



INVESTMENT CAPITAL UKRAINE
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Focus
Ukraine

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Economics

Quarterly Report

Muddling through no more



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Executive summary

ICU's macroeconomic view on Ukraine in the forecast period of 2H13 and 2014-15 is summarised below.

Ukraine's economy tired, nearly exhausted, and cornered. To paraphrase sports commentators, the 2008 crisis knocked Ukraine's economy to the mat, it barely got on its feet in 2010-11 and then was pummeled by another round of heavy fighting in late 2012 and again in 2013. Yet the coach has been pretending he/she had a winning strategy.

In our view, there are three areas of profound concern—the economy and fiscal deficit, sizable external debt and an appreciating currency in real terms.

First, weak economy and high state expenditures. In 2013, the economy and, hence, state revenues are underperforming by a considerable margin. Likely no real growth in 2013 contrasts with the still official view of 3.4% increase. GDP size is a good 10% short of the pre-2008 crisis peak. Government expenditures as a share of GDP have settled above 28% in the post-crisis period, 2ppt above the 26% ceiling seen prior to the crisis. Hence, government's fiscal performance indicates growing financial needs this year as well as for the next one.

In 2013, we expect the central government's budget deficit to increase to UAH60bn or 4.2% of GDP; last year's deficit was UAH53bn or 3.8% of GDP. Total government financing requirements to cover deficit and debt refinancing are increasing 18% from the previous year to a local-currency equivalent of UAH141bn.

The prospect for next year is for 3% YoY growth, according to our base-case scenario, which is, in fact, a trivial pace for Ukraine's economy. This growth would not relieve the government's fiscal burden in 2014, a pre-election year, and we forecast a budget deficit of UAH73bn or 4.6% of GDP. Hence, the government's financial needs are set to increase again by 9% to a local-currency equivalent of UAH154bn.

Second, external debt refinancing still a looming and large issue. Authorities must manage a large external debt burden, including principal and interest, which stands at US\$11bn in 2013 and at least US\$9bn in 2014 (see pp.63). The vast majority of the debt due is on the books of the central government and central bank, which accounts for a 87% share of the two-year total. Over 2013 to date, they have successfully refinanced the external debt due to the IMF in the Eurobond market where investors had been yield-chasing until recently. Further, the state banks and state-owned corporations have served as a conduit by raising USD abroad and then providing them to the government by buying government-issued, USD-denominated bonds locally.

In total, MoF borrowed US\$5.5bn in 1H13 to refinance external debt (US\$2.25bn through Eurobond placements and US\$3.26bn via domestic foreign-currency bonds). Over the rest of the year, MoF has to borrow an additional US\$5.5bn to refinance sovereign external debt, including the NBU payouts to IMF. In the near term, this is a prime challenge to the government in 2H13.

In our view, the domestic market has quite limited capacity to provide MoF with enough US dollars to refinance the external debt due in the remainder of 2013. Moreover, since this June, global fixed-income markets have been re-positioning for the new era of less monetary support from the US Federal Reserve. In particular, Eurobond market investors

have turned their backs on Ukraine (and rightly so, in our view, because high Ukraine credit risk reflects its rigid macroeconomic policies and its low preparedness to weather the coming era.

Third, UAH appreciates in real terms by “standing still.” The economy is enduring a lengthy period of real appreciation of the hryvnia (UAH), which is being managed to “stand still.” This happens when the hryvnia’s nominal exchange rate stays de-facto fixed to the US dollar, while the relative change in FX rates of its main trading partners and their inflation rates versus Ukraine’s are producing a stronger real rate for the UAH. As measured by ICU’s CPI-based, real trade-weighted index, which tracks UAH’s real rate, the UAH appreciated by nearly 6% to date from this year’s low seen in early February. We forecast this appreciating trend to continue well into 2H13 and likely beyond on the back of trade partners’ currencies, like the Russian ruble, depreciating versus the US dollar and Ukraine’s inflation accelerating while its trade partners’ decelerates. And, an appreciated currency in the real terms is a negative factor for exports and the industrial sector of the economy. This, together with bond investors’ lack of appetite for Ukraine sovereign debt, could create a negative cycle, which eventually could lead to a further rise in sovereign credit risk and, ultimately, Ukraine being frozen out of the market.

Authorities’ response to these challenges: domestic stimulus through tax incentives, and, lately, own QE. Ukraine’s authorities have been responding to these challenges with a regulatory, fiscal and monetary policy mix, which has proved unsuccessful and is broadly referred to as “muddling through”. Indeed, recovery from the deep 2008 recession has been unsatisfactory; GDP is still nearly 10% smaller than its pre-crisis peak. Back in 2010, to spur recovery the government introduced tax incentives for businesses by lowering taxes on corporate profits from 25% in 2010, to 19% now, and 16% in 2014. It has yet to result in a reasonable increase in fixed investments, which still accounts for a low 19% share of GDP. This year, NBU has made two cuts of the key interest rate by a cumulative 1ppt to 6.5% and a base-money increase expected to reach 18% YoY as of end 2013. This results in balance-sheet expansion via government bond purchases for an equivalent of UAH60bn for entire year. Also, it allows NBU to fix this year’s state revenues, which were underperforming, with a profit transfer to the tune of UAH28bn.

At the end, while this response is addressing the issue of a stagnated economy and likely spurring inflation (out of the deflation zone), it does not resolve the issue of securing an effective backstop for the government’s external-debt refinancing needs. Via higher inflation, Ukraine’s own QE is set to produce real appreciation of the UAH going forward, in a growth-negative environment.

Summing it all up: Becoming a bit more flexible is base-case; “muddling through” is a worst-case. In our view, to a large extent authorities are aware of the upcoming challenges. That is why our base-case scenario assumes that a bit more flexibility will be introduced into the economy. This will allow the government to secure an effective backstop of USD inflows from the IMF, once a new programme is in place in early 2014, to remedy balance of payments problems. Too, it allows nominal exchange rate flexibility to avoid overvaluation of the currency. In our view, UAH’s competitive nominal exchange rate one year from now will be 8.75/USD.

Otherwise, if authorities’ stick to a “muddling through” approach, under our worst-case scenario, then the economy would lose external competitiveness due to the “standing still” effect of a gradual appreciation of the currency’s real rate. In a upcoming environment of higher USD interest and exchange rates, this would likely lead to a deepening recession and a balance-of-payments crisis in 2015. Hence, Ukraine’s economy would end up with a lost decade, which began with the 2008 crisis, of stagnant growth and recurring recessions.

Politics & geopolitics

Politics are in a full sway in preparing for the presidential election campaign, which *de-jure* starts in 2014 while *de-facto* has started already. With a lot of time left until election day in late March 2015, there will be plenty of developments that will spotlight prospective candidates as they challenge incumbent president Yanukovich's bid for re-election. For the time being, despite the current economic doldrums, Yanukovich is the favourite to win, which is reflected in his current (albeit slim) lead in the polls, tight grip on power and the overwhelmingly positive coverage by main TV channels, still the main source of information for the nation. However, if our worst-case scenario (detailed throughout this report) materialises, then it could be an iron-fisted, knock-down blow on the incumbent's chances to be re-elected, and pave the way for a new breed of politician running the country.

The 2013-14 political cycle in full sway

The presidential race has been in full sway since as early as 1H13

Just six months after the current political cycle started in December 2012², the nation has already begun to brace itself for a likely spectacular culmination in March 2015, when a highly tense rivalry for the presidency is decided. Opposition implies both a domestic opposition, which has at least three active leaders, and a cluster of "other" domestic oppositions fostered by the Kremlin, which is leaderless so far. More details on these peculiarities follow.

Incumbent President Yanukovich enjoys a 23% approval rating now ...

Incumbents: Lead polls, powerful, and determined to take the prize

Despite quite inconclusive economic achievements, President Yanukovich continues to lead in the polls, albeit with only a slim margin above rivals. A national poll held this May by two well-respected Kiev-based think-tanks, the Razumkov Centre and Democratic Initiatives Fund (DIF), showed the incumbent has the support of slightly more than a 23.1% share of voters³. Indeed, this represents nearly a 10ppt decline in his approval rating of 33% back on the very eve of presidential elections in early 2010, and a 12ppt drop from the 35.3% of voters who supported Mr Yanukovich in the first round of the presidential elections, which he effectively won in the second round. However, Mr Yanukovich's rating has recovered from the low of 22.9% reported by DIF as recently as December 2012.

... 5ppt ahead of his closest rival, according to the most recent poll

In our view, Mr Yanukovich's approval rating has reached a trough, or natural resistance level, as there are voters who would readily support him under any circumstances. Back in the second half of the 2000s, after having lost his first presidential bid in late 2004, his personal approval rating was at a historical low, as prevailing political views of him among voters was that he was a defeated politician, and, hence, he was abandoned by many former supporters. During that time, however, the polls showed that his approval rating was at 21.3% in September 2005, a share of voter support that indicated a core base of Mr Yanukovich's constituents at the time.

Given his above-mentioned share of core voters and the more recent, abrupt increase of Mr Yanukovich's approval rating (from 22.9% in December 2012 to 23.1% in May 2013), his

² We count the timing of the current political cycle from the date when newly elected MPs convened in the parliament.

³ We are aware of the opinion [poll](#) carried out by Kyiv International Institute of Sociology (KIIS) at the end of May, which assigned Mr Yanukovich 14% of the vote, placing him behind the 16% approval rating of Vitaliy Klitschko. However, we regard this opinion poll as inconsistent with previous polls carried out by KIIS in cooperation with DIF. A [poll](#) by these two think tanks held in March 2013 yielded 21.2% for Mr Yanukovich and 14.4% for Mr Klitschko.

re-election team is working on creating conditions that would translate this flash into a confirming trend that will allow him to win.

In addition to his lead in the polls, Mr Yanukovich remains a powerful figure

...

Moreover, President Yanukovich presides over a government, which, since the last elections in October 2012, was reshuffled and stacked with a mixture of old-guard and fresh-faced ministers, the former referring to officials like PM Mykola Arbutov and the latter to Deputy Ministers Serhiy Arbutov (37 years old) and Oleksandr Vilkul (39 years old). (This is a direct indication of the planned continuation of the reforms initiated by President Yanukovich when he arrived in office in 2010, and which were then shelved in the face of public criticism⁴.)

... having the support of the government and a parliamentary majority

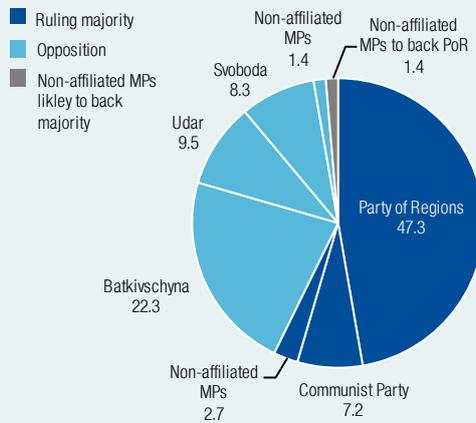
Furthermore, President Yanukovich's support base in parliament (see Chart 1 and Chart 2, pp.7) has remained solid in terms of Ukrainian parliamentary style⁵ despite fierce dissent from the opposition. The ruling majority commands a total of 240-something MPs, which is quite enough to get their laws passed. Over the next year-and-a-half, he is likely to retain this majority (Chart 3, pp.8), as a re-run of the election of MPs after a handful of constituencies in dispute should bring a couple of votes into the ruling-majority camp.

There is a proliferation of media outlets that will support a successful re-election bid

In addition to President Yanukovich's power in the executive and legislative branches, there is a group of businessmen loyal to Mr Yanukovich whose interests include diverse media outlets (print, television, radio, and Internet) who stand ready to launch a formidable media barrage for his re-election bid in late March 2015.

Chart 1. Breakdown of Parliament, voting on 13 December, 2012: ruling majority, opposition and non-affiliated MPs (%)

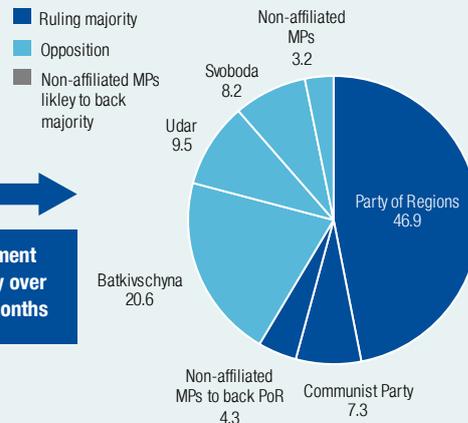
100% = 444 MPs



Sources: Parliament of Ukraine, Investment Capital Ukraine LLC.

Chart 2. Breakdown of Parliament, voting on 5 July, 2013: ruling majority, opposition and non-affiliated MPs (%)

100% = 441 MPs

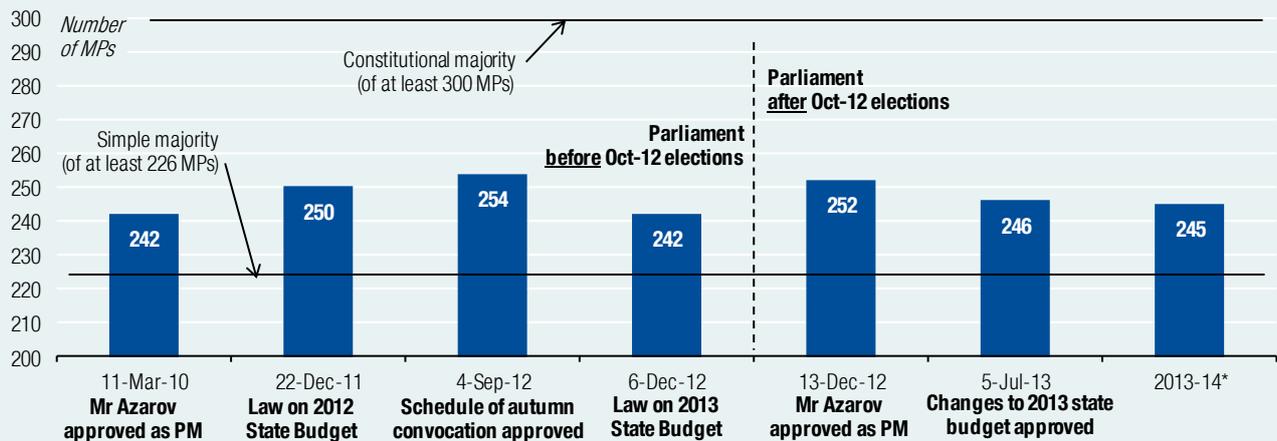


Sources: Parliament of Ukraine, Investment Capital Ukraine LLC.

Parliament majority over last 6 months

⁴ The first serious domestic political crisis took place in the fall 2010, when Mr Azarov introduced a government-led reform of business taxation. Alongside aggressive corporate tax cuts, it proposed a revision of the simplified taxation of self-employed entrepreneurs, a legal loophole for businesses to avoid a true tax rate. This latter proposal caused mass protests by self-employed entrepreneurs, which forced President Yanukovich and his government to pull back on this particular issue in late 2010. This crisis left its stamp on the reformist agenda and since, they have become more cautious.

⁵ Over the past half-year, competition between the incumbent ruling parties and opposition inside the legislature has been marked with theatrical skirmishes, and behind-the-scenes agreements that led to defections by MPs, mainly from the opposition factions into the de-facto ruling factions.

Chart 3. Number of MPs that form ruling majority in Ukraine's parliament during key benchmark votes¹ (number of MPs)


Sources: Parliament of Ukraine, Investment Capital Ukraine LLC.

Opposition: Popular, ready to fight, but fragmented

The opposition is represented by three parties, which do differ on some issues ...

While Julia Tymoshenko, until recently an opposition front-person, remains in jail (though widely expected to be released to a German hospital for treatment), the opposition camp has three quite serious political contenders. Each of them is relatively young, and all have high ambitions. This trio includes, in descending order by approval rating from the most recent opinion poll (by Razumkov Centre and DIF, see above): Vitaliy Klitschko (41 years old); Arseniy Yatsenyuk (39); and Oleg Tyagnybok (44).

Mr Klitschko is relatively new to the top rungs of the political ladder, and leads the newly-founded party Udar⁶, which, notably, tries to be centrist. In our view, it has effectively found some support of the former supporters of Serhiy Tigipko, who eventually merged with Mr Yanukovych in 2010.

Mr Yatsenyuk replaced Ms Tymoshenko at the helm of her party, Batkivschyna, and now competes for Mr Klitschko's voter base in the western and central oblasts of the country. However, he and his party lack new ideas and are instead stuck repeating old-fashioned slogans used by Ms Tymoshenko regarding what they see as the total corruption of their political opponents.

Mr Tyagnybok leads a party that has been hugely active in staging political protests (either on the streets or inside the legislature), and holds very orthodox views on society, effectively playing with fire as it touches on issues of the ethnic groups that are a part of the nation.

... and they will remain at odds with each other until March 2015

This troika is expected to remain very active campaigning in the current presidential race which, effectively, has already begun, through March 2015. They are trying to rally their supporters, whose views largely overlap on many social and political issues, to unify with the prime purpose of agreeing on a sole candidate to defeat President Yanukovych. However, this plea for unity is likely to wear down over the course of this year and next. The on-going rivalry between incumbents and each of the opposition parties is very likely to reveal widening differences, a development which would be eagerly exploited by the vast media outlets under the control of businessmen loyal to Mr Yanukovych.

⁶ The Ukrainian-name for the party is an acronym of its official four-word name, while the English-translation is 'punch,' an effective reminder of what Mr Klitschko used to be until recently, and intentionally meant to characterise its leader as someone who will successfully fight political battles.

Ultimately, our base-case scenario envisages that Mr Yanukovich will successfully win out over the fragmented opposition, a much desired outcome for his constituents.

Opposition fostered by Kremlin: So far, leaderless, 'against-all' play

Disenchanted with incumbents of the former Soviet Union, the Kremlin decided to continue its long-term effort on fostering its own political agenda

Kremlin's 'near abroad' policy on preventing the countries of the former Soviet Union (including two large countries of the Baltic states, Latvia and Lithuania) from developing into independent global economic and political entities has a particular aim on restraining Ukraine. In politics, the Kremlin has played the role of supporting those politicians who are capable and willing to foster pro-Kremlin policies. Past experience of supporting Mr Yanukovich is likely considered by Kremlin as a more of a failure than a success, because their expectations have fallen short of outcomes, especially in terms of President Yanukovich's rejection of the high-speed and full-scale integration process lobbied by Kremlin.

Mr Yanukovich has appeared to be an opponent to the Kremlin's plans for integration of the former Soviet colonies, on par with previous President Viktor Yuschenko, whom the Kremlin has longed to discredit. Since at least 2012, the Kremlin has changed its tactics and turned to fostering its own presence in the local political game by shaping information flows, in particular, focusing on Viktor Medvedchuk, former head of President Kuchma's administration, an active blogger, as its point person in this initiative on Ukrainian soil.

The project started this year by launching a free daily tabloid, rivalling similar publications by local businesspeople. It is set to expand into radio and TV outlets, a strategy seemingly aimed at allowing the Kremlin to play a third-party role in Ukraine's domestic affairs, while standing apart from battles between incumbents and the opposition.

The same question: IMF, Kremlin or going it alone?

After success in avoiding acquiescing to the demands of either the IMF or Kremlin, Ukraine's incumbent leadership is enjoying its authority over its relatively large nation and economy. And apparently, after weighing all the costs and benefits of going it alone, effectively a policy on limiting interference and *diktat* from the outside, it has come to the conclusion that net, the benefits of political alignment outweigh the costs.

