% YoY in 2018.** Authorities are running the economy under a quite tight mix of fiscal and monetary policy. The state budget had a record-high primary surplus of 3.9% of GDP on a LTM basis in August. The central bank is committed to pay low, double-digit rates for excess UAH monetary reserves on banks' accounts, and this boosts the attractiveness of UAH assets, and hence, eliminates the negative impact from the FX market on inflation. We expect this to continue well into 2018. Further, in our view, hiking the minimum wage will have a limited impact on inflation, because unemployment continues to be high. There is still a way to go before the labour market tightens, which certainly won't happen over the next year. Our view on inflation is that it will slow gradually over 2018 towards 10%. Hence, the NBU will continue cutting its policy rate in 2Q18 and through rest of the year.

**Ukraine: financial flows reveal risky structure of sectoral balances.** Before Ukraine's last two financial crises in 2008 and 2014, sectoral balances signaled a warning. Leading up to these two periods, the domestic private sector as a whole had been running financial deficits for a year or two. These deficits coincided with current account deficits, and now, a similar pattern is forming. Since 2005, Ukraine had been a chronic net importer, and now it is returning to this position again. If the country fails to correct the current account deficit by becoming a net exporter, then the situation of an improving economy we observe now will reverse over time, leading to another FX correction. Our base-case scenario calls for gradual FX flexibility and gradual USD/UAH weakening.

**UAH: There are a number of supportive factors.** We outline three factors that are supportive for relative, FX rate "stability" for the UAH. These will allow orderly movements in the FX market into 2018, similar to 2017. Details are on pp.40.

# Global economy

***"…[it looked like] the Goldilocks economy had arrived."***
*Claudio Borio, Head of the Monetary and Economic Department of Bank of International Settlements[1], 17 September 2017*

**At first glance, major global economies are doing just fine, enjoying real GDP growth in tandem. Consumer inflation is running below central banks' targets, and real GDP growth rates seem steady. When considered together, it's being called a "Goldilocks economy." We heard this before the recessions of the 1990s and 2000s, and we heard it again on the eve of 2008 global financial crisis, when it was thought that both growth and inflation were just right, i.e., not too high and not too low. Nowadays, we're hearing this theme once more, but this time we're cautious. We call attention to the parallels between what's happening now and what happened in the not-too-distant past.**

**The US dollar's steady slide over January-August of this year, as measured by the DXY, did help a number of emerging-market economies. This downward trend halted in September, as the DXY recovered on the back of the EUR retreat, likely because of Germany's election result, which was not seen as helpful for France and Italy's reform agendas. Going forward, the next major milestone for financial markets will be who is nominated as the next Fed chair, likely someone other than the incumbent. Regardless, we expect a continuation of a mix of still-low USD interest rates and a weaker dollar, with the DXY is forecast to be in 85-90 range in 2018.**

## Major developed economies: US & Eurozone

We again see signs that global financial markets are buying into the notion that major parts of the global economy are in a Goldilocks scenario. The global economy is "not too hot, not too cold, but just right", i.e., both real GDP growth and inflation are just right. This is true of major economies on different continents from Latin America to Europe, and from the US to the East Asia region.

### US: 'Goldilocks economy' theme re-emerging

*US economy has a near-tight labour market, steady growth of ~2%, and subdued inflation…*

The pace of real GDP growth in the 1H17—acceleration to 3.1% in 2Q17 from 1.2% in 1Q17 (in SAAR terms)—and over 3Q17[2] has supported the upbeat business mood, which is based on promises from the Trump administration for a number of breakthrough, pro-business policies, namely, lowering corporate tax rates, and business and financial deregulation, among others. This has powered financial-assets appreciation, other than the US dollar, and created an impression that the economy is "just right," based on headline macroeconomic indicators like GDP, unemployment, and inflation.

[1] Quarterly Review, September 2017 (http://www.bis.org/publ/qtrpdf/r_qt1709_ontherecord.htm)

[2] As of 29 September 2017, Atlanta Fed estimates GDP now yield 2.3% SAAR. See: https://www.frbatlanta.org/cqer/research/gdpnow.aspx. New York Fed has own estimate of the current quarter real GDP that yields +1.5% and 2% in 3Q17 and 4Q17, respectively. See: https://www.newyorkfed.org/research/policy/nowcast.html .

In March of this year, talk of a Goldilocks economy came after an interview with Gary Cohn[3], currently the chief economic advisor to President Trump, and formerly CEO of Goldman Sachs. At that time, this assessment was drawn from upbeat developments in the US labour market, when the unemployment rate was inching down to 4.5%, and from the stock market, when the S&P 500 and NASDAQ indices were hitting new highs.

*…This increased perception that the US economy was in a "Goldilocks scenario"*

In May, a survey conducted by BoAML of 213 fund managers with an impressive US$645bn AUM, found "a record 34% of respondents . . . describe[ing] the economy as being in a Goldilocks state."[4]

In July, the *Financial Times,* in an interview with a Goldman Sachs multi-asset strategist, remarked on how quiet the financial markets were in terms of volatility, another confirmation of a "Goldilocks scenario"[5]. At that time, a particular feature of the financial markets was that they were "too quiet," as different assets were rising in value, despite mounting, serious geopolitical issues, such as a new wave of sanctions against Russia, and North Korea threatening the US and its allies in the Pacific.

More recently, the BIS's quarterly report of 17 September, 2017 on the state of the global economy and financial system, leaned towards a Goldilocks assessment, too. The bank's economists highlighted a "strong outlook." Hence, if "Goldilocks economy" talk was marginal last year, it became mainstream by mid-2017, as financial markets' performance was positive for investors[6].

*Term "Goldilocks economy" used to describe seemingly benign conditions…*

So, what is all the fuss about the "Goldilocks economy," and why does it matter? In our view, it is an expression of the complacency that has spread over the financial markets. On one hand, markets are cheering tax reform promised by President Trump; however, it has yet to materialise. We note that Gary Cohn is in the driver's seat here, and we expect him to aggressively push this legislation through Congress. The same goes for another market-friendly move involving financial deregulation. However, markets are shrugging off risks that are usually associated with an economy having these characteristics.

*…before the 2007-08 global financial crisis*

There are two compelling similarities between the global economy today and in the pre-2008 period: First, the persistence of global imbalances as measured by current-account surpluses and deficits, where the US economy is in a deficit position; and second, the degree by which the private sector in the US is sliding to debt accumulation via deficit financing of both (consumer) consumption and (corporate) investment.

In terms of current-account balances, the global economy is more fragile than it is stable. The US and UK are the largest deficit economies, while Germany, China, and Japan have the largest surpluses. The current monetary arrangements between major economies with flexible FX rates and FX swap lines between central banks is supportive of the global economy. Not so with regard to national politics: President Trump has yet to deliver on his promise to make US trade agreements "fair for America", which implies that he will attempt to slash US imports and push exports, which would result in deflation for the global economy. Meanwhile, Germany's persistent current-account surpluses, along with those of the other surplus nations, put smaller, deficit economies under greater FX debt risk, as, unlike the US and UK, they cannot finance imports in their own currencies.

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[3] https://www.axios.com/gary-cohn-2309200714.html

[4] https://www.cnbc.com/2017/05/16/record-level-of-investors-see-goldilocks-economy.html

[5] See video: https://www.ft.com/video/790120c6-7357-4168-a371-bd63d5c32c3a

[6] Read: http://www.marketwatch.com/story/what-rose-in-the-third-quarter-stocks-bondsbasically-everything-2017-09-29

*Today, talk of a Goldilocks economy again points to inherent risk in the structure of the US economy*

In the US, the prevailing sentiment is towards restraining government size, and, in fact, government consumption and gross investment have been in decline in real terms since 1H17. Currently, US sectoral balances are such that they are steps away from bringing the domestic private sector into net deficit, as it was before the 2008 financial crisis. In fact, during both periods—the late 1990s and early 2000s—the private sector was in noticeable deficit, yet there was a widely shared notion of a Goldilocks economy.

Today, the Trump administration's business-friendly reforms of tax cuts and deregulation are likely to push the economy into sectoral balances where the private sector turns to deficit financing and, hence, is back in debt (Chart 1, p.8). As of 2Q17, the private sector was running a miniscule surplus, which could easily reverse. Recent media reports suggest[7] that this has already happened, and this is before Trump's reforms are passed. The trade deficit was greater in the January-August period this year than in the same period last year. And, as mentioned above, there is evidence from quarterly statistics that the government has reduced its purchases in an effort to reduce the government deficit. Under such a mix of developments, the US economy could be in the early stages of the same conditions that led up to the 2008 crisis, and we could be seeing the early warning signs. Given the experiences of the 1990s and 2000s, we believe the US economy can weather unfavourable sectoral balances for a good 10 years before a crises reverses them.

*Depreciation of the US dollar (DXY index) helped reinforce the view of a global Goldilocks economy*

While risky sectoral balances are a medium or long-term issue for the US economy, in the short term, it is the valuation of the US dollar that is of greater concern. Since most US debt is in its own currency, the value of the USD has less significance to the US than to other economies that frequently borrow in US dollars. Since April of this year, as measured by the DXY index, the US dollar has been in decline. This was a massive help to the global economy, as many countries saw their national currencies stabilise or appreciate. In fact, it was one of the longest depreciation streaks of the dollar in the past 20 years.

In our view, in September, the dollar decline was halted by a mix of factors. One was the Fed's commitment to raise the fed funds rate in December, and to cautiously unwind its balance sheet. Another was due to the election results in Germany, where PM Merkel's grip on power has somewhat weakened, and hence, her capacity to support reforms desired by France, Italy, and other member states diminished. In the run-up to elections, the latter factor was behind the market's positive view of the EUR, and hence, of the USD's decline.

*Naming the new Fed chair will be the next milestone for FX markets*

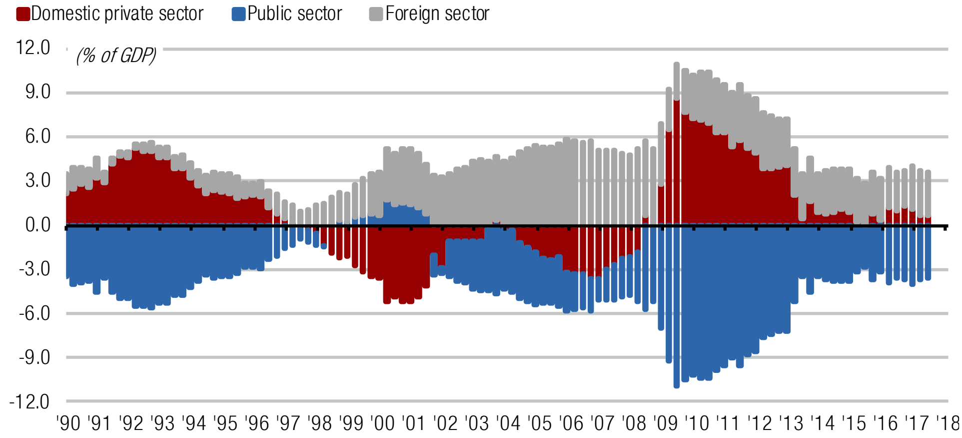
Currently, our view on the dollar is that it will maintain a range of 92-95 over most of 4Q17, as the expected December rate hike has been priced in. The next major issue affecting the financial markets will be who is nominated as chair of the Fed when Yellen's term expires. Among those being considered are Yellen herself, but regardless of who it is, markets will react. Out of the many risks that are mentioned over the future path of monetary policy by the Fed, in our view, there is a greater risk of the economy cooling, including recession and continued weak inflation, rather than overheating, where growth and inflation accelerate. With this in mind, our view is that the USD index (DXY) is likely to extend declines in early 2018 towards the 85-90 range.

In terms of USD interest rates, the Fed announced that it will increase the rate one more time in December 2017. In 2018, with, as we expect, a new chair who is someone other than Yellen, the Fed will make no more than two increases, as the economy and markets deteriorate. We forecast the Fed funds rate to be around 2% by year-end 2018, while the yield on the 10-year Treasury note will be in the neighbourhood of 3% in the same time frame.

[7] See article published by FT.com on 1 October 2017, https://www.ft.com/content/33138fda-a20f-11e7-b797-b61809486fe2

**Chart 1. US history of sectoral balances (% of GDP)**

*Annualised quarterly data from 1Q 1990 through 2Q 2017*




Source: BEA.

## Eurozone

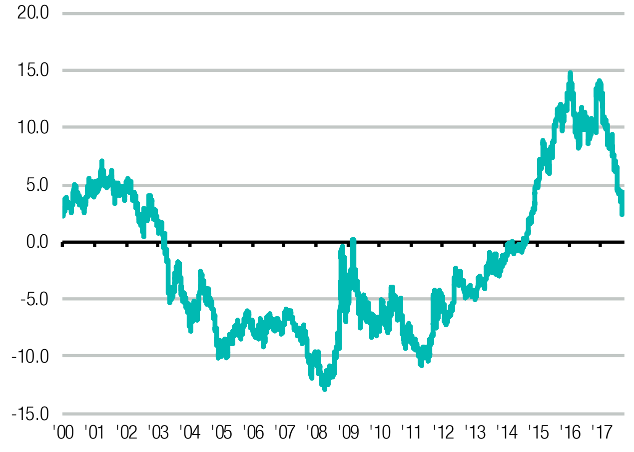
In the Eurozone, the 2017 political season is over. The Netherlands, France, and Germany saw the public sticking to the core of the political spectrum while rejecting non-mainstream political parties. In Italy, elections will not be held until early 2018, but the main opposition political party—the anti-establishment Five Star Movement, which does not have a physical headquarters[8], has cooled its rhetoric against politicians of the traditional parties to appeal to a wider group of voters. So even in Italy, the risk of another EU exit is diminishing. This helped the EUR recover over 2017, alongside improving GDP growth metrics by member states.

Going forward, there are a number of factors to pay attention to: 1) the ability of France's new president, Macron, to push his ambitious agenda on reforming the monetary union and EU, given that Merkel's somewhat weakened position adds to the growing risk that Macron-Merkel reforms end up as half measures, 2) Macron's popularity with voters, if his reforms do not go through, and 3) whether protectionist measures are put in place against Germany by deficit countries, including the US, due to its record-high current-account surplus.

[8] See video https://www.ft.com/video/f29e8f29-24c7-4f41-a7b1-ebb0effdec83

**Chart 2. USD misalignment, according to ICU real trade-weighted analysis**

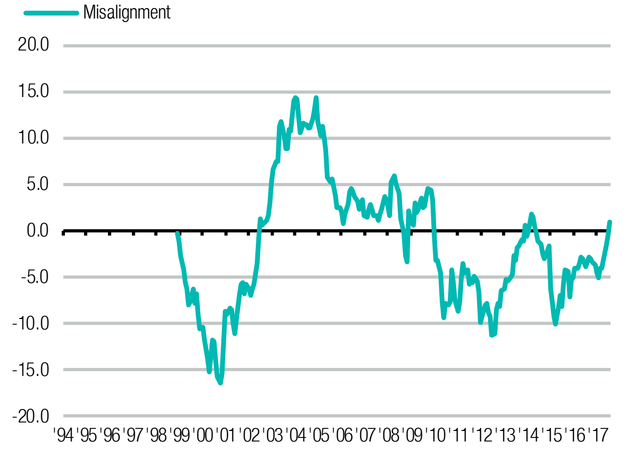
*Daily history from 1 January 2000 through 27 September 2017*




Source: ICU.

**Chart 3. EUR misalignment, according to BIS real trade-weighted analysis**

*Monthly history from December 1998 through September 2017*




Source: BIS, ICU.

## Major emerging economies: China & Russia as key parts of BRIC

BRIC, a sizable part of the global economy, has two economies—namely, China and Russia—that influence macro conditions in Ukraine via trade flows and monetary conditions—specifically, national currencies FX rates and domestic inflation—which impact Ukraine's currency valuation. Hence, we single out these two economies from the emerging-markets universe.

### China: With worries over debt still high, there is flexibility

Over the past two years, as bets against the CNY spiked in early 2016 and 2017, China successfully managed to contain its domestic money and foreign-exchange markets. The bears came up with a number of reasons, including those given in this recent article in Bloomberg[9]. Among them is the rapid accumulation of debt in China's domestic economy, which has raised concerns about the source of growth, especially in fixed assets. Markets are focusing on the amount of debt on the balance sheets of Chinese non-financial businesses, which reached 268% of GDP as of end-2Q17,[10] a level where other countries have seen their economies stall or capsize.

[9] See https://www.bloomberg.com/amp/news/articles/2017-09-29/hong-kong-deep-in-danger-zone-of-nomura-early-crisis-alert-gauge

[10] As reported by FT.com on 24 September 2017: https://www.ft.com/content/1b1c453e-9f80-11e7-8cd4-932067fbf946

*China's growth is taking place thanks to sizable expansion of debt, which reached 268% of GDP;…*

*……at the same time, there is a strong productivity push in China via robotics and automation*

Nevertheless, China's economy has been growing at 6-7%, and this resilience has placated its detractors. In our view, the trick to maintaining China's growth is that the economy is tightly managed by the authorities. They keep an eye on the issues like relative size of debt and productivity, which, for example, explains their push into electric cars, according to a story run by WSJ.com[11]. An indirect confirmation is in a recent series of articles in the Western media that critically evaluates China's industrial drive into robotics and automation. The *Financial Times* ran an article a year ago, "China's Robot Revolution,"[12] with this revealing commentary:

> *"On China's southern coastline, thousands of factories like Chen's are turning to automation in a government-backed, robot-driven industrial revolution the likes of which the world has never seen. Since 2013, China has bought more industrial robots each year than any other country, including high-tech manufacturing giants such as Germany, Japan, and South Korea."*

*There is sizable state intervention in the economy, which escalates risk of US trade retaliation*

The strategy here is to carry out a state-driven push for productivity improvement. Strikingly, in 2016, there was a total of 87,000 industrial robots installed in China, a third of which were produced domestically. However, this creates a social problem for China's rulers, which is future unemployment and social discontent, as robots replace people. However, China's authorities are aware of these concerns, and are likely prepared to support stagnant sectors, which will have to absorb this shift in employment. We suspect this strategy is paying off, because it appeared in the spotlight of US authorities who raised concerns that this highly competitive automation strategy (among other factors) ultimately hurts the US economy[13]. Hence, we conclude that while China's economy maintains resilience, it also creates international friction, especially with its largest net importers like the US.

After a lengthy streak of loses, there has been a stabilisation and upward trend in FX reserves through August 2017, when they increased for the seventh month in a row, to US$3.1tn. Markets are now bullish with regard to the future value of the CNY, as it has appreciated in nominal terms. Our analysis is that the CNY has fluctuated around its fair value since mid-2016 within a +/-5% interval, which means that there is no sizable misalignment in its valuation (see Chart below). Our mid-term forecast for the CNY is that it will trade inside the 6.6–6.9/USD range over next 6-12 months.

## Russia: Weak sanctions not hurting much

*Russia's economy is growing at 2% YoY, shrugging off a weak sanctions regime*

Over the summer of 2017, Russia was again in the global spotlight over the US's imposition of a new round of sanctions. Potentially, they may lead to a ban on US investors in Russian government bonds, which may be imposed in the 1H18. So far, the market's reaction has been calm. It appears to have been a non-event, as neither the ruble nor the Russian sovereign bond market has deteriorated, and their place in global financial markets remains unchanged. We have been skeptical of the efficacy of these sanctions from the very beginning[14]. They've been soft, and haven't hurt the Russian economy. If anything, we see

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[11] See https://www.wsj.com/articles/china-with-methodical-discipline-takes-global-lead-in-electric-cars-1506954248

[12] See https://www.ft.com/content/1dbd8c60-0cc6-11e6-ad80-67655613c2d6

[13] See https://www.ft.com/content/08c9e370-a33e-11e7-9e4f-7f5e6a7c98a2

[14] See http://www.intellinews.com/comment-how-will-the-new-us-sanctions-affect-russia-s-economy-127471/#.WZp-DvZ1bbo.twitter

the current sanctions as aiding the Kremlin in its task of adapting the economy to the new reality of lower oil prices and increased reliance on domestic producers.

Recent monthly statistical data points to the resilience of the Russian economy to the tightening sanctions. There have been no knock-on effects on consumer nor business confidence. Instead, government officials see better growth prospects for 2017. The Economic Minister eyes a full-year growth rate for 2017 of "above 2%" YoY,[15] better than the previous rate range of 1-2%.

Among the key driving forces of the economy are industrials, construction, agriculture, and cargo transportation; however, the retail sector remains somewhat stagnant; see charts on the performance of these sectors below (Chart 12-Chart 15, p.14-14). Underperformance of the retail sector underlines how the Russian economy is still recovering from the recent recession. This recovery is driven by only moderate consumer demand.

*Monthly consumer price deflation is a new feature of the Russian economy*

The key element of today's economic conditions in Russia is the authorities' focus on inflation. Headline CPI moved further down, to 3.3% YoY in August, well below the central bank target of 4%. Hence, the CPI has been trending below the target for the two months of July and August, where it likely stayed in September. Weekly price data indicate deflation has been ongoing[16], which implies that by the end of September, the on-year CPI is likely to land at 3% YoY or even lower.

*Real GDP is at 2%YoY, and headline CPI is at 3%YoY—this appears to be Russia's version of the Goldilocks economy*

There is evidence that economic policy has been successful in Russia. Real GDP growth has moved towards 2% YoY, while consumer inflation declined closer to 3%, far better than official targets. This creates the illusion of success, very much dear to financial markets economists who tend to describe such conditions as a "Goldilocks economy" where growth and prices are just right. This notion is even more empowered given the strong correlation observed recently between improvement in the consumer mood and the decline of consumer price inflation, as depicted on Chart 9 on pp.13.

*The flip side of the seemingly benign conditions is a slow wave of corporate failures among banks and firms*

In our view, Russian authorities have been adhering to a mix of tight monetary and fiscal policies, together with a sizable devaluation of the national currency, the most acute episode having been in 2014-15 (Chart 10 on p.14). The recovery over the past year was not sufficient to prevent a slowly spreading wave of cross defaults, which has caused bankruptcies and state bailouts of businesses. Even the Russian media has recognised these business failures as part of a wider trend.[17] Among the most prominent were Bank Otkritiye, Binbank, and VIM-Avia, a private airline. They were too big to be ignored—by state authorities or the media. Underreported, or worse—completely ignored, are the failures of scores of smaller businesses.

*President Putin is eyeing re-election in May 2018*

These conditions have created a situation whereby we expect to see the new government institute policies to turn around the economy after the presidential elections in in May 2018. PM Medvedev appears to have lost what little was left of his public support, and is now sidelined (Chart 5, p.12). At the same time, Putin retains high approval ratings, thanks to continued military aggression against Ukraine. He faces an easy re-election (Chart 4, pp.12), and is nurturing a younger generation of government officials. Among them are 35-year-old Economic Minister Oreshkin, who is regularly mentioned as becoming the future head of Russia's Cabinet of Ministers.

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[15] See http://www.vedomosti.ru/newsline/top/economics/news/2017/09/28/735814-minekonomrazvitiya-rost-vvp

[16] See http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d02/198.htm

[17] See (in Russian) https://www.vedomosti.ru/opinion/articles/2017/10/02/736034-nikto-ne-hotel

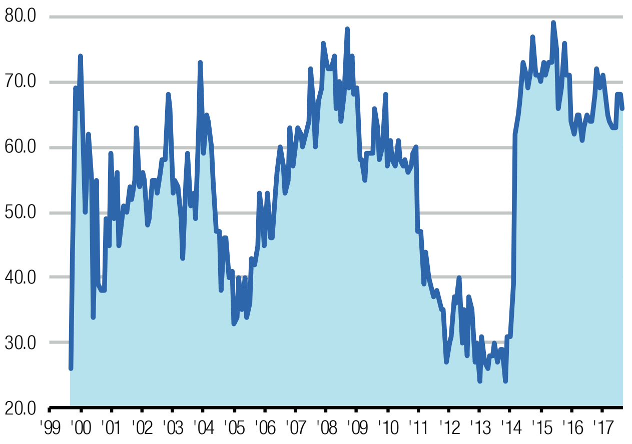
*Changes in the government will take place eventually*

Judging from Oreshkin's media appearances and his remarks about the economy, he adheres to mainstream policy tools and prefers low inflation and accelerated headline growth, considering investments as the key element of near-future growth. This implies that should he be the next PM, he is unlikely to engineer a fiscal-policy boost, nor he would push the central bank to lower interest rates. He must focus on structural changes in the economy instead. If a state-directed stimulus does not happen, then the growth rate will not be more than 2-3% a year.

We expect the Russian economy to trend at about 2-3% in the near term, while domestic interest rates will be guided by the Russian central bank to maintain the attractiveness of RUB interest-earning assets over those denominated in foreign currencies. This implies that the key policy rate of the RCB will be inside 7-8%. This will allow the Russian ruble to trade inside the 50-60/USD range, which is appropriate, according to our real trade-weighted FX analysis. (Chart 10 on pp. 15 shows that as of 27 September, the ruble was undervalued by 8%).