In this regard, all recent exchanges with the IMF and Kremlin were carried out in a diplomatic fashion to, on one hand, avoid cutting ties, and on the other, avoid a situation where cooperation with either of the two entities, ie, via a Stand-By Arrangement programme with the IMF or subscribing to Kremlin-run union(s), would become detrimental in terms of cost and or loss of potential benefits that could be enjoyed under self-rule.

A scenario of co-operation is more probable; however, given the gathering clouds over the global economy, there is the likelihood that Ukraine will require a backstop by either the IMF or the Kremlin.

In this regard, in our view, the eventual choice would likely be to favour cooperation with the IMF, which may, nevertheless, be only a short-term exercise with an exit strategy, while cooperation with the Kremlin is a long-term project with a vague and tricky exit strategy, or even more likely, a "no-exit" strategy.

Global economy

We underline the factors of changing macroeconomic conditions in the leading global economies, a number of which are Ukraine's key trade partners (like Eurozone, Russia). Some of others (like Japan) have a profound impact on the global economy and, indirectly, on Ukraine's economy, as well. The takeaway of this section is that going forward a mix of macroeconomic developments in the global economy is producing upward pressure on the real rate of Ukraine's currency.

Multi-speed world economies changing the course of key central-bank policies

If there had been no decisive steps taken in monetary policy by two of the world's major global economies over the course of 1H13—namely, the US and Japan—then current global macroeconomic conditions would likely be more volatile than they are.

Other major world economies that were reluctant to enact swift structural changes have seen disappointing growth and expectations. Those economies that were most aggressive with policy decisions—namely, the US and Japan—have at least succeeded in achieving upbeat expectations for their markets for the mid-term future.

United States: Policy "normalisation" seen ahead

There are differing views on the US economy's performance in 2013 ...

... with the Fed being more optimistic than the IMF and market consensus, though both views agree on a growing economy

The US economy has been recovering, albeit below the growth-rate trend (above 3%⁷) of the pre-crisis period, and, according to the Fed's most recent projections⁸, this year's real GDP growth is expected to be in the 2.3-2.6% YoY range (this is a bit lower than the Fed's forecast made back in March, for a wider range of 2.3-2.8% YoY). This implies that even if the economy grows in the lower band of the range, which is 2.3% YoY, this would represent a 0.1ppt growth acceleration from the 2.2% YoY seen in 2012.

However, such a forecast by the Fed appears to be a deviation from the most recent growth forecast update by the IMF (according to which, as a rule, we adjust our global macro view in compiling our *Quarterly Reports*)⁹, which expects the US economy to grow at just 1.7% YoY in 2013 (while back in April, the IMF had forecast this year's growth at 1.9% YoY). Also, the Fed's view on US economic growth this year appears marginally higher than the 1.8% median consensus forecast compiled by Bloomberg this July, which polled economists covering the US. In June, consensus showed a 1.9% median.

In light of the above-mentioned divergence in forecasts, the Fed's strategy, in our view, is to prepare the US economy for an eventual abatement in QE, given more signs that growth is trending up. In May and June, the Fed's communications on the matter were somewhat stressful for the US economy (the housing market, a vital component of the economy, was

⁷ Prior to the "Great Recession," which started in the US in 2008, the annual average economic growth rate in the period from 1992, ie, the year when the previous recession occurred in the US, through 2007, was at 3.2% YoY.

⁸ See Monetary Policy Report by Board of Governors of the Federal Reserve System published on 17 July 2013 ([here](#)).

⁹ See World Economic Outlook Update published by IMF on 9 July 2013 ([here](#)).

hit by a 1ppt increase in the 30-year mortgage rate¹⁰). In July, a series of communications by the Fed chairman somewhat calmed the initial market reaction to the talk of QE3 "tapering." The Fed has effectively incorporated the following three statements into its current monetary stance: 1) it starts a gradual withdrawal of monetary stimulus this year, provided that 2) improvements in unemployment continue, allowing the unemployment rate to move towards the "vicinity of 7%," and inflation to move towards the Fed's 2% target; and finally, 3) if employment and inflation expectations worsen, then the Fed would instead provide even more monetary stimulus.

Indeed, there have been signs of improvement in the economy and markets, which encouraged the Fed to start its QE3 "tapering" talk ...

In the past three months through June, the pace of US job creation continued, and at a firm pace: raw data for June as well as upwardly revised data for April and May delivered positive news, as more than 190,000 jobs were added to the economy. In total, this year's monthly average has been at more than 200,000 new jobs a month, allowing the unemployment rate to decline from 7.9% early in the year to 7.6% in June. Yet, this is hardly in the "vicinity of 7%," which was earmarked by the Fed as a condition to taper QE3. However, the market's expectations for July's employment data were encouraging¹¹ on the back of the most recent weekly data of lower initial jobless claims.

In other areas of inflation, data on consumer and producer price indices showed that in May and June, there was a steady increase in the monthly rates, suggesting that demand has showed signs of recovering: CPI and PPI increased 0.1% and 0.5% MoM in May, respectively, followed by a more accelerated rates of 0.5% and 0.8% MoM in June. This translated into a steady acceleration of inflation rates in year-on-year terms from low levels seen in April: CPI rose from 0.8% YoY in April to 1.7% in June and PPI from 0.8% YoY in April to 2.3% YoY in June.

... the market's inflation expectations initially worsened, but have recently recovered, indicating that the economy is adapting to the idea of "tapering"

True, this quite sizable inflation acceleration reported in the CIP and PPI was not supported by the data on the so-called break-even inflation rates¹² that track investors' expectations for inflation in the US. For instance, the 2-year and 5-year "break-even" rates had recovered just recently to 1.6% and 1.9%, respectively, from the lows (0.9% and 1.6%) seen at the end of June, when markets were very nervous on the back of talk of "tapering" by the Fed. These rates still remain subdued from the current year's highs seen before the Fed's "tapering" rhetoric (these rates both were around 2.4% area as late as end 1Q13).

However, we attribute the behaviour of the "break-even" rates over 2Q13 to investors' increased concern over risks that pose the possibility of increased long-term rates (monetary tightening induced by selling-off of US Treasuries) on the recovery prospects of the US economy. The Fed chairman, in his recent testimony in the US Congress on 17 July, did his best to assuage investors' worries by assuring the public that the Fed's recent talk of "tapering" does not mean that the Fed would decrease its current volume of monthly purchases of securities from the market (a policy known as QE3) "unless warranted". Hence, the Fed indicated that it would be tapering to a mild degree, and if employment data worsens, inflation expectations decline, or growth indicators disappoint, then it would step in by supplying liquidity to the markets.

¹⁰ Over 2013, this climbed from 3.41% on 18 April to 4.51% on 11 July, and now stands at 4.37% (Source: <http://www.freddiemac.com/pmms/>).

¹¹ The market expects that July's nonfarm payroll employment could repeat the strong reading seen in the previous month, when employment increased by 195,000.

¹² The difference between yields on US Treasury Inflation-Protected Securities (TIPS) and comparable US Treasuries by maturity (Bloomberg codes for 2-year and 5-year rates are USGGBE02 and USGGBE05, respectively).

In our view, the US is on path to an extended recovery, albeit a gradual one

Going forward, we expect to see a gradual pick-up in the data coming out on employment and general economic activity. We acknowledge that recent monetary tightening has caused higher long-term rates and has had a negative impact on the US economy. The 10-year US Treasury rate declined on Mr Bernanke's testimony on 17 July to 2.5% from 2.6%, but this is still well above the 1.6% seen in late April (see Chart 5 on pp.13). However, on net, the US economy is likely to adjust to this higher interest rate environment rather smoothly (ie, without a serious fallout in terms of growth pace¹³).

All in all, in our view, a continued growth story in the US in 2H13—albeit still at a rate near the 2% YoY threshold, which is lower than the pre-crisis level of 3%YoY—should provide a base for the eventual push by Fed officials to start phasing out QE3 this fall and consider raising the key lending rate at the end of 2014 or early 2015. Eventually, US Treasury yields are likely to remain volatile, albeit trending higher, and the 10-year note yield to tilt upwards, towards the 2.6-3.0% range.

USD weakness, a side effect of QE series, supported recovery

Another quite important takeaway regarding the outlook on the US economy for the future is that it has benefited from currency weakness, which came as a side effect from the Fed's launching of a series of quantitative easing in late 2008 and onward. The real rate of the US dollar not only dropped from the high seen in the post-crisis 2008 period, but it nosedived to a new record low that surpassed the previous low seen in early 2008, when the global economy was recovering (see Chart 4, pp.13). This real devaluation of USD, in our view, was one of the key layers in the foundation for real GDP growth in the US of 2.1% as a yearly average in the 2010-12 period.

Conclusion

In relative terms, the US economy is stronger than other major world economies ...

Our main conclusions regarding the US economy's growth prospects in 2013 are related to its currency valuation.

First, it is important to note that in relative terms, key global economies like the US, the Eurozone, Japan, China, and other BRIC countries are experiencing differing growth paths. Of these, the US economy has shown the most positive performance, thanks mainly to the Fed's policies, which were undertaken to recover from 2008's "Great Recession" (see Chart 6, pp.13).

Indeed, the Eurozone remains in recession, but is expected to revert to growth later this year, though this growth is expected to be sluggish at first. Japan has been mired in a long-lasting period of stagnation and only this year has found the power to muster an aggressive monetary and fiscal stimulus plan. China and other BRIC countries, like Russia, are slowing down, and appear quite intent on finding a quick fix to turn around their economies.

... hence, its currency is likely to continue strengthening versus those of weaker economies

This divergence in growth among the larger economies results from different approaches to policymaking. Given that most world economies have been undergoing fiscal retrenchment (this is especially true for the Eurozone, and less so for the BRIC economies), the array of monetary policy tools will be the key to the other economies' success in emerging from economic stagnation. Hence, in relative terms, an extension of monetary easing in the Eurozone, Japan, and in BRIC countries, while the US exits its monetary stimulus programme, will create a stronger US currency and weaker national currencies relative to the dollar. This is why one of our cornerstone views on the outlook for the global economy is a stronger US currency versus those of economies as vital to Ukraine as the Eurozone and Russia.

¹³ Equity-market performance over early July does confirm this proposition. The S&P 500 index back at all-time high levels indicates that confidence in the US economy (albeit supported by monetary policy) has been firming. This suggests the market's view that the Fed would start a "normalisation" campaign in an untimely manner, ie, too early, engendering a recession, or too late, engendering higher inflation.

Chart 4. US dollar trade-weighted indices by BIS*

Monthly history from January 2000 through June 2013.
Rebased at 100 points as of 1 January 2000



Note: * Bank of International Settlements.
Source: BIS, Investment Capital Ukraine LLC.

Chart 5. Long-term US dollar interest rates (%)

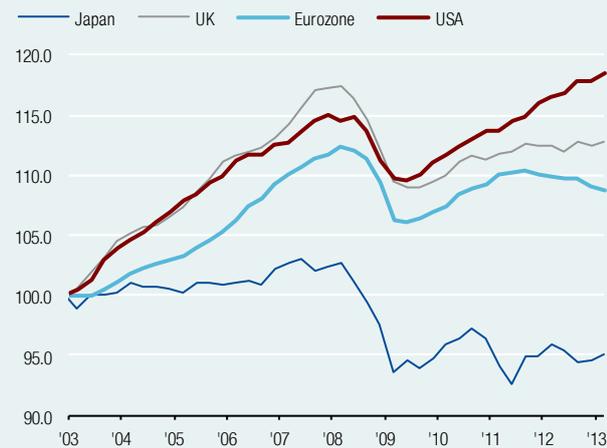
Daily history from January 2000 through June 2013



Source: Bloomberg.

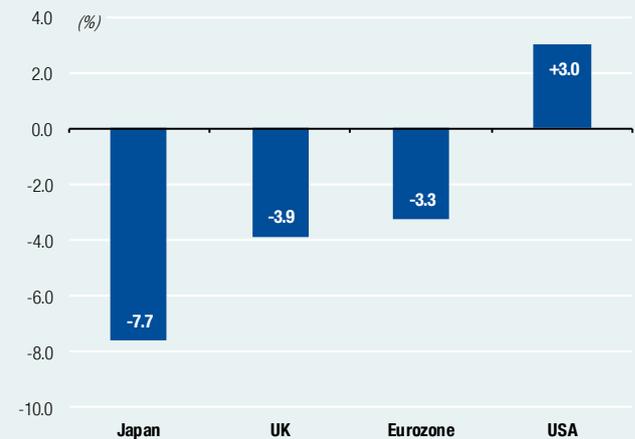
Chart 6. Key developed- market economies: How well they have fared while recovering from Great Recession of 2007-08?

Quarterly seasonally adjusted data on GDP in seasonally adjusted terms
Last 10-year history from 1Q of 2003 through 1Q of 2013



Source: Bloomberg, Investment Capital Ukraine LLC.

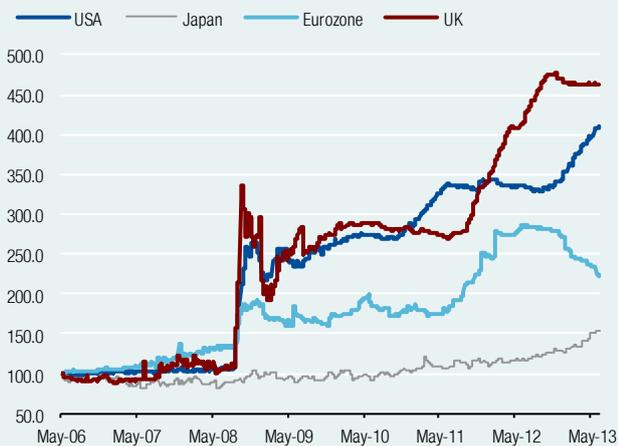
Difference between size of economy in 1Q13 and pre-2008 peak.
Quarterly seasonally adjusted data



Source: Bloomberg, Investment Capital Ukraine LLC.

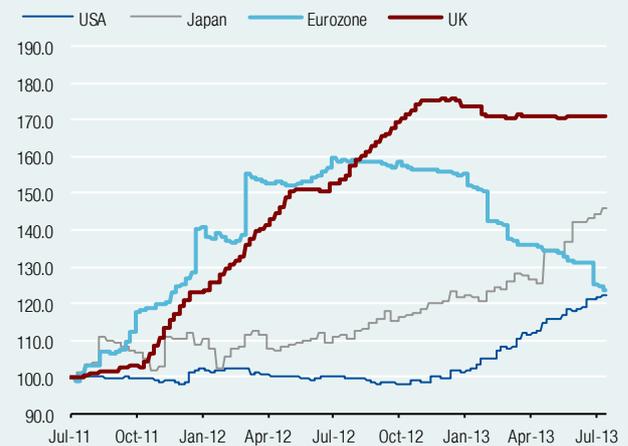
Chart 7. Key developed-market economies: Pace of expansion of the central bank's balance sheet (Rebased at 100 as of beginning of the period)

Since 31 May 2006



Source: Bloomberg, Investment Capital Ukraine LLC.

Since 1 July 2011



Source: Bloomberg, Investment Capital Ukraine LLC.

Eurozone and the UK: Prolonged recession requires monetary easing

Both the Eurozone's and the UK's GDP are more than 3% short of their pre-2008 peaks ...

In Europe, the two largest economies with central banks key for the global economy—the Eurozone and the UK—are grappling with the aftermath of the Great Recession and their own internal issues that are impeding a fast recovery. Indeed, both economies are nearly equally lagging in terms of recovery behind the US and are still each more than 3% short of their respective peak levels before the 2008 crisis. The size of the Eurozone's economy this quarter is 3.3% short of the pre-recession peak, and UK's is 3.9% lower (see Chart 6, pp.13).

... indicating extended weakness in both the economies

While there are a number of similarities between these entities, including weak economies, fiscal retrenchment, the size of public debt, banking-sector issues, and so on, there is one similarity, which is a top priority for us for the purpose of this report: monetary policy shifts that remain as viable options in policymakers' tool chests to support their economies.

To overcome this, both the ECB and BoE pledged to keep interest rates low for an extended period ...

The Bank of England (BoE) has been one of the most pro-active and key global central banks in terms of providing monetary stimulus. Since late 2008, its balance sheet has expanded the most out of all major central banks of developed-market economies (see Chart 7, pp.13). Hence, as a side effect of this policy, the real rate of the British pound (GBP) has undergone a massive drop in value (see Chart 8, pp.14). Despite such a re-pricing of the currency's real exchange rate, the UK economy has been struggling to recover to its pre-crisis levels. In our view, one of the key impacts on the economy has been slightly higher inflation than in other major DM economies.

... and in our view, this implies GBP weakness and thus EUR weakness, too

In its most recent monetary policy committee meeting on 4 July, 2013, the BoE, acting under the leadership of the newly installed non-British governor, decided to maintain its current rate level and monetary stimulus programme, while shifting towards so-called "forward guidance." The latter move turned out to be clear guidance for the market about the central bank's future move on its key policy rate. And, July's decision by the BoE was that it would keep interest rates low. One eventual outcome of the monetary policy in the UK is likely to be an extension of the period of a weak GBP, at least in 3Q13.

Chart 8. British pound trade-weighted indices by BIS*

Monthly history from January 2000 through June 2013.
Rebased at 100 points as of 1 January 2000



Note: * Bank of International Settlements.
Source: BIS, Investment Capital Ukraine LLC.

Chart 9. Eurozone trade-weighted indices by BIS*

Monthly history from January 2000 through June 2013.
Rebased at 100 points as of 1 January 2000



Note: * Bank of International Settlements.
Source: BIS, Investment Capital Ukraine LLC.

As for the Eurozone, the ECB's über-conservative stance has been softening recently under the weight of risks that have accumulated, as social unrest has spread across the southern members of the Eurozone, which have been implementing fiscal austerity measures. Very

recently, there were again mass protests in Greece while its parliament was preparing to vote on a bill of mass firings of public sector employees, a move insisted upon by the troika of official lenders—EU, ECB, and IMF—to obtain another instalment of financial aid for the country that continues to be plagued with a high level of public debt (180%¹⁴).

One key feature of the Eurozone, which distinguishes it from the UK's case and other DM economies, and which partially explains the prolonged recession, is the euro valuation in real terms. Chart 9 on page 14 shows that it has a strong currency that has been appreciating since mid-2012. Given the considerable amount of social anguish that has spawned new political crises in Southern Europe, the ECB is seen as forced to become more flexible in terms easing monetary conditions that would support a recovery, and that would provide a weaker currency as a side effect. Hence, we project a weakening path in the nominal exchange rate of the EUR versus the USD, at 1.29 as of year-end 2013 and then at 1.28 as of end of each year of 2014 and 2015 (see Table 1, pp.21).

Japan: Weaker yen proves instrumental

With the arrival of a new political leadership, Japanese authorities are determined to engineer an economic recovery from decades-long stagnation. The key element in achieving this goal has been monetary policy, which earmarked an aggressive 2% inflation target via an asset-purchase programme designed to double the monetary base. The most recent data showed that the Japanese government has been rather successful in getting economic growth back on track. And its long-lasting struggle with deflation also appears to be on the right course (CPI added 0.3% MoM in April and 0.1% MoM in May, and should move back into positive territory in year-on-year terms this June, for the first time since May 2012). One substantial benefit that the Japanese economy realised from the new policy regime is a devaluation in the real exchange rate of the Japanese yen since early 1H12 (see Chart 10 below).

Chart 10. Japanese yen trade-weighted indices by BIS*

Monthly history from January 2000 through June 2013. Rebased at 100 points as of 1 January 2000



Note: * Bank of International Settlements. Source: BIS, Investment Capital Ukraine LLC.

¹⁴ As expected by Fitch in 2013-14. See press-release "Fitch Upgrades Greece to 'B-'; Outlook Stable," published on 14 May, 2013 ([here](#)).

An easing in monetary policy has been a key component of the Japanese authorities' strategy ...

... resulting in a 25% devaluation of the currency in real terms

The JPY's real devaluation helped bring about a 4.1% increase in the country's economic growth rate in 1Q13 ...

...which is likely to unnerve other major economies, as Japan further extends its easy monetary policy

There is a risk of the UAH's real rate being pressured upward, if the Eurozone and China act to counterbalance JPY's real devaluation

Chinese economic growth has been slowing ...

According to the Bank of International Settlements (BIS), the JPY's real trade-weighted index dropped by one-quarter from 2012's peak of 81.1 points in rebased terms in July 2012 to a lower level of 60.9 points seen this May (see chart above). This real rate decline corresponds with the devaluation of the nominal exchange rate of the JPY versus the USD, from 76.20/USD as of 1 February, 2012 to a low of 103.16/USD on 22 May, 2013.

This currency devaluation supported economic growth and allowed the economy to post a 4.1%¹⁵ increase in real GDP in 1Q13. This was such a strong pick-up in growth that it forced the IMF to revise upward its 2013 forecast from 1.5% YoY as of April to 2.0% YoY as of July.

The parliamentary elections in Japan (held on 21 July, 2013) are widely expected to result in strengthening the current government's leadership, allowing it to enjoy stronger support from the legislature and strengthening its "hand to act."¹⁶ This means that the incumbent government will likely pursue its aggressive policy of "Japan renewal" with additional vigour. This would be reflected in the monetary sphere, where the Japanese currency would be pressured down further (in nominal terms, toward the 120/USD level and possibly beyond), helping make Japan's vast and diverse industrial sector more competitive in foreign trade.

Conclusion: Why Japan's turnaround story has relevance to Ukraine's

First, Japan is a large exporter, and competes with many economies in global trade. Japan's car-making sector epitomises this point; the country competes with German car-makers as well as with South-Korean and Chinese ones, which is why the recent JPY devaluation path was viewed with much apprehension by the afore-mentioned nations.

Second, Japan's aggressive monetary stance has been showing early signs of success. If this success solidifies, then Japan's key trading partners—such as those mentioned above, which were decidedly anxious during Japan's recent JPY devaluation campaign—could consider implementing their own monetary policy tools to counterbalance Japan's gains, which would require a weaker national currency in real terms for these countries. This would also include Germany, the largest Eurozone member country and one that epitomises the Eurozone in terms of policymaking, as well as China.

Third, these two economies (the Eurozone and China) account for 13.4% and 7.2% share, respectively, of Ukraine's foreign turnover, and 18.5% and 8.9% share, respectively, of ICU's UAH trade-weighted indices basket. Hence, any reflection by the Eurozone, China, or other large, global economies on Japan's monetary stimulus in terms of constructing a counterbalancing monetary weakening by a weakening of the currency would affect Ukraine's economy with upside pressure on UAH's real exchange rate.

China: Rebalancing in a shaky external environment

This year, the market's changing view on China's economic story has centred on a constant trimming of its growth forecast for the current year. In the very recent past, there were expectations that the arrival of new leadership in China would open the way for new stimulus (such as the one that followed in the post-2008 period). However, these expectations diminished as the new Chinese leadership switched to a new tactic: cutting back on ineffective official expenses in an attempt to shift the economy from export- and investment-led growth to consumption-led, combatting the country's real estate bubble, curbing the so-called shadow banking sector, and becoming more assertive in terms of

¹⁵ In terms of seasonally-adjusted annual rate.

¹⁶ This phrase is borrowed from the WSJ article on the subject, entitled "Next Economic Step for Japan's Abe Could Be Toughest," on 19 July, 2013 ([here](#)).

foreign policy by rekindling its controversy with Japan over disputed ownership of the Senkaku/Diaoyu islands. However, a broader picture of the Chinese economy shows that its main focus has been on a slowdown in real GDP growth, which grew by only 7.6% YoY in 1H13 after 7.8% in full-year 2012. From a wider historical perspective, this slowdown is even more dramatic than in the pre-2008 period, when it was expanding by more than 10% YoY, while in the post-2008 period, it posted a 10.4% YoY increase only one year in 2010.

... likely indicating a rebalancing from investments to consumption

Indeed, it is very likely that the new Chinese leadership, which inherited an economy with an unsustainable investment-to-GDP ratio (of more than 40% in the last decade), had decided to start shifting the economy into slightly more sustainable shape by trying to lower investments and increase household consumption. In this regard, it would be logical for authorities to foster a slow and gradual appreciation of the USD/CNY exchange rate through a pro-consumption trend, as well to eliminate the risk that US authorities would again label China as a "currency manipulator."

In our view, currency real appreciation has come to a critical point that hampers growth

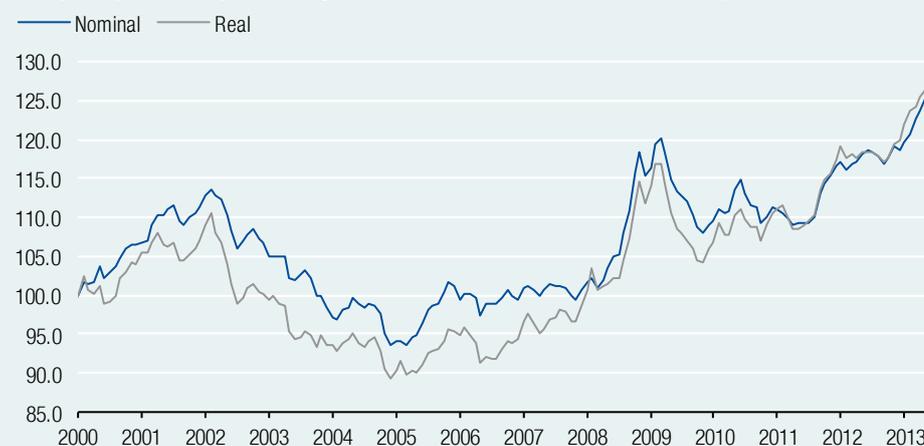
However, in our view, the fast-moving changes in the global economy that have been quite unsupportive to China's economy recently (eg, the recession in the Eurozone, a large trading partner with China) could force Chinese authorities to use more short-term tools to support the economy, one of which could be a greater tolerance of the downward move in the nominal exchange rate of the USD/CNY. (BIS data on the Chinese currency real rate indicate that it has been appreciating quite sizably over the past two-and-a-half years (see Chart 11)).

China is exposed to retaliation risk to Japan's easy monetary policy

Another risk to China's new moves to restructure its economy, described in more detail in the section above on Japan, stems from the possibility that the Japanese yen will weaken further. China has, so far, been quite accommodative of this, and has been guiding the CNY incrementally higher despite the JPY's massive gain in external competitiveness. However, going forward, this accommodative stance to the JPY's weakness would exacerbate China's growing dilemma on reigniting economic growth. In our view, the trend of CNY appreciation has little room to co-exist with the JPY's devaluation and China's own economy being near stagnation. Hence, China's authorities may allow flexibility of the exchange rate on both sides, and as such, its mid-term path may not be upward necessarily. More likely, it could be downward. If so, a downward move in the CNY would be negative to the UAH, as it would pressure the UAH's real rate upward, which is negative for Ukraine's economic prospects.

Chart 11. Chinese renminbi trade-weighted indices by BIS*

Monthly history from January 2000 through June 2013. Rebased at 100 points as of 1 January 2000



Note: * Bank of International Settlements. Source: BIS, Investment Capital Ukraine LLC.

Russia: Political liabilities require growth in the near term

Russian authorities carry the burden of political liabilities of the nation, which necessitates finding a quick fix to the economic growth dilemma

Russia's economy has been slowing since late last year. The country's political establishment has been under pressure to stay on course to fulfil the pre-election promises made by President Putin in the 2012 elections. Judging from the heated debates in the Russian government over growth and availability of resources to mitigate political liabilities with the public, Russia has been facing a serious dilemma over economic growth. There is little debate inside the government that structural reforms are a priority. At the same time, however, there is a nearly equally shared perception that these reforms would require a long time to begin bearing fruit (ie, accelerating growth and pushing up state revenues). Hence, a quick fix for the economy is dependent upon monetary policy, and expectations have risen that a newly appointed central bank governor, Ms Elvira Nabiullina, a long-time loyal lieutenant to Putin, would be supportive of the pro-growth authorities' agenda.

One of the key, quick fixes would be the easing of monetary conditions, including a weakening of the RUB

There are a number of factors that, in our view, spell an end to the past few years' upward pressure on the RUB. These include: 1) prospects for a lower crude oil price on the back of lesser geopolitical risks and a dearer USD as the Fed withdraws its stimulus later this year; 2) a narrowing trade surplus and increasing non-oil trade deficit as authorities continue to support domestic consumption; 3) capital flight being a near-constant issue for the current shape of the balance of payments (rather than diminishing at a sensible pace, capital flight remains an on-going issue that is dragging down the currency value); and 4) in real terms, as the BIS's and ICU's data show, the ruble has been appreciating quite significantly in the pre-2008 as well as the post-2008 period (see Chart 12, pp.19). Hence, further real appreciation is widely viewed as unrealistic and counterproductive to Russia's economic growth.

Conclusion

ICU's model of the RUB's fundamental value supports our above-mentioned viewpoint

All in all, in our view, the Russian ruble appears to be a relatively expensive currency. We see several cyclical and structural tendencies that would cause it to trend lower than where it was in 2012. Our forecast on the USD/RUB nominal exchange rate (see Table 1, pp.21) suggests that the past positive misalignment¹⁷ of the RUB rate from its long-term fundamental value will likely narrow. Furthermore, our assessment of the future indicators that characterise the shape of RUB's trade-weighted basket in real terms (adjusted by the forecast for CPI and PPI for the 2013-15 period in Russia and its main trading partners) suggests that a nominal weakening of the RUB would gradually diminish the positive misalignment of the real rate that hampers the growth prospects for the Russian economy.

As far as Ukraine's economy is concerned, the RUB's future, as depicted below, would pressure the UAH's real rate upwards, which would be negative to Ukraine's economic growth prospects, given its current monetary policy mix, which maintains a UAH pegged to the USD.

¹⁷ Positive misalignment means that ICU's real TWIs of RUB are higher than five-year rolling averages of these indices. This implies the currency is overvalued on the spot market, which is referred to as the nominal exchange rate.

Chart 12. Russian ruble trade-weighted indices by BIS* and ICU

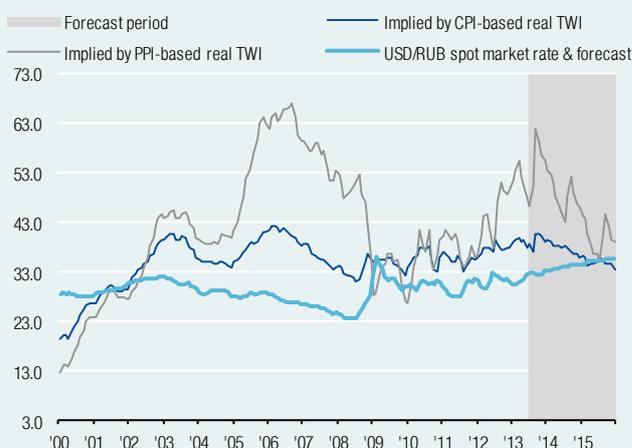
Monthly history from January 2000 through June 2013.
Rebased at 100 points as of 1 January 2000



Note: * Bank of International Settlements; ICU's Real – ICU's CPI-based real trade-weighted index of RUB. Source: BIS, Investment Capital Ukraine LLC.

Chart 13. RUB's exchange rate forecast against the exchange rates implied by ICU's RUB real TWIs (CPI- and PPI-based)

Monthly history from January 2000 through June 2013



Sources: Bloomberg, Investment Capital Ukraine LLC.

Global macro indicators vital to Ukraine's economy

Growth globally and in Russia

We have adjusted our global economy growth forecast in line with the most recent update by the IMF¹⁸. Our previous publication, *Quarterly Report*: "Keep the music playing," published on 31 January, 2013, was based on our full-year 2013 growth projection for the global economy at 3.5% YoY. As of now, this has been cut by 0.4ppt to 3.1%. Similarly, the reductions to our projections for 2014-15 are 0.3ppt, and our current yearly forecast for these two years shows a base-case scenario at 3.8% and 4.0% in year-on-year terms.

A more dramatic revision in our forecast has been made for the Russian economy in line with the IMF's forecast. Back in the early part of this year, our macro view centred on a real GDP growth rate of 3.7% YoY for Russia in 2013, followed by 3.8% YoY in each successive year of 2014-15. Now, our 2013 forecast has been cut by 1.4ppt, to 2.3% YoY (0.2ppt lower than IMF's view, as the Russian economy is likely to miss the 2.5% YoY rate, which is the government's target) and 2014's forecast lowered by 0.5ppt, to 3.3% YoY. In 2015, we anticipate acceleration in growth towards 3.5% YoY, thanks to structural reforms that should be pushed through, despite voters who are ever-sceptical over the incumbent government's rule.

Crude oil

Again, we acknowledge that in January, our forecast for the WTI crude oil price in our quarterly forecasts for 1Q13 and 2Q13 proved short of actual developments. Thus, our 1Q13 call for US\$89.5/bbl turned out to be nearly US\$5.00 behind the quarter's average price of US\$94.3/bbl; similarly, our 2Q13 call for US\$90.9/bbl made back in January was wide of the mark, too, but by a lower margin of US\$3 (the actual quarterly average price

¹⁸ World Economic Outlook Update, 9 July 2013 ([here](#)).

was US\$94.06/bbl). Now, given the recent spike of WTI crude oil price beyond the US\$100/bbl level, our updated forecast for 2013 envisages WTI crude at nearly US\$98/bbl as the yearly average price. We expect it then to go back below the US\$100/bbl level towards US\$97/bbl and US\$91/bbl, respectively, in 2014-15. This declining path of the crude price reflects, in our view, lower geopolitical risks as well as the USD's gradual rise in value, as long as the Fed starts withdrawing its stimulus, on the back of the US economy's continued recovery.

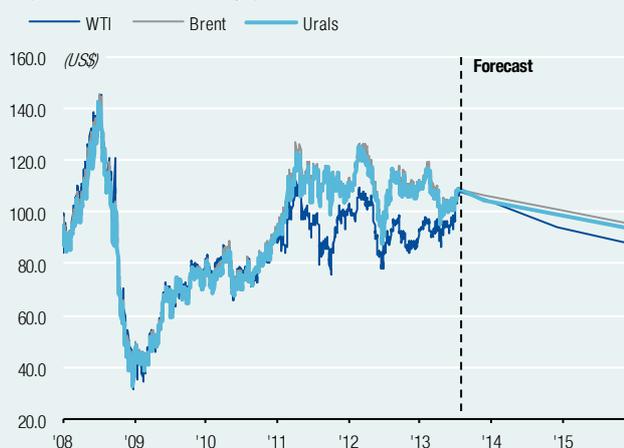
Steel

The steel market has been testing new lows, as the Asian growth factor has diminished its upward impact on commodities' prices, and, in particular, on the steel market. The above-mentioned factor of China's rebalancing from investment into consumption, though expected to be quite gradual and in its very early stages, has been factored in by the market. LME steel billet futures have nosedived as of late, factoring in all the negativism coming from China's rebalancing story. Here, too, our January call on steel prices appeared wide of the mark, albeit of less magnitude than our crude oil calls. Our 1Q13 call on the HR coil price in the Black Sea area was US\$556 per tonne, while the actual quarterly average level was US\$578; for 2Q13, our January call of US\$533 was closer to the actual US\$535. However, this time, we are revising downward our past forecast¹⁹ for yearly average prices for the 2013-15 period (see Table 1 below).

¹⁹ Quarterly Report "Keep the music playing", 31 January 2013 (<http://ib.icu.ua/files/ICUQtlyReport-20130131.pdf>).

Chart 14. Crude oil price (US\$ per barrel)

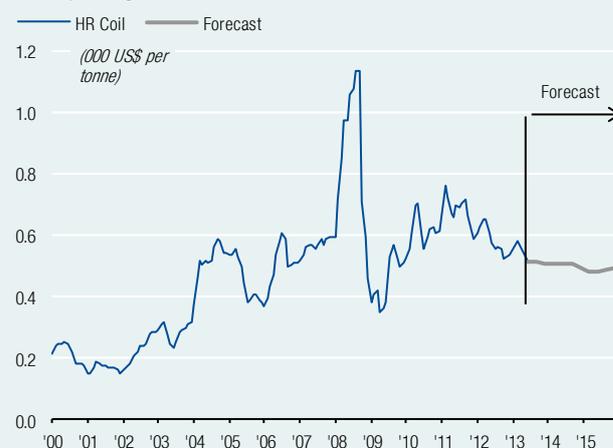
Spot and futures market daily quotations



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 15. CIS export steel prices (US\$ 000s per tonne)

Quarterly averages



Sources: Bloomberg, Investment Capital Ukraine LLC.

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

	Actuals & Est's				Quarterly forecast								Annual forecast ⁴		
	1Q13	2Q13E	3Q13F	4Q13F	1Q14F	2Q14F	3Q14F	4Q14F	1Q15F	2Q15F	3Q15F	4Q15F	2013F	2014F	2015F
World real GDP ¹	3.1	3.1	3.1	3.1	3.8	3.8	3.8	3.8	4.5	4.5	4.5	4.5	3.1	3.8	4.5
Russia real GDP ¹	1.6	1.9	2.2	3.5	3.2	4.0	4.0	4.0	3.5	4.0	4.0	3.8	2.3	3.8	3.8
Crude oil (US\$ ²)	94.3	94.1	103.4	100.0	99.0	98.0	97.0	95.0	93.6	92.2	90.8	88.0	97.9	97.3	91.2
Steel (US\$ ³)	578.0	535.0	512.0	503.0	504.0	505.0	507.0	492.0	477.0	481.0	485.0	489.0	532.0	502.0	483.0
EUR in US\$ (eop)	1.30	1.32	1.30	1.29	1.29	1.28	1.28	1.28	1.28	1.28	1.28	1.28	1.29	1.28	1.28
US\$ in RUB (eop)	30.83	32.34	32.50	33.00	33.50	34.00	34.50	34.50	35.00	35.00	35.50	35.50	33.00	34.50	35.50

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

Source: Investment Capital Ukraine LLC.

Ukraine's economy brief

In 2013, we forecast no growth in real GDP, ie 0% YoY, as the economy is stagnating under the weight of external demand loss and high interest rates in real terms. First-half contraction will be counterweighted by recovery in the second half thanks to a better harvest. Fiscal deterioration takes its toll as this year's central government budget deficit reaches 4.2% of GDP. NBU is expected to fix state budget revenues by a profit transfer to the tune of higher-than-planned UAH29bn. The central bank is expected to undertake its own version of QE by increasing its government bond holding by UAH60bn, and pushing base-money growth up to 18% YoY in December 2013. A revival of inflation should extend further UAH real appreciation, a lasting and growth-negative trend that will span from early 2013 until next year.