**Chart 4. President Putin approval index***

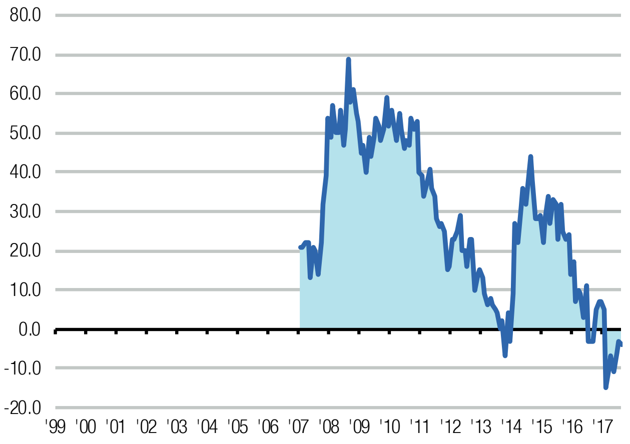
*Monthly history from July 1996 from September 2017*




Note: * Levada had been producing this index through mid-2014, it discontinued producing this index, while continued producing components on which one can make the calculation by him/her-self, ICU research department does this calculation. See explanation by Levada by this link.
Source: Levada.ru, ICU.

**Chart 5. Prime Minister Medvedev approval index***

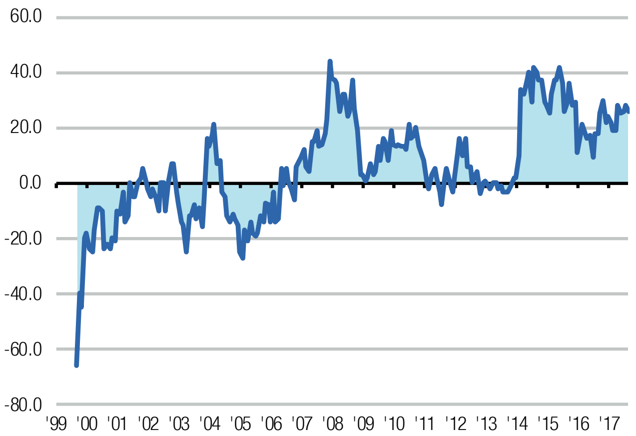
*Monthly history from February 2007 from September 2017*




Note: * Levada had been producing this index through mid-2014, it discontinued producing this index, while continued producing components on which one can make the calculation by him/her-self, ICU research department does this calculation. See explanation by Levada by this link.
Source: Levada.ru, ICU.

**Chart 6. Index of assessment of current conditions in the country***

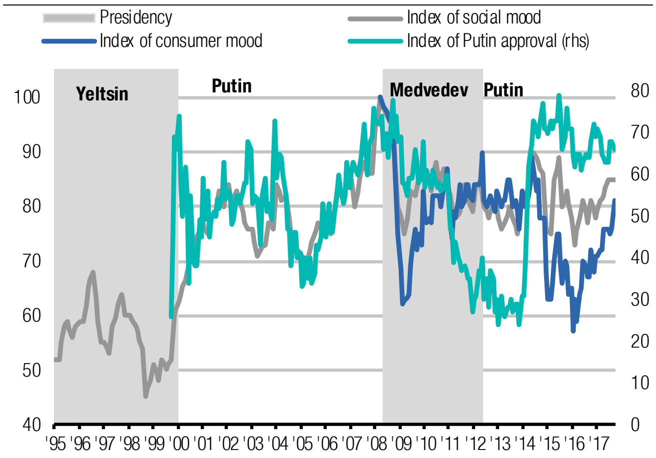
*Monthly history from July 1996 from September 2017*




* Difference between those who consider that conditions are on right path and those who consider they are on wrong one.
Source: Levada.ru, ICU.

**Chart 7. Russia presidents against the history of social mood and consumer mood indices**

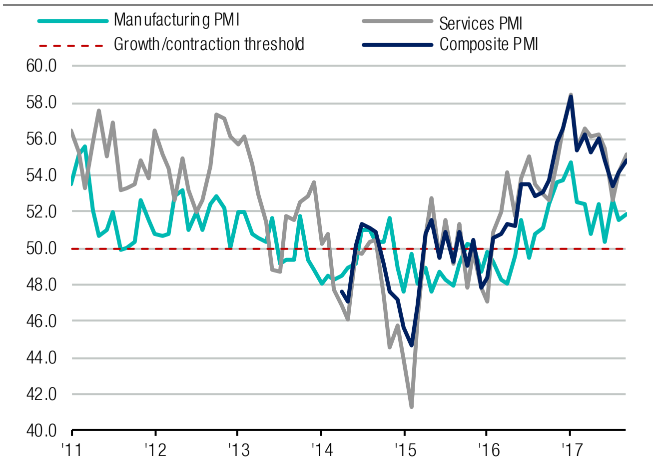
*Monthly history from January 1995 from September 2017*




Source: Levada.ru, ICU.

**Chart 8. Russia PMIs: history from January 2010 through September 2017**

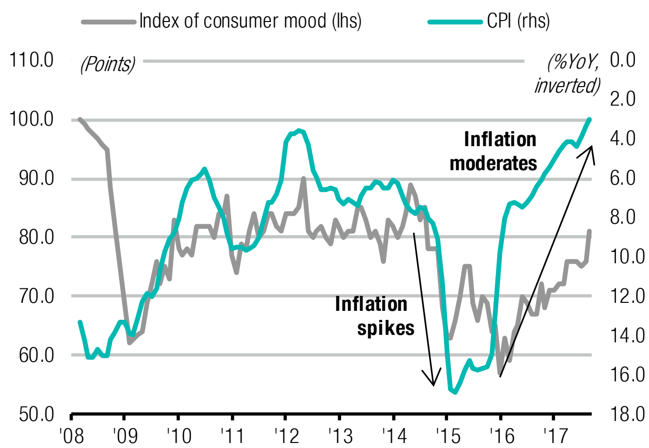
*Monthly data*




Source: HIS Markit, ICU.

**Chart 9. Russia's public consumer mood (points, left scale) and headline inflation (%YoY right scale, inverted)**

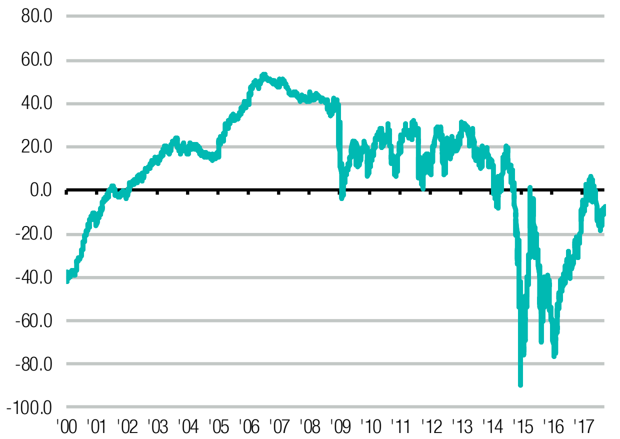
*Daily history from April 2014 through September 2017*




Source: State statistics office of Russia, Levada.

**Chart 10. RUB misalignment, according to ICU real trade-weighted analysis**

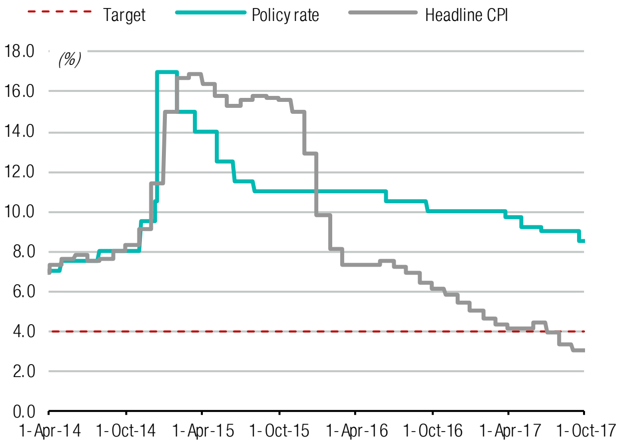
*Daily history from 1 January 2000 through 27 September 2017*




Source: ICU.

**Chart 11. Russia's central bank policy rate versus current rate of headline CPI and inflation target (%)**

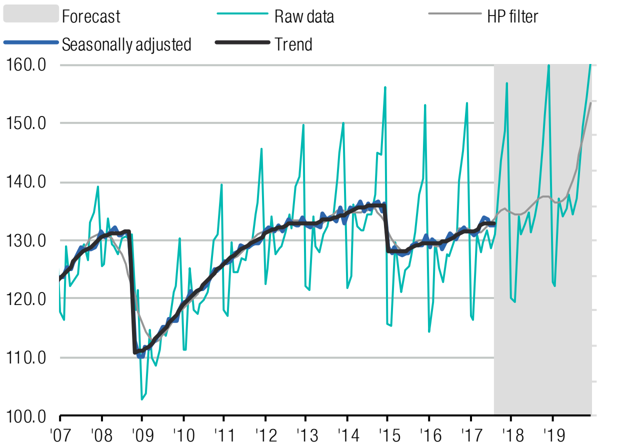
*Daily history from April 2014 through May 2017*




Source: Bloomberg.

**Chart 12. Monthly performance of the industrial sector**

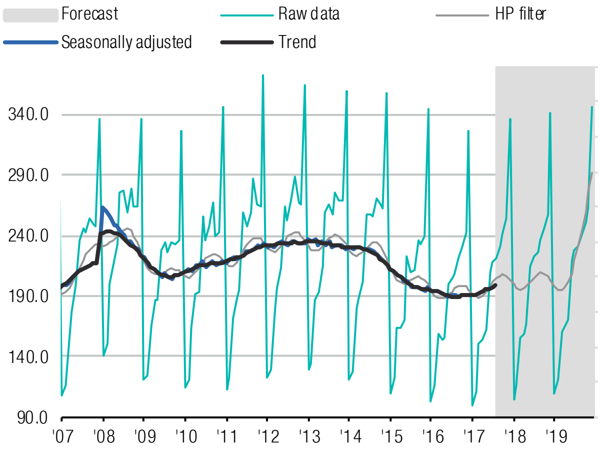
*Monthly history through August 2017*




Source: Russian state statistics agency, ICU.

**Chart 13. Monthly performance of the construction sector**

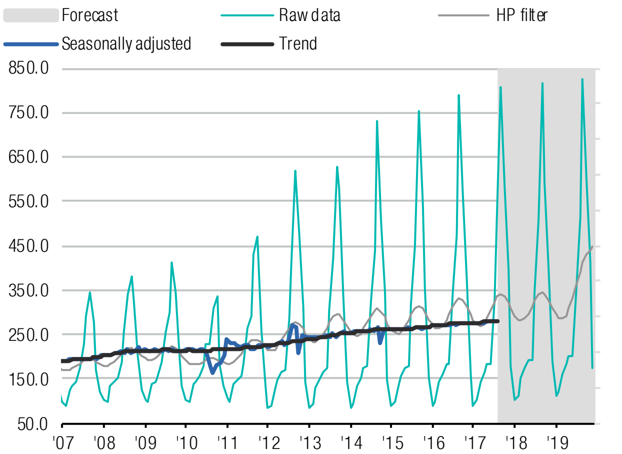
*Monthly history through August 2017*




Source: Russian state statistics agency, ICU.

**Chart 14. Monthly performance of the agriculture sector**

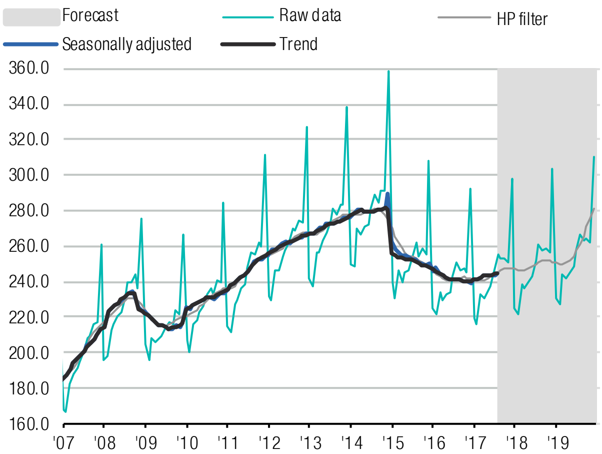
*Monthly history through August 2017*




Source: Russian state statistics agency, ICU.

**Chart 15. Monthly performance of the retail sector**

*Monthly history through August 2017*




Source: Russian state statistics agency, ICU.

# Oil prices: No significant increase ahead

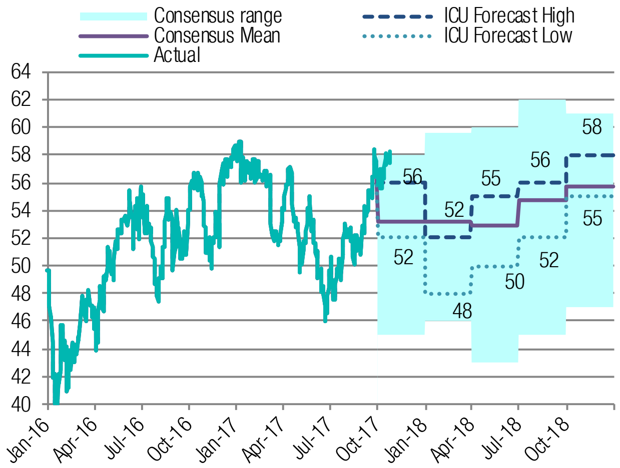
**The September-October rally in oil prices was spurred by signs of market rebalancing as a result of stronger demand and the OPEC production-cut agreement beginning to work. However, the rebalancing appears to be taking place slower than it was initially hoped. The effect of the OPEC production-cut agreement was undermined by a resumption of the fast growth of US shale oil production, production recovery of OPEC countries exempt from the agreement, and lagging compliance on the part of certain OPEC members. Oil demand, in turn, is likely to slow into 2018, as its key drivers—the effect of lower prices and high economic growth in EM economies—are fizzling out. While OPEC will likely have to extend production beyond 1Q18 to avoid oil inventory build-up, it is increasingly costly for members of the agreement to restrain output. Without further escalation in geopolitical tensions, average Brent price should remain within the US$52–56 range in 4Q17, and slowly move up to US$60-62 during 2018–20.**

## Brent is range-bound within US$50-60 in 2017-20

*We expect Brent prices to be in the range of US$52-56/bbl in 4Q17, growing to US$60-62 in 2018-20*

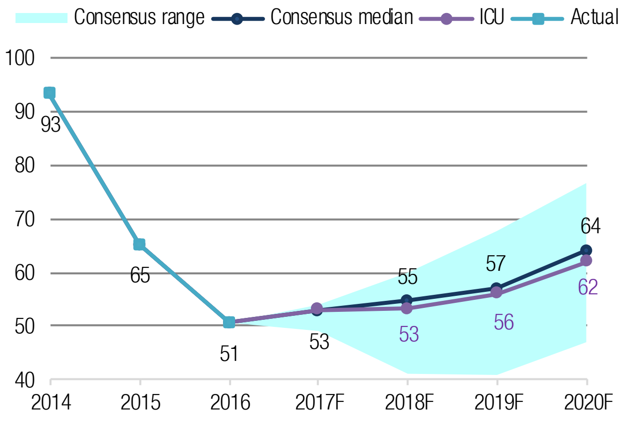
We expect average Brent price to stay in the range of US$52-56/bbl in 4Q17, and then slip to US$48–52/bbl in 1Q18, due to the demand seasonally slowing down, US shale production rising, and crude inventories again building up. Our long-term view on Brent is largely in line with Bloomberg's consensus median, and suggests a gradual increase in price to US$60/bbl in 2018-20. The key upside risk for oil prices is possible escalation in geopolitical tensions (anti-Iranian sanctions, conflicts in Nigeria, Libya, etc.). The key downside risk is a sharper than expected slowdown in demand from emerging markets.

**Chart 16. Quarterly Brent price forecast**




Sources: Bloomberg, Goldman Sachs, Morgan Stanley, ICU.

**Chart 17. Annual Brent price forecast**




Sources: Bloomberg, Goldman Sachs, Morgan Stanley, ICU.

## Effectiveness and longevity of OPEC cuts questionable

*The OPEC production cut agreement turns out to be less effective than expected by the market*

The agreement between OPEC and non-OPEC countries to cut oil production has become one of the drivers helping to rebalance the global oil market. The original agreement became effective in January 2017, and provided for a combined 1.8mbpd output cut by its members for six months. In May 2017, OPEC and its allies decided to extend supply cuts to 1Q18. Speculation that the supply cuts would likely be extended beyond March 2018 further supported the market in August–September.

In reality, however, OPEC's production-cut agreement appears to be working less effectively than was expected by the market. As OPEC producers significantly increased output before reaching the agreement in 2H16, the 2H17 YoY decline is being driven mainly by base effect, rather than strong compliance. The effect of the agreement is further undermined by stronger-than-expected production recovery in Nigeria and Libya, the two OPEC countries exempt from obligatory cuts. The other two OPEC members in question, Iraq and UAE, are lagging in compliance with supply cuts. Russia, the largest non-OPEC member of the agreement, indicated from the start it would phase in its pledged cut, and already achieved its target cut in May 2017; further extension of cuts would be increasingly costly for Russian producers.

## US drillers are the main disruptive force for oil prices

*US oil producers have acclimated to the lower price environment, and are the key contributors to non-OPEC supply growth*

As the US remains the largest source of non-OPEC total supply growth (50–60% in 2017E and ~40% in 2018E), US shale oil production is the key supply factor that is disruptive for oil prices. After US crude oil production declined by 560kbpd YoY in 2016, it is expected by IEA to rise by 400kbpd in 2017, and by another 590 kbpd in 2018.

A large proportion of US shale oil producers appear profitable below $50/bbl. New shale-oil wells are becoming more and more productive, with higher efficiency and shorter drilling times. While the US rig count has recently declined, there is a large inventory of drilled-but not-completed wells that can help quickly ramp up output. Furthermore, as soon as oil prices reach US$50/bbl, US producers are increasingly comfortable hedging forward production.

## Oil demand is past its peak

*Global oil demand will slow, as the lower price effect is fizzling out, and economic growth is insufficient*

Most market watchers forecast a slowdown in global oil demand growth to 1.2-1.4mbpd in 2018, from 1.5-1.6mbpd YoY in 2017. Strong 2mbpd YoY growth in oil demand in 2015 was driven by lower prices. In 2016, demand growth moderated to 1.3mbpd. The lower price effect is fading, and economic growth looks insufficient to provide strong supportive income effects.

China is the major contributor to demand, accounting for about 50-60% of YoY growth in the global oil market in 2017. However, the country is likely to ease off the infrastructure and consumer spending that drove fuel consumption on 2016-17. Another risk for oil demand stems from a possible slowdown in refilling China's oil storage tanks. While China so far continues actively buying relatively low-priced crude for its Strategic Petroleum Reserve and Commercial Petroleum Reserve, some industry members fear that even with slower imports, the country may reach full crude oil storage capacity by mid-2018.

## Market rebalancing takes longer than expected

*Despite OPEC production cuts, the market will not experience a crude deficit in 2017; however, if OPEC does not extend cuts beyond 1Q18, oil inventories will build*

In 2017, OPEC's crude production should approximately match the "call" on its oil from the market. This implies that the current level of supply cuts induced by the OPEC/non-OPEC agreement should not lead to material inventory draws in 2017.

In 2018, the call on OPEC crude may decline, while non-OPEC supply is likely to grow. In case the production-cut agreement unwinds, OPEC supply will grow in 2H18, and thus will cause crude oil inventories to build again. Otherwise, the countries participating in the agreement may find it increasingly burdensome to further restrain their oil output in the stagnating oil price environment, which is likely to affect their ability/desire to comply with the agreement's cuts

# Domestic politics

**The current domestic political cycle comes to an end in a bit over a year, as presidential elections will be held in March 2019. However, Ukraine's politicians are already preparing for the event. The government is planning to reflate the economy, aiming to accelerate growth in 2018, as well as boost incomes of ordinary Ukrainians via social spending and another minimum-wage increase. Conditions of the global economy, characterised by a Goldilocks scenario, are supportive to the government, and will even provide some time to formulate and push the IMF required reforms without immediate urgency.**

## Final, pre-election phase begins

*Ukraine's top politicians are already bracing themselves for presidential elections in March 2019*

By the established protocol of Ukraine's politics, politicians are positioning themselves for the next elections just shortly after the previous electoral battle ended. If at the beginning of 2017, there was sporadic talk in the media and those close to power that early parliamentary elections were "imminent" (which we considered as a low-probability event), by year end, we conclude that no such undertaking will have taken place. The next election results will be determined according to the constitution, and these presidential elections will be held on Sunday, 31 March 2019. That is the date all Ukraine politicians have marked on their calendars.

*Peace and the economy are two key issues that will be used by politicians while selling their track records to the public*

Opinion polls now place the incumbent president, who will definitely seek re-election, a bit behind opposition politicians. Among them are old guard politicians Yuliya Tymoshenko (56) and Yuriy Boiko (58), who are not able to unite because public support will not add up to a win. However, Poroshenko may outplay both of them if he: 1) succeeds with the peace plan for Donbas that has been agreed to by the new US administration; and 2) reflates the economy such that benefits are shared via social payments as well as via increasing the minimum wage.

As far as peace talks are concerned, Ukraine's authorities will stick to the line pushed by Kurt Volker, US Special Envoy to Ukraine. So far, the Kremlin continues to play its own game and shows little willingness to step back from its aggressive stance towards violating Ukraine's sovereignty. We underline that the Minsk Peace Agreement is a developing story that has had little progress despite the best efforts of Ukraine's authorities.

## Appetite for a new 'blockade' gig diminishes

Another positive feature in the Ukraine's politics these days is that the political opposition has slacked off in its efforts to again disrupt economic life. Earlier this year, disruption was a homegrown effort by opposition politicians who interfered with the operations of certain businesses, alleging that they were showcasing corruption. It ended with a sporadic, militia-led blockade of the cargo-transport flows between mainland Ukraine and the occupied territories of the Donbas region.

What started as a PR stunt by political opposition parties forced the authorities to intervene, and put an official blockade on cargo supplies. As a result, Ukraine's industrial sector as a whole ended up in another year of stagnation (see Chart 20, pp.20). Now, with the "start of a new political season," as the month of September is recognised by Ukraine's political watchers, we see an op-ed[18] from an MP from the opposition party, Natalya Veselova, who was perceived as backing the blockade. She is calling for the elimination of the official blockade, and wants a more progressive legal regime for the businesses operating in the occupied territories. This is effectively a U-turn in the narrative of the opposition politicians, who favoured the blockade in early 2017, and now are urging that it be dismantled. In our view, this is positive news from Ukraine's politicians, and perhaps an indication that they will cease their economically disruptive behaviour.

## IMF cooperation: Depends on how long the notion of a Goldilocks economy persists

*The trick with the Goldilocks economy is that it allows EM economies like Ukraine to delay socially painful reforms*

With elections looming on the horizon, there is concern about whether Ukraine's authorities will maintain the pace of reform mandated by the IMF programme. Socially complicated reforms such as pension and land reforms, as well as reform of natural gas tariff pricing, are not the type of programmes that boost approval ratings. The current agenda has consisted of pushing through a series of reforms, and then doing nothing for a period of time.

This year has been no exception to that rule. Furthermore, the warm reception Ukraine received for its Eurobond issuance in the global financial markets in September has given authorities a certain amount of breathing room. In September, Ukraine's government issued a 15-year bond denominated in US dollars, and secured an additional US$1.32bn for its FX account balance, now estimated at US$2bn. This is the balance at the central bank; the total including FX balances in the domestic commercial banks amounting to US$3bn. This improves Ukraine's ability to service its external debt (see Chart 72-Chart 73, p.40). Even without new FX borrowings, the government can service its FX debt through mid-2018.

This additional financial capacity will potentially allow Ukraine's authorities to delay pushing through required reforms. And, if the Goldilocks economy holds through 2018, and risky EM sovereigns can continue to borrow in the Eurobond market, then IMF-mandated reforms could be delayed through the end of the current political cycle, which ends in March 2019.

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[18] In Ukrainian http://www.epravda.com.ua/columns/2017/09/28/629546/

# Ukraine's economy

**We revised upward our 2017 real GDP growth rate to 1.8% YoY, from 1.2% YoY previously. This was thanks to consumer demand, which was pushed up by government intervention that doubled the minimum wage.**

## Economic activity in 2Q17 and 3Q17: Steady recovery after weak start to the year

*Ukraine's economy is expected to register 1.8% YoY real GDP growth for full-year 2017*

Ukraine's economy again flirted with recession in 1Q17, as it did in the first quarter last year. However, in the 2Q17, the economy turned to growth. Official statistics have produced a first reading of 2Q17 real GDP, pointing to an expansion of 0.6% over the previous quarter in seasonally adjusted terms, after a contraction of 0.3% QoQ SA in 1Q17. In year-on-year terms, growth slowed to 2.3% in 2Q17, from 2.5% in 1Q17.