Growth: Base-, worst- and best-case scenarios depicted

Growth pattern in the 2H13 and in 2014-15

Ukraine's economy has uneven growth path in 1H13 as 1Q13 on 0.6% rise was followed by a 0.4% decline in 2Q

After sliding into a double-dip recession in 4Q12, Ukraine's economy did post a 0.6% SA QoQ²⁰ increase in real GDP in 1Q13 and returned to recession-free status, albeit for now, as 2Q13 preliminary data showed that economy again contracted by 0.4% SA QoQ (in the on-year terms economy slipped by 1.1%).

Such uneven on-quarter growth rates since the first of the year—with the first quarter positive, but then followed by a decline in the second quarter—suggests that there is a risk for economy again to slip into recession if 3Q13 turns out to be the second in a row of QoQ decline. However, this risk is not a part of our base-case scenario; instead it is rather our worst-case scenario.

As for the 2H13, we believe the agricultural sector is likely to post a 20% YoY full-year increase in the output index, thanks to the expected rich grain harvest of more than 50m tonnes (some argue that this year's harvest could beat the record of 56.7m in 2011). Also, we estimate that the construction sector is likely to benefit from the government's programme on economic revival in 2013-14; hence, activity in this sector will be stronger in 2H13 than in 1H13.

In 2H13, rich harvest and better external demand should turn economy growing again

The industrial sector is believed to be experiencing a gradual flattening of the recent declining trend, and should show a mild recovery at the end of the year. Transportation is set to be weak in year-on-year terms in 3Q13, and then see some rebound in the 4Q13, as demand from the agriculture and construction sectors is likely to push activity up in the cargo segment. In retail trade, we are hopeful that activity will stay in positive territory in year-on-year terms during the 2H13. However, we believe it will slow down in on-quarter terms, as household consumption, at 71% of GDP in the last 12-month period ending 1Q13, is running at a level that is unsustainable in the long run.

Ultimately, we arrive at on-year growth rates for 3Q13 and 4Q13 of +0.6% YoY and +1.7% YoY, respectively. The contraction in the first two quarters of this year of 1.1% each, implies that the full-year growth rate for real GDP will be zero.

²⁰ Quarter-on-quarter change of quarterly volume of real GDP in seasonally adjusted terms.

Chart 16. Quarterly real GDP expected growth in 2013 (% YoY)

History from 1Q10 through 1Q13; forecast from 2Q13 through 4Q13



Note: activity in key sectors – this represents an aggregation of key sectors of the Ukraine's economy: agriculture, industrial sector, construction, transport and trade. Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Going forward, our scenarios for 2014-15 are as follows...

Authorities are maintaining state expenditures high in 2013-14, spurring inflation and real appreciation of UAH...

...bond markets will question Ukraine's currency policy mix and push Ukraine to open talks with IMF to agree to financial assistance

Going forward, the growth pattern in 2014-15 is likely to depend to a great extent on the authorities' strategy in 1) resolving the issue of accessing external financing or, in other words, finding an effective backstop for USD funding, and 2) staging a presidential election campaign that would culminate with an incumbent victory in March 2015.

Base-case scenario (40% probability)

Our base-case scenario envisages authorities extend from 2013 into 2014 looser fiscal policy (state budget expenditures are set above the 28% threshold²¹), with debt monetisation by the central bank being accelerated. This would lead to headline inflation acceleration from its low of a 0.1% YoY average rate of inflation in 2013 towards a 6.5% average in 2014 (8.4% as of year-end 2014). Hence, growth in 2014 is likely going to be driven again by household consumption, with some limited pick-up in fixed investments. External demand should be more favourable next year, though its relative increase is likely to be supported by domestic demand, supported by authorities' pro-consumption fiscal policy (mainly to woo voters in the pre-election year). Ultimately, we forecast a real GDP growth rate of +3.0% YoY next year.

However, this growth is likely to prove to be short-lived and, hence, the government puts at even further risk its creditworthiness in the eyes of the bond markets (especially the Eurobond market). This would result in the following. A pro-consumption policymaking mix will lead to a loss of external competitiveness, given that the authorities will try to maintain the UAH peg to the USD at the level of 8.00-8.15/USD, which is regarded as a comfort zone. This strategy may still be workable in 2H13, thanks to good harvest and still downside pressure on inflation; hence, the UAH real rate appreciation may be muted. However, we think market pressure will intensify as it would become more visible that Ukraine needs an effective USD backstop and this will push UAH FX rate to 8.20/USD this year-end. By early 2014, the markets are likely to further question sustainability of Ukraine's current policy mix and dump its sovereign bonds, forcing up the cost of borrowing. Ukraine then turns to the IMF in 1H14 as external financing needs in 2014 are no less than in 2013.

²¹ In terms of central government level. In the end of the 2013, the state expenditures are projected to be at 28.7%. Then, in 2014 and 2015 they are to be, respectively, at 28.5% and 28.0%. Prior 2010, the ratio of state expenditures at the central government level as share of GDP was up most at 26.5% in 2009. In 2010-12, this ratio ranged in 25.6-28.1%.

With base-case scenario (real GDP +3% in '14 and +2% in '15) economy is still below pre-crisis peak at the end of '15 by 4%

As external pressure on the UAH real rate to appreciate gathers steam in late 2013 and early 2014, and if the UAH nominal rate does not adjust to keep the local currency undervalued in real terms, it would hamper exports and industrial production, eventually leading to a slowdown in growth in the very eve of the election year of 2015. In our view, authorities would allow a UAH nominal-rate change in late 2013 and in 2014 to avoid such a negative impact on growth from a stronger UAH real rate.

This would lead to subtle recovery in growth, which would avoid a triple-dip recession²² in 2014-15. Overall, we forecast the real GDP growth rate at +2.2% YoY in 2015.

Worst-case scenario (30% probability)

This is a true "muddle through" scenario, where authorities try to maintain the status quo well into the election cycle in March 2015...

Our worst-case scenario takes a more drastic view on the developments in 2014 in terms of authorities' aggressiveness in undertaking loose fiscal policy and monetising public debt. In our view, under this scenario, headline CPI inflation will rise towards 12.4% as the yearly average in 2014. This fiscal boost, aimed at appeasing voters, would support consumption and the overall growth of the economy, which is likely to increase by 1.5% YoY in the pre-election year. At the same time, such acceleration in inflation would lead to a substantial erosion of external competitiveness, pushing down exports and industrial production to such an extent that it would become economically unbearable, as slimmer corporate earnings would result in even thinner budget revenues for the government, particularly as: 1) authorities would defend the UAH peg to the USD at the level of 8.00-8.15/USD, seen as a comfort zone in 2013-14; and 2) external developments in the US and in Ukraine's main trading partners would lead to appreciation pressure on the UAH's real rate.

...it ends in grand failure (a triple-dip recession in 2015) as economy is still below pre-crisis peak at the end of '15 by 10%

Economic growth would see a substantial slowing in early 2015. A misalignment of the local currency with its fundamentals would either: 1) require authorities to correct this misalignment via the FX market; or 2) result in a failure by the authorities to contain FX market pressure to eliminate this misalignment by a change in the USD/UAH nominal exchange rate (devaluation). Specifically, this scenario envisages a one-step devaluation to 11/USD in 2Q15, which would cut domestic consumption and hamper sectors that are consumer-driven (banks, retail, etc). This would lead to a recession that could span nearly all of 2015. At the same time, currency devaluation would allow Ukraine's economy to regain competitiveness, as real devaluation would take place, and UAH would see continued negative misalignment with its long-term fundamental value in 2015. This would prevent the beginning of economic recovery until after 2015.

Best-case scenario (20% probability)

Best-case scenario envisages flexible policy mix by authorities, implies IMF programme too...

In a best-case scenario, in our view, authorities' increased confidence in their re-election prospects would allow them greater flexibility in terms of policymaking and managing the hryvnia in the FX markets. Overall, the impact of a looser fiscal policy on headline inflation would be much more moderate than in our base- and worst-case scenarios, as it would run at a more a sustainable level of 5.4% as a 2014-15 yearly average.

²² A triple-dip recession means a third recession in a row in an economy that struggles to grow beyond the peak seen before the first recession. The first recession was in late 2008, and then was followed by a second recession in 4Q12. By size, Ukraine's economy is still nearly 11% below its pre-2008 crisis peak (see Appendix section "Quarterly GDP: Reported statistics and ICU's calculations", pp.48). Furthermore, in our base-case scenario, the stagnant growth seen in 2013 and forecast still-meager growth rates for 2014-15 will leave the economy well below its pre-2008 crisis peak as of the end of 2015.

...it yields an eventual recovery of the economy above the pre-crisis peak in 2008 by 2% at the end 2015

Given our exchange rate and inflation projections for Ukraine and its main trading partners, which we use to construct future real rates (ie, CPI- and PPI-based, trade-weighted indices) for the hryvnia, the external competitiveness of Ukraine's economy under this scenario is still at a level supportive of growth. Hence, our real GDP projections for 2014-15 are more robust than under the previous two scenarios, standing at +4.9% YoY and 5.4% YoY, respectively. This pace of real GDP growth would allow Ukraine's economy to fully recover from the lengthy slump resulting from the 2008 deep recession, which we then forecast to take place in 3Q15 (see Chart 17, pp.25).

Chart 17. Size of Ukraine's economy: History and forecast (UAHbn)

History from 1Q of 1996 through 1Q of 2013; forecast from 2Q13 through 4Q15.

Data is at constant prices of Dec-95 and adjusted for seasonality



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

Inflation: Good harvest in 2013 and election campaign in 2014

In 2013, inflation stays muted at near zero ...

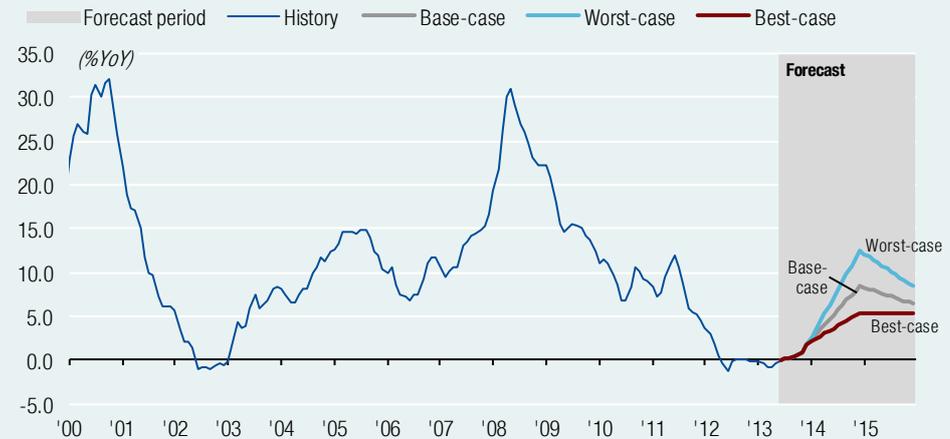
...then in 2014 pre-election year state spending is kept high, accelerating inflation

In our view, the expected good grain harvest this year will have a downside effect on the food component of the consumer price index. Hence, headline consumer inflation is set to run at a very subdued level over the rest of 2013, ending the year at below the 2% YoY level and at 0.1% as the year's average on-year rate of inflation. As was described above, the path of inflation in the next two-year period of 2014-15 depends on the authorities' approach to winning the next presidential elections for the incumbent. Our base-case scenario assumes that a range of measures taken to appease voters (an increase in public-sector wages, pensions, and other incentives²³ by the incumbents) would push CPI up to 8.4% YoY as of year-end 2014 and then recede to 6.4% YoY next year, due to an economic slowdown. In a worst-case scenario, the authorities will step on the gas to spend money in the pre-election year, hence, provoking headline inflation to soar from a near-zero level in 2013 to beyond the 10% threshold, provoking a recession in early 2015 due to lower competitiveness.

²³ For instance, an extension of its practice of paying out UAH1,000 per head to the former depositors of the late Sberbank of USSR, whose deposits were wiped out by inflation, after the bank itself was dismantled on the back of the collapse of the Soviet Union in 1991.

Chart 18. Headline inflation CPI: History and forecast (% YoY)

History from January 2000 through June 2013; forecast from June 2013 through December 2015



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

Interest rates: Rates remain too high in real terms

Low inflation and high nominal lending rates are growth negative...

In our view, one of the key drags on the economy over past two years has been the phenomenon of double-digit, local-currency real rates. Chart 9 below provides a clear illustration of the situation. While nominal local-currency rates charged to borrowers have been hovering inside the 15-30% range during 2006-13, with the 15% level as the prevailing floor of the lending rate, in real terms (adjusted for headline CPI), the local-currency lending rate turned sharply upward in late 2012, as both of the following factors played out: 1) a deceleration in inflation began; and 2) the nominal lending rate increased. Since then, Ukraine's economy has been operating in an environment of double-digit real lending rates, which, alongside other numerous factors, has caused a drag on economic growth.

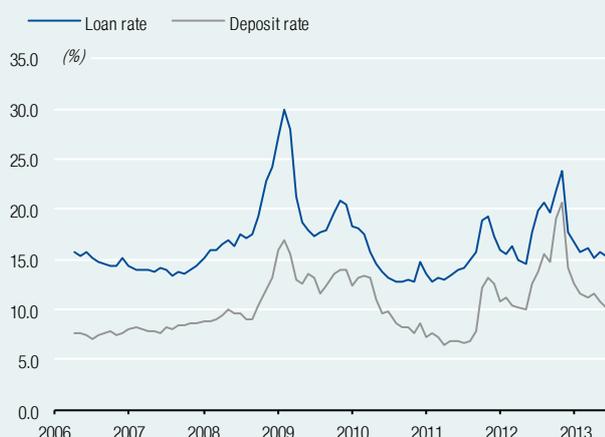
...due to double-digit real interest rates banks charge businesses

Going forward, real rates being as high as of the recent reporting period (over 15% in May) will be hugely disruptive to the economy as business sentiment worsens, fixed investments lag behind, and the prevailing conditions of the economy remain in stagnation. Hence, in our view, given the fact that in 2H13 and in 1H14, inflation is going to be low, authorities will try to push nominal as well as real rates down, targeting a revival in local-currency bank lending, which will be a pro-growth development. Past history suggests that economic growth of a reasonable pace of at least 4% YoY or higher has taken place in Ukraine alongside a UAH real lending rate of around 5%.

Hence, our growth projections for this year do reflect the rational expectation that the real lending rate in UAH will remain quite high, ie, above 10%, and likely a bit lower than the current level of slightly above 15%. In 2014, the real lending rate for the UAH is set to gradually decrease, due to rising inflation and the authorities' push to stimulate affordable lending rates in the local currency. This trend expected in 2014 is one of the factors that would support economic growth alongside pro-consumer fiscal policy expected in the final year before presidential elections.

Chart 19. History of banking sector's local-currency nominal (left) and real (right) interest rates on loans and deposits (%), data from 2006 through June 2013

Monthly averages of nominal interest rates



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Monthly averages of real^[1] interest rates



Note: [1] real rate is a nominal rate minus the on-year CPI inflation rate.

Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Monetary policy: Between pro-growth measures and high real interest rates

Past tight monetary conditions backfired with economic recession and lowered state revenues...

In our view, the current government over-reacted (via monetary tightening) to devaluation pressures in late 2011 and through 2012, and their policies, essentially, backfired. This resulted in lower revenues to the state budget and quite lengthy economic stagnation, which briefly slipped into recession in 4Q12.

If they repeat this in 2H13 (or next year) in response to rising devaluation pressures by an another aggressive withdrawal of liquidity from the banking sector, which would increase nominal interest rates both in the inter-bank money market and in the bank-lending market to businesses and households, this would bode ill for the economy and would push it into recession again. And an increase in devaluation pressure is quite real and likely, given the current negative private business and consumer sentiment.

...hence, this time authorities should use tighter regulation to calm devaluation expectations...

In this regard, we suspect Ukraine's authorities are readying their time-tested tools of tighter regulations, tougher requirements and more controls. These are negative to growth, but they are likely to allow the authorities to weather the anticipated storm of financial instability for some time.

An example is the surrender requirement (a central bank requirement to exchange FX into UAH) that was reinstated last fall at 50% of exporter's foreign currency proceeds, which could be increased towards 100% via a two-step move (initially by 25ppt and then if needed by another 25ppt). Other measures that would be wrong-headed, in our opinion, could be taxation of FX purchases by households, which are not linked to the foreign-currency debt servicing and redemptions, etc.

...meanwhile, base money growth keeps rising from 14% now to 18% at year-end

Aside from the possible measures to contain devaluation pressures, authorities have been accelerating the growth rate of base money and monetary aggregates since very early 2013 (see Chart 20 and Chart 21 below). Base money was up 14.2% YoY in May 2013 and is expected to accelerate to 18% YoY in December 2013, while M3 grew by 17.2% YoY (or by 17.7% YoY in inflation-adjusted terms).

More robust growth in these macro indicators is likely to spur economic growth, which has been nearly non-existent to date. Realizing that the inter-bank market is barely functional,

authorities put emphasis on channelling liquidity created by the central bank through the state-controlled banks towards eligible borrowers, which are determined by the government's Programme on Economic Activity revived in 2013-14. The programme itself focuses on stimulating fixed investment growth, including by state-backed bank lending.

Chart 20. Base-money and nominal GDP growth (%YoY)

Average annual growth rate; history from January 2005 through May 2013

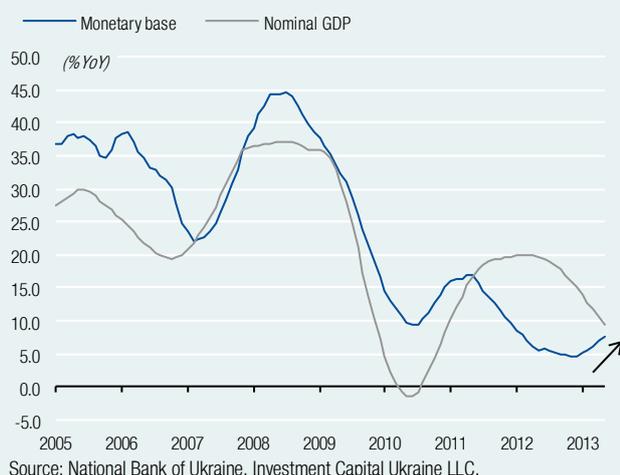


Chart 21. Monetary aggregates growth (% YoY)

Monthly raw data, adjusted for CPI; history from January 1997 through May 2013



Fiscal policy: Coping with deficit, debt service rise

Since very early 2H12 and over 1H13, there have been several negative developments in Ukraine's fiscal performance, which we comment on below.

State budget deficit in 2013 is set to reach 4.2% of GDP, up from 3.8% in 2012

Primary balance is to stay in red, albeit at lower level than in 2012...

...on the back of increasing volume of debt-service expenditure

- General deterioration.** Due to economic stagnation and the government's targets for revenues above the actual level realisable by economic conditions, the fiscal deficit on a 12-month rolling basis started to widen from below 2% of GDP (seen at the end of 2H12) towards 4.8% in May 2013. It will likely end this year at 4.2% of GDP with increased revenues collection in the 2H13 rather than in 1H13 as the economy is expected to pick up going forward. (See Chart 24, pp.31.)
- Primary balance in the red, again, albeit a bit lower.** In similar fashion, the government has loosened its tight, zero-primary balance policy in effect from mid-2011 to mid-2012, and allowed the primary deficit to increase to 2.9% of GDP in May 2013. Our calculations show that the primary deficit reached a peak of 3.0% this June. It is then expected to slip back to 2.0% of GDP at year-end 2013 on rising debt-servicing expenditures. (See Chart 24, pp.31.)
- Volume-wise, debt servicing on a steady increase.** One of the key observations we make of fiscal performance in 2013 is that debt-servicing grew starting in May when the monthly volume rose to UAH3.3bn. This implies that debt-servicing as a share of GDP on a 12-month rolling basis crossed the 1.9% of GDP threshold, and is expected to reach 2.2% as of year-end 2013. Indeed, after May's statistics, the monthly debt-servicing volume is set to be UAH2.6bn for the rest of this year, while in the preceding 12-month period (from May 2012 through April 2013), it was UAH2.2bn. One of the key factors explaining this trend is the on-going substitution of low-cost debt financing from the IMF with more costly market-based financing. Chart 25 (pp.31) depicts this tendency, where foreign-currency debt-service volumes have been

accelerating since early 2013. Their growth rate is projected to outpace the growth rate of local-currency debt servicing in 2H13, which has also been on the rise.

- **Ratio of debt servicing to revenues approaches authorities' comfort level.** Incumbent Minister of Finance, Yuriy Kolobov, mentioned this year in an interview with the local media that the MoF has an internal threshold that determines public-debt-level critical mass. This measurement is a ratio of debt-servicing to state budget revenues. For the MoF, a ratio above the 10% threshold is considered out of the comfort zone for the government. Prior to the 2008 economic crisis, it stood at comfortably low level of 1.6% and then it soared in the post-crisis period. Over the course of 1H13, it has been on the rise, at 7.3%, as of the beginning of the year, and reaching 7.8% in May. Our projections for the 2H13 show that this ratio is likely to reach 8.6% as of year-end 2013 (see Chart 27, pp.32). It should be noted that our projections for the 2014-15 period suggest that this ratio is set to go beyond the 10% threshold, reaching the 11-12% range.

State budget expenditures are likely to stay high above 28% of GDP in 2013-15, not seen before 2010

- **"Bigger state" extends.** Half a year ago, in our previous *Quarterly Report* publication, we made a call that was wide of the mark, suggesting that authorities would adhere to their policy of maintaining a "smaller state" by targeting a level of budget expenditures as a share of GDP that tends towards 26%, down from the 28.1% seen in 2012, a year plagued with a sizable economic slowdown and eventual recession. The state budget for 2013 envisages that this level should be even higher, at 28.6%, as economic growth should miss the government's target of +3.4% YoY, and is likely to stay flat in real terms, according to our estimates. Going forward, in our view, there is a risk that government would keep fiscal expansion intact in the pre-election year of 2014, maintaining the level of budget expenditures at 28.5% of GDP. This would imply a deficit of 4.6% of GDP or UAH73bn, an 8% increase in financing needs to UAH154bn, according to our base-case scenario, if compared with the expected volume of MoF's financing needs in 2013 (UAH141bn). In an extreme case, authorities could adhere to inflationary financing (via high-speed debt monetisation²⁴ by the central bank).

Budget deficits will push public-debt level further up in each of our three scenarios

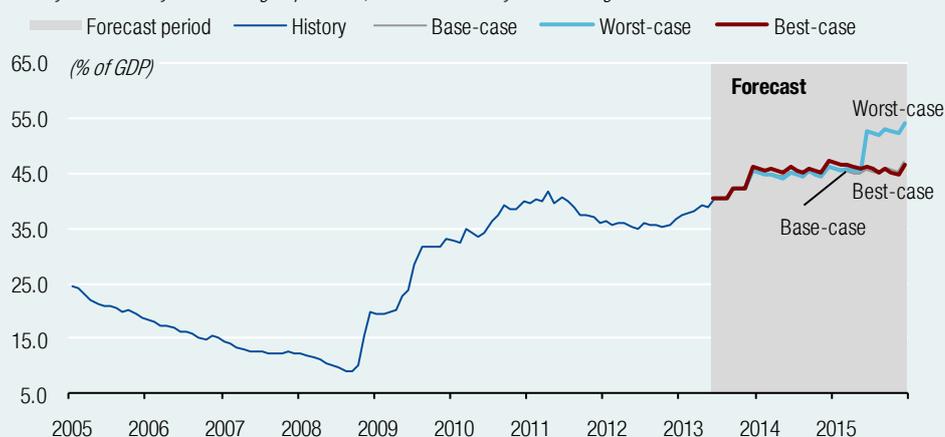
- **Public debt level is heading up.** According to our base-case scenario, the public debt level is seen to be on the rise over 2H13 towards 45.6% of GDP as of year-end 2013, then decreases based on the assumption that growth rebounds in 2014, and then increases again to 46.3% at end 2014, as financial needs will be quite substantial (UAH154bn²⁵ or more than UAH141bn seen required for 2013 state budget). The worst-case scenario anticipates a jump in the public-debt level of nearly 9ppt to 54.1% as of year-end 2015, due to a projected devaluation that takes place in 1H15. (Our best-case scenario yields a very similar public-debt level as in the base-case scenario as shown at the chart below, albeit under different macroeconomic conditions. The best-case scenario envisages gradual weakening of the currency towards 9/USD in 2015, while the base-case scenario envisages slower growth, higher inflation and the likely correction of the nominal exchange rates after the period forecast, ie the end of 2015).

²⁴ Under "high-speed debt monetisation by the central bank" is meant such a monetary base growth rate, which is above normal level, ie forcing a kind of explosion of money supply growth rates, resulting at the end in a double-digit inflation.

²⁵ This volume includes debt due in this year, plus budget deficit.

Chart 22. Public-debt level: History and forecast (% of GDP)

History from January 2000 through April 2013; forecast from May 2013 through December 2015



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

NBU is expected to make a contribution to the 2013 state budget revenues, which is about 8% of total state revenues...

...as government's tax incentives for businesses to expand via fixed-investments had not payback

- NBU participation in budget revenues.** In 2H13 NBU transferred to state budget revenues a total of UAH10.1bn. It accounted for a 6.2% share of total revenues that MoF collected in the first half of the year. Given this year's planned volume of NBU's payment to the state budget at UAH16bn, the central bank once again is appearing as state body that props up the state budget. Last year, NBU payment to the state budget was ahead of the planned volume by a factor of 1.79x (it transferred UAH23.6bn while the planned contribution was UAH13.2bn). Hence, given current deterioration in the growth of tax-based revenues it is very likely that this year NBU will increase the planned volume of payment to the state budget. In our view, NBU this year will transfer in total UAH28.7bn, representing a further increase in the share of NBU profit transfer to total revenues up to 8.1% (see Chart 31, pp.35). Below in the section called "NBU's part in the state budget revenues" on pp.33 we analyse the possibility, feasibility and implication of this move by the central bank.
- Government's strategy on boosting business sentiment via tax incentive proves slow to pay back.** The data on fiscal performance for 2H13 shows that corporate tax contribution to the state budget revenues slid to 16.0% from 18.7% in 2012. Economic stagnation and a lower corporate tax rate (19% in 2013 versus 21% in 2012) are likely key factors behind the decline. As Chart 29 on pp.32 and Table 11 on pp.66 show Ukraine's authorities have been undertaking an aggressive multi-step cut of the corporate tax rate from 25% in 2011 to 16% to be effective in 2014, the lowest corporate tax level among the neighbouring countries except Romania, which also charges 16%. This, however, has not resulted yet in a breakthrough of increased fixed investment by businesses (measured as share of GDP). Hence, real GDP acceleration has been postponed and generally this tax incentive appears to be outweighed by other factors that have soured the business environment (a weak legal system, weak market for corporate financing, etc). As of 1 January 2014, a 16% corporate tax rate will be in effect and the MoF will face the same issue of strained public finances as business expansion and new business creation has been slow.

Chart 23. State budget size: nominal (UAHbn, left) and relative (% of GDP, right)

Monthly history from January 2002 through April 2013; forecast from May through December 2013

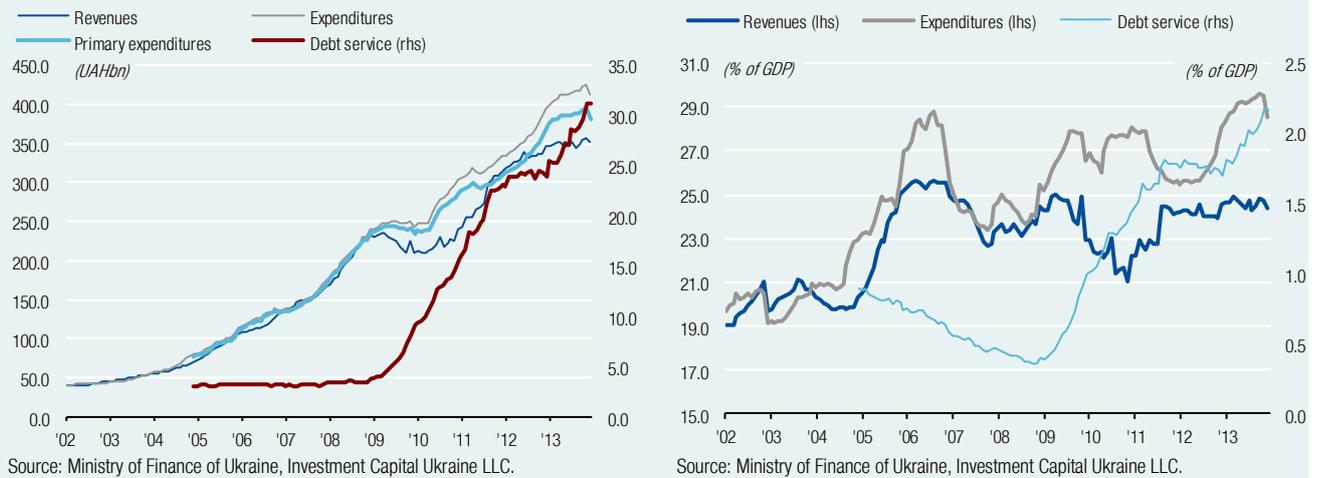


Chart 24. State budget balance: nominal (UAHbn, left) and relative (% of GDP, right)

Monthly history from January 2002 through April 2013; forecast from May through December 2013

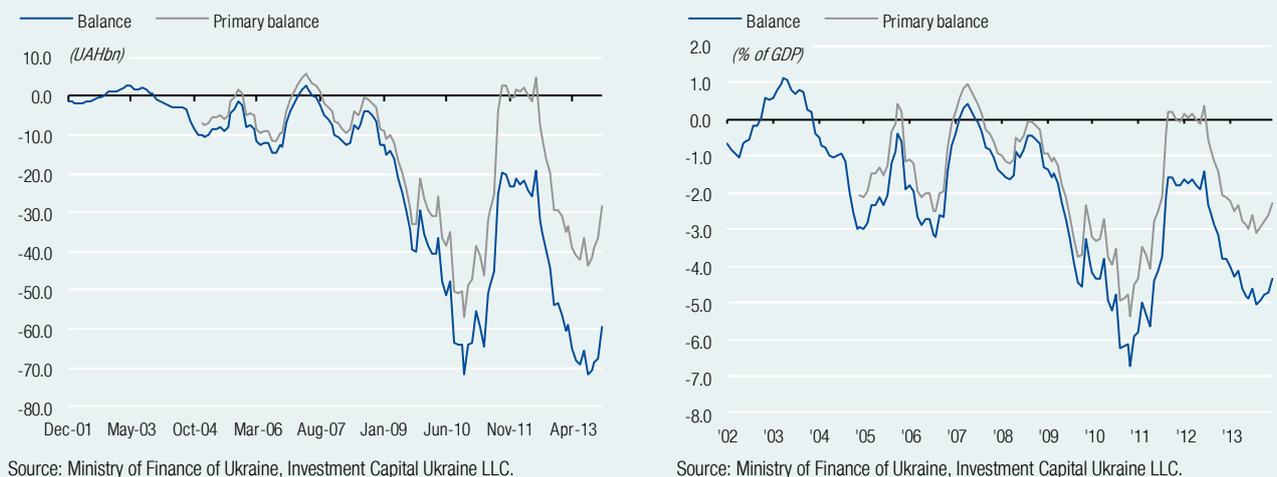
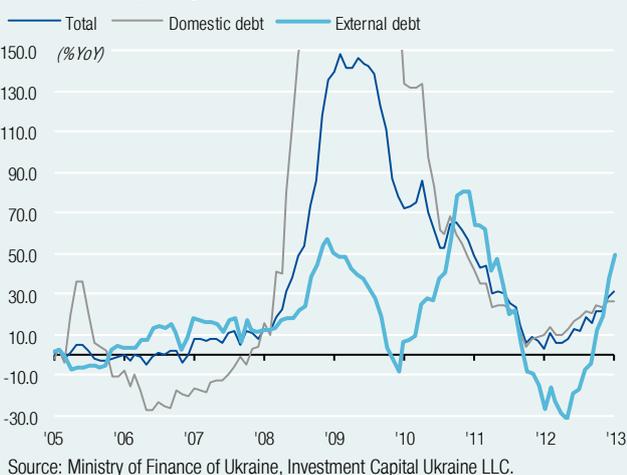


Chart 25. Debt servicing expenditure: Growth rate (%YoY) and average cost of debt (% per annum)

Monthly history from January 2002 through April 2013; forecast from May through December 2013

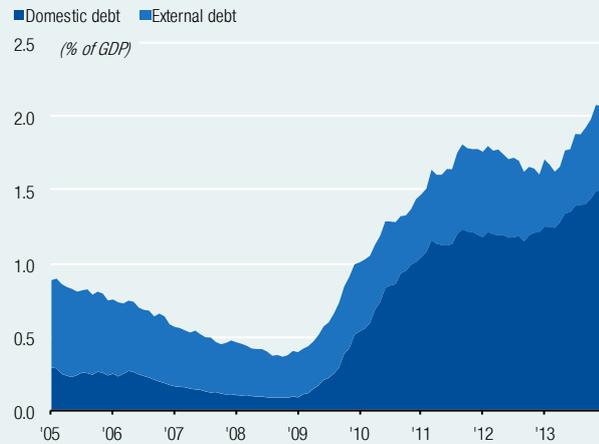


Monthly history from January 2002 through April 2013; forecast from May through December 2013



Chart 26. Debt servicing expenditure (% of GDP, 12-month rolling)

Monthly history from January 2002 through April 2013; forecast from May through December 2013



Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 27. Ratio of debt servicing expenditure to state budget revenues (%)

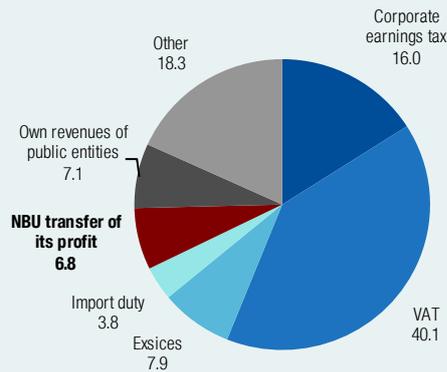
Monthly history from January 2002 through April 2013; forecast from May through December 2013



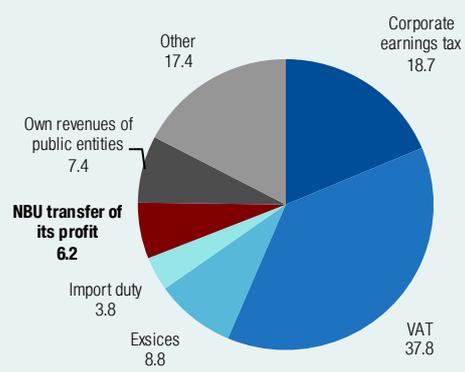
Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 28. Breakdown of state budget revenues (%): full-year of 2012 (left) and first half of 2013 (right)

100% = UAH346bn



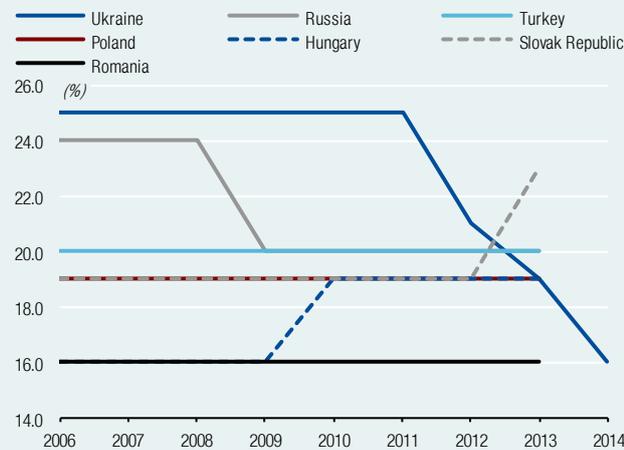
100% = UAH163bn



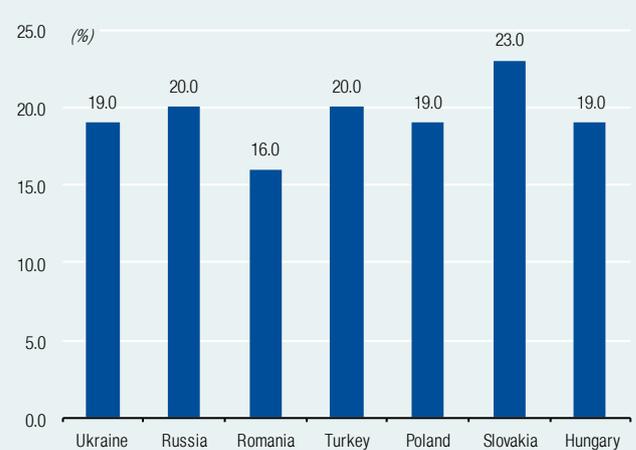
Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 29. Ukraine vs. other economies by corporate tax rate: history of 2006-13 (left) and the rates effective in 2013 (right)



Note: Since 2014 a 16% corporate tax rate is applied in Ukraine. Source: KPMG.



Note: Since 2014 a 16% corporate tax rate is applied in Ukraine. Source: KPMG.

NBU's part in the state budget revenues

Historical context

In 1H13 as in 2012, NBU was ahead of plan of transferring its profit to the state budget

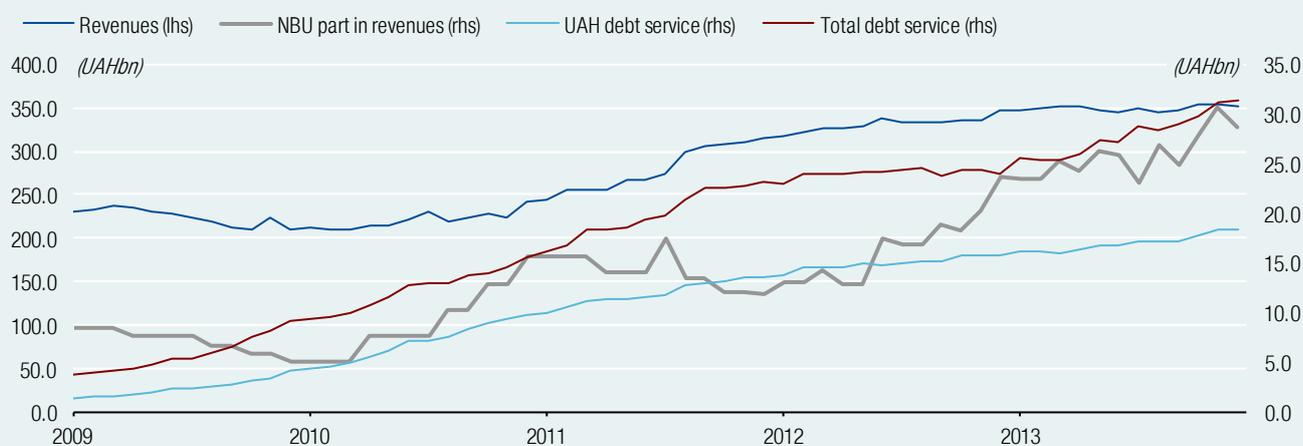
Over 2012 and 1H13, the state budget has been receiving ever greater support from the central bank, which has been transferring most of its profits earned from operations. In full-year 2012, NBU transferred to the state budget UAH23.6bn or 6.8% of all revenues the central government gathered in the period. This was up from the 3.8% share or UAH11.9bn paid by NBU a year earlier in 2011. In 1H13, NBU transferred a total of UAH10.1bn or UAH25.8bn in the 12-month period through this June. This confirmed our idea voiced above (on pp.30) that the volume of NBU support of the state budget revenues from its profits from operations will be rising further.