Despite a slowdown in year-over-year terms, the economy started expanding on a quarterly basis. The monthly statistical data on key non-financial sectors of the economy in the second month of 3Q17 revealed an upturn in the industrial sector, as the industrial production index rose 3.3% MoM in seasonally adjusted terms. Reported raw data for August was a 3% YoY increase, while for the January-August period, it was still a 0.4% YoY decline. The industrial sector rose on average 1.2% per month in May through August; hence, this particular sector stabilised and turned to modest growth. Other sectors like agriculture, retail trade, and cargo transportation were performing more capably. Construction continued recovering more robustly, albeit from a low base. The only sector that posted a monthly decline was passenger transportation. Improved performance on a monthly and quarterly basis (compared with July and 2Q17, respectively) suggests that the third quarter is going to be stronger than the previous one. Given the high-frequency data for 3Q17, we expect that the real GDP growth rate will be reported at 1% QoQ SA to be followed by 0.5% QoQ SA in 4Q17.

**Table 1. Performance of key sectors of Ukraine's economy in August and over June–August 2017**

| 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 | +1.6 | +0.02 | +3.0 | +0.1 | +0.1 | +0.3 |
| Retail trade, retailers (UAHm, CPI-adj) | +2.7 | +5.0 | +32.4 | +1.1 | +5.3 | +31.4 |
| Transport turnover, cargo (tonne*km) | +2.4 | -1.6 | +7.8 | +0.6 | -1.3 | +6.5 |
| Transport turnover, passenger (passenger*km) | -1.6 | -1.0 | -4.9 | -0.6 | -1.5 | -4.4 |
| Industrial production index | +3.3 | +0.7 | -0.9 | +0.4 | +0.2 | -2.1 |
| Construction (UAHm, CPI-adj) | +6.1 | +7.6 | +30.5 | +1.2 | +6.4 | +26.3 |
| **Composite index** | +2.6 | +1.7 | +9.6 | +0.5 | +1.6 | +8.1 |

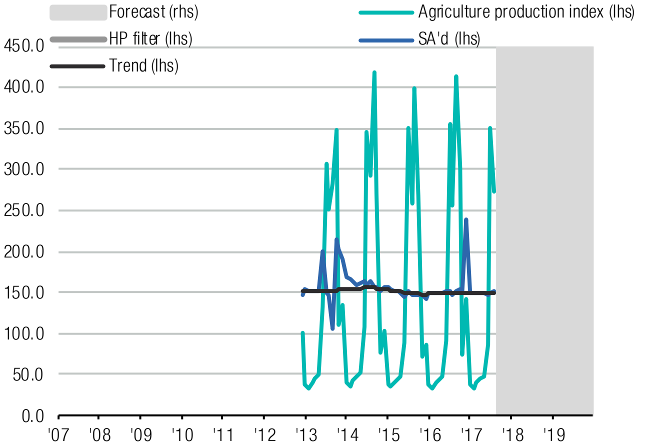
Notes: * Adjusted by Demetra using adjustment method of Tramo-Seats; [1] month-on-month change of November of 2016 to October 2016; [2] quarter-on-quarter change of Sep-Nov of 2016 to Jun-Aug of 2016; [3] year-on-year change of November of 2016 to November of 2015.

Source: State Statistics Service of Ukraine, ICU.

Overall, full-year growth of real GDP amounts to 1.8% YoY. This represents an upward revision made mid-summer from 1.2% YoY. For 2018, we expect that a government-led boost to the economy on the eve of presidential elections will be quite decisive, and result in a 3% YoY real GDP increase. This will be followed by a slowdown to 1% YoY, as it would require a FX flexibility injection, and, hence, it would serve as a mini-shock for corporate balance sheets, which usually are loaded with FX debt.

**Chart 18. Agriculture production index**

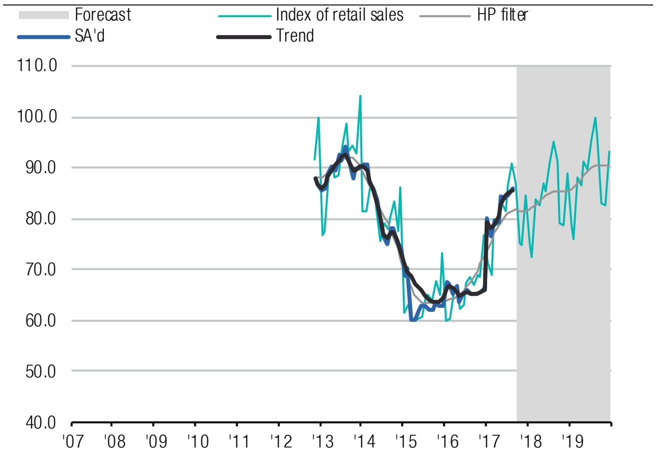
*History (from January 2007 through August 2017), forecast for 2017-19*




Source: State Statistics Service of Ukraine, ICU.

**Chart 19. Retail trade (UAHbn, in constant prices of Dec-1999)**

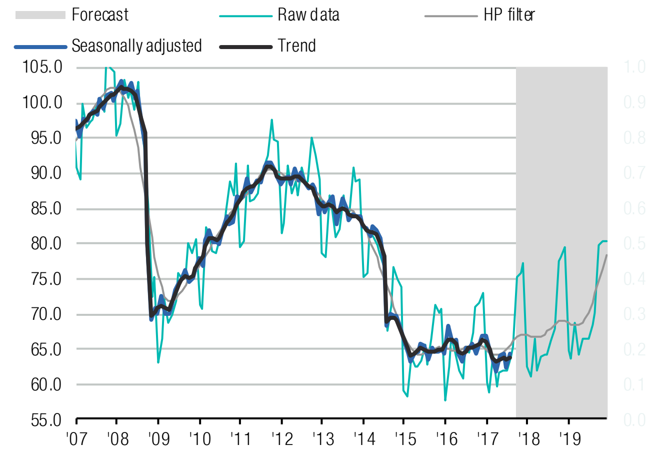
*History (from January 2007 through August 2017), forecast for 2017-19*




Source: State Statistics Service of Ukraine, ICU.

**Chart 20. Industrial production index**

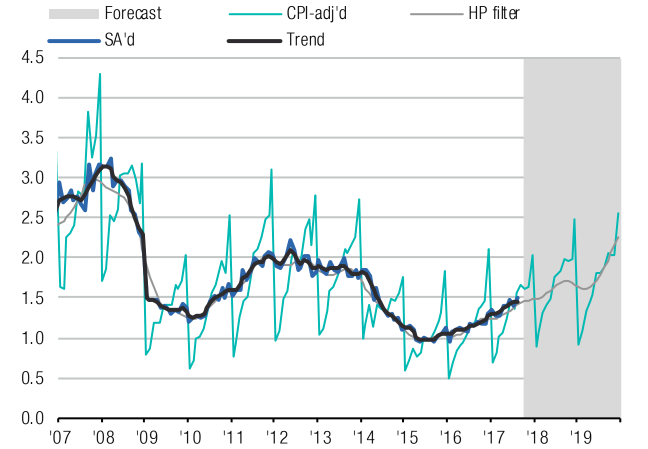
*History (from January 2007 through August 2017), forecast for 2017-19*




Source: State Statistics Service of Ukraine, ICU.

**Chart 21. Construction (UAHbn, in constant prices of Dec-2001)**

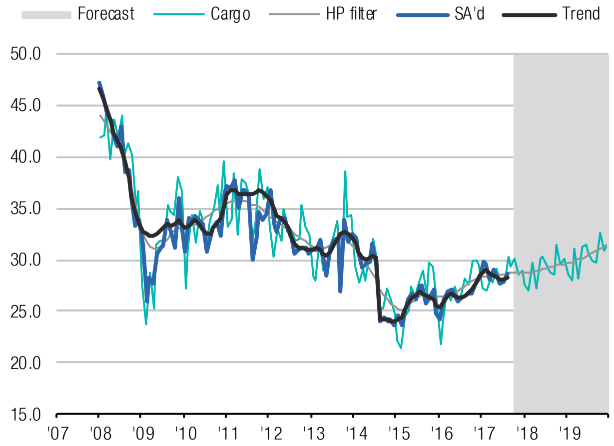
*History (from January 2007 through August 2017), forecast for 2017-19*




Source: State Statistics Service of Ukraine, ICU.

**Chart 22. Cargo transportation turnover (m tonne * km)**

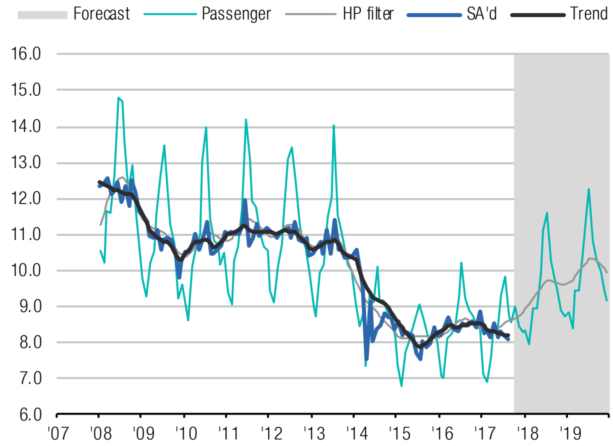
*History (from January 2007 through August 2017), forecast for 2017-19*




Source: State Statistics Service of Ukraine, ICU.

**Chart 23. Passenger transportation turnover (m * km)**

*History (from January 2007 through August 2017), forecast for 2017-19*




Source: State Statistics Service of Ukraine, ICU.

## Sectoral balances: Decoding their recent evolution

***By mid-2017, the economy again runs with sectoral balances that have proved to be unstable over the past 10 years; …***

We have detailed data on national accounts that reveal the state of sectoral balances through 2Q17. The headline trend in this last quarter (of 2Q17) was increased deficit spending by the government (and accounts for final expenditures on goods and services, excluding social transfers).

This resulted in a quarterly deficit of UAH32bn, or 4.9% of the three-month nominal GDP of this particular sector. While the surplus of the external sector—as measured by Ukraine's trade balance in goods and services—has been expectedly resilient, amounting to 4.3% of GDP, the balance of the domestic private sector—both businesses and households—landed a surplus of 0.6% of GDP.

On the basis of 12-month rolling data from 3Q16 through 2Q17, Ukraine's sectoral balances extended the pattern seen in the recent past: the external sector had a surplus of 5.5% of GDP, up from 5% three months ago, while the domestic private sector remained in a deficit of 1%, just 0.1ppt up from end 1Q17. Lastly, the government balance, which is traditionally in deficit, expanded to 4.5%, up from 4.1%.

***…this is not about Ukraine's ability to produce competitive goods for sale abroad…***

The gradually expanding balances of these subsectors underline the cautious-yet-steady recovery of the economy. Ukraine, nevertheless, struggles to find adequate external demand for own goods and services. Hence, the economy is again running a trade deficit. As the domestic economy recovers, it increases imports[19] well ahead of its ability to find export markets. Hence, our key concern, as always, is that as a net importer, Ukraine is also a net borrower. This burden has extended over the past 10 years. Nonetheless, we are cautiously optimistic that this time around, the future will be brighter.

[19] Imports of goods and services in 2Q17 increased both in the year-on-year terms for last three months of data, and in the quarter-on-quarter terms for the last 12-month of data. Respectively, they rose by 26.8% YoY and 5.6% QoQ. At the same time, growth of exports lagged behind – it was 20.4% YoY and 4.6% QoQ, respectively.

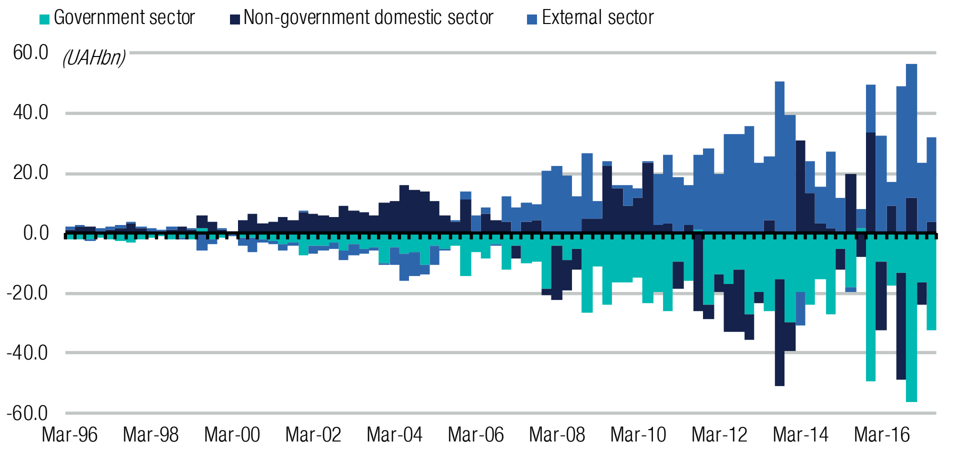
*…it is viewed as an organizational setup, where private businesses tend to run profit centres abroad and use FX loans as convenient tools for corporate optimisation*

The issue of Ukraine's chronic external deficit is not a lack of capacity for producing/ competitive products for international markets. Rather, it is the more complex issue of corporate structure. Private businesses tend to have headquarters and profit centres abroad, and use intracompany credit lines as profit optimisation instruments. This is because debt servicing is not taxable, while dividend payments are. Further, companies are subjected to regular state intervention due to concern over FX rate stability, and in this regard, debt service cross-border payments are more protected than dividend cross-border payments from state intervention. In the end, exports tend to be underreported, and the economy is hindered by complex constraints of the FX regime and FX indebtedness.

Because of this, it is more realistic to expect Ukraine's sectoral balances to remain as they are now, with the private sector running deficits and the trade position also in deficit. Moreover, given the prevailing view that the government sector should avoid widening the deficit,  it is likely that the private sector will again build up FX debt. The global perception of a Goldilocks economy will facilitate this process, as creditors are willing to take on risk.

**Chart 24. Ukraine's sectoral balances: quarterly volumes (UAHbn)**

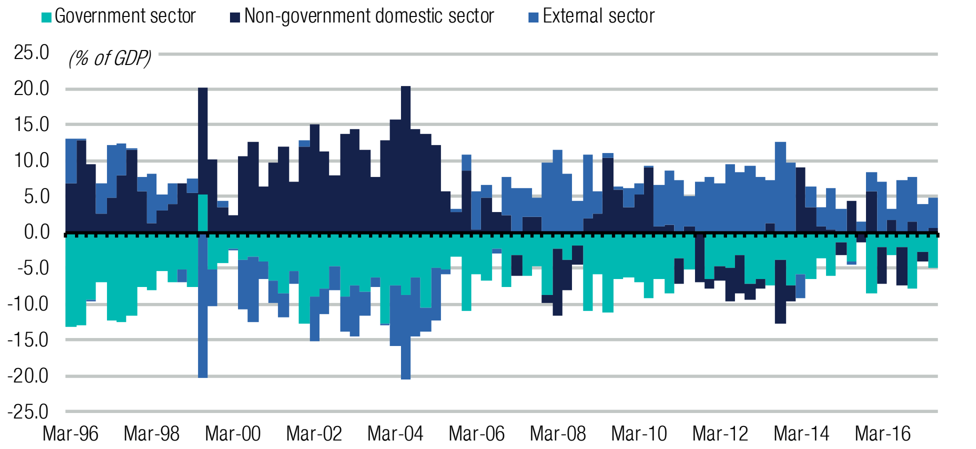
*History from 1Q of 1996 through 2Q of 2017, at current prices*




Source: State Statistics Service of Ukraine, ICU.

**Chart 25. Ukraine's sectoral balances: quarterly volumes (% of GDP)**

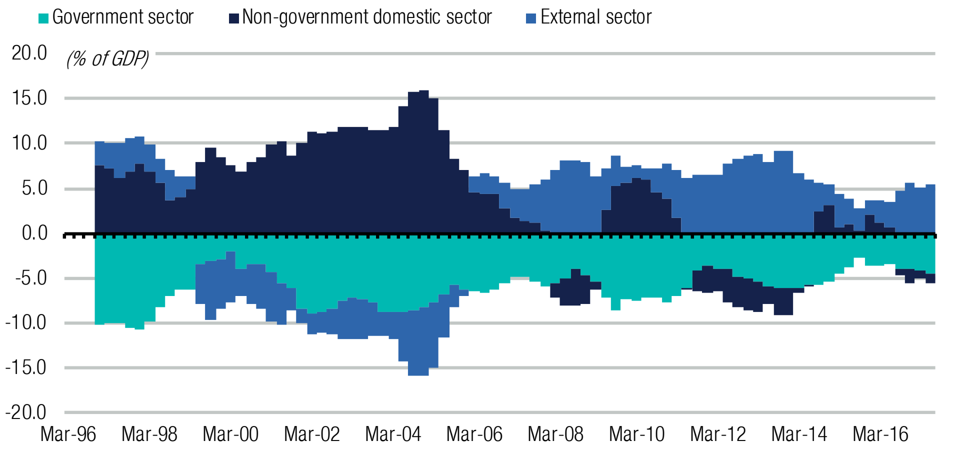
*History from 1Q of 1996 through 2Q of 2017, as a percentage of quarterly GDP*




Source: State Statistics Service of Ukraine, ICU.

**Chart 26. Ukraine's sectoral balances: last four-quarter rolling volumes (% of GDP)**

*History from 1Q of 1996 through 2Q of 2017, as percentage of quarterly GDP*



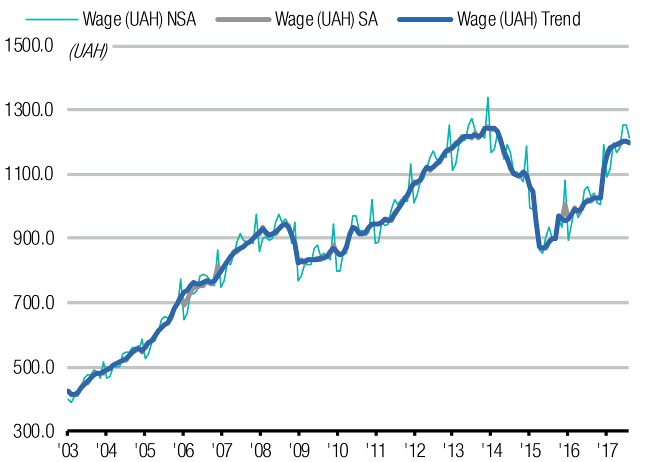

Source: State Statistics Service of Ukraine, ICU.

## Consumer spending: Recovery amid stagnant jobs

*In 2017, the state pushed to increase wages. This is expected to be repeated in 2018, alongside state spending to spur economic activity and increase jobs*

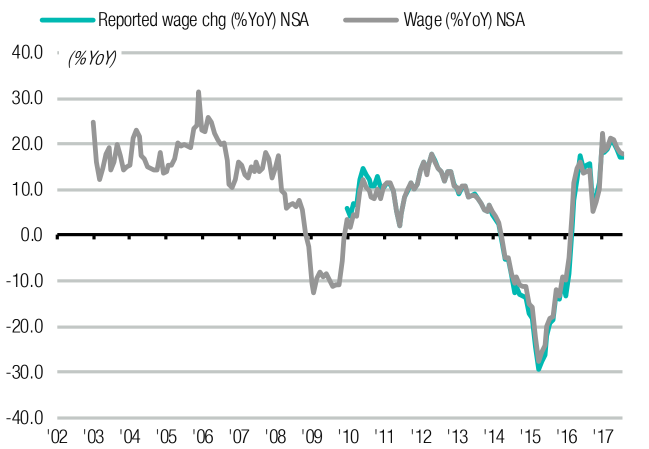
Consumer demand has increased, as wage growth, in both nominal and real terms, was quite noticeable this year. Albeit slowing to 17% YoY as of the latest reporting period in August, it peaked at 20% in very early 2017. This development took place against a backdrop of a still-stagnant job market. Official statistics put the economically active population at 17.83m, which is lower than a year ago (17.93m). Out of this population, the number of employed was 16.12m as of end 1H17, less than the 16.24m seen a year ago. The latest reported unemployment rate of 9.6% is up from 9.4% a year ago. Hence, Ukraine's economic recovery, which has been taking place since late 2015 has been a jobless one. Further, it coincided with a contraction of the official (recorded) part of the economy, pushing more people statistically into the unofficial economy. In the run-up to presidential elections in 2018, the government will address the issue of raising the minimum wage again, after having doubled it in January 2017, and by spending on civil infrastructure, a kind of domestic trickle-down economics, in the expectation that this will benefit the broader public.

**Chart 27. Average monthly wage through August 2017 (UAH, adjusted for CPI) at constant prices of December 2001**



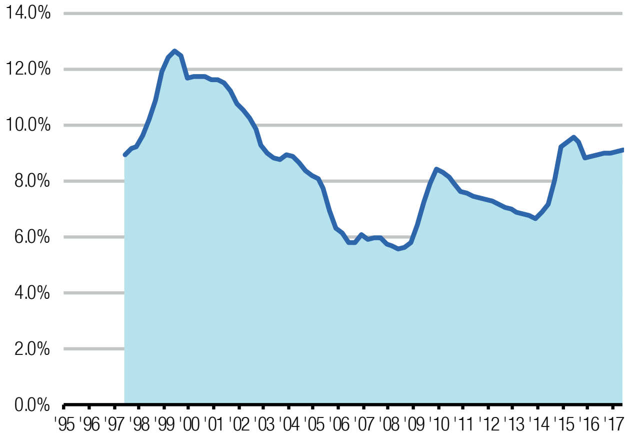

Source: State Statistics Service of Ukraine, ICU.

**Chart 28. Growth rate of average monthly wage (UAH, adjusted for CPI) at constant prices of December 2001**



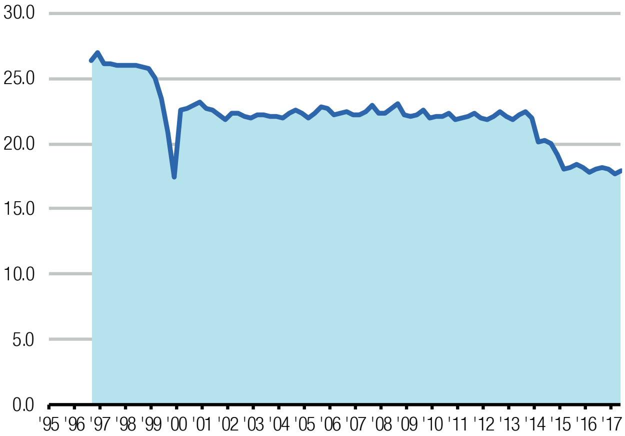

Source: State Statistics Service of Ukraine, ICU.

**Chart 29. Unemployment rate* through 2Q17 (%)**




Note: * Data series is based upon last 12-month quarterly averages. Source: State Statistics Service of Ukraine, ICU.

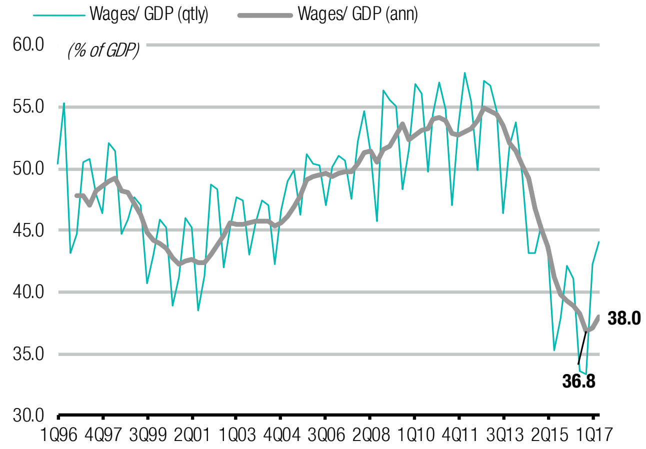
**Chart 30. Economic active population through 2Q17 (m)**




Note: * Since 1Q of 2014 population is adjusted for occupied territories (Crimea and parts of Donbas). Source: State Statistics Service of Ukraine, ICU.

**Chart 31. Share of wages component in GDP (% of total)**

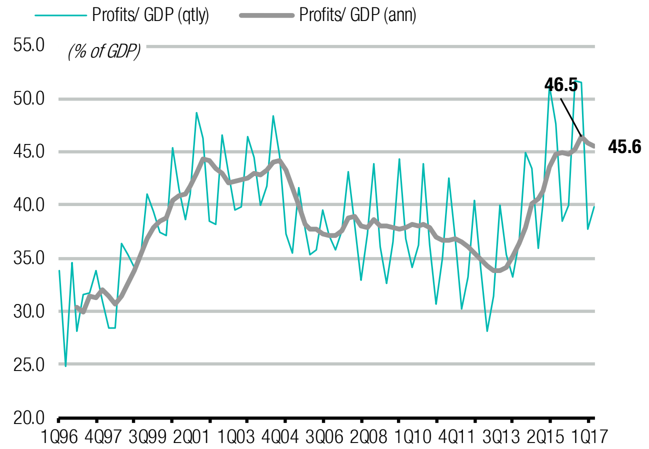
*Quarterly history from 1Q of 1996 through 2Q of 2017*




Source: State Statistics Service of Ukraine, ICU.