NBU's transfer to state budget routinely covers the debt-service expenditure by a factor above 90%

If in 2012, NBU's payment to the state budget covered the debt-servicing expenditures of the government by a factor of 99% (nearly totally covering them²⁶), then, the 12-month rolling data shows that at the end of 1H13 this coverage ratio stood at a bit lower at 95%. At the end of 2013, according to our expectations, NBU's payment for the entire year of UAH28.7bn to the state budget will cover the rising expenditures on debt servicing by a factor of 92%. It should be noted that historically (there is available data on NBU financials starting from 2001) this coverage ratio of debt servicing by NBU profit transfer ranged between 30-50% when economy was growing²⁷ and it covered them completely during the years of economic contraction.

Chart 30. State budget figures: revenues, debt servicing and NBU's payments to state budget (UAHbn)

History from January 2000 through April 2013; forecast from May 2013 through December 2015



Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

NBU has been propping state revenues on regular basis, paying more when economy underperforms

Another parameter worth mentioning is the historical ratio between NBU's payment to the state budget and the size of its net profit (see right part of the Chart 32, pp.35). In years of state revenues underperformance and in pre-election periods, this ratio was above 100%. In a more critical episode of deep recession in 2009, it stood at 176%. In 2011-12, it was running above 110%. In 2013, given the state's revenue underperformance is expected to be under wide mismatch between the government's growth projections (+3.4% YoY) and actual outcome (we expect flat change in real GDP) this ratio is projected to be at 166%.

²⁶ This is not the first occasion when NBU's payment to state budget revenues fully covered the debt servicing expenditures from the state budget. Thus, in 2010 this ratio stood at 100% and in the crisis-hit year of 2008 it was at 221%.

²⁷ In 2004 this ratio was at 42% and 31% the following year of 2005. In 2006 and 2007, when economy was booming, the ratio was even accelerating from the preceding couple of years at and stood 41% and 56%, respectively.

The above discussion on the relative size of NBU payment to state budgets points to its inverse relationship with domestic demand conditions, which epitomize performance of state revenues. Thus, during the years of underperforming revenues (short of planned volume) the government looked to state agencies for a larger share of their profits as a contribution to the state budget. The same logic we apply in the current year that is characterized by stagnation of the economy.

NBU's expected earnings from operations in 2013

Over 2013, NBU is expected to undertake domestic QE by increasing its holding of government bonds by UAH60bn...

In order to provide sensible support to the state budget this year, NBU should undertake monetary expansion in 2H13 at a larger pace than in 1H13. While state budget law prescribes NBU to submit a total of UAH16.0bn from profits this year, in our view, the central bank is likely to be asked by authorities to be again ahead of plan and we project UAH28.7bn will be channelled to the state budget.

In 2012, NBU earned a net profit of UAH20.9bn on operating income of UAH23.7bn. Its gross interest margin²⁸ earned in that year was at 5.5%, being just fractionally up by 0.1ppt from the previous year's level of 5.4%. In the previous years, NBU earned a larger interest margin than in the past couple of years thanks to a mix of factors like the size of the balance sheet and level of interest rates (see left part of the Chart 32, pp.35). To project NBU's earnings in 2013, we assume that central bank policy would encourage a lower interest rate environment in the banking sector to support economic recovery, and avoid an interest rates increase, which would be growth-negative. Hence, our assumption is that NBU is retaining a gross margin of 5.5% while carrying out operations in 2013.

...resulting in 18% YoY base money increase ...

Then, NBU is projected to increase the monetary base by UAH45bn or 18% YoY this year in order to support its balance sheet, which is expected to expand by UAH60bn of domestic government bond purchases. This is expected to allow NBU to earn UAH18.2bn or 5.5% gross interest margin on an average interest-bearing assets of nearly UAH340bn.

Risk of inflation

...dragging inflation out of deflation territory...

In our view, in 2013 the above mentioned central bank's activism (that is expected to push up the monetary base up 18% YoY this December from 6% YoY seen at the end of each year of 2011-12, currently as of June 2013 it was up by 13.4% YoY) is likely to spur inflation from its current deflationary level. For Ukraine, it is quite dangerous now to stay in the deflation zone (headline CPI and PPI are at 0% and -1.6% respectively in year-on-year terms in July 2013), as it would prolong economic stagnation, which would likely turn to recession.

...then, higher domestic inflation would mean upward pressure on UAH real rate to persist...

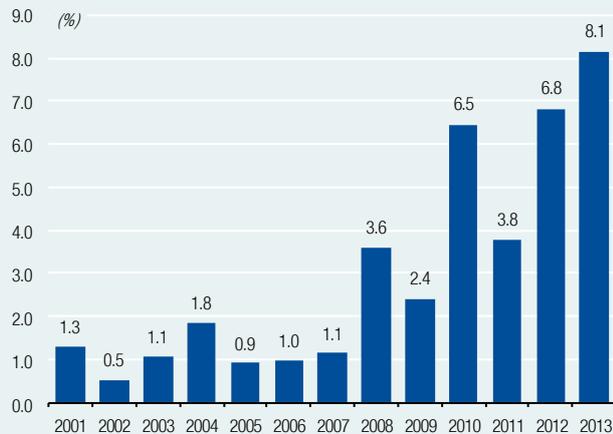
On the other hand, there is another risk from the monetary policy activism by NBU, which is that by trying to lift the economy out of deflation, it would trigger long-term inflation. In relative terms, while the domestic inflation level would be quite acceptable at 1.8% YoY in December 2013 according to our base case scenario, the inflation dynamics of Ukraine's main trade partners are on an opposite path (for instance, in Russia consumer price index is expected to slow down from this current peak of 7% towards 5-6% range). This relative change in inflation would be negative to Ukraine's economy, because it forces real appreciation of the currency. Next year, 2014, government's increasing fiscal challenges²⁹ and still-high sovereign credit risk would mean that authorities would rely again on NBU activism. Domestic inflation would result in UAH real appreciation, which would be a heavy burden on the economy and public finances due to slower exports and activity in the industrial sector.

²⁸ Interest rate determined as interest income divided by average volume of interest bearing assets.

²⁹ Government financing needs are set to increase further, see pp.27.

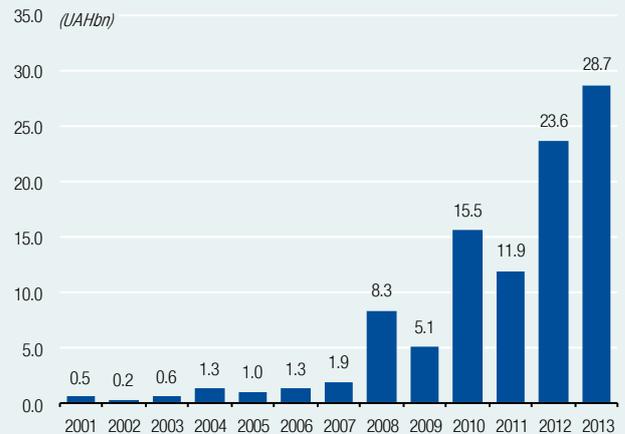
Chart 31. NBU's payment to state budget: as percentage of state budget revenues (%), left) and nominal volume (UAHbn, right)

Yearly history from 2001 through 2012; forecast for 2013



Sources: National Bank of Ukraine, Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

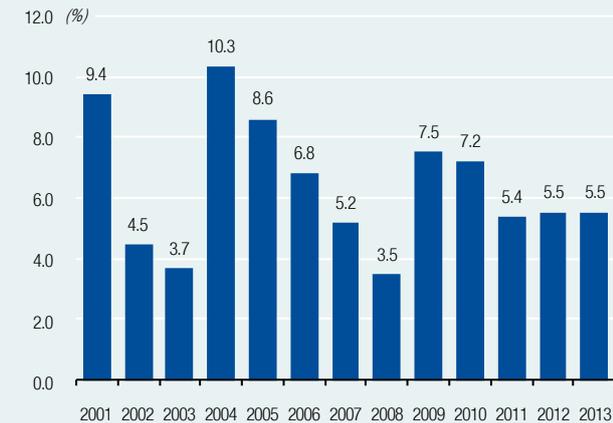
Yearly history from 2001 through 2012; forecast for 2013



Sources: National Bank of Ukraine, Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

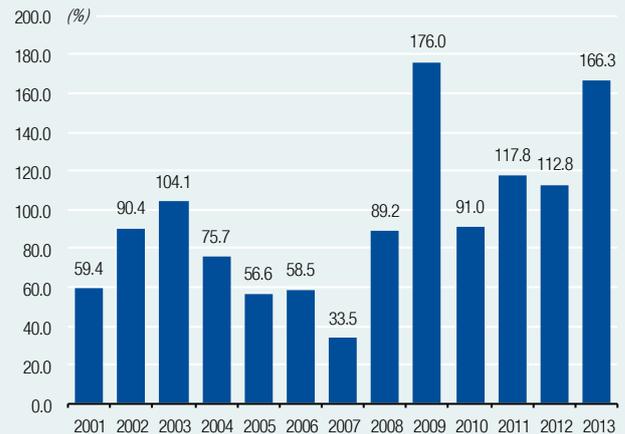
Chart 32. NBU's interest margin¹ (%), left) and ratio of payment to state budget to net profit (%), right)

Yearly history from 2001 through 2012; forecast for 2013



Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

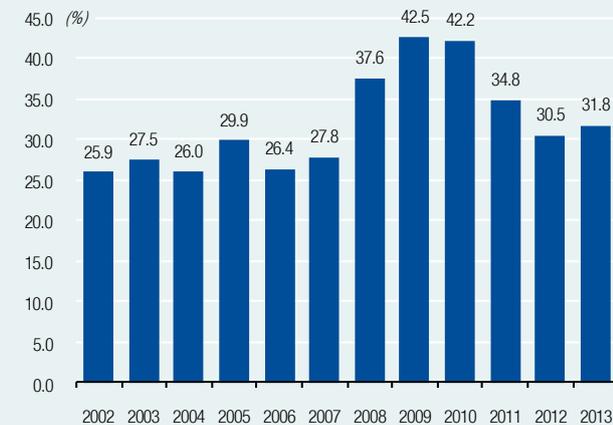
Yearly history from 2001 through 2012; forecast for 2013



Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 33. NBU's balance sheet as share of GDP (%)

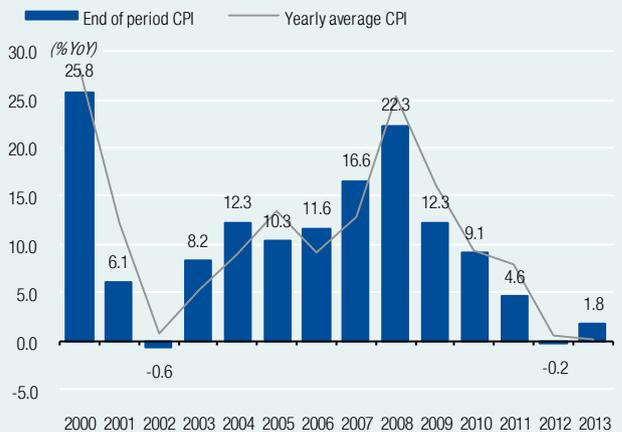
Yearly history from 2002 through 2012; forecast for 2013



Sources: National Bank of Ukraine, Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 34. Headline CPI: year-end and yearly average levels (%YoY)

Yearly history from 2000 through 2012; forecast for 2013



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

MoF borrowings: Domestic market "Original Sin"

Facing large external debt due this year, MoF is trying to replicate its success of 2012...

This year the government has been trying to replicate the success it had in 2012 when it managed to refinance a large volume of debt without painful concessions to either the IMF or Kremlin. However, the IMF is now demanding progress on socially-painful reforms and Moscow has been pushing for deeper integration of the Kremlin-run organizations such as the Customs Union, natural gas consortium, grain cartel, and others.

On the back of demand collapse since the 2008 crisis, NBU has actively expanded its balance sheet by carrying out purchases of government bonds issued locally (see Chart 36, pp.40). Hence, refinancing of local-currency debt has been an easier task than the foreign-currency debt.

...when it refinances increased level of debt without IMF's financial assistance

In 2011, the MoF introduced innovations in the domestic bond market with a USD-linked bond (a local-currency government bond with an adjustment for the USD/UAH exchange rate change over the life of the bond) and a foreign-currency denominated bond (denominated in US dollars and the euro). While the former bond failed to become a popular instrument, the latter fared better.

MoF committed "original sin", FX borrowing, from domestic market

The government's decision to undertake a risky shift in public borrowing policy—by borrowing in a foreign currency—a practice referred to as "original sin"—from the domestic market, which has primarily been in US dollars—was dictated by its desire to tap Ukraine's commercial banks' external assets, where more than US\$8bn has been held in cash and transferable deposits. However, Ukraine's commercial banks, as a whole, have quite sizable external liabilities (of more than US\$20bn) and they are still gradually reducing these liabilities by repaying their lenders, which in many cases are the banks' parent entities like European and Russian banks. Due to banks' negative net external assets, which they are gradually reducing, they did not subscribe to MoF's FX bonds initially. However, still-sizable foreign currency assets among the banks and other local market players allowed MoF to extend its FX-denominated borrowings over the past two years.

As Chart 37 on page 40 shows, MoF's domestic borrowings in foreign currency increased from US\$0.4bn in 2011, ie in the debut year, towards US\$3.0bn in 2012 and to US\$3.5bn in the January-July 2013. It appears that the MoF will fail to re-gain market access to the Eurobond market for US dollar funding (as it enjoyed earlier this year through April). Instead, it is quite likely they will try to repeat their success of 2012, by tapping the local market for US dollars. Hence, for the remainder of 2013, the MoF will need to borrow a total of US\$1.2bn of FX-denominated bonds from the domestic market to cover the FX debt due.

To repeat success of 2012, MoF needs to borrow FX from domestic market at much bigger volume (US\$5.4bn)

If MoF manages to be successful in 2013 in refinancing foreign-currency debt without bowing to the demands of official creditors like the IMF or Russian government, then this year could become the first one in ten years that, in net terms, the MoF paid down the external part of the debt (Chart 38, pp.40). This is expected to be accompanied by larger borrowing from the domestic market—either in local or foreign currency.

Given the government's large financing needs of UAH144bn, according to our estimates, and current deflationary conditions in the economy, the NBU is likely to carry out government bond purchases of record volumes in nominal terms (our estimate of UAH60bn in total this year, half of that sum in the 7M13 and the rest in the remaining five months of the year).

However, despite the recent success of MoF in refinancing the foreign-currency part of the sovereign debt via the domestic market, in our view, the available pool of domestic US dollars, which the MoF depends on, has shrunk. To borrow US dollars from the domestic market the MoF was forced to increase the yield (by 50bp to 8.25%) while raising fewer and fewer volumes.

While refinancing external debt, government has been borrowing and draining down its FX balance ...

The left side of the Chart 39 on pp.40 shows the volume of funds the central government held in the central bank and commercial banks (most of the funds are held at the central bank). In 1H13, the average volume of these funds was UAH14.6bn (in local currency equivalent), down from the past year's monthly average of UAH19.0bn and in 2011 the monthly average balance was at UAH31.1bn. Our assessment of the currency breakdown of central government cash buffers, which is depicted on the right side of Chart 39, shows that the monthly average foreign-currency balance was on the decline—at US\$1.3bn in 1H13, a quite noticeable decrease from the monthly average US\$1.8bn during full-year of 2012 and even less than 2013's average of US\$2.9bn.

Over the course of current year, MoF enjoyed a quite welcomed access to the Eurobond market from January through April, borrowing in total US\$2.25bn along the way. Then, since May, due to the Fed's tapering talk, Ukraine's sovereign cost of borrowing from the Eurobond market spiked by nearly 2ppt. Since then, MoF's access has been nearly frozen and quite sizable external debt repayments have forced MoF to drain its cash buffers.

At the end of April 2013, MoF's total cash balance was at UAH18.2bn, including foreign-currency balance of US\$1.8bn (record high for 2013) and local-currency balance of UAH3.8bn. After that MoF's cash position worsened; there was a drain on foreign-currency funds, while local-currency ones held steady.

...it now stands at US\$0.6bn, which would cover just the next few weeks of debt repayments and servicing, if MoF stops FX borrowing

Thus, at the end of 1H13, the central government had a balance of UAH8.3bn in all its accounts, in both local and foreign currencies, according to central bank data. Of this volume, the foreign-currency account had a balance of US\$0.6bn, according to our assessments. The remainder was funds held at the government's local-currency account at the state treasury was reported to have a balance of UAH3.8bn.

Our assessment of the central government cash buffer capacity to service budget deficit and debt principal re-payments that come due in near future shows that MoF is running a quite slim liquidity position (low volume of cash at hand), which covers just few next weeks of central government operations if it does not borrow both in local and foreign currencies (see Chart 40, pp.41). Hence, risk of default emerges (this is reflected by an increase in the sovereign credit risk premium at the USD Eurobond market).

While borrowing in the local-currency has a benefit for MoF since its own central bank serves as backstop, borrowing in foreign-currency is a more tricky issue, especially when it concerns the domestic market.

Indeed, MoF has been tapping the Ukraine domestic market for US dollars this year and has been able to raise some funds even despite the deterioration of its credit risk in the Eurobond market.

In 7M13, MoF's domestic FX borrowings amounted to US\$3.5bn...

In 7M13, MoF raised US\$3.54bn and together with Eurobond proceeds of US\$2.25bn (a total of US\$5.79bn), it was enough to refinance external debt due and service the interest payments of the Eurobond issue, IMF loan (including the NBU's part³⁰) and domestic FX-denominated bonds.

³⁰ Without this volume official FX reserves of Ukraine could have drop more than they actually did.

...it would need to raise domestically US\$5.4bn more in the rest of 2013

For the remaining part of 2013, in August-December, MoF needs to refinance a total of US\$3.64bn. However, if authorities care about a possible loss of FX reserves over the rest of this year—and, in our view, state borrowings in 1H13 reveal they do—then MoF's refinancing needs increase up to US\$5.37bn.

The key question then is: given Eurobond market access shut, stalled IMF programme talks, a decline in Kremlin's willingness to extend financial assistance, how much capacity is there in the domestic market to provide US dollar liquidity to MoF in the volume of US\$3.64bn (or let alone the US\$5.37bn)?

In our view, domestic market has reached its limit in providing USD funding to MoF...

Before providing an answer to this question, we underline the following:

- Previous attempts of the authorities to spur domestic demand from the private sector for government debt have not gone well. Domestic borrowings ended up with NBU being a major holder.
- A particular bid to tap the foreign-currency pool of funds held by households outside the banking sector proved a failure. MoF borrowed just US\$100m via selling the so-called retail USD bond, peanuts for public finances.
- In the banking sector, too, private-sector banks (the entire banking sector, excluding state-owned banks and banks that have close ties with the ruling establishment) showed quite cool reception to the FX-denominated bonds issued by the government. Our assessment of these banks' financials reveals, overall, they keep a distance. (This changed a bit since 2H13 as NBU is trying to incentivize wider purchases of FX-denominated bonds by private-sector banks, see one pint below).
- Hence, we zoom in our assessment on the public-sector banks and, quite importantly, on public-sector corporations. Both have been quite active in the 1H13, as well as in the past years, attracting external long-term debt financing; state banks raised US\$1.00bn in 1Q13³¹ and state corporations attracted US\$2.55bn from last December 2012 through May 2013³². It total, they raised US\$3.55bn over the span of the six-month period from December 2012 through May 2013.
- Then, it is interesting to take a look at the details of public-sector corporations' aggregate balance sheet. State corporations actively expanded their balance sheets by taking on debt, at the same time (from December 2012 through June 2013—as we suppose and as the Chart 41 on pp.41 depicts—their assets' item "Cash in bank deposit") increased by one-third or, in US dollar equivalent, by US\$1.1bn to nearly US\$3.0bn³³. In our view, state corporations that raised US dollar debt and are holding these funds as deposits in the state banks could have indirectly provided USD liquidity to MoF as well as the state banks. Interestingly enough, since December 2012 through July 2013, the MoF raised a total of US\$3.6bn via selling FX-denominated bonds, nearly an equal volume to the cash borrowed by state banks and corporations from foreign lenders.

...recent attempt to borrow FX cash from households turned a failure...

...borrowing the FX cash from state banks and corporations is no longer possible, in our view...

³¹ State-owned Oschadbank and Ukreximbank issued US\$0.5bn Eurobond each.

³² State-owned corporations UkrInf issued US\$0.55bn in December 2012, State Food & Grain corporations received US\$1.5bn loan from Chinese Ukreximbank in December 2012, and Ukrzaliznytsia (Ukraine Railroads) issued US\$0.5bn Eurobond in May 2013.

³³ In December 2012, state corporations' deposits in banks rose by UAH12.5bn (US\$1.6bn) to UAH27.3bn (US\$3.4bn) from November 2012. As of end 1H13, state corporations' deposits stood at UAH23.9bn (US\$2.9bn), down by UAH3.3bn (US\$0.5bn) over January-June period.

...as they spent their recent FX cash raised from abroad in 1H13 buying gov't USD domestic bonds

- To conclude, in our view, the inflow of USD cash into MoF's FX-denominated bonds issued domestically that took place until end 1H13 was supported by state banks and, indirectly, state corporations. The latter were borrowing USD from abroad and not investing. Instead, they were parking the raised USD cash in the state bank and likely financing their domestic operations by local-currency "back-to-back" lending from the same bank. This idea fits well to the developments observed over December 2012 till end 2013. In 2012, when state banks and corporations did not borrow from abroad, MoF was tapping the accumulated USD liquidity (over 12-month period through November 2012, average monthly stock of deposits of state-owned corporations in the banking sector stood at UAH23.2bn or US\$1.9bn).
- Hence, in our view, the past capacity of USD liquidity at the state banks and state corporations has been largely drained. We think that without sizable new borrowings from abroad by a state bank or a state corporation, MoF faces a struggle to raise a sizable volume of FX-denominated bonds unless some other pools open.

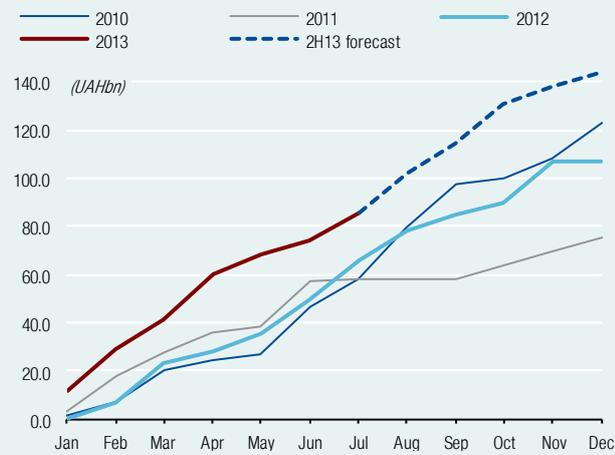
...FX borrowing from the private sector is still proving a difficult task

- Since 1 July 2013, the banks have operated under new regime of central bank imposed reserve requirements. NBU increased reserve requirement ratios (RRRs) this June on banks' foreign-currency deposits (the most dramatic increase of 5ppt to 10% concerned household call deposits and their current accounts), while it left RRRs on UAH liabilities intact (at zero). In our view, this was done by NBU to bolster demand for government FX-denominated bonds from private-sector banks. So far, this strategy of the authorities has been working—interest rates on mid- and long-term FX deposits are declining towards 7.5%, opening an attractive opportunity for banks to invest into MoF's bonds in USD that have simple yield of 8.25%. However, so far, the government bond auctions held in August did not reveal sizable demand that would satisfy MoF.

Returning to the question we raised above (pp.38), in our view, the domestic market has quite limited capacity to provide MoF with enough US dollars to refinance the external debt due in the remainder of 2013. USD liquidity created by state banks and corporations at the end of 2012 and in 1H13 appears totally withdrawn by MoF. NBU's shift with RRRs this June hints that authorities are trying to tap USD liquidity that sits in the private-sector banks and, so far, this tool has worked poorly. So, there are at least two possible options going forward. One, authorities tighten regulations in order to move USD cash from private hands to state ones. Second, authorities open talks with foreign lenders (IMF, Russian government, Chinese government, etc) that would provide inward USD flows, which would then cover the outward flows of USD.

Chart 35. Cumulative volume of monthly gross borrowings by MoF from 2010 to 2013 (UAHbn)

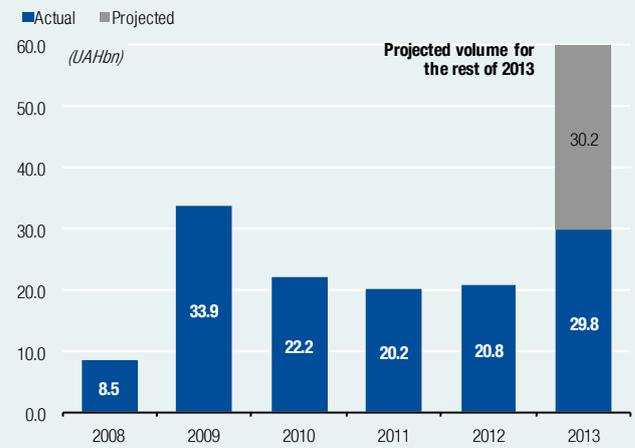
All type of instruments (domestic and external), in gross terms



Sources: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 36. Net increase in the NBU's holding of government bonds issued at the domestic market (UAHbn)

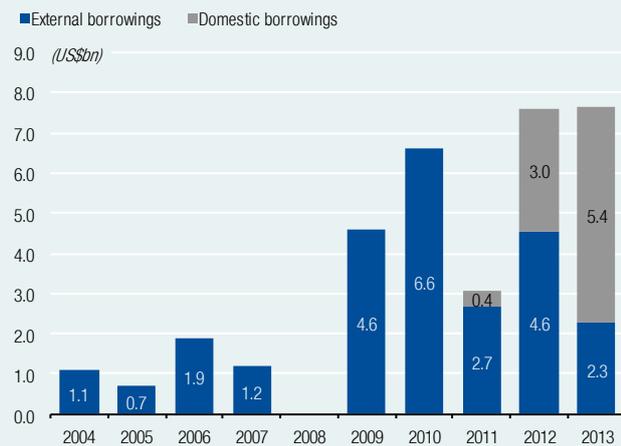
Yearly history from 2008 through 2012; for 2013 – actual data for the period of January-July



Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 37. Foreign-currency gross borrowings by MoF (US\$bn)

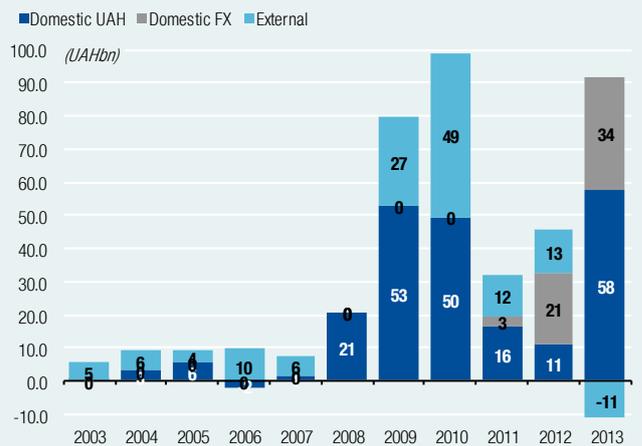
Annual history for 2004-12 and 7M13; forecast for the rest of 2013



Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 38. Net volume of MoF borrowings (UAHbn)

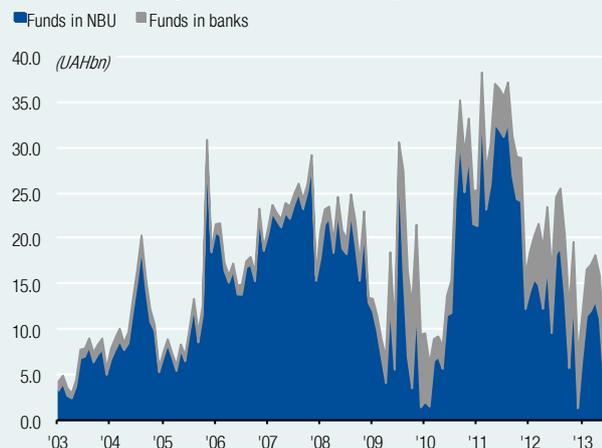
Annual history for 2004-12 and 7M13; forecast for the rest of 2013



Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

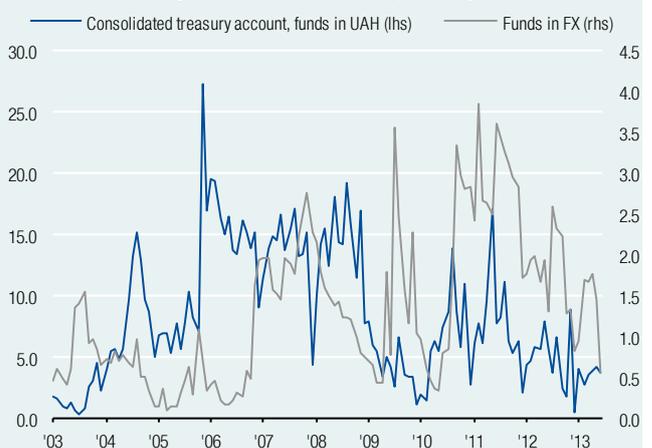
Chart 39. History of central government's cash buffers from January 2003 through June 2013

Breakdown of central government's cash balance by deposited institution



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

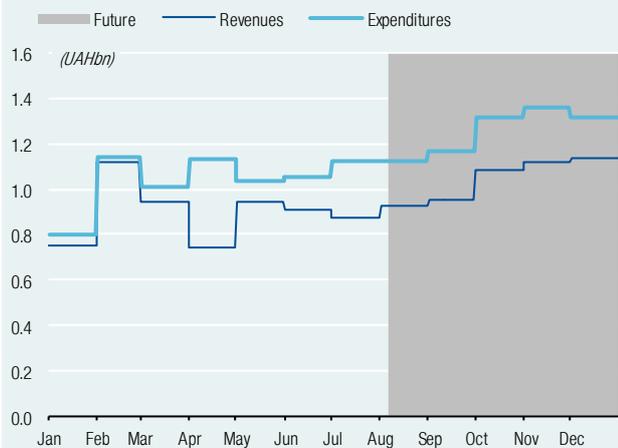
Breakdown of central government's cash balance by currency



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 40. State budget daily synthetic performance over 2013: revenues vs. expenditures (left) and balances of government accounts in local and foreign currencies (right)

Data is based on available history of state budget execution in 1H13 and own projections for the rest of the year



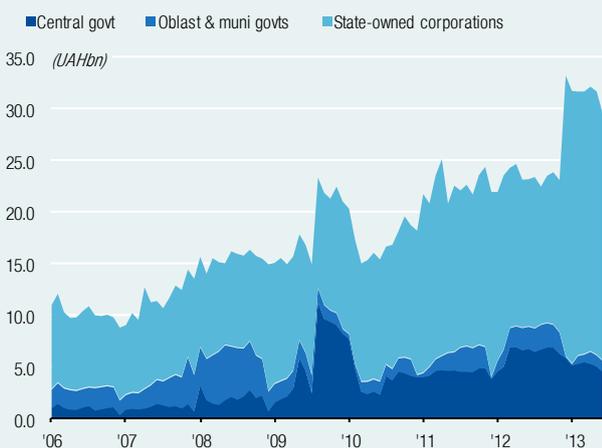
Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Data is based on available history of government's treasury account balance in local currency and data for overall balance of government funds in NBU and commercial banks



Source: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

Chart 41. Deposits of central government, regional authorities and state-owned corporations: in local currency equivalent (left) and in US dollar equivalent (right)



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

External balance: Projected shape of balance of payments

The latest data from the NBU on balance of payments developments through June 2013 allow us to project the following.

Trade flows were contracting on weaker domestic and external demands

- Trade flows contracting further after a year-long sharp slowdown.** Over the past year, the link between the state of the economy and foreign trade couldn't be clearer. Ukraine's economy was in decline during most of the past 12-month period through 1H13, along with parallel results in foreign trade. On a 12-month rolling basis, volumes of merchandise exports and imports have been contracting since February 2013. Thus, exports slid 3.0% YoY in June, while imports declined by 7.0% YoY. Over 2012, the growth rate of exports was constantly declining, from a 33.0% YoY increase of exports in December 2011 towards a 0.6% YoY increase in December 2012.

Authorities have been very keen to restrain domestic demand for imports, effectively lowering C/A deficit

- **Authorities guide current-account deficit lower.** Despite the overall contraction in foreign trade, there were a few positive developments that contributed to a lower current-account deficit. On a 12-month rolling basis, NBU data show that at end 1H13, the trade deficit stood at US\$12.7bn or 7.3% of GDP, down 1.2ppt from 8.5% or US\$14.8bn seen at the end of 2012. Despite declining demand for Ukraine's exports, authorities' efforts to cut down on imports have led to a sizable contraction in the current-account deficit, a strategy that has proven workable.

Imports of natural gas are cut to 31bcm this year from nearly 33bcm in 2012

- **Imports of natural gas down.** Since 2013, authorities fixed the domestic natural gas market via allowing a handful of private entities to take over parts of Naftogaz's operations. Prior to 2013, state-owned Naftogaz had been the sole buyer of expensive natural gas from Gazprom, which it, in turn, sold it to domestic businesses and households. In 1H13, Ukraine's economy imported a total of 10.2bcm³⁴, of which Naftogaz purchased 6.6bcm according to our assessments and the rest was imported by private-sector businesses. In volume terms, natural gas total imports in 1H13 amounted to US\$4.4bn, of which US\$2.7bn were paid by Naftogaz, this is US\$2.4bn less than total value of natural gas imports in the 1H12, which amounted to US\$6.8bn. Hence, in physical volume terms, Ukraine cut natural gas imports by 35.9% YoY from 15.9bcm in 1H12 to 10.2bcm in 1H13 and in the US dollar terms, the economy managed to cut imports by 35.7% YoY (from US\$6.8bn to US\$4.4bn). The rates of reduction of USD-based volume and physical volume are identical because import prices have been nearly flat (as depicted at the, pp.48). For 2H13, it is expected that imports of natural gas will increase, as this year's plan for the natural gas assumes 31bcm imports. Authorities deliberately postponed purchases into the second half of the year because of the expected decline of the natural gas price (see Chart 48, pp.47). According to our forecast, the natural gas price under agreement between Naftogaz and Gazprom will be at US\$395 per 1,000 m³ and US\$387 per 1,000 m³ in 3Q13 and 4Q13 respectively, resulting in a 2013 yearly average of US\$401³⁵ (5.4% down from US\$424 in 2012). Given the past practice of Ukraine's government on spreading natural gas imports over the year, we assume a total of 8bcm is imported in 3Q13 and the rest, 12.8bcm, in 4Q13. In total, natural gas imports volume is likely to reach US\$12.4bn in 2013, down by 12.7% YoY from 2012.

Authorities paid special attention to car imports by introducing higher import tariff

- **Car imports down, too, after higher tariff.** Another category of imported goods, a sizable component that dragged the trade deficit into the red, is cars. As Chart 49 on pp.47 shows, monthly US dollar-based volumes of car imports were on a gradual decline since 1H12 due to slower bank lending for car purchases. In 2012, they slowed from a peak of US\$341m in April to US\$230m in December. In 2013, they slid further to US\$170m before rising again as news of the government's plan to introduce an import tariff brought demand forward to avoid the higher tariff. Hence, car imports jumped above the US\$300m in March and April and then dropped to US\$200m. In June and in the 2H13, monthly volume of car imports are likely to stay subdued on the back of the government's policy to limit the trade deficit. And, hence, in USD-based volume terms, full-year 2013 will see car imports down by 2.4% YoY to US\$3.17bn from US\$3.25bn.

³⁴ Bcm – billion cubic meters.

³⁵ Projections are made upon the crude oil forecast for 2H13 and 2014-15, see Table 1, pp.20.

Once the key export sector, steel-making is stagnating and, hence, lower steel exports likely

- **Steel exports stagnating.** Once the key USD earner for the economy, the steel-making sector does not shine as it once did. Demand is rather weak, physical volumes are not growing (although they remain stable) and export prices are under pressure (see Chart 44, pp.46). Prospects of a stronger USD going forward (as the US economy recovers faster than other developed economies) and generally weak demand for steel globally (as emerging the Asia factor has also lost its shine and BRIC countries are grappling with domestic problems) are a negative play for the Ukraine economy. Hence, our projections for steel exports are based on the projected level of export prices (see Table 1, pp.21) for which we see a 23.3% decline in USD-based volume terms to US\$14.5bn in 2013 from US\$18.9bn in 2012.

Instead, it is food & agribusiness exports that will be top export items for Ukraine in 2013

- **Food and agribusiness exports up further.** Thanks to low inflation and the dire need to earn USDs by all possible means to balance outflows, the risk of grain-export quotas is practically zero. Moreover, authorities eye more grain exports as this year's harvest is expected to be at a record high. Given expected global recovery to concentrate in the second half of this year and global demand for food to remain solid, Ukraine exports of food and agribusiness products are expected to be up 4.5% YoY this year to US\$18.7bn from US\$17.9bn. Hence, we expect the food and agribusiness sector to outperform the steel-making sector as the top earner of USD this year.

Due to slowdown in Russia, the main buyer of Ukraine's machinery abroad, expectations are low for this sector

- **Machinery exports: down due to Russia risk.** Kremlin's petulant stance regarding Ukraine's exports to Russia in the wake of Ukraine's outright rejection to move under the umbrella of the Kremlin-led Customs Union is a key risk to the sector whose main customers are in Russia and countries that once formed the Soviet Union. An even more important factor is the slowdown of the Russian economy this year. Russian authorities would prefer to support domestic producers by cutting imports. We project a 6.2% decline in USD-based volume of exports in this category.

Our projection of C/A deficit is US\$10bn in 2013, down from 2012

- **Overall trade and current-account balance.** Our projections for merchandise and services trade are for a deficit of US\$9.8bn in 2013, down from US\$14.8bn in 2012. Still quite sizable surpluses in the services trade at US\$4.6bn, which have been on a declining trend recently due to lower natural gas transportation services provided to Gazprom, counterbalances the merchandise trade deficit of US\$14.5bn (it was US\$20.5bn in 2012). This, together with a negative balance between net-income outflows of US\$3.2bn and current-transfers inflows of US\$2.7bn creates a final level for the 2013 current-account deficit at US\$10.5bn or 5.9% of GDP. For 2014 and 2015, we project a 6.2% and 5.2% current-account deficit as a share of GDP, respectively.