**Chart 32. Share of incomes component in GDP (% of total)**

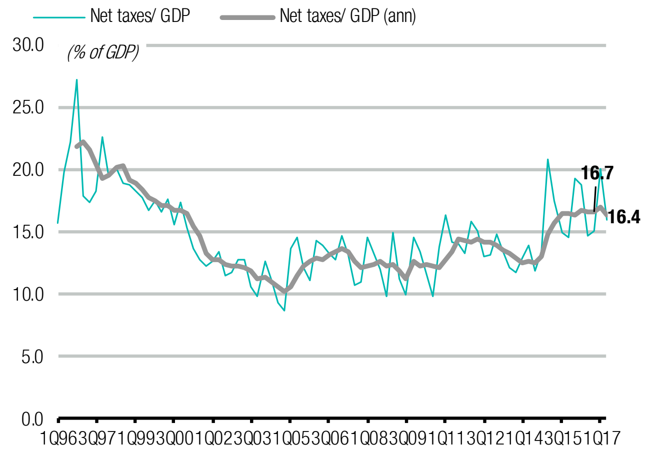
*Quarterly history from 1Q of 1996 through 2Q of 2017*




Source: State Statistics Service of Ukraine, ICU.

**Chart 33. Share of the net taxes component in GDP (% of total)**

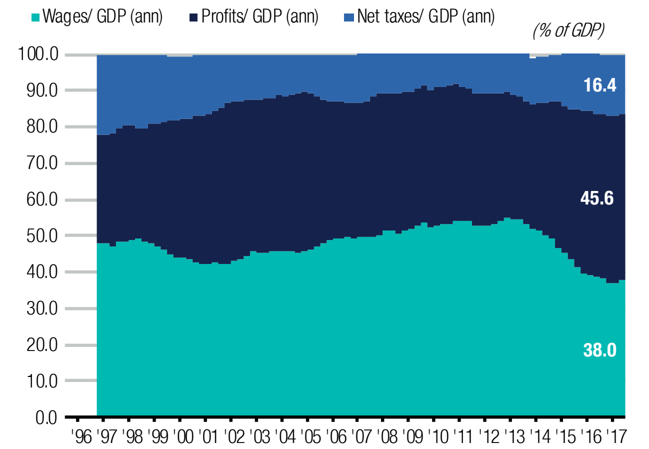
*Quarterly history from 1Q of 1996 through 2Q of 2017*




Source: State Statistics Service of Ukraine, ICU.

**Chart 34. Breakdown of GDP by incomes (% of total)**

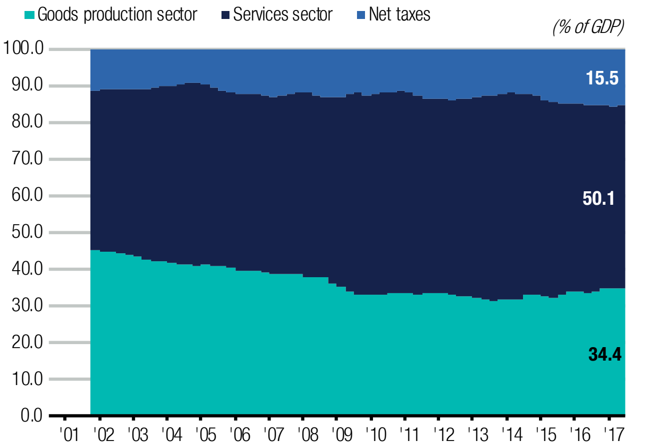
*Quarterly history from 1Q of 1996 through 2Q of 2017*




Source: State Statistics Service of Ukraine, ICU.

**Chart 35. Breakdown of GDP by production (% of total)**

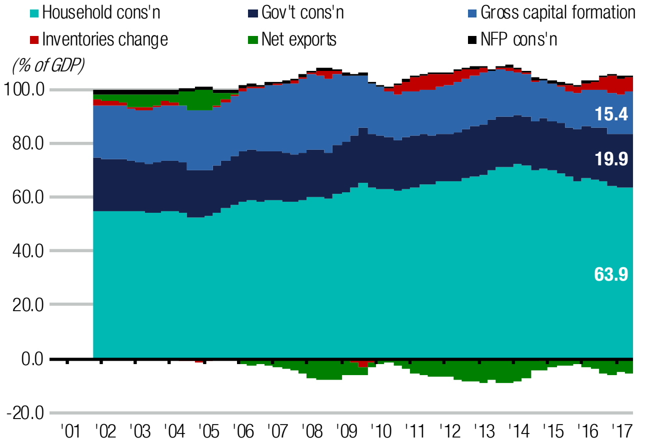
*Quarterly history from 1Q of 1996 through 2Q of 2017*




Source: State Statistics Service of Ukraine, ICU.

**Chart 36. Breakdown of GDP by expenditures (% of total)**

*Quarterly history from 1Q of 1996 through 2Q of 2017*




Source: State Statistics Service of Ukraine, ICU.

# Consumer confidence: Up, lifting demand for imports

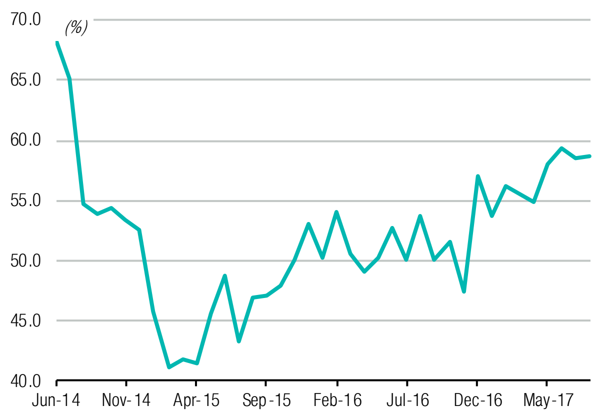
*In July, consumer confidence was at its highest level since mid-2014*

May's consumer confidence was at the highest level since July 2014, and has remained at that level over the last four months through July (see Chart 37). The increase in confidence was boosted mostly by appreciation of the hryvnia, rising real wages, and macroeconomic stabilisation.

However, rising consumer confidence, together with the strengthening domestic currency, has caused an increase in the current account balance, as imports increased at a faster pace than exports. The survey conducted by GfK in January 2017 shows that 28.6% of all loans were taken out by consumer electronics (see Chart 38), which is in line with an upward trend of total imports.

**Chart 37. Consumer confidence index in Ukraine**

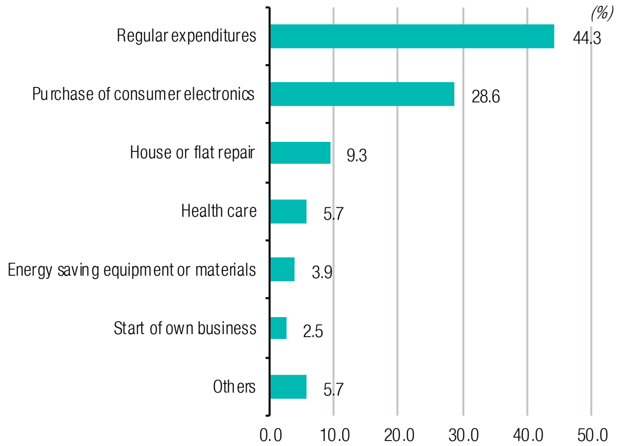
*Monthly history from June 2014 through August 2017*




Source: GfK Ukraine, ICU

**Chart 38. Reasons for applying a new loan**

*As of January 2017*

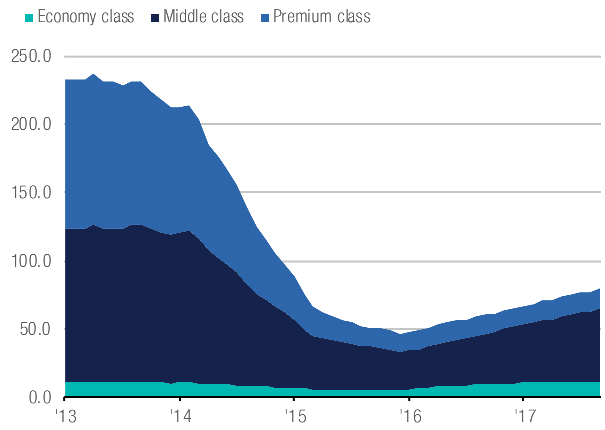



Source: GfK Ukraine, ICU.

Another indicator of rising consumer confidence is an increase in the purchasing of durable goods. A good example here will be new cars, whose sales have risen since June 2016, and have gathered momentum (see Chart 39, p.27). At the same time, it must be noted that sales of economy-class cars, which had dropped significantly, have not yet recovered. Another important dynamic is evident in the sales of middle-priced cars, which increased the most among the three classes. Imports of cars in terms of both value and units have also risen (see Chart 40, pp.27).

**Chart 39. Sales of new cars in Ukraine (thousands of units, last 12-month rolling volumes)**

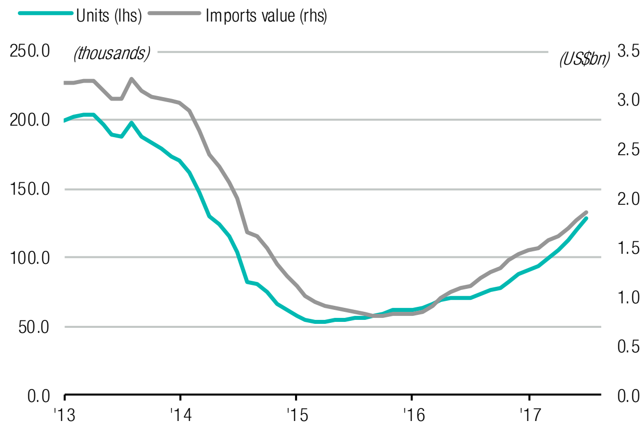
*Monthly history from January 2013 through September 2017*




Source: UkrAutoProm, ICU.

**Chart 40. Imports of cars (last 12-month rolling volumes)**

*Monthly history from January 2016 through July 2017*




Source: State Statistics Service of Ukraine, ICU.

## Industrial activity: Mixed conditions in 3Q17

Industrial orders for Ukraine's goods—official data is available through August (depicted in charts below)—have shown quite a sluggish performance for the most part of this year. It appears that the upward momentum of 2016 was short-lived. Current conditions are mixed, as foreign orders turned negative in both inflation and seasonally adjusted terms, while there is just a marginal pickup in domestic orders.

*The industrial sector was hit hard by political turmoil that ended with a blockade of industrial enterprises in the occupied territories*

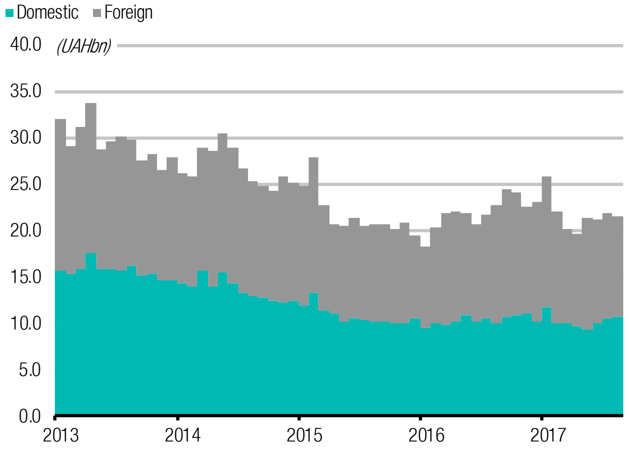
Earlier this year, a blockade-the-cargo-flows-with-Donbas political gig took place. This put a halt to the sector's recovery, which was gaining strength last year. The industrial production index went into decline in April, reaching a multi-year low. However, having adapted to new circumstances, the industrial sector has stabilised over the following months and turned to growth, albeit at very slow pace.

The blockade slowed the recovery in the industrial sector seen last year, and had a negative impact on other areas within the sector. This was evidenced by the monthly official statistics on orders for goods produced by businesses from a range of sub-sectors of the industry. The latest available data through August indicates that the growth rates were slightly above zero after a significant drop in March (see charts below), and turned negative again in August. The decrease in industrial orders was driven by a contraction of orders from abroad, as a result of the hryvnia's appreciation, while domestic orders turned to growth. Taking into account the recent development in the sector, there is a possibility that 3Q17 will be stronger than the previous quarter, with the growth rate QoQ SA running close to 0.5%.

*In 4Q17, state expenditures are to increase noticeably, implying some share will be spent on domestic industrial goods*

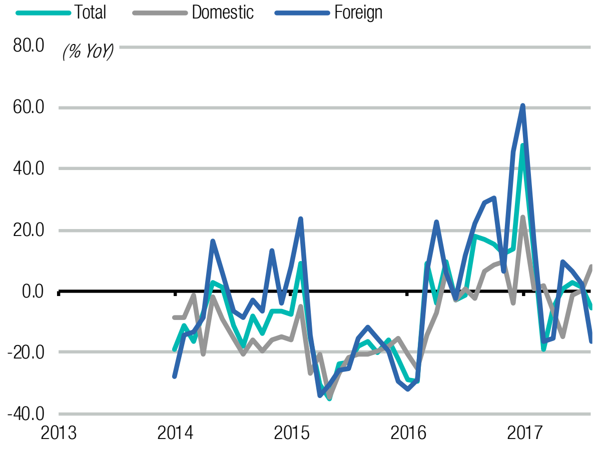
As 4Q17 progresses, it is expected that the government's expenditures will hit the entire year's target of UAH841bn. Through August, total spending by the central government amounted to UAH489bn, UAH61bn/month on average, implying the rest to be spent during the September-December period to be UAH352bn, or UAH88bn/month on average. Hence, once again, state expenditures will be skewed to the last quarter of the year. This suggests that some part of state expenditures will be spent on domestic industrial goods (directly or indirectly), and hence there is reason to think that domestic industrial orders will increase, allowing support for domestic producers. In 2018, there is also an expectation that state orders will spur some activity in the sector.

**Chart 41. Monthly volume of industrial orders through Aug-17 (UAHbn, seasonally adjusted, at constant prices of December 2012)**



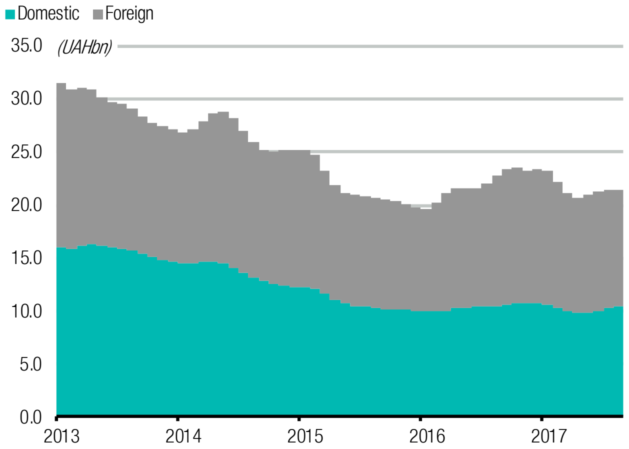

Source: State Statistics Service of Ukraine, ICU.

**Chart 42. Change in the monthly volume of industrial orders through Aug-17 (% YoY, seasonally adjusted, at constant prices of December 2012)**



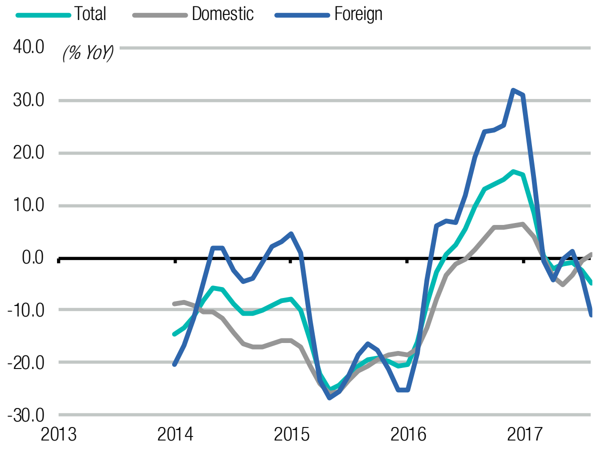

Source: State Statistics Service of Ukraine, ICU.

**Chart 43. Monthly volume of industrial orders through Aug-17 (UAHbn*)**




Note: * Based upon seasonally-adjusted, at constant prices of December 2012.
Source: State Statistics Service of Ukraine, ICU.

**Chart 44. Change in the monthly volume of industrial orders through Aug-17 (% YoY, trend*)**




Note: * Based upon seasonally-adjusted, at constant prices of December 2012.
Source: State Statistics Service of Ukraine, ICU.

## Inflation: Consumer vs. producer prices

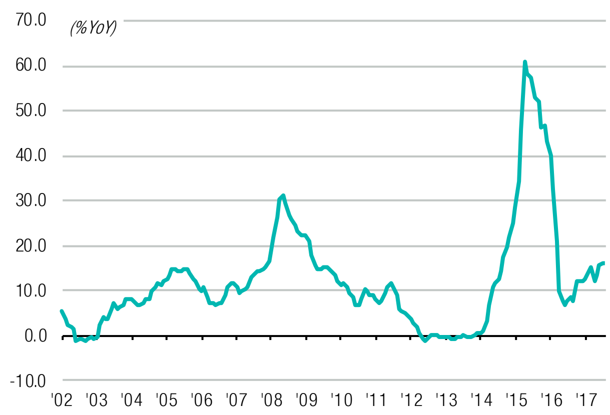
In August, consumer inflation was -0.1% MoM, thanks to a seasonal decrease in prices of un-processed fruits and vegetables. However, in year-on-year terms, headline CPI has been rising for five months in a row, and reached 16.2% in August, the highest level since March 2016.

In September, headline CPI accelerated by 2% MoM on food, clothes, and education services. This pushed up on-year headline inflation toward 16.4% YoY, up from 0.2ppt a month ago. However, on-year core CPI slowed 0.1ppt, to 7.7% YoY, from August suggesting that the general trend of the consumer inflation skewed to the downside despite the uptick of the headline measure of CPI. This leads us to believe that the recent bump in inflation was transitory, and hence will not force the NBU to increase its policy rate in 2017.

We stick to the view that given the preference of Ukraine's government to adhere to "stability," which goes hand-in-hand with suppressed volatility in the nominal exchange rate, ensured by maintaining a state budget primary surplus, the trend for consumer inflation is to slow over 4Q17 towards 14-15% YoY by year-end 2017 from the current 16.2% YoY level. Over 2018, the trend has been extended, and a mild slowdown in headline consumer inflation will take place, i.e., towards the range of 10-12%

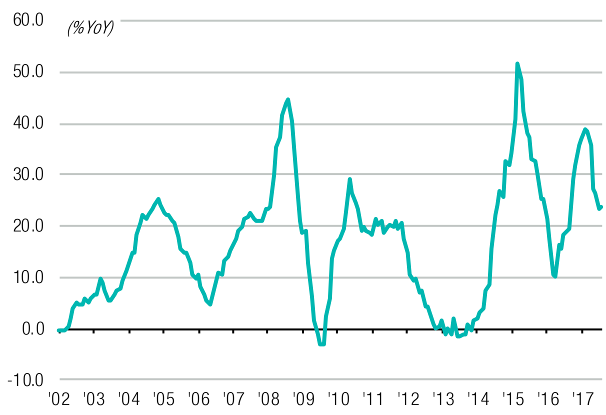
Our view on global commodities prices stems from the so-called macro-and-monetary mix, which exhibits an inverse correlation between the US dollar value and commodities prices. Given our base-case scenario, expectation that the dollar's value will pause for the next three-to-six month period, and then gradually decline over the next six-month period, we see prospects for the CRB index to increase somewhat. Hence, our base-case scenario remains unchanged from our previous forecast update of early 2017. Ukraine's PPI is likely to react in step, i.e., the current slowdown will be followed by a muted acceleration.

**Chart 45. Change of headline CPI (% YoY)**



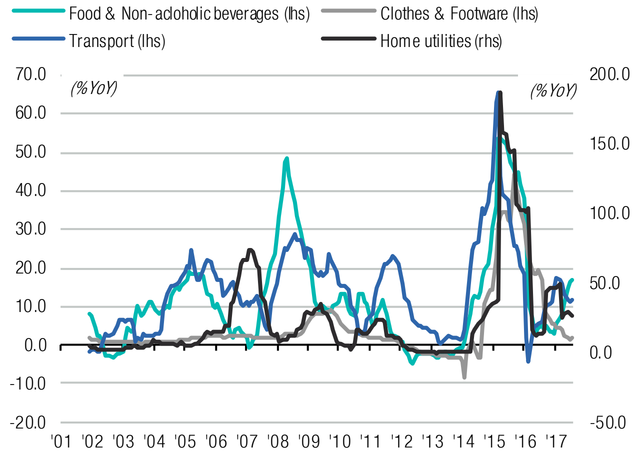

Source: State Statistics Service of Ukraine, ICU.

**Chart 46. Change of PPI (% YoY)**



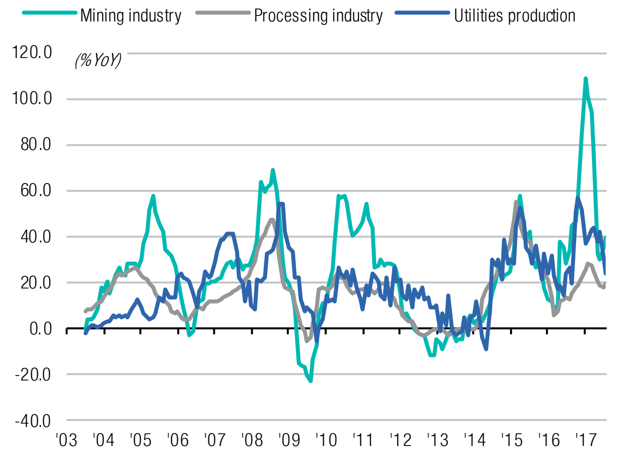

Source: State Statistics Service of Ukraine, ICU.

**Chart 47. Change of key components of headline CPI (% YoY)**



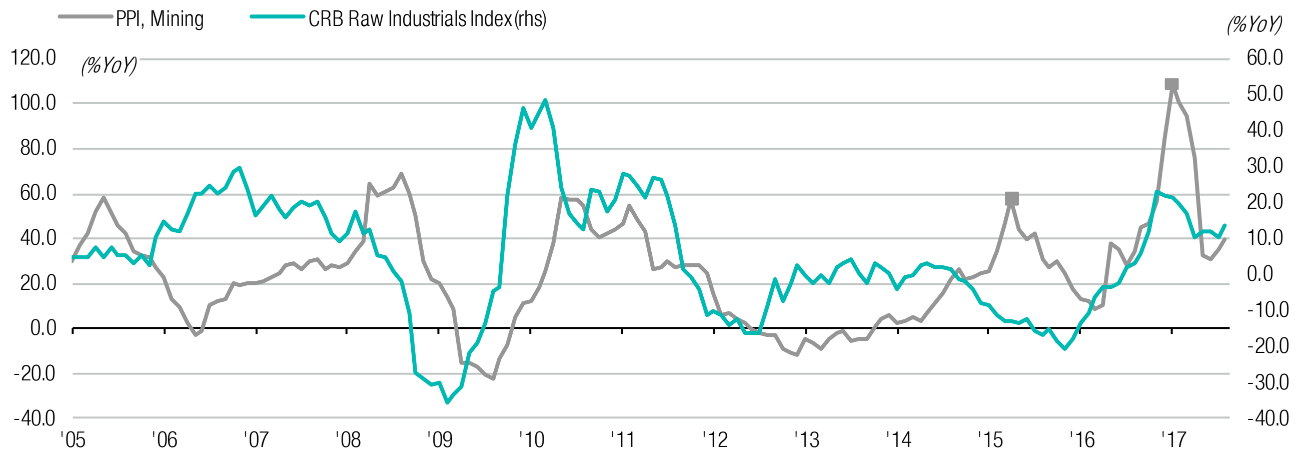

Source: State Statistics Service of Ukraine, ICU.

**Chart 48. Change of key components of PPI (% YoY)**




Source: State Statistics Service of Ukraine, ICU.

**Chart 49. A year-on-year change of Ukraine's mining sector producers price index, a PPI sub-component, plotted against growth in the CRB Raw Industrials index[1] (% YoY)**




Note: [1] http://www.crbtrader.com/data.asp?page=chart&page=chart&sym=BVY00&name=BLS%20Raw%20Industrials
Source: State Statistics Service of Ukraine, ICU.

# Sovereign debt update: Maturity extension is currently a key theme

**Last month, there was a lot of positive news about the Ukrainian debt. There was a buyback of USD1.576bn of Eurobonds maturing in 2019-20, the issuance of a new 15-year US$3bn Eurobond at 7.375%, return of non-residents to Ukraine's domestic bonds market, and the improved likelihood of re-profiling government bonds held in the NBU's portfolio. Together, these developments portend a stable outlook for Ukraine's debt policy.**

## Sovereign debt deal 2017: Buyback and new issue

*Ukraine replaced US$1.576bn of debt with new bonds on the market*

Recently, the Ukrainian Ministry of Finance successfully brought to market a new Ukrainian sovereign Eurobond, its debut market operation with sovereign debt, based on its main goals of: reducing the country's debt burden for 2019-20 and creating a path to return to capital markets with new issues. Ukraine purchased US$1.576bn of Eurobonds with maturities in 2019, and 2020, and issued new US$3bn Eurobonds due 2032 (WAL14.25).

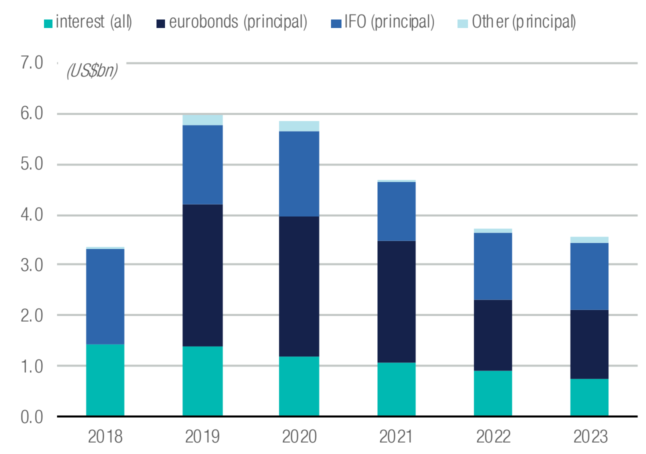
*Deal improves the debt repayment schedule*

Prior to the deal, the state faced a heavy debt burden for these two years, which amounted to US$5.96bn and US$5.84bn for external debt principal and interest repayments, respectively. The main portion of this deal was the redemption of Eurobonds for US$2.82bn and US$2.78bn, respectively. There will be a significant increase in payments to IFOs during 2018, including the redemption of IMF loans. This transaction takes some pressure off in 2019, reducing payments by US$1.06bn, and in 2020 by US$0.23bn, smoothing out the payment schedule. Based on our calculations, the net positive impact from deal for the next five years will be US$0.55bn, as the reduction in principal payments will be partially offset by an increase in interest payments.

The charts below show that the burden of debt repayments, and possible problems they could have caused, were shifted from 2019 to 2020, which gives the Ukrainian government additional time to smooth out this schedule again, probably next year.

**Chart 50. Old schedule of external debt repayments**

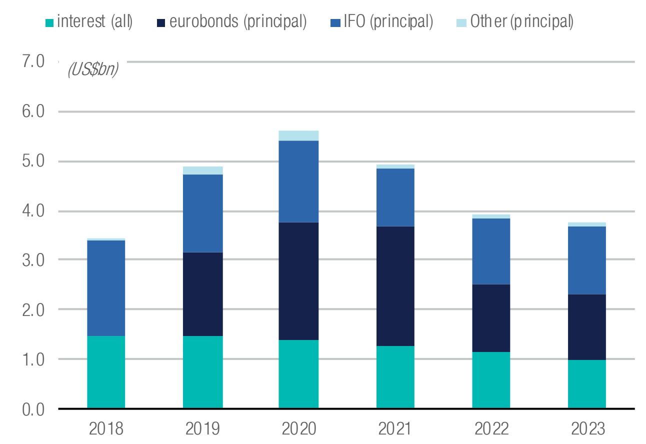
*Yearly for following five years*




Source: MoF of Ukraine, ICU

**Chart 51. Schedule of external debt repayments after deal**

*Yearly for following five years*




Source: MoF of Ukraine, ICU

*The MoF extended the yield curve and created a new base for corporate issues*

On the subject of the new issue of Eurobonds, we should also note that the weighted average life of this issue was reduced from 15 years to 14.25 years using an amortisation scheme. This will allow the government to reopen this issue and add to it at least another US$1bn later this year or next. The yield of this issue was set at 7.375%, or 514bp above the benchmark, a bit lower than the rate for bonds issued under the restructuring in 2015. Ukraine returned to the markets after an absence of more than four years with this public issue, which sets up a new long end of the yield-curve and a new benchmark for possible corporate issues later.

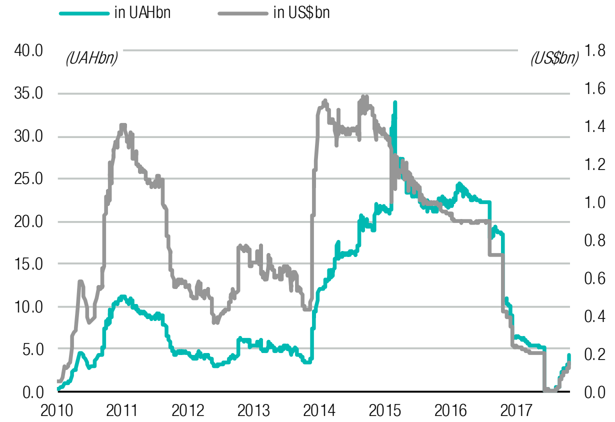
## Non-residents' attendance at local market

*Non-residents were cutting their portfolios significantly till August 2017*

Since the end of 2014, non-residents' portfolios have declined with low volatility, due to the UAH/USD exchange-rate movements, which means there have been fewer non-residents in the market. Most non-residents hold exiting bonds until redemption, and do not purchase new issues. Chart 52 below shows the dynamic of non-residents' portfolios in both currencies, hryvnia and US dollars. By August 2017s non-residents' portfolios had fallen to UAH11m (about US$0.04m).

**Chart 52. Non-residents portfolio in UAH and USD equivalent**

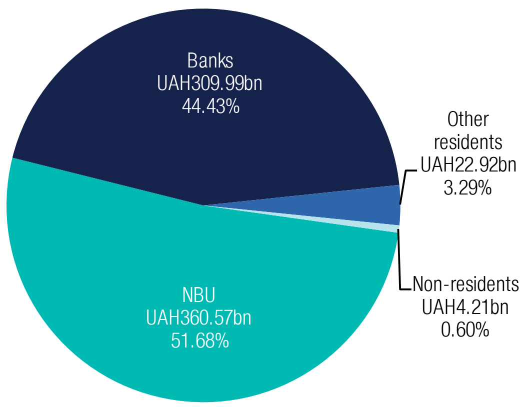
*Daily, since January 2010*




Source: NBU, ICU

**Chart 53. Domestic bondholders' structure, (UAHbn, %)**

*As of 26 October, 2017*




Source: NBU, ICU

*In the last two months, portfolios have risen sharply*

Cash flows reversed in mid-August and portfolios increased to UAH4.21bn, or US$0.16bn at market exchange rates (see current statement of bondholders' structure (Chart 53). During this period of two months, non-residents purchased only local-currency debt. Most of these purchases were at primary auctions, through primary dealers, but there was also activity in the secondary market. The greatest demand was for three-year bonds, at about 15.10% YTM, but there was some interest recently in the two-year, five-year and a small portion of the 12-month bonds at 14.97%, 15.51% and 14.91% YTM, respectively.

We should also note that non-residents' portfolios are insignificant at this time. Most domestic debt is held by the NBU (about 51.68%), and state-owned banks (about 44.43%).

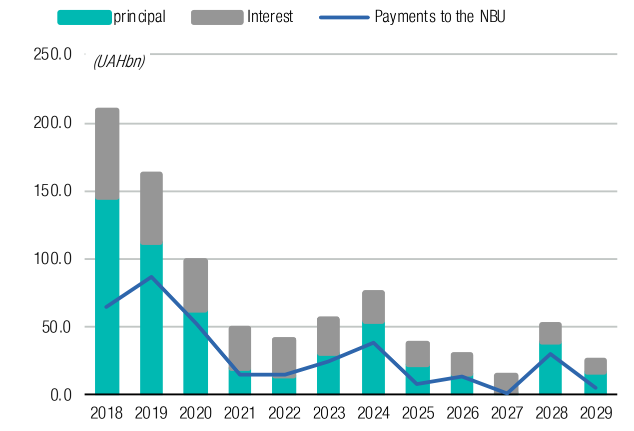
## NBU portfolio reprofiling

*NBU holds about 52% of domestic debt, and some years it could receive more than 50% of domestic debt repayments*

In the case of domestic debt, the largest problem was with the debt held in the NBU's portfolio of UAH362.24bn, or 52% of total domestic bonds outstanding. Payments to the NBU could exceed 50% of yearly payments in 2019, 2020, 2024, and 2028 (see Chart 54), and during the following 10 years, payments will amount to UAH316.6bn out of UAH768.6bn, or about 41.2% of domestic debt repayments. This situation is a bit less problematic than external debt repayments, as the NBU holds only local-currency-denominated bonds, and these repayments do not require access to the FX market. In addition, domestic debt is only about 35% of the total sovereign debt outstanding. But, these payments made to the NBU are concentrated in the years 2018-19 (see Chart 55), and will require the MoF to significantly increase domestic or external borrowings to finance the budget deficit and cover these repayments.

**Chart 54. Schedule of domestic debt repayments and NBU's share of them (UAHbn)**

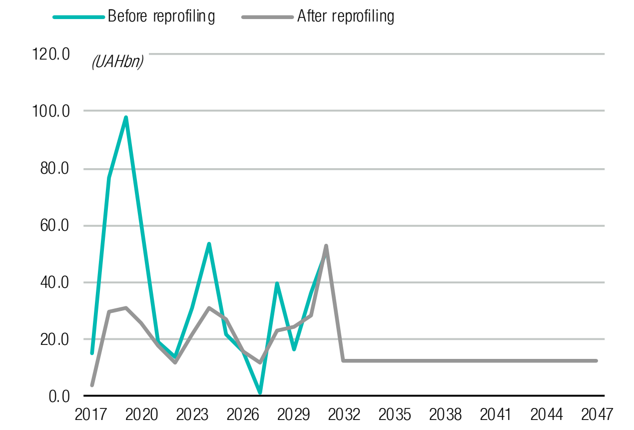
*For the next 10 years*




Source: NBU, MoF of Ukraine, ICU

**Chart 55. Assumed domestic debt repayments (UAHbn)**

*Before and after reprofiling*




Source: NBU, MoF of Ukraine, ICU

*To solve this problem the MoF and NBU will reprofile this portfolio with an exchange of old bonds into new issues of inflation-linked bonds and bonds with fixed coupon rates*

The main idea, also approved by parliament in a budget bill this year, is to allow the Ministry of Finance and NBU to reprofile the NBU's portfolio. As the Parliament's approval has a limited period of time, just until the end of this year, on 4 October, the Cabinet of Ministers made a second attempt to reach an agreement, and adopted a new resolution. This time, the MoF and NBU agreed to exchange UAH219.6bn (out of UAH361bn in the NBU portfolio) into new bonds; UAH74.4bn of new bonds will be issued with maturities in 2025-35 with coupon rates in the range of 8.12-11.30%, and UAH145.17bn of bonds will be issued with a floating coupon rate linked to 12-month inflation plus 2.20%, with maturities in 2036-47.

*This deal will be a voluntary agreement between the MoF and NBU without any influence on other bondholders*

The most important element of this deal is that it will be an agreement between the NBU and MoF only, and will not involve default or a freezing of debt payments. This means that the deal will not affect other bondholders. On a positive note, it will provide the NBU with new inflation-linked bonds, which could be attractive to insurance companies and pensions funds, so the NBU may be able to sell these bonds at the market, and decrease its share of sovereign debt.

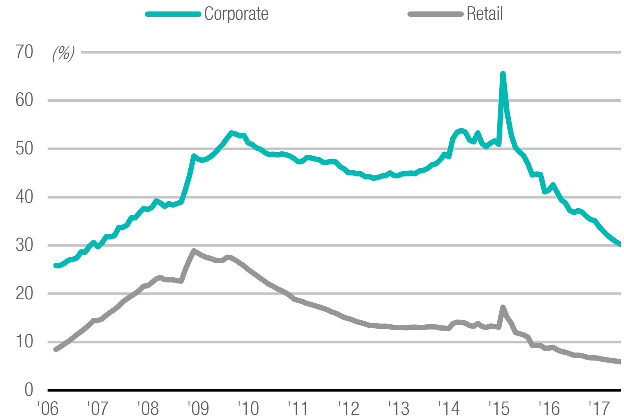
## Bank lending: Sluggish recovery

**Retail lending demonstrates a much faster than other sectors recovery due to the realization of delayed demand and improved consumer expectations. Corporate sector remains under heavy credit burden and its recovery is expected to remain sluggish.**

Lending has not recovered since the 2008-09 crisis, as the loans-to-GDP ratio is in constant decline. Rare spikes were often caused by insider lending when the 2014-15 devaluation increased the value of FX-denominated loans faster than nominal GDP growth.

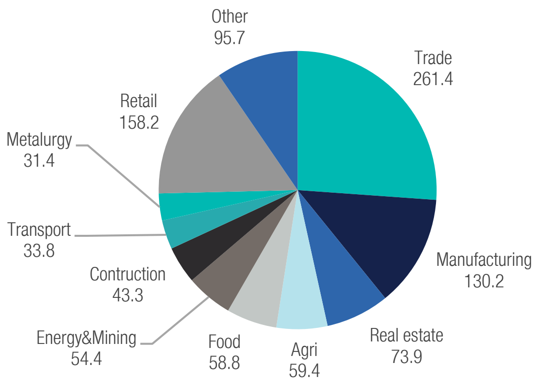
**Little appetite for corporate lending.** Due to heavy debt burdens and credit impairment, it is difficult for many borrowers to access credit from banks. Falling interest rates and abundant liquidity in most of the top banks have created a situation where banks heavily compete for the good, solvent borrowers.

**Chart 56. Loan-to-GDP ratio of Ukrainian banks**




Source: NBU, ICU estimates.

**Chart 57. Gross loan portfolio composition (UAHbn)**



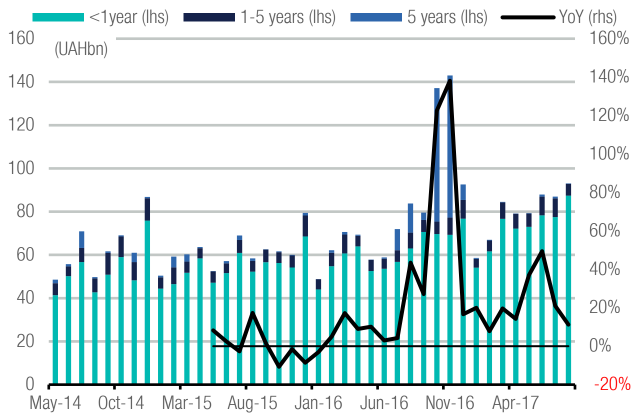

Source: NBU, ICU estimates

*NBU has launched a centralized credit registry to help banks identify troubled borrowers*

Numerous cases of borrowers trying to avoid paying debt to some or all creditors at any cost, including legal battles, have made banks more cautious. The NBU has launched a single-credit registry project, albeit one that is being criticised by the credit history bureaus, which aim to create a single database of borrowers that would identify those debtors that dodge creditors.

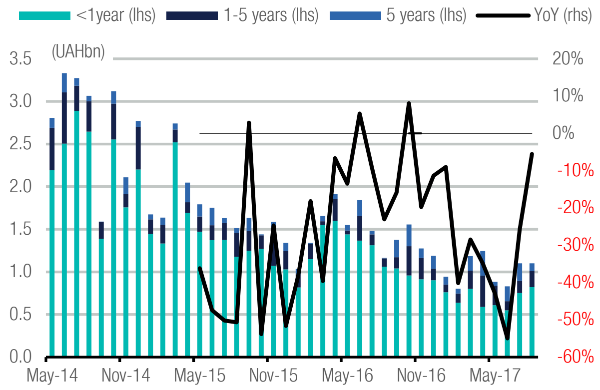
*De facto* banks issue only short-term loans, up to one year. Longer-maturity loans are provided to the top borrowers by the likes of EBRD, IFC, or banks with European capital. The abnormal spikes in new loans issued in the second half of 2016 were primarily caused by the so-called “transformation” of the loan portfolio made by PrivatBank prior to nationalisation, which was more creative accounting than legitimate business activity.

**Chart 58. New UAH corporate loans (other than overdraft)**




Source: NBU, ICU estimates.

**Chart 59. New FX corporate loans (other than overdraft)**




Source: NBU, ICU estimates

However, the amount of newly issued local currency loans has reached UAH80bn per month, due to the numerous loan restructurings that are frequently accompanied by the currency change from USD to UAH.

**Loans to SME is a new trend.** Nearly all of the big banks are stating that lending to small and medium enterprises is their priority now. For years, SME had been overlooked by the big players. It was much easier and less costly to inflate the balance sheet with several large loans to the businesses owned by the country's largest oligarchs than to painstakingly provide loans to small-scale local entrepreneurs. Even the NBU provides no aggregate statistics on SME lending that would give an estimate of the amount of loans issued to this sector. Small loans to entrepreneurs are often registered as consumer debt, and are provided in the form of a credit card, which is effectively a super-high-yielding loan.

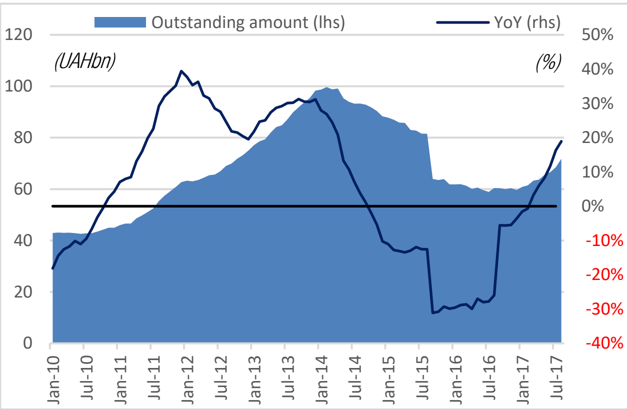
### Household loans

*Retail lending has the fastest pace of recovery*

Retail lending shows the best dynamic compared with other sectors. Increased consumer confidence and postponed demand resulted in an increase in retail spending in sectors such as electronics and appliances, which grew by 20% YoY during the first seven months of 2017. Such goods are frequently bought using credit facilities such as POS loans. In addition, PrivatBank, with the largest client base in Ukraine, was able to increase the credit lines on its credit cards after its nationalisation and change in business model. With gross consumer loans growing 20% YoY in August 2017, there is an expectation that this trend will continue into the 4Q17, the seasonal peak of consumer lending, and in 2018.

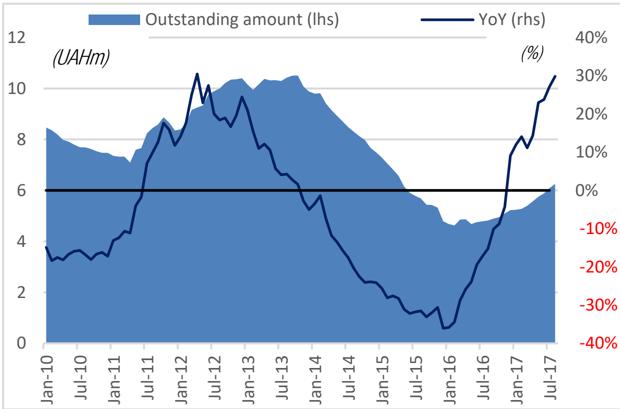
Auto sales demonstrated record growth after several years of stagnation. This resulted in a surge in auto loans of 30% YoY in August. Yet, in absolute amounts, auto sales are far from pre-2014 levels, and it is reasonable to expect both an increase in sold autos and a continuous rise in auto lending.

**Chart 60. UAH consumer loans to households**




Source: NBU, ICU estimates.

**Chart 61. UAH auto loans to households**




Source: NBU, ICU estimates

# Bitcoin and cryptocurrency market

**Little by little, Ukraine's economy has been embracing cryptocurrencies. "Mining" and popularisation are sporadically visible, thanks to media coverage. Ukraine's authorities are carefully observing these developments, although they will definitely wait for a global consensus on the legal status of the cryptocurrencies. In Ukraine, as elsewhere, the hype about the mining of cryptocurrencies is considerable; there is genuine enthusiasm around this innovation. Even in occupied Crimea, a local government official was caught mining bitcoins at the workplace,[20] indicating that the Russia-run administration hasn't dampened consumer interest.**

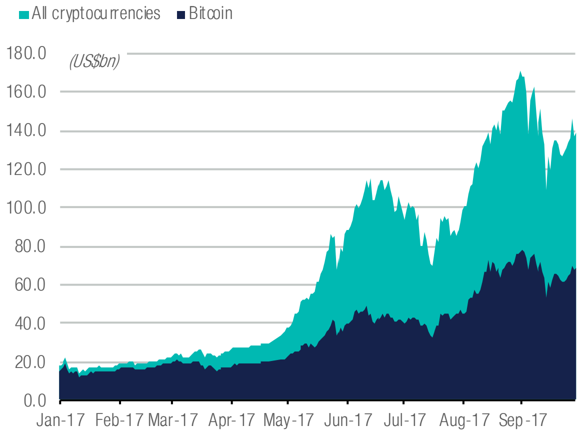
*Global hype over bitcoins: Ukraine is in, too*

Cryptocurrencies have become a global phenomenon. Bitcoin and other cryptocurrencies have attracted the attention of financial institutions and private parties across the globe, and in Ukraine, in particular, as prices soared this year. So far, most world regulators cannot answer the question of what cryptocurrencies, namely Bitcoin, are, as so many of them are taking the position to "wait and see." Even the IMF cannot classify cryptocurrencies as a currency, intangible asset, or financial security. On the other hand, market capitalisation of all cryptocurrencies now exceeds US$140bn (see Chart 62, pp.37) as of the end of September 2017, which will  likely encourage world regulators to control this market.

[20] See (in Russian) https://www.vedomosti.ru/finance/news/2017/09/29/735977-zdanii-pravitelstva-krima

### Chart 62. Cryptocurrency market capitalization

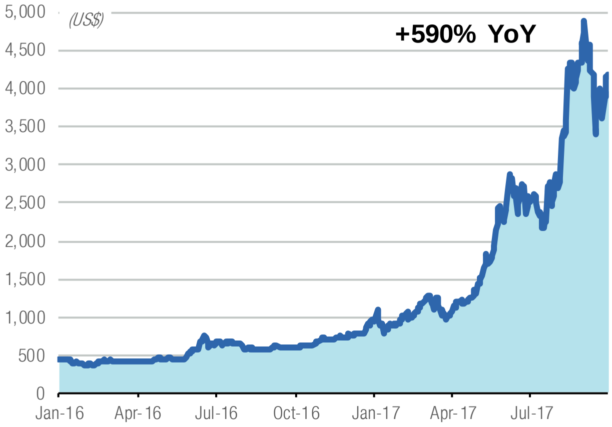
*Daily, January through September 2017*




Source: Coin Dance, ICU

### Chart 63. Bitcoin price

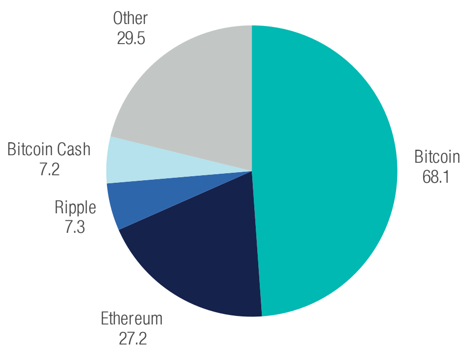
*Daily, January through September 2017*




Source: Bloomberg, ICU

### Chart 64. Market capitalization by cryptocurrencies

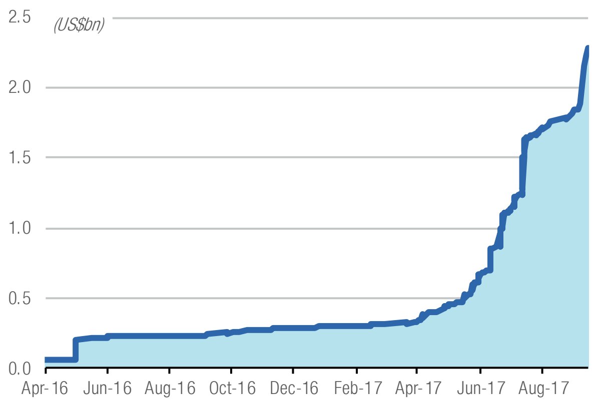
*US$bn, as of 29 September, 2017*




Source: CoinDesk, ICU

### Chart 65. Cumulative ICOs funding

*Weekly, April through September 2017*




Source: Coin Dance, ICU

***Cryptocurrencies in Ukraine: there are miners and pushers, while authorities wait and see***

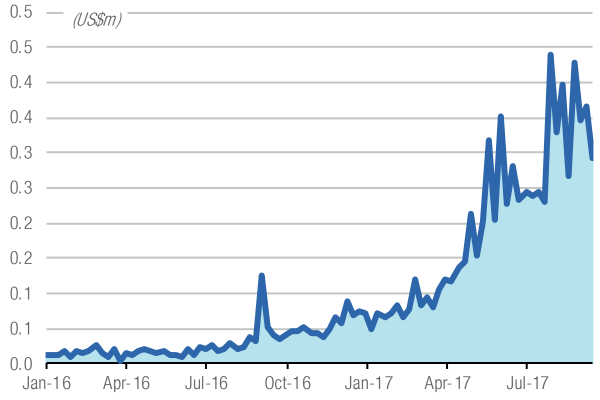
The National Bank of Ukraine does not recognize Bitcoin as a currency, because it does not have a central issuer. Therefore, the NBU cannot accept Bitcoin as a means of payment in Ukraine, but the regulator does not prohibit cryptocurrencies. The National Securities and Stock Market Commission is ready to recognize Bitcoin as financial instrument, but it needs amendments to current legislation to be able to regulate cryptocurrencies as a special type of financial instrument that will allow the Commission to impose sanctions on unscrupulous players, protect investors, and clean up fraud in the cryptocurrency market.

Bitcoin and other cryptocurrencies are becoming very popular in Ukraine. The average weekly trading volume of Bitcoin in Ukraine rose 7.1x, to US$219,526 in 2017 from US$30,732 in 2016. At the same time, the average weekly trading volume of Bitcoin in October amounted to US$438,179, which is 17x higher compared with the same period last year (see Chart 66, p.38).

Around 1% of total bitcoin infrastructure is located in Ukraine (ranked 17$^{th}$ in the world). The US is in first place with a 27.6% share, while in second and third places are Germany and France, where 17.6% and 7.1% of all reachable nodes in the network are located (see Chart 67, p.38).

**Chart 66. Bitcoin trade volumes in Ukraine**

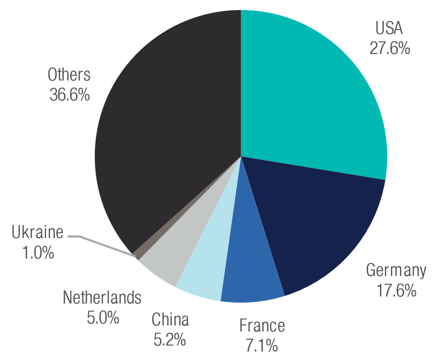
*Weekly, January 2016 through September 2017*




Source: Coin Dance, ICU

**Chart 67. Size of Bitcoin network by country** [21]

*As of 29 September, 2017*




Source: Bitnodes, ICU

Ukraine's government has taken steps to adopt blockchain technology. The Justice Ministry conducted the world's first trial auction using blockchain technology. This technological improvement will be useful in eliminating corruption. Ukrainian authorities are also partnering with Propy, the global property store and decentralized title registry, to allow online real estate purchases by foreign investors. In August 2017, real estate was officially sold for cryptocurrency for the first time in Ukraine. The investor used a smart contract from the Ethereum blockchain. The transaction amount was equivalent to US$60,000.

## Money: Domestic and foreign flows

Domestically, credit remains tight (See Chart 68, pp.39), as both private sector units—like banks and non-bank businesses—are not eager to expand by means of domestic credit. They still have sour relations, as the reported NPL ratio of the entire banking sector is more than 50%.

From the perspective of the government, it has been enjoying a sizable increase in revenues that allowed it to run the state budget at a record-high primary surplus of 3.9% of GDP as of August[22] (the previous peak was at 3.3%, in November 2015).

The government's tight fiscal stance can be explained by: 1) authorities' desire to restrict any attempt of FX instability as tight fiscal policy retains limited volume of UAH monetary reserves at banks' banks accounts with central bank, and 2) authorities' attempt to improve the government's debt sustainability metrics such as government debt as share of GDP, which by August 2017 was on a downward-sloping trajectory, thanks to nominal GDP growth as well as limited volume of debt accepted on the government balance sheet (see Chart 69 on p.39.)

[21] In order to remain secure and validate transactions, Bitcoin network needs broadcast massages using "nodes" that have the bitcoin core client on a machine instance with the complete block chain. The more nodes there are the more secured is the network.

[22] Even if we take into account the extraordinary revenue (confiscation of funds owed to fugitive ex-president Yanukovych, which is a one-off item) of nearly UAH 30bn (1.1% of GDP), then primary surplus size of 2.8% is still quite sizable.

Domestic credit flows in 3Q17 show signs that banks have been gradually increasing lending. The three-month volume of bank credit flow rose to UAH10.9bn as of August from UAH0.6bn as of June, accelerating local-currency lending on the back of continued FX deleveraging of banks' clients.

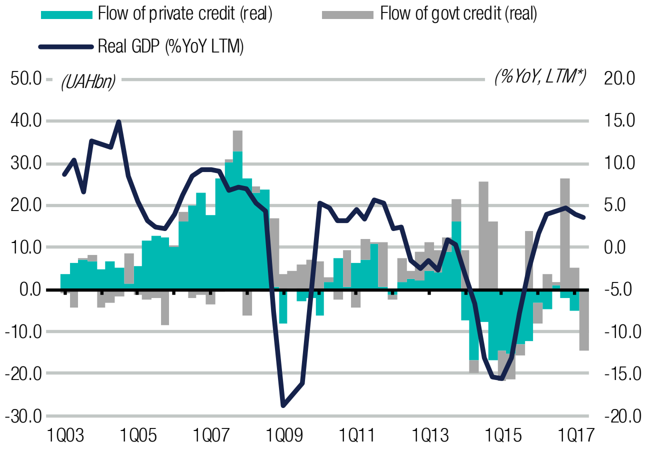
This uptick in the bank lending, in our view, is not another false start, as the one seen in mid-2016, which lasted three months. Rather, it is a full-fledged attempt by banks to re-launch their business. This expansion should continue in 4Q17 and over 2018.

At the same time, the government is seen as maintaining a cautious approach to expanding its role in credit via deficit spending as prescribed by state budget law, given the two above-mentioned factors. It would rather enjoy over-performance of revenues, which will bring a full-year deficit lower than was previously expected, given the pre-determined size of expenditures, than overspend, given over-performance of revenues to meet the deficit target.

Balance of payments (BoP) considerations are still very important for money flows. As domestic credit becomes more restricted both from business and from regulatory considerations, domestic economic units until very recently used trade credit and reduced their own FX assets (cash outside the banking system) and used less offshore credit.

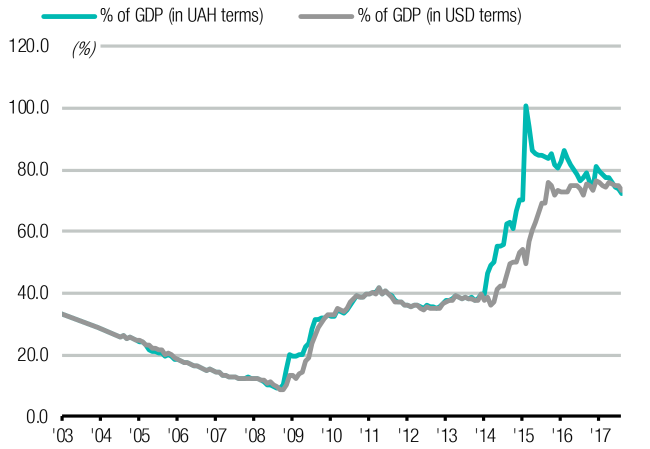
Given successful placement by the Ukraine's government of the USD 15-year Eurobond in September and general upbeat expectations in the global financial markets (see above our discussion of Goldilocks scenario), our base-case scenario envisages that it will be new offshore credit that will prevail over the use of FX cash or trade lending in the Ukraine's BoP. This will provide additional impetus to the gradual widening of the current account deficit, which by year-end of 2017 will amount to US$4bn (3.8% of GDP), expanding to US$6bn (4.2%) in 2018.

**Chart 68. Quarterly volumes of domestic credit flows, i.e. government deficit spending* and bank credit creation through 2Q17 (UAHbn, price adjusted**)**



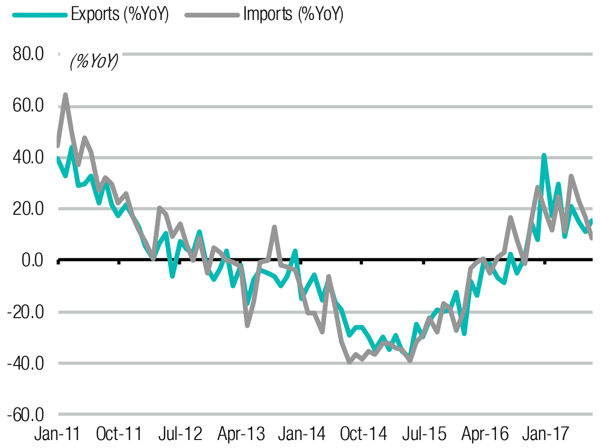

Notes: * positive bars mean state budget deficit, negative ones mean state budget surplus; ** adjusted for CPI, at constant prices of December 2002;
record government credit flow in 3Q14 was designed to assist Ukraine's natural gas state-run company Naftogaz to repay its Eurobond in September 2014, this local currency credit flow was counterweighted by reduction of official FX reserves, the move that caused heightened devaluation expectations and eventually ended up with a wave of currency devaluation spread from 3Q14 into 1Q15.
Source: National Bank of Ukraine, ICU.

**Chart 69. Ukraine's public debt size* through Aug-17 (% of GDP)**



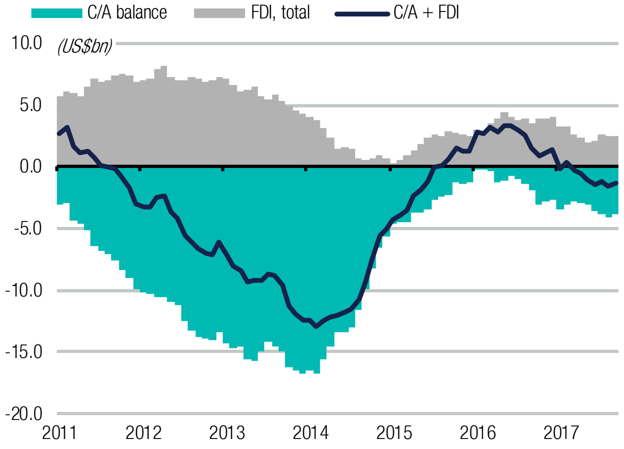

Note: * in local currency terms and in US dollar terms.
Source: National Bank of Ukraine, ICU.

**Chart 70. Change of monthly volume of exports and imports of goods and services through Aug-17 (%YoY)**



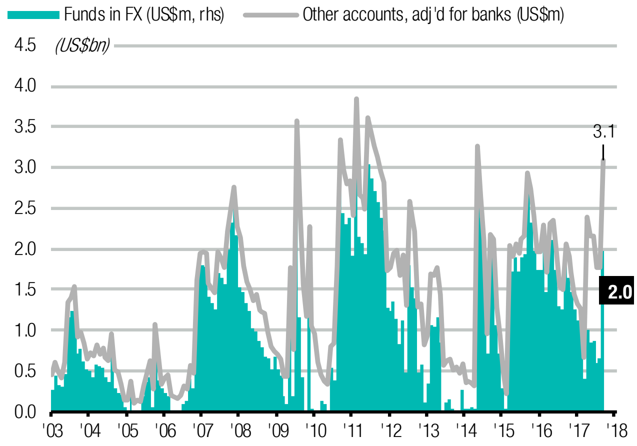

Source: National Bank of Ukraine, ICU.

**Chart 71. Current account balance and FDI through Aug-17 (US$bn, last 12-month rolling volumes)**



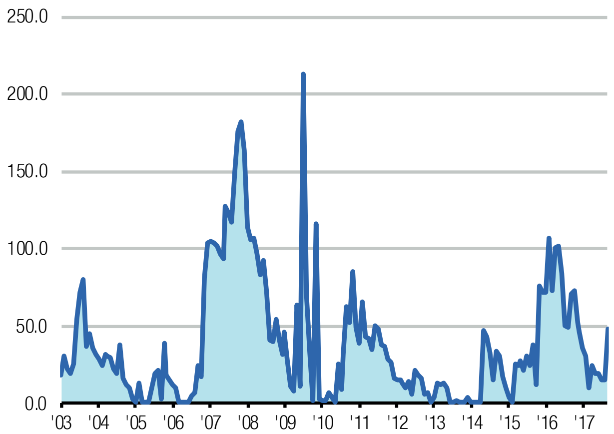

Source: National Bank of Ukraine, ICU.

**Chart 72. Government's balance of FX funds (US$bn) US$3.1bn as of 1 October 2017**




Source: National Bank of Ukraine, ICU.

**Chart 73. Coverage ratio of FX government debt due next 12 months by government's FX funds again (%)**




Source: National Bank of Ukraine, ICU.

## View on UAH: A number of factors provide support, while long-term perspective is weaker

As of early October 2017, our in-house currency valuation analysis, which is based on trade-weighted data for FX exchange rates as well as inflation rates (CPI and PPI), yields the following conclusions:

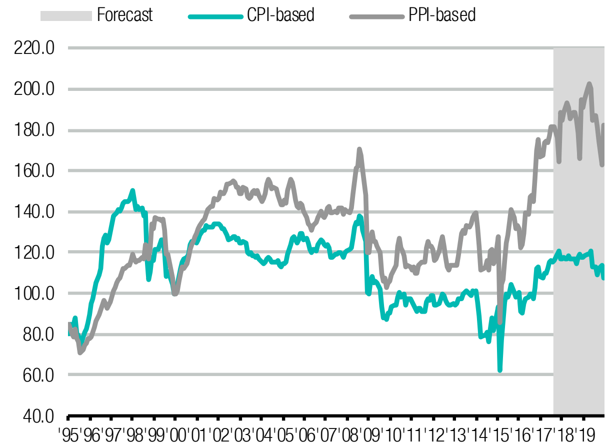
- **The results of UAH valuation according to trade-weighted methodology strikingly differs from current market rates.** Thus, today's market rate for USD/UAH is 26.7. However, our understanding of the TWI-based valuation reveals that notional parameters for the exchange rate, i.e., the so-called appropriate rate range, is quite a distance away (much weaker) from what a buyer of UAH will get by selling USD (see Chart 76, pp.43). So, these notional rates seem quite unrealistic currently. This situation is opposite to that seen right after the 2008 financial crisis, when USD/UAH market rate of around 8 hryvnia per dollar by year-end 2009 had a notional rate range as implied by TWIs, which was quite far away too, albeit, much stronger (for instance, at 5.4). For other countries, similar results were observed of a persistent sizable misalignment between the market and TWI-implied rates in the past several years. Among those countries were China, Russia, and Kazakhstan, and it took a span of several years to eliminate those misalignments. History also shows that these misalignments could be eliminated in an orderly as well as in abrupt way. China is an example of the former case, while Russia and Kazakhstan represent the latter. Going forward, it is not clear how Ukraine's future will unfold. While it seems that the latter case is more natural for Ukraine, given its history of UAH disorderly devaluations and the recent abrupt devaluations in Russia and Kazakhstan, it may turn out to be the opposite this time. We just do not know. However, our base case envisages an orderly scenario. Why? There are three factors, at least. The first one is political capacity, the second, the modern-day setup of Ukraine's financial system, and the third, the global "Goldilocks scenario". Below are details of these factors.

- **Politics: Current cycle comes to an end; the less FX rate moves in an election year, the better.** This is a simple conclusion given that presidential elections will be held just over one year from now. The government and president will be trying their best to have a central bank and regulatory environment that accommodates the economy and avoids runs on the UAH in the banking sector and in the FX markets. Explicitly, authorities are very keen to support the agenda of liberal reforms, while implicitly, they (rightfully) sense that advancing a pure liberal agenda, especially in the FX market, is risk in itself, which could potentially accelerate (not attenuate) a future financial crisis. Here, we think that the new law on foreign currency, hailed as most liberal bill of all in this field, will be quite a difficult feat to adopt it in parliament.
- **Reformed banking system; hence, it is more scrutinised for the elimination of related-party lending.** Over 2015-16, Ukraine's banking sector has undergone dramatic repair, and it is in a final, although still-pending phase after the financial crisis of 2014-15. As a result of this exercise, most creative bankers that used to vastly expand the balance sheets of their banks and non-financial businesses via related-party lending, eventually failing to recapitalise their banks, are out of the banking business. Those who remained are under increased scrutiny, which is much tighter than previously. Hence, now, the banking system has reduced its capacity to expand its balance sheet and then allow a skewed roster of clients to run from deposits into UAH monetary reserves, which are subsequently converted into FX monetary reserves in the form of cash currency or in the form of a deposit in a foreign bank (and every time this happens, it is the NBU that provides the monetary reserves in both cases—first UAH reserves and then converting them into FX reserves—in the end, it is a recipe for a compounded currency devaluation).
- **Global financial markets are in a perceived "Goldilocks scenario"** This perception of a "Goldilocks economy," which has grown into widespread acceptance, is quite supportive of the above-mentioned factors. Thus, Ukraine's government very likely is planning its next Eurobond issue for early next year. It is following the steps of many other borrowers with low credit ratings that are using the current situation in the financial markets to refinance their existing debt at lower yields and with better maturity profiles, or to borrow new money, because the window is open. Hence, as long as the notion of a Goldilocks economy persists, then the more room Ukraine's authorities have to maintain the UAH's FX market in relative calm. In our view, the Goldilocks economy will last into 2018, but no longer (our base-case scenario). Still, this is quite enough time to guide the economy through the remaining part of the current political cycle, which culminates with the presidential elections at the end of March 2019.

- **Tight policy mix is also quite supportive to UAH.** The policy mix utilised by Ukraine's authorities today consists of a quite tight fiscal balance (generating primary surpluses which drive down government's debt-to-GDP ratio) and quite high interest rates paid by the central bank for excess reserves in the banking system, as these rates are tied to the NBU's key policy rate. The NBU has announced today about raising its key policy rate by 1ppt to 13.5%. This interest rate level is likely to remain in place by year-end 2017. In 2018, it will be guided lower by the NBU, as long as headline CPI continues inching downward (our base-case scenario). By year-end 2018, the NBU's key policy rate is projected to be at 10%. At this level, the UAH interest-rate environment will remain quite attractive; hence, supportive for UAH's FX rate.
- **Our UAH FX rate projections:** The UAH's adjustment according to the TWI-implied range will be quite gradual (see Chart 77, below, and in the appendix tables for precise details of the forecast). For this December, our view on the UAH is that it will be at 26.5/USD, sliding just gradually toward 28.5/USD by year-end 2018 (with two-way fluctuations, the year average rate is 27.75). Only in 2019, when elections are over, our base-case scenario is again calls for an orderly weakening of UAH, which will be micromanaged (the average rate for the year is forecast at 30.5/USD).

**Chart 74. UAH's CPI- and PPI-based real trade-weighted indices, rebased at 100 points as of December 1999**

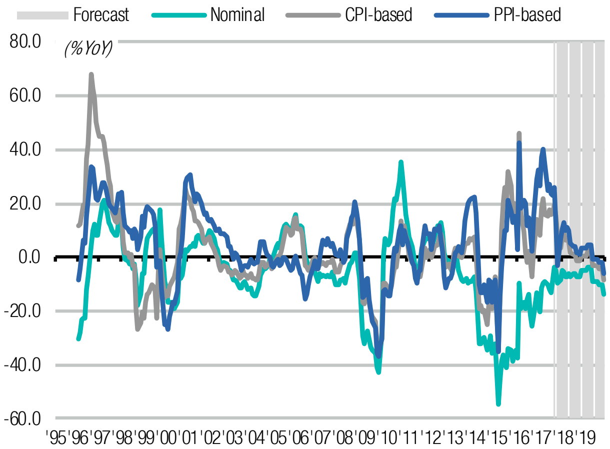
*Monthly history from Jan-95 through Dec-16. Forecast for 2017-19*




Source: ICU.

**Chart 75. Percentage change over previous year of the UAH's nominal and real* trade-weighted indices (% YoY)**

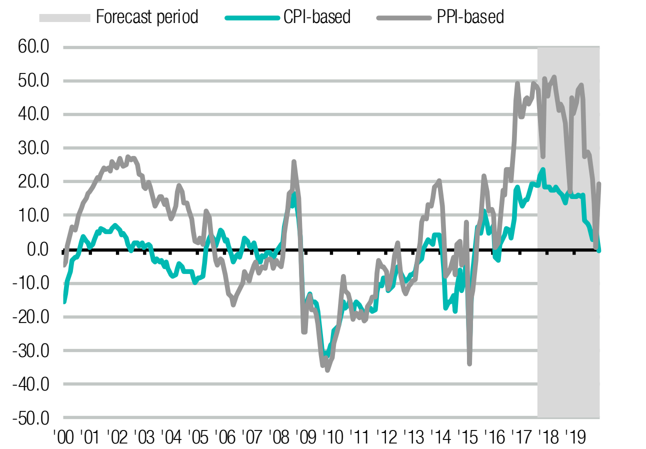
*Monthly history from Jan-95 through Dec-16. Forecast for 2017-19*




Note: * CPI- and PPI-based indices. Source: ICU.

**Chart 76. Misalignment of Ukrainian hryvnia (UAH) as measured by its CPI- and PPI-based real trade-weighted indices**

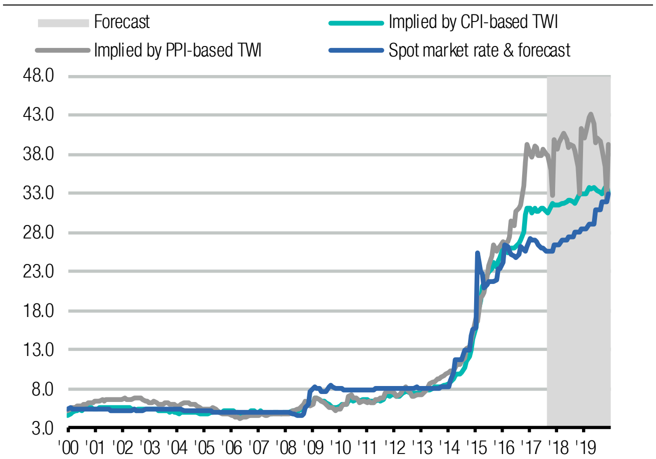
*Monthly history from Jan-00 through Dec-16. Forecast for 2017-19*




Source: ICU.

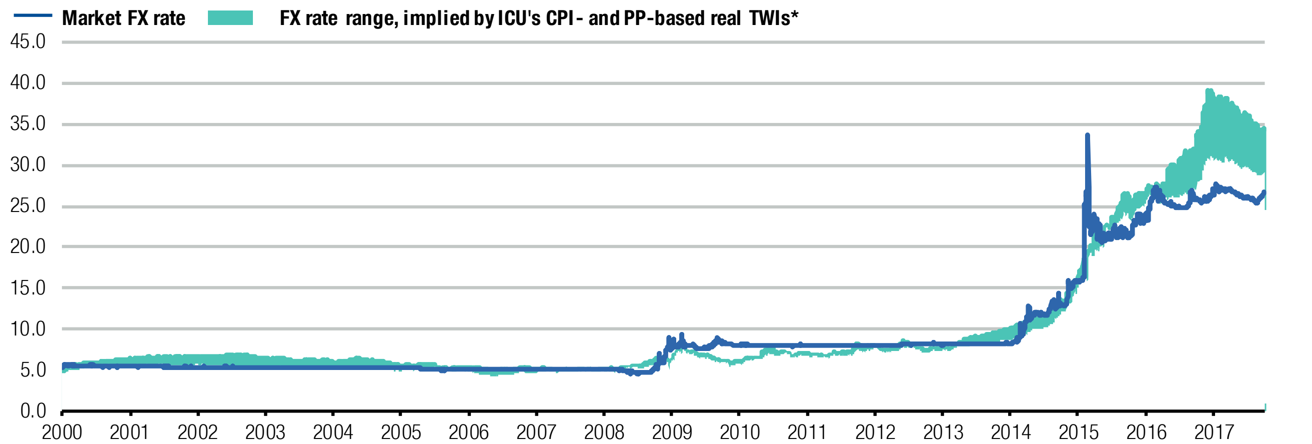
**Chart 77. Monthly data on UAH's market rate and ICU's real TWI-implied fair-value range through 3 October 2017 and forecast for rest of 2017 and 2018-19 (UAH per USD)**

*Monthly history from Jan-00 through Dec-16. Forecast for 2017-19*




Source: ICU.

**Chart 78. Daily data on UAH's market rate and ICU's real TWI-implied fair-value range through 3 October 2017 (UAH per USD)**




Source: ICU.

# Forecast for 2017-19

**The following two pages of statistics are our yearly and quarterly key macroeconomic indicators with forecasts through 2019.**

# Yearly forecast 2017-19, base-case scenario

**Table 2. Forecast of key macroeconomic indicators for 2016-18 (annual)**

| | Historical data for 2007-16 | | | | | | | | | | Forecast by ICU | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017F | 2018F | 2019F |
| **Activity** | | | | | | | | | | | | | |
| Real GDP (%YoY) | 7.9 | 2.3 | -14.8 | 4.1 | 5.2 | 0.2 | -0.1 | -6.4 | -10.3 | 2.2 | **1.8** | **3.0** | **1.9** |
| Nominal GDP (UAHbn) | 721 | 948 | 913 | 1,083 | 1,302 | 1,409 | 1,465 | 1,567 | 1,957 | 2,383 | **2,877** | **3,377** | **3,827** |
| Nominal GDP (US$bn) | 143 | 184 | 114 | 136 | 163 | 174 | 180 | 131 | 89 | 93 | **109** | **121** | **123** |
| GDP per capita (US$, ann) | 3,091 | 3,986 | 2,474 | 2,978 | 3,572 | 3,823 | 3,962 | 3,057 | 2,077 | 2,189 | **2,553** | **2,860** | **2,887** |
| Unemployment rate (%) | 6.4 | 6.4 | 8.8 | 8.1 | 7.9 | 7.5 | 7.2 | 9.3 | 9.1 | 9.3 | **9.5** | **9.4** | **9.2** |
| **Prices** | | | | | | | | | | | | | |
| CPI headline (%YoY, eop) | 16.6 | 22.3 | 12.3 | 9.1 | 4.6 | -0.2 | 0.5 | 24.9 | 43.3 | 12.4 | **14.7** | **10.4** | **10.3** |
| CPI headline (%YoY, average) | 12.8 | 25.3 | 16.0 | 9.4 | 8.0 | 0.6 | -0.3 | 12.1 | 48.5 | 14.9 | **14.7** | **13.0** | **9.8** |
| PPI (%YoY, eop) | 23.2 | 21.1 | 15.3 | 18.8 | 17.4 | 0.4 | 1.7 | 31.8 | 24.0 | 32.3 | **15.8** | **9.0** | **9.0** |
| PPI (%YoY, average) | 20.5 | 33.6 | 7.4 | 21.4 | 19.9 | 6.0 | -0.1 | 17.0 | 36.5 | 18.0 | **27.1** | **12.5** | **9.0** |
| **Fiscal balance** | | | | | | | | | | | | | |
| Consolidated budget bal. (UAHbn) | -6.1 | -11.3 | -34.4 | -63.3 | -18.3 | -46.9 | -63.0 | -67.1 | -27.8 | -52.8 | **-20.8** | **-62.5** | **-141.5** |
| Consolidated budget bal. (% of GDP) | -0.8 | -1.2 | -3.8 | -5.9 | -1.4 | -3.3 | -4.3 | -4.3 | -1.4 | -2.2 | **-0.7** | **-1.9** | **-3.7** |
| Budget balance (UAHbn) | -9.8 | -12.5 | -35.5 | -64.3 | -23.6 | -53.4 | -64.7 | -78.1 | -45.2 | -70.2 | **-43.0** | **-72.2** | **-142.8** |
| Budget balance (% of GDP) | -1.4 | -1.3 | -3.9 | -5.9 | -1.8 | -3.8 | -4.4 | -5.0 | -2.3 | -2.9 | **-1.5** | **-2.1** | **-3.7** |
| **External balance** | | | | | | | | | | | | | |
| Exports (US$bn) | 61.4 | 82.5 | 52.1 | 65.6 | 83.7 | 86.5 | 81.7 | 65.4 | 47.6 | 46.0 | **52.0** | **56.5** | **62.8** |
| Imports (US$bn) | 69.5 | 96.8 | 54.0 | 69.6 | 93.8 | 100.9 | 97.4 | 70.0 | 49.0 | 51.8 | **57.7** | **63.1** | **67.4** |
| Trade balance (US$bn) | -8.1 | -14.4 | -2.0 | -4.0 | -10.1 | -14.3 | -15.6 | -4.6 | -1.5 | -5.8 | **-5.7** | **-6.6** | **-4.6** |
| Trade balance (% of GDP) | -5.7 | -7.8 | -1.7 | -2.9 | -6.2 | -8.2 | -8.7 | -3.5 | -1.6 | -6.2 | **-5.2** | **-5.4** | **-3.8** |
| Current account balance (US$bn) | -5.3 | -12.8 | -1.7 | -3.0 | -10.2 | -14.3 | -16.5 | -4.6 | -0.2 | -3.8 | **-4.1** | **-4.8** | **-2.7** |
| Current account balance (% of GDP) | -3.7 | -6.9 | -1.5 | -2.2 | -6.3 | -8.2 | -9.2 | -3.5 | -0.2 | -4.1 | **-3.7** | **-3.9** | **-2.2** |
| Net FDI (US$bn) | 9.2 | 9.9 | 4.7 | 5.8 | 7.0 | 7.2 | 4.1 | 0.3 | 2.9 | 3.3 | **2.0** | **1.7** | **1.7** |
| Net FDI (% of GDP) | 6.4 | 5.4 | 4.1 | 4.2 | 4.3 | 4.1 | 2.3 | 0.2 | 3.3 | 3.5 | **1.8** | **1.4** | **1.4** |
| C/A bal. + net FDI (% of GDP) | 2.8 | -1.6 | 2.6 | 2.0 | -2.0 | -4.1 | -6.9 | -3.3 | 3.1 | -0.5 | **-1.9** | **-2.6** | **-0.8** |
| External debt (US$bn, eop) | 80.0 | 101.7 | 103.4 | 117.3 | 126.2 | 134.6 | 142.1 | 126.3 | 118.7 | 123.5 | **130.2** | **136.6** | **137.5** |
| External debt (% of ann'd GDP, eop) | 55.8 | 55.3 | 91.0 | 86.1 | 77.4 | 77.3 | 79.1 | 96.2 | 133.7 | 132.4 | **120.0** | **112.5** | **112.2** |
| FX reserves (US$bn, eop) | 32.5 | 31.5 | 26.5 | 34.6 | 31.8 | 24.5 | 20.4 | 7.5 | 13.3 | 15.5 | **18.5** | **20.0** | **18.0** |
| FX reserves (% of ann'd GDP, eop) | 22.6 | 17.2 | 23.3 | 25.4 | 19.5 | 14.1 | 11.4 | 5.7 | 15.0 | 16.7 | **17.0** | **16.5** | **14.7** |
| External debt / FX reserves (x, eop) | 2.5 | 3.2 | 3.9 | 3.4 | 4.0 | 5.5 | 7.0 | 17.7 | 10.4 | 7.9 | **7.0** | **6.8** | **7.6** |
| FX reserves imports cov (months) | 5.6 | 3.9 | 5.9 | 6.0 | 4.1 | 2.9 | 2.5 | 1.3 | 3.3 | 3.6 | **3.8** | **3.8** | **3.2** |
| **Interest rates** | | | | | | | | | | | | | |
| Central bank key rate (%, eop) | 8.00 | 12.00 | 10.25 | 7.75 | 7.75 | 7.50 | 6.50 | 14.00 | 22.00 | 14.00 | **13.50** | **10.00** | **10.00** |
| 3-month rate (%, eop 4Q) | 7.58 | 21.60 | 17.59 | 6.12 | 19.72 | 25.52 | 11.71 | 18.37 | 23.86 | 23.34 | **21.67** | **18.65** | **18.24** |
| **Exchange rates** | | | | | | | | | | | | | |
| UAH trade-weighted index (nominal) | 88.22 | 62.35 | 62.62 | 72.39 | 77.27 | 74.23 | 67.38 | 43.88 | 28.69 | 24.54 | **22.83** | **21.64** | **21.44** |
| UAH trade-weighted index (real) | 120.06 | 100.21 | 90.26 | 97.73 | 98.76 | 94.72 | 100.84 | 85.40 | 99.38 | 107.32 | **103.80** | **103.76** | **108.41** |
| UAH/US$ (eop) | 5.05 | 7.80 | 8.00 | 7.94 | 8.00 | 8.05 | 8.24 | 15.82 | 24.03 | 27.10 | **26.50** | **28.50** | **32.50** |
| UAH/US$ (average) | 5.03 | 5.25 | 8.03 | 7.94 | 7.99 | 8.08 | 8.16 | 12.01 | 21.96 | 25.53 | **26.57** | **27.75** | **31.13** |
| UAH/€ (eop) | 7.36 | 10.90 | 11.45 | 10.63 | 10.37 | 10.62 | 11.32 | 19.14 | 26.10 | 28.50 | **29.15** | **32.21** | **39.00** |
| UAH/€ (average) | 7.32 | 7.10 | 11.70 | 10.51 | 10.50 | 10.60 | 11.17 | 14.79 | 23.92 | 26.92 | **29.31** | **30.94** | **35.95** |
| US$/€ (eop) | 1.46 | 1.40 | 1.43 | 1.34 | 1.30 | 1.32 | 1.37 | 1.21 | 1.09 | 1.05 | **1.10** | **1.13** | **1.20** |
| US$/€ (average) | 1.46 | 1.35 | 1.46 | 1.32 | 1.32 | 1.31 | 1.37 | 1.23 | 1.09 | 1.05 | **1.10** | **1.12** | **1.16** |
| **Population** | | | | | | | | | | | | | |
| Population (million, eop) | 46.4 | 46.1 | 46.0 | 45.8 | 45.6 | 45.6 | 45.3 | 42.9 | 42.8 | 42.6 | **42.5** | **42.5** | **42.4** |
| Population (%YoY) | -0.6 | -0.5 | -0.4 | -0.4 | -0.3 | -0.2 | -0.5 | -5.3 | -0.4 | -0.4 | **-0.2** | **-0.1** | **0.0** |

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

# Quarterly forecast 2017-19, base-case scenario

**Table 3. Forecast of key macroeconomic indicators for 2017-19 (quarterly)**

| | | | Forecast by ICU | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 3Q16 | 4Q16 | 1Q17 | 2Q17 | 3Q17E | 4Q17F | 1Q18F | 2Q18F | 3Q18F | 4Q18F | 1Q19F | 2Q19F | 3Q19F | 4Q19F |
| **Activity** | | | | | | | | | | | | | | |
| Real GDP (%YoY) | 1.8 | 2.4 | 2.5 | 2.3 | 1.3 | 1.0 | 3.0 | 3.0 | 3.0 | 3.0 | 2.5 | 2.0 | 1.8 | 1.5 |
| Nominal GDP (UAHbn) | 664.7 | 727.8 | 583.9 | 657.0 | 790.9 | 845.7 | 691.6 | 779.8 | 927.6 | 977.4 | 788.1 | 883.5 | 1,050.4 | 1,105.3 |
| Nominal GDP (US$bn) | 26.2 | 28.1 | 21.6 | 24.6 | 30.4 | 31.9 | 25.6 | 28.4 | 33.1 | 34.3 | 27.2 | 28.5 | 32.8 | 34.0 |
| GDP per capita (US$, ann) | 2,117 | 2,181 | 2,278 | 2,358 | 2,454 | 2,550 | 2,646 | 2,735 | 2,799 | 2,856 | 2,893 | 2,897 | 2,890 | 2,884 |
| Unemployment rate (%) | 9.2 | 9.3 | 10.1 | 9.6 | 9.6 | 9.5 | 9.5 | 9.5 | 9.4 | 9.4 | 9.3 | 9.3 | 9.2 | 9.2 |
| **Prices** | | | | | | | | | | | | | | |
| CPI headline (%YoY, eop) | 7.9 | 12.4 | 15.1 | 15.6 | 16.4 | 14.7 | 13.7 | 13.2 | 11.5 | 10.4 | 9.5 | 9.5 | 10.4 | 10.3 |
| CPI headline (%YoY, average) | 8.0 | 12.3 | 13.9 | 13.8 | 16.2 | 14.9 | 14.3 | 14.8 | 12.3 | 10.5 | 9.8 | 9.5 | 9.8 | 10.1 |
| PPI (%YoY, eop) | 15.2 | 32.3 | 38.3 | 26.4 | 23.1 | 15.8 | 11.6 | 14.2 | 11.8 | 9.0 | 9.0 | 9.0 | 9.0 | 9.0 |
| PPI (%YoY, average) | 14.4 | 27.8 | 38.1 | 29.7 | 23.6 | 17.0 | 14.6 | 12.5 | 12.2 | 10.7 | 9.0 | 9.0 | 9.0 | 9.0 |
| **Fiscal balance** | | | | | | | | | | | | | | |
| Consolidated budget bal. (UAHbn) | -20.5 | 8.1 | 4.0 | 48.2 | -22.0 | -50.9 | -10.4 | -24.8 | 5.6 | -32.9 | -24.4 | -44.4 | -12.6 | -60.1 |
| Consolidated budget bal. (% of GDP) | -3.1 | 1.1 | 0.7 | 7.3 | -2.8 | -6.0 | -1.5 | -3.2 | 0.6 | -3.4 | -3.1 | -5.0 | -1.2 | -5.4 |
| Budget balance (UAHbn) | -28.1 | 2.6 | -9.7 | 38.8 | -23.2 | -48.9 | -12.5 | -25.7 | 0.2 | -34.2 | -25.1 | -43.2 | -16.2 | -58.4 |
| Budget balance (% of GDP) | -4.2 | 0.4 | -1.7 | 5.9 | -2.9 | -5.8 | -1.8 | -3.3 | 0.0 | -3.5 | -3.2 | -4.9 | -1.5 | -5.3 |
| **External balance** | | | | | | | | | | | | | | |
| Exports (US$bn) | 11.8 | 12.1 | 12.6 | 13.1 | 13.0 | 13.3 | 14.1 | 14.1 | 14.0 | 14.4 | 15.7 | 16.0 | 15.2 | 16.0 |
| Imports (US$bn) | 13.6 | 13.9 | 13.9 | 14.4 | 14.5 | 14.9 | 15.4 | 15.8 | 15.8 | 16.1 | 16.3 | 16.8 | 17.1 | 17.2 |
| Trade balance (US$bn) | -1.9 | -1.8 | -1.3 | -1.3 | -1.5 | -1.6 | -1.3 | -1.7 | -1.8 | -1.7 | -0.6 | -0.9 | -1.9 | -1.2 |
| Trade balance (% of GDP) | -7.1 | -6.4 | -6.0 | -5.2 | -5.0 | -5.0 | -5.2 | -6.1 | -5.5 | -4.9 | -2.2 | -3.0 | -5.9 | -3.5 |
| Current account balance (US$bn) | -1.7 | -1.2 | -1.3 | -0.6 | -1.2 | -1.0 | -1.1 | -1.1 | -1.4 | -1.1 | -0.3 | -0.3 | -1.5 | -0.6 |
| Current account balance (% of GDP) | -6.4 | -4.2 | -6.0 | -2.4 | -4.0 | -3.0 | -4.4 | -4.0 | -4.4 | -3.2 | -0.9 | -1.0 | -4.5 | -1.9 |
| Net FDI (US$bn) | 1.0 | 0.6 | 0.1 | 0.5 | 1.0 | 0.4 | 0.3 | 0.4 | 0.5 | 0.4 | 0.4 | 0.4 | 0.5 | 0.4 |
| Net FDI (% of GDP) | 3.8 | 2.1 | 0.7 | 1.9 | 3.4 | 1.1 | 1.3 | 1.4 | 1.6 | 1.2 | 1.5 | 1.4 | 1.4 | 1.3 |
| C/A bal. + net FDI (% of GDP) | -2.6 | -2.0 | -5.3 | -0.5 | -0.6 | -1.9 | -3.1 | -2.5 | -2.8 | -2.0 | 0.5 | 0.4 | -3.1 | -0.6 |
| External debt (US$bn, eop) | 119.9 | 120.5 | 119.3 | 119.4 | 119.6 | 120.2 | 121.0 | 121.7 | 122.6 | 123.3 | 123.2 | 123.0 | 124.1 | 124.3 |
| External debt (% of ann'd GDP, eop) | 132.7 | 129.5 | 122.8 | 118.8 | 114.4 | 110.8 | 107.5 | 104.6 | 103.0 | 101.6 | 100.2 | 100.0 | 101.0 | 101.4 |
| FX reserves (US$bn, eop) | 14.6 | 15.0 | 15.1 | 18.0 | 18.2 | 18.5 | 18.9 | 19.3 | 19.6 | 20.0 | 19.5 | 19.0 | 18.5 | 18.0 |
| FX reserves (% of ann'd GDP, eop) | 16.1 | 16.1 | 15.6 | 17.9 | 17.4 | 17.0 | 16.8 | 16.6 | 16.5 | 16.5 | 15.9 | 15.4 | 15.1 | 14.7 |
| External debt / FX reserves (x, eop) | 9.6 | 9.4 | 7.9 | 6.6 | 6.6 | 6.5 | 6.4 | 6.3 | 6.2 | 6.2 | 6.3 | 6.5 | 6.7 | 6.9 |
| FX reserves imports cov (months) | 3.5 | 3.6 | 3.3 | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 | 3.7 | 3.5 | 3.3 | 3.2 |
| **Interest rates** | | | | | | | | | | | | | | |
| Central bank key rate (%, eop) | 15.00 | 14.00 | 14.00 | 14.00 | 12.50 | 13.50 | 12.00 | 11.50 | 10.00 | 10.00 | 10.00 | 10.00 | 10.00 | 10.00 |
| 3-month rate (%, eop 4Q) | 18.65 | 18.24 | 15.00 | 15.00 | 13.00 | 13.00 | 12.50 | 12.00 | 12.00 | 12.00 | 13.00 | 14.00 | 15.00 | 16.00 |
| **Exchange rates** | | | | | | | | | | | | | | |
| UAH trade-weighted index (nominal) | 22.97 | 24.54 | 24.77 | 23.87 | 23.10 | 22.83 | 22.53 | 22.24 | 21.91 | 21.64 | 21.60 | 21.62 | 21.58 | 21.44 |
| UAH trade-weighted index (real) | 96.51 | 107.32 | 107.59 | 104.99 | 101.32 | 103.80 | 102.11 | 102.44 | 100.94 | 103.76 | 103.23 | 104.98 | 104.87 | 108.41 |
| UAH/US$ (eop) | 25.94 | 27.10 | 27.07 | 26.01 | 26.00 | 26.50 | 27.00 | 27.50 | 28.00 | 28.50 | 29.00 | 31.00 | 32.00 | 32.50 |
| UAH/US$ (average) | 25.37 | 25.91 | 27.07 | 26.70 | 26.00 | 26.50 | 27.00 | 27.50 | 28.00 | 28.50 | 29.00 | 31.00 | 32.00 | 32.50 |
| UAH/€ (eop) | 29.14 | 29.13 | 28.83 | 29.71 | 30.42 | 29.15 | 29.70 | 30.53 | 31.36 | 32.21 | 32.77 | 35.34 | 36.80 | 39.00 |
| UAH/€ (average) | 28.46 | 28.48 | 28.93 | 0.00 | 30.06 | 30.08 | 29.70 | 30.39 | 31.22 | 32.06 | 32.77 | 35.19 | 36.64 | 38.19 |
| US$/€ (eop) | 1.12 | 1.07 | 1.07 | 1.14 | 1.17 | 1.10 | 1.10 | 1.11 | 1.12 | 1.13 | 1.13 | 1.14 | 1.15 | 1.20 |
| US$/€ (average) | 1.12 | 1.10 | 1.07 | 0.00 | 1.16 | 1.14 | 1.10 | 1.11 | 1.12 | 1.13 | 1.13 | 1.14 | 1.15 | 1.18 |
| **Population** | | | | | | | | | | | | | | |
| Population (million, eop) | 42.65 | 42.61 | 42.61 | 42.56 | 42.54 | 42.50 | 42.55 | 42.50 | 42.49 | 42.45 | 42.53 | 42.48 | 42.47 | 42.43 |
| Population (%YoY) | -0.4 | -0.4 | -0.2 | -0.2 | -0.2 | -0.2 | -0.1 | -0.1 | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 |

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.**

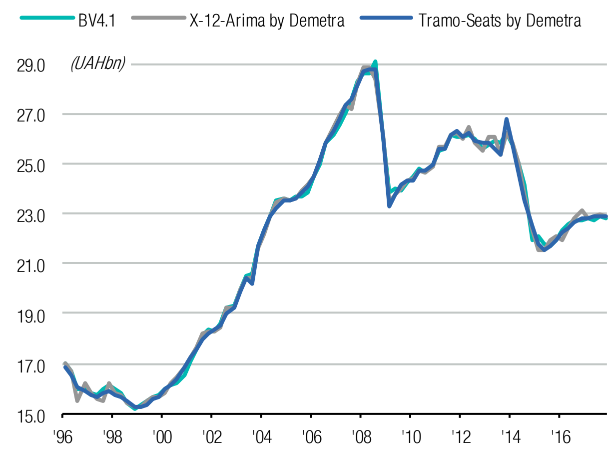
# Quarterly GDP: Reported statistics and ICU's calculations

**Chart 79. Ukraine's economy from the perspective of quarterly GDP volumes (left) and on-quarter growth rates (right)**

1Q96-1Q17 and forecast for 2Q17-4Q17

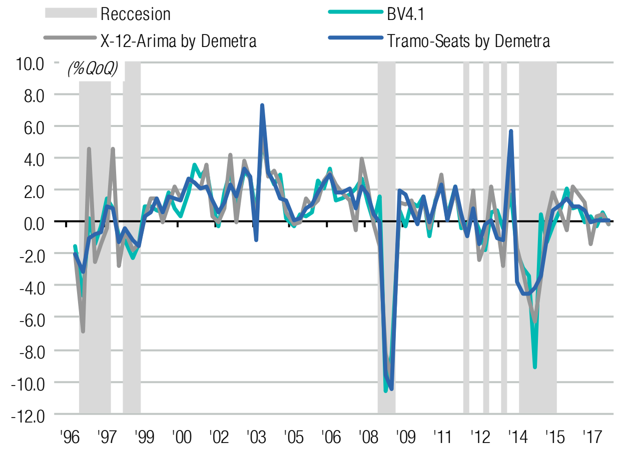
Data is adjusted for inflation and seasonal factors; seasonally adjusted by three methods BV4.1, X-12 Arima and Tramo-Seats

*Quarterly GDP size in constant prices of Dec-95*




Sources: State Statistics Service of Ukraine, ICU.

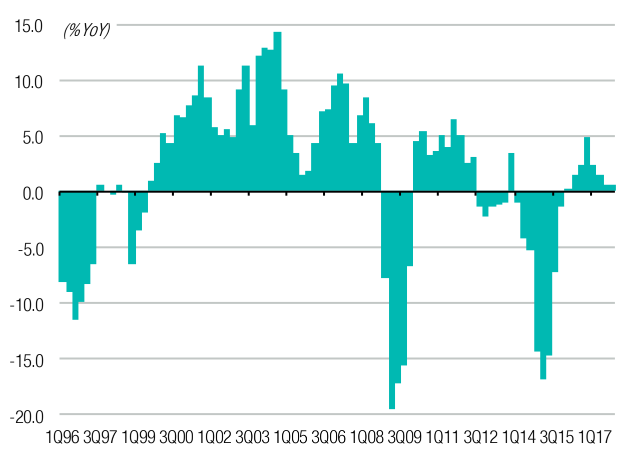
*Quarterly GDP growth rates (% QoQ)*




Sources: State Statistics Service of Ukraine, ICU.

**Chart 80. Reported on-year quarterly GDP growth (% YoY)**

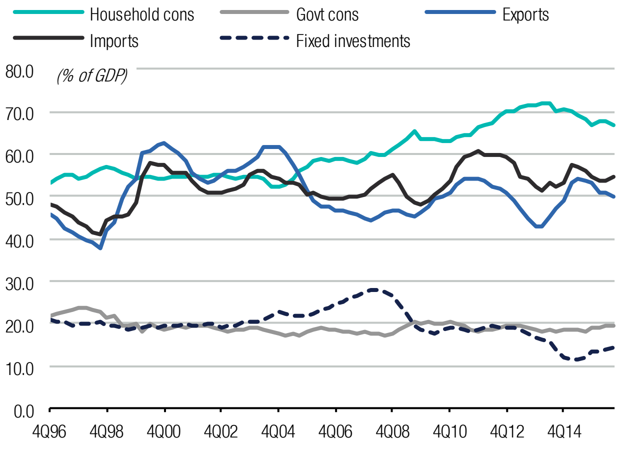
*1Q96-1Q17 and forecast for 2Q17-4Q17*




Source: State Statistics Service of Ukraine.

**Chart 81. Demand-side components of GDP (% of total, LTM)**

*1Q96-4Q16*




Sources: State Statistics Service of Ukraine, ICU.

**Table 4. Ukraine quarterly GDP size: History from 4Q96 through 1Q17 (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 cons prices[1] (UAHm, SA) | | | Real GDP growth (%QoQ, SA) | | |
| | 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) | 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 |
| … | … | … | … | … | … | … | … | … | **…** | … | … | **…** |
| 1Q09 | 189,028 | -19.6 | | 22.8 | -4.8 | 21,148 | 23,824 | 23,487 | **23,295** | -8.4 | -9.9 | -10.4 |
| 2Q09 | 214,103 | -17.3 | | 9.7 | -10.6 | 22,181 | 23,991 | 23,767 | **23,749** | +0.7 | +1.2 | +2.0 |
| 3Q09 | 250,306 | -15.7 | | 7.4 | -15.2 | 26,886 | 23,930 | 24,022 | **24,161** | -0.3 | +1.1 | +1.7 |
| 4Q09 | 259,908 | -6.7 | | 14.1 | -15.0 | 25,412 | 24,230 | 24,332 | **24,331** | +1.3 | +1.3 | +0.7 |
| 1Q10 | 217,286 | +4.5 | +0.7 | 10.7 | -9.2 | 21,959 | 24,451 | 24,389 | **24,294** | +0.9 | +0.2 | -0.2 |
| 2Q10 | 256,754 | +5.4 | +1.4 | 15.1 | -3.5 | 23,110 | 24,829 | 24,705 | **24,685** | +1.5 | +1.3 | +1.6 |
| 3Q10 | 301,251 | +3.3 | +0.4 | 17.5 | +1.5 | 27,539 | 24,605 | 24,606 | **24,691** | -0.9 | -0.4 | +0.0 |
| 4Q10 | 307,278 | +3.7 | +0.7 | 15.6 | +4.2 | 25,989 | 24,924 | 24,908 | **24,982** | +1.3 | +1.2 | +1.2 |
| 1Q11 | 257,682 | +5.1 | +2.0 | 12.9 | +4.4 | 23,066 | 25,526 | 25,651 | **25,571** | +2.4 | +3.0 | +2.4 |
| 2Q11 | 311,022 | +3.9 | +0.3 | 16.6 | +4.0 | 24,009 | 25,628 | 25,670 | **25,596** | +0.4 | +0.1 | +0.1 |
| 3Q11 | 369,818 | +6.5 | +2.5 | 15.2 | +4.8 | 29,347 | 26,193 | 26,182 | **26,167** | +2.2 | +2.0 | +2.2 |
| 4Q11 | 363,557 | +5.0 | +0.3 | 12.6 | +5.1 | 27,309 | 26,092 | 26,215 | **26,300** | -0.4 | +0.1 | +0.5 |
| 1Q12 | 293,493 | +2.5 | -0.8 | 11.4 | +4.5 | 23,584 | 26,065 | 25,962 | **26,067** | -0.1 | -1.0 | -0.9 |
| 2Q12 | 349,212 | +3.1 | +0.5 | 9.0 | +4.3 | 24,731 | 26,175 | 26,474 | **26,273** | +0.4 | +2.0 | +0.8 |
| 3Q12 | 387,620 | -1.3 | -1.5 | 6.2 | +2.3 | 28,963 | 26,033 | 25,837 | **25,917** | -0.5 | -2.4 | -1.4 |
| 4Q12 | 378,564 | -2.3 | -0.8 | 6.6 | +0.5 | 26,681 | 25,562 | 25,499 | **25,861** | -1.8 | -1.3 | -0.2 |
| 1Q13 | 303,753 | -1.3 | +0.2 | 4.9 | -0.5 | 23,277 | 25,724 | 26,046 | **25,875** | +0.6 | +2.1 | +0.1 |
| 2Q13 | 354,814 | -1.2 | -0.7 | 3.8 | -1.5 | 24,208 | 25,910 | 26,046 | **25,624** | +0.7 | -0.0 | -1.0 |
| 3Q13 | 398,000 | -1.1 | +2.3 | 4.0 | -1.5 | 28,595 | 25,802 | 25,331 | **25,323** | -0.4 | -2.7 | -1.2 |
| 4Q13 | 408,631 | +3.4 | -1.5 | 4.3 | -0.1 | 27,612 | 26,241 | 26,274 | **26,763** | +1.7 | +3.7 | +5.7 |
| 1Q14 | 313,568 | -1.0 | -3.3 | 4.5 | +0.0 | 22,994 | 25,741 | 25,847 | **25,769** | -1.9 | -1.6 | -3.7 |
| 2Q14 | 375,903 | -4.3 | -4.2 | 11.1 | -0.8 | 23,084 | 25,004 | 25,023 | **24,615** | -2.9 | -3.2 | -4.5 |
| 3Q14 | 434,166 | -5.3 | -4.7 | 15.4 | -1.9 | 27,031 | 24,161 | 23,796 | **23,503** | -3.4 | -4.9 | -4.5 |
| 4Q14 | 443,091 | -14.4 | -4.1 | 27.2 | -6.4 | 23,538 | 21,969 | 22,301 | **22,525** | -9.1 | -6.3 | -4.2 |
| 1Q15 | 367,577 | -17.0 | -3.5 | 41.5 | -10.4 | 19,049 | 22,076 | 21,515 | **21,774** | +0.5 | -3.5 | -3.3 |
| 2Q15 | 449,575 | -14.7 | -1.4 | 40.1 | -13.0 | 19,706 | 21,792 | 21,553 | **21,539** | -1.3 | +0.2 | -1.1 |
| 3Q15 | 555,044 | -7.2 | +1.1 | 37.8 | -13.4 | 25,077 | 21,726 | 21,946 | **21,681** | -0.3 | +1.8 | +0.7 |
| 4Q15 | 584,781 | -1.4 | +1.4 | 32.7 | -10.3 | 23,410 | 21,912 | 22,066 | **21,913** | +0.9 | +0.5 | +1.1 |
| 1Q16 | 455,637 | +0.1 | +0.5 | 20.5 | -6.0 | 19,596 | 22,364 | 21,946 | **22,223** | +2.1 | -0.5 | +1.4 |
| 2Q16 | 535,324 | +1.5 | +0.9 | 15.2 | -1.8 | 20,369 | 22,544 | 22,431 | **22,445** | +0.8 | +2.2 | +1.0 |
| 3Q16 | 669,170 | +2.3 | +1.4 | 15.5 | +0.6 | 26,176 | 22,763 | 22,818 | **22,670** | +1.0 | +1.7 | +1.0 |
| 4Q16 | 723,051 | +4.8 | +1.9 | 18.0 | +2.2 | 24,534 | 22,745 | 23,095 | **22,844** | -0.1 | +1.2 | +0.8 |
| 1Q17 | 550,487 | +2.4 | -0.3 | 18.0 | +2.7 | 20,066 | 22,811 | 22,777 | **22,840** | +0.3 | -1.4 | -0.02 |

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

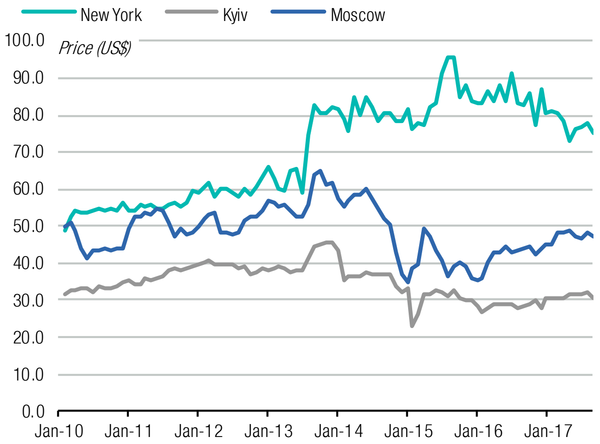
**Table 5. ICU consumer basket as of end of September 2017**
Prices of consumer goods in Kyiv, New-York, and Moscow

| Item of the basket | Description | Kyiv, central district 30-Sep-17 Price (UAH) | New York metro-politan area 30-Sep-17 Price (US$) | Moscow, central district 30-Sep-17 Price (RUB) |
|---|---|---|---|---|
| **Consumer goods** | | | | |
| Coca-cola (0.5 litre, plastic bottle) | Non-alcohol beverages | 8.50 | 1.49 | 58.20 |
| Beer Corona Extra (0.33 litre, glass bottle) | Alcoholic beverages | 22.33 | 2.00 | 121.00 |
| Bunch of fresh bananas (1 kg) | From Ecuador | 17.99 | 1.52 | 54.99 |
| Pack of milk (1 litter) | Locally produced, soft package, i.e., not glass bottle | 27.29 | 1.59 | 71.60 |
| Chicken meat (1 kg pack) | Locally produced and branded package, boneless breast | 99.25 | 12.08 | 259.00 |
| Canned pineapple (0.565 kg, can) | Pineapple circles, Dole brand | 56.98 | 2.19 | 146.00 |
| Pasta (0.5 kg) | Soft package, produced in Italy | 35.00 | 1.75 | 72.50 |
| Sugar (1 kg) | | 23.33 | 3.07 | 50.90 |
| Package of table salt (1 kg) | | 12.99 | 1.61 | 27.90 |
| Chicken eggs (10 units pack) | White eggs, standard size | 25.85 | 2.99 | 100.73 |
| Chocolate bar (50 g) | Snickers | 7.90 | 1.50 | 29.60 |
| Toothpaste (75ml package) | Colgate | 42.42 | 1.46 | 155.00 |
| Shampoo (200ml package) | Head & Shoulders brand, for normal hair | 43.87 | 3.14 | 189.00 |
| Toilet paper (4 rolls package) | Kleenex Cottonelle brand, white paper, Regular toilet tissue | 42.04 | 3.20 | 111.00 |
| Magazine | Playboy, local edition, A4 format (standard one, not a pocket book format) | 49.71 | 6.99 | 155.00 |
| Gasoline (1 litre) | Lukoil, regular | 26.10 | 0.75 | 42.00 |
| Batteries (AA x 4 pack) | A 4-pack of AA Duracell batteries, Alkaline | 92.85 | 4.99 | 214.00 |
| Coffee (250 g, vacuum pack) | Lavazza Caffe Espresso, brick-like vacuum pack | 94.00 | 4.60 | 308.00 |
| **Services** | | | | |
| Underground commute ticket | Within the central part of the city | 5.00 | 2.75 | 55.00 |
| Cinema ticket | Thursday's night price for the seat with good location, Hollywood film | 80.00 | 15.59 | 500.00 |
| **Total basket value (in local currency)** | | **813.40** | **75.26** | **2 721.42** |
| Exchange rate versus US dollar at spot market as of date of observation | | 26.584 | 1.000 | 57.555 |
| **Total basket value (in US$)** | | **30.60** | **75.26** | **47.28** |
| **Overvalued "+" / undervalued "-" (%)** | | | | |
| UAH vs. USD | | **-59.34** | | |
| UAH vs. RUB | | **-35.29** | | |
| **Fair value in the long-run as of observation date** | | | | |
| UAH per USD | | **10.808** | | |
| UAH per RUB | | **0.299** | | |

Source: ICU.

**Chart 82. ICU consumer basket value (US$)**

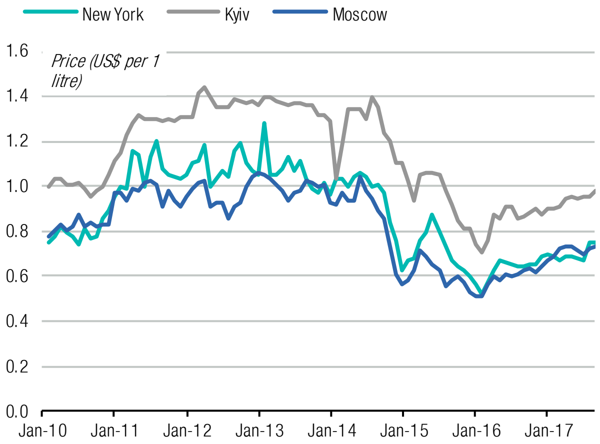
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 83. Gasoline A95 equivalent 1 litre (US$)**

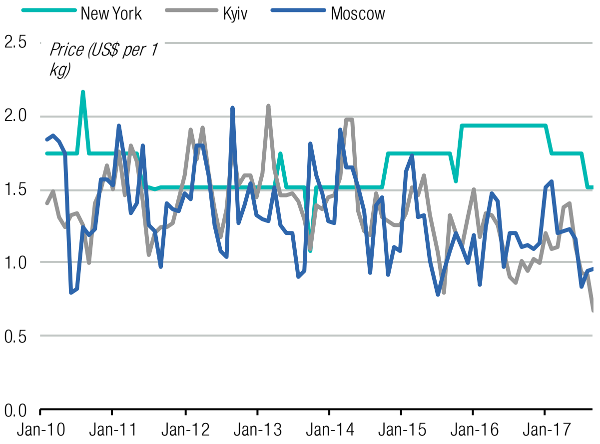
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 84. Fresh banana 1 kg bunch (US$)**

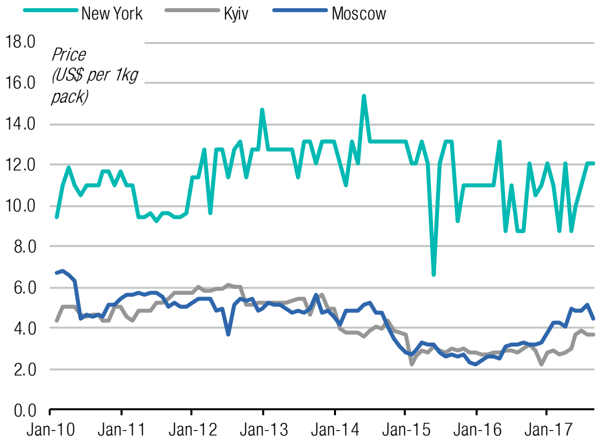
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 85. Chicken meat 1 kg pack of boneless breast (US$)**

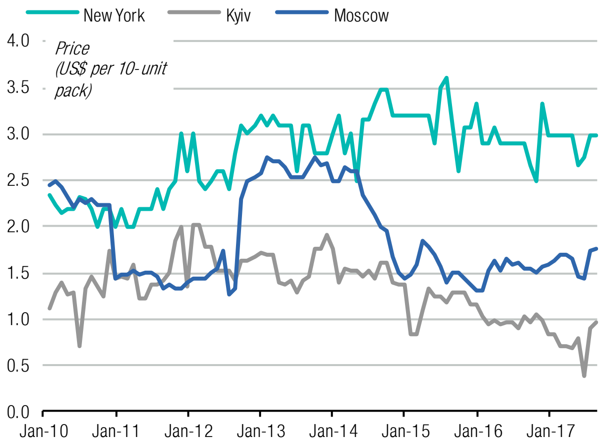
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 86. Chicken eggs 10-unit pack (US$)**

*Price history from February 2010 through September 2017*




Source: ICU.

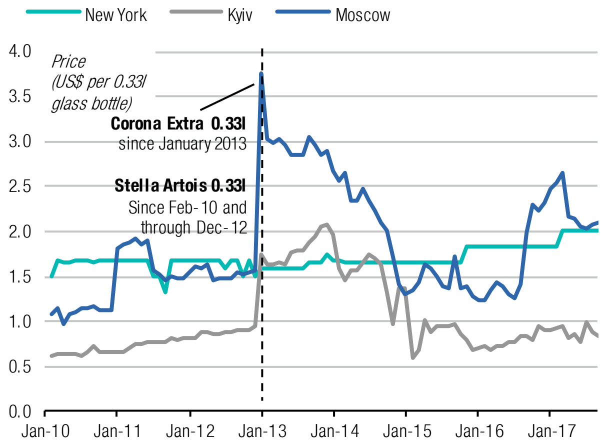
**Chart 87. Pasta 0.5 kg soft package Italy-made (US$)**

*Price history from February 2010 through September 2017*


Source: ICU.

**Chart 88. Beer Corona Extra 0.33 litre glass bottle (US$)**

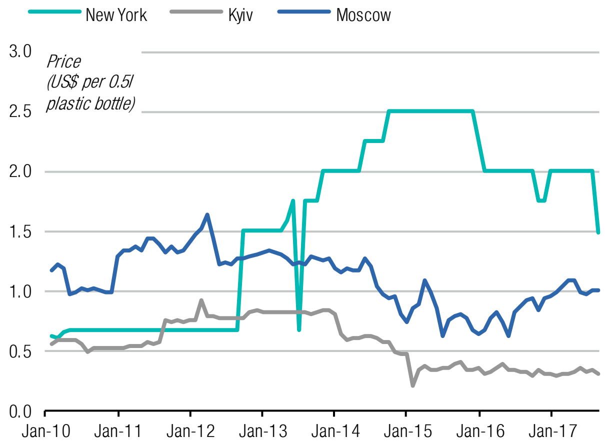
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 89. Coca-Cola 0.5 litre plastic bottle (US$)**

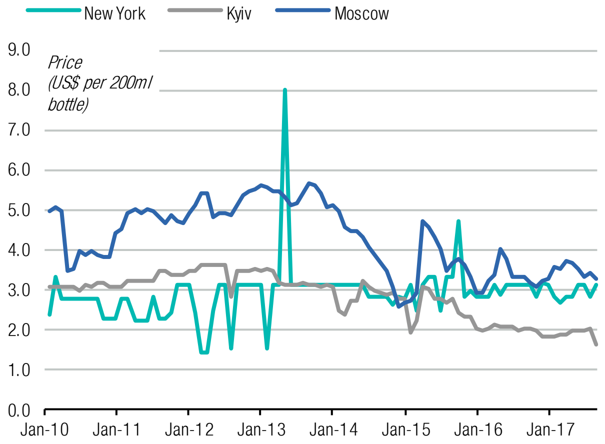
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 90. Shampoo 200ml bottle Head & Shoulders (US$)**

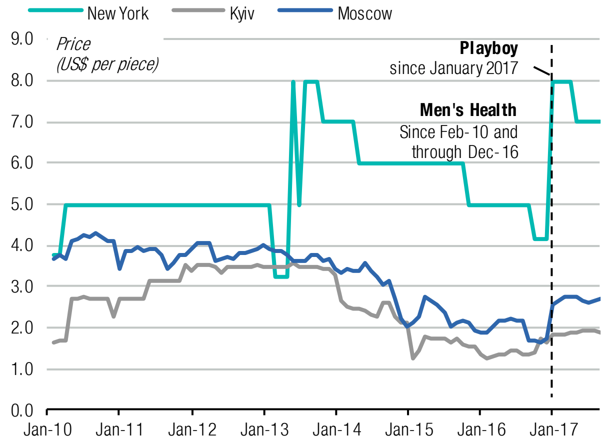
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 91. Magazine *Playboy*, A4 format (US$)**

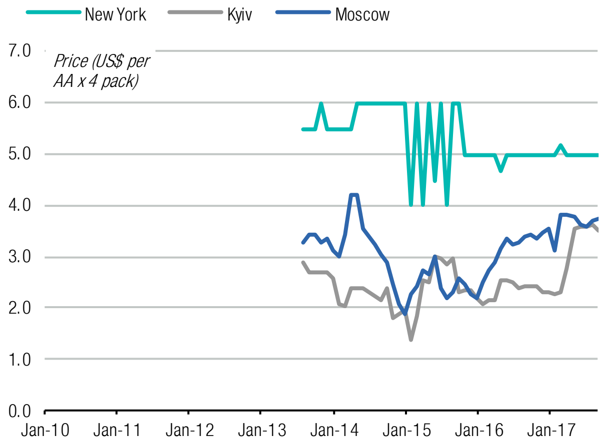
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 92. Duracell batteries (AA x 4 pack) (US$)**

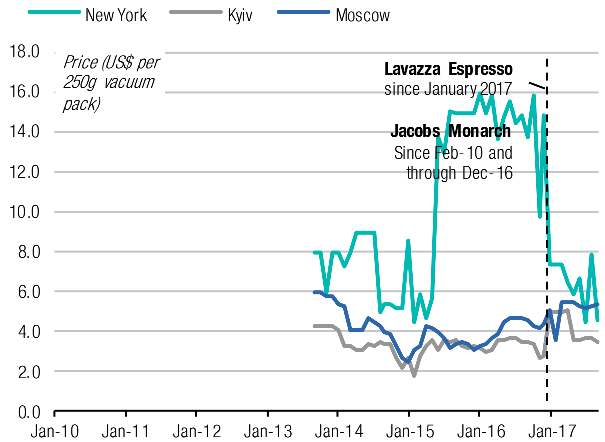
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 93. Lavazza Cafe Espresso, 250 g vacuum pack (US$)**

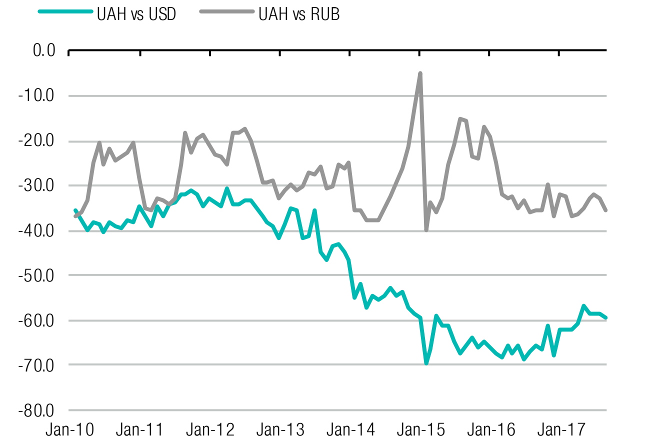
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 94. Value gap of ICU basket in UAH vs. USD and RUB (%)**

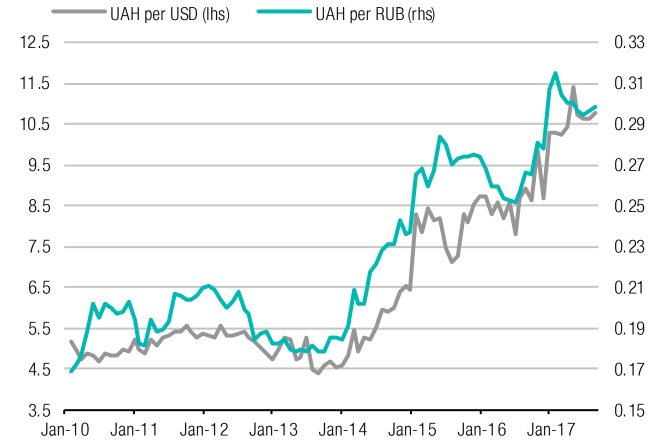
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 95. An exchange rate level of UAH per USD and UAH per RUB, which would eliminate the value gap of ICU basket**

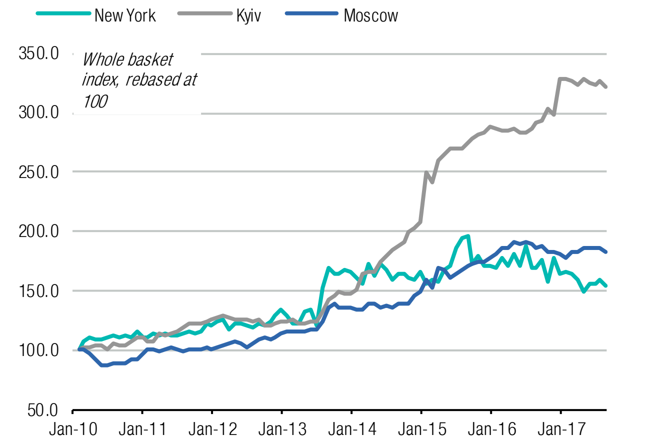
*Price history from February 2010 through September 2017*




Source: ICU.

**Chart 96. Index of the ICU consumer basket value in local currency (points, rebased at 100 as of February 2010)**

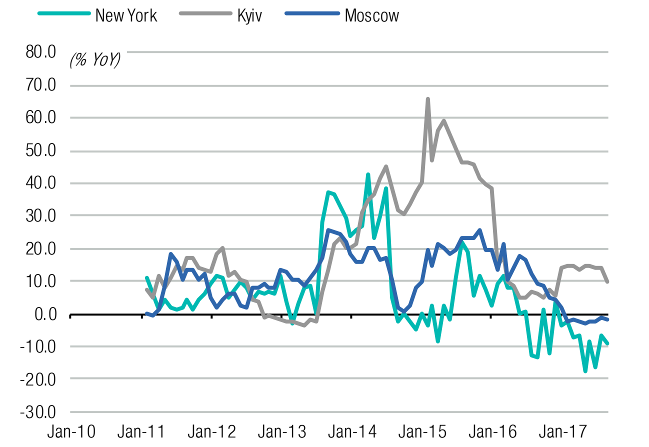
*Price history from February through September 2017*




Source: ICU.

**Chart 97. Growth rate of the index of the ICU consumer basket value in local currency (% YoY)**

*Price history from February 2010 through September 2017*




Source: ICU.

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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

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

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

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

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