Net FDI is weak this year and in 2014-15 due to poor business environment and Cyprus factor

- **Direct investments at slower pace.** Due to the current business environment in the country and the Cyprus factor (where Ukraine's businesses lost a percentage of their savings) net inflow of FDI is down in 1H13 and is projected in the full-year to fall short of the previous year's US\$6.8bn, to slightly more than US\$5.0bn. A gradual and quite sluggish recovery in FDI is projected into 2014-15 at US\$5.7bn and US\$6.0bn, respectively.

Sovereign borrowings from abroad are becoming difficult with USD monetary tightening...

...in our view, strained access to domestic USD liquidity is pushing Ukraine government to IMF as a backstop for USD funding

Our base-case scenario envisages IMF funding in 2014, which will go onto NBU's books

- External debt financing: Sovereign borrowings going forward.** In our view, there are several factors that will not play out in favour of Ukraine's government. One, is its current, poor sovereign credit risk, which is reflected in very low credit ratings³⁶, and is hovering around 800bp measured by the market of credit-default swaps on Ukraine's 5-year sovereign debt. Two, prospects of an increase in base rates in the USD due to Fed's gradual rollback of QE3 this fall are negative to Ukraine's government borrowing cost. Three, our assessment of the future path of the UAH's real exchange rate—as measured by ICU's family of trade-weighted indices of hryvnia—is for a further appreciating of the local currency in the real, trade-weighted terms, which is negative to growth and fiscal prospects. Effectively, combining these factors suggests that going forward there will be very limited (if no) room for Ukraine's government to exploit Eurobond market investors' "thrust for yield".
- Ukraine needs an effective backstop for USD funding.** Ukraine requires an effective backstop for its USD funding needs, which are to remain quite large in the next year. In our view, USD liquidity on the balance sheets of state-owned banks and corporations has been drained substantially. And it needs to be covered and without external borrowings by state-owned banks and corporations from the Eurobond market, or Russian or Chinese banks, which we think is unrealistic. At the same time, quasi-sovereign borrowings depend on the sovereign ones—if the government does not have access to the Eurobond market, then the state-own businesses too are cut off from it. Hence, looking for USD liquidity from the balance sheets of state-run banks and corporations appears very limited going forward and, subsequently, MoF's ability to borrow in USD domestically will be constrained due to this. An alternative has been undertaken by authorities of changing domestic banking regulations to squeeze USD liquidity from private-sector banks into the state banks or into USD-denominated government bonds. It is likely workable, however, not sufficient in terms of volumes. Hence, in our view, very thin USD cash buffers of the government and drained pool of domestic USD liquidity, which is investable to USD-denominated government bonds, will push Ukraine's authorities into an agreement with the IMF, as a more effective backstop for USD funding. We put this event (a new programme with IMF in early 2014) as part of our base-case scenario, which opens the door for a reduction in sovereign credit risk premium and eventual access to Eurobond market. Otherwise, Ukraine's authorities should adhere to a rough policy of mobilizing domestic USD liquidity from private-sector (banks, corporations, households) to carry on with repaying external USD debt by borrowing domestic USD debt. This scenario is negative to an already-soured business environment and eventually would lead to protracted stagnation and an eventual lengthy recession, which is why this development is a part of our worst-case scenario.
- External debt financing: NBU.** In our base-case scenario with an IMF programme in place beginning in early 2014, NBU receives tranches from the Fund. Hence, its rollover ratios for the debt due to IMF is 0% for full-year 2013, 343% for 2014 (IMF provides incoming flow of debt of US\$3.6bn, while NBU pays back US\$1.1bn) and 513% for 2015 (inflow from IMF at US\$2.5bn, outflow to IMF at US\$0.5bn). In the worst-case scenario NBU's rollover ratios for 2013-15 are zero.

³⁶ 'B' by S&P, 'B' by Fitch and 'B3' by Moody's and all rating agencies have Negative outlook suggesting further downgrades are likely.

In our view, only state-owned banks will enjoy access to Eurobond market, if IMF programme is in place...

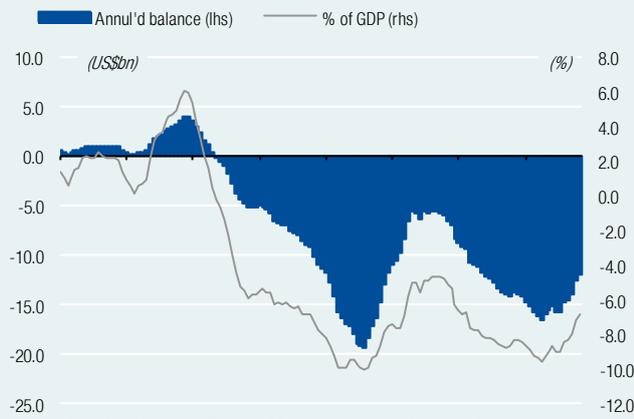
...nearly the same approach is applied to corporate borrowings; private-sector corporations will have access to Eurobond market if there is IMF programme

- External debt financing: Banks.** As in our previous macro report, our view is we based on the assumption that Ukraine's banks are going to be very rare visitors to the Eurobond market, which will allow only state-owned banks to issue bonds. Thus for 2014-15, out of all bank bond redemptions only state-owned Ukreximbank and Oschadbank are likely to tap the Eurobond market for refinancing of past debt. Hence, our rollover ratios for these couple of years is 130% and 103%, respectively (even this assumption would have low chances to materialize if authorities do not address the 2014 dilemma of hefty external debt repayments, a rising real exchange rate, and heightened sovereign credit risk via agreeing to a new programme with IMF). As for other debt, we apply a gradual step up increase by 5ppt in the rollover ratio from 71% this year to 76% and 81% in 2014 and 2015.
- External debt financing: Corporations.** In our base-case scenario, which assumes IMF programme in place since early 2014, Naftogaz is able to refinance its US\$1.5bn Eurobond due in 2014 with a state guarantee on the new bond. In general, corporate external borrowings are likely to pick up if the Eurobond market opens to Ukraine borrowers on the back of lower sovereign credit risk. That is why we assign by far more than 100% rollover ratios in 2014-15 (in fact, they reaching 200%) for corporate Eurobonds due in those years. For other corporate borrowings, we assign 130% rollover ratio in 2013, up from 125% set to 2013 and this pick-up in the rollover ratio is as a sign of better risk perception of corporate risk from lenders. Then, in 2015 we assume the rollover ratio for other borrowing slides to 125%.
- The bottom line: Base-case.** Our base-case scenario BoP yields a near US\$4.2bn deficit in 2013 and, hence, a loss of FX reserves by the same volume towards US\$20.4bn as of year-end. Due to this decline, FX reserves import coverage steps down further to 2.5x from 2.8x seen a year ago. In 2013 and 2014, BoP turns positive and allows NBU to build up reserves by nearly US\$1bn and US\$2bn respectively. This implies that over the next two years, 2014 and 2015, the ratio of imports coverage by FX reserves equals 2.6x (flat to previous year) and then increases to 2.8x. See more details on how this scenario plays out in numbers in Table 2 on pp.49.

The bottom line: Worst-case. In a worst-case scenario BoP stays chronically in the red in 2013-15, forcing NBU to cover the deficit with FX reserves. They drop to US\$16bn by the end of 2014, undermining financial stability and in 2015 (after elections). The authorities then will be forced to allow the market to correct the nominal exchange rate of UAH, which until that time would appreciate in real terms by more than 10%. See more details on this in the Table 3 on pp.50.

Chart 42. Merchandise trade balance, last 12-month rolling

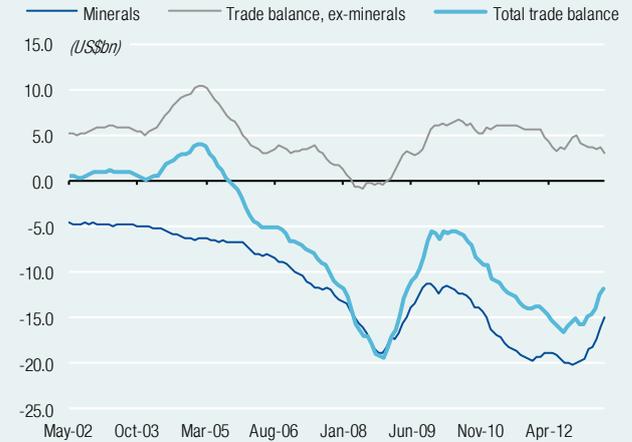
History from May 2002 through June 2013



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

Chart 43. Trade balance breakdown between minerals and non-minerals items (US\$bn), last 12-month rolling

History from May 2002 through June 2013



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

Chart 44. Monthly exports of steel: volume (million tonnes) and export price (US\$ per tonne)

History from January 2007 through May 2013



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

Chart 45. Monthly exports of natural gas: volume (billion m³) and export price (US\$ per 1,000 m³)

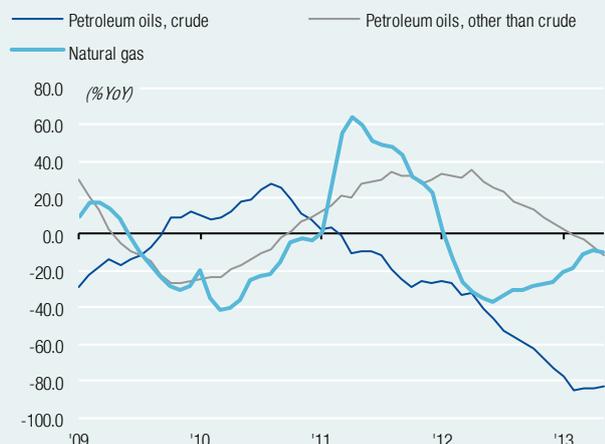
History from January 2007 through May 2013



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

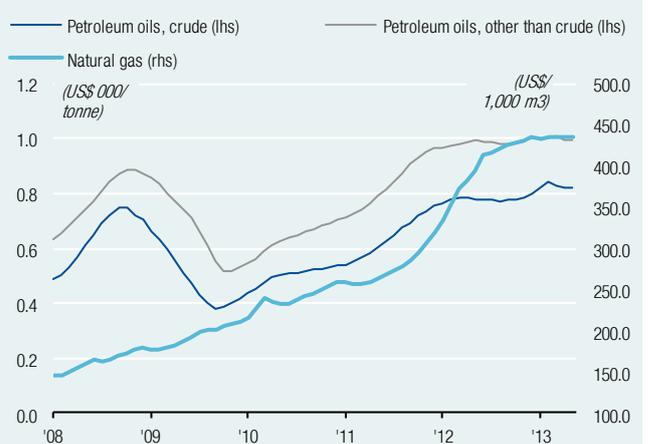
Chart 46. Imports of minerals (crude oil, oil products and natural gas): growth rates (%YoY, left) and import prices (US\$, right)

History from January 2009 through May 2013



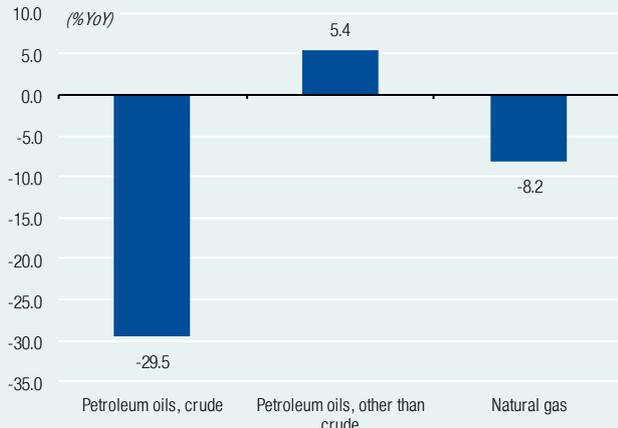
Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

History from January 2008 through May 2013

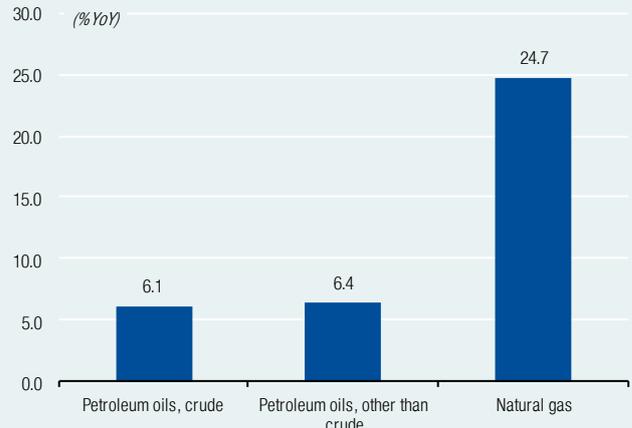


Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 47. Imports of minerals (crude oil, oil products and natural gas): average monthly growth rate (%YoY) of physical volumes (left) and prices (right) during December 2008 through May 2013



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



Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 48. Projected natural gas price (US\$ per 1,000 m3) as contracted between Naftogaz of Ukraine and Gazprom of Russia



Source: Bloomberg, Investment Capital Ukraine LLC.

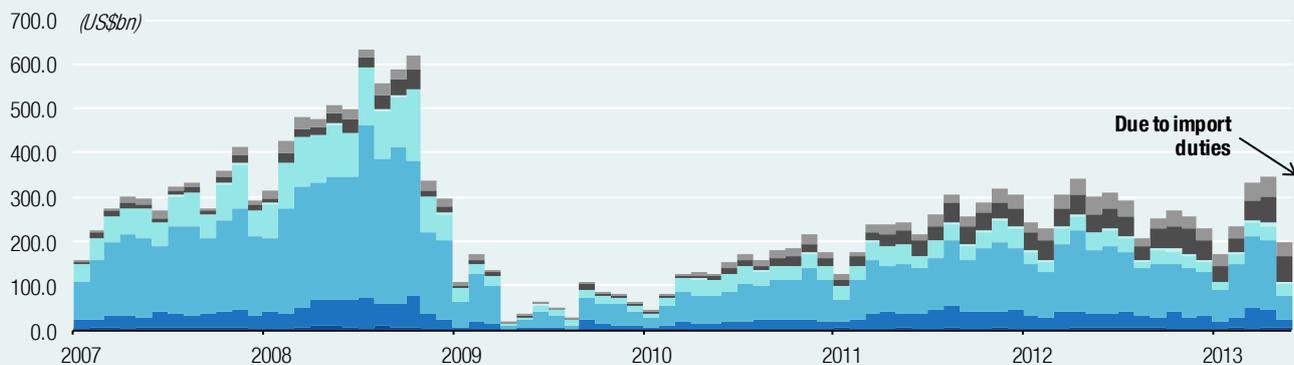


Source: Bloomberg, Investment Capital Ukraine LLC.

Chart 49. Monthly value of cars imports: breakdown by type of engine (US\$)

History from January 2007 through May 2013

- GEV cc ≤ 1000 sm3
- GEV cc 1-1.5*1000 sm3
- GEV cc 1.5-3*1000 sm3
- GEV cc ≥ 3000 sm3
- ICEV cc ≤ 1500 sm3
- ICEV cc 1.5-2.5*1000 sm3
- ICEV cc ≥ 2500 sm3



Note: GEV – Gasoline engine vehicles; ICEV – Internal combustion engine vehicles.
Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Chart 50. Monthly history of car imports in last 12-month rolling basis: value volume and number of unites (left) and their growth rates (right)

History from December 2007 through May 2013



History from November 2008 through May 2013



Table 2. Base-case scenario (with new IMF programme starting in 2014)

ICU's assessment of Ukraine's economy balance of payments in 2013-15 and its external financial needs (US\$m)

Balance of payments	Forecast period				Rollover ratios				Comment
	2012	2013	2014	2015	2012	2013	2014	2015	
Current account balance	-14,761	-10,447	-11,454	-10,039					
ST debt due next 12M¹	-58,352	-63,387	-61,321	-64,306					
Government									
Official lenders (IMF)	-769	-2,586	-2,578	-753	0%	0%	0%	0%	Government pays back to IMF, no new borrowings
Russian banks (VTB)	-2,000	0	0	0	0%	0%	0%	0%	No new borrowings
Eurobonds	-500	-1,000	-1,000	-1,298	970%	225%	300%	250%	If IMF then MoF borrows from the Eurobond markets
Dom FX bonds ²	-420	-1,913	-838	-1,836	706%	286%	200%	100%	Rollover ratios steps down
Other	589	0	0	0	133%	0%	0%	0%	ICU assumption
Central bank									
Official lenders (IMF)	-2,665	-3,222	-1,061	-482	0%	0%	343%	513%	New IMF programme in 2014 (US\$10bn)
Other	34	0	0	1	0%	0%	0%	0%	ICU assumption
Banks									
Eurobonds	-1,065	-15	-772	-969	0%	7878%	129%	103%	If IMF then banks borrow from Eurobond market
Other lenders	-13,031	-11,708	-9,518	-8,258	70%	71%	76%	81%	European banks continue withdrawing, at lower pace each year
Corporations									
Eurobonds	-225	0	-1,645	-1,785	244%	N/M*	200%	175%	If IMF then corporations borrow from Eurobond market
Loans	-11,762	-11,160	-11,579	-12,902	130%	125%	130%	120%	ICU assumption: pick-up in 2014, retreat in 2015
Trade loans	-17,579	-21,140	-22,249	-24,792	130%	125%	130%	120%	The same as above
Other	-8,960	-10,644	-10,081	-11,233	130%	125%	130%	120%	The same as above
Demand for foreign ccy, net	-7,537	-6,891	-9,130	-7,000					ICU assumption
Total financing needs⁴	-80,650	-80,726	-81,905	-81,345					
FDI, net	6,788	5,142	5,767	6,195					ICU forecast for the period
Borrowings									
Government	7,027	7,729	4,675	5,081					ICU calculations based on debt due this year and roll-over ratios
Central bank	0	0	3,639	2,469					ICU calculations based on debt due this year and roll-over ratios
Banks	9,092	9,518	8,258	7,710					ICU calculations based on debt due this year and roll-over ratios
Corporations	50,494	54,180	60,372	61,835					ICU calculations based on debt due this year and roll-over ratios
Total financing⁵	73,402	76,568	82,711	83,291					
FX reserves change	-7,249	-4,157	+806	+1,946					
FX RESERVES									
At the start of year	31,795	24,546	20,389	21,195					
At the end of year	24,546	20,389	21,195	23,141					
Change (%YoY)	-22.8	-16.9	4.0	9.2					
FX reserves (% of GDP)									
At the start of year	18.2	14.1	11.6	11.5					
At the end of year	14.1	11.6	11.5	11.9					
Change (ppt)	-4.2	-2.5	0.0	0.4					
FX res.imports cov⁶ (mth)									
At the start of year	3.6	2.8	2.5	2.6					
At the end of year	2.8	2.5	2.6	2.8					
Change (months)	-0.8	-0.3	0.0	0.2					

Notes: [1] Short-term debt due in next 12 month period since beginning of the respective year; [2] domestically issued bonds denominated in foreign currencies (USD and EUR), including USD-denominated Treasury Obligations; [3] N/M – not meaningful, this is because the rollover ratio cannot be applied to a volume that equals to zero, in fact we include into calculation the US\$0.5bn Eurobonds issued by Ukrzaliznytsia in May 2013;

[4] total financing needs equals to the sum of current account balance, short-term debt due next 12 months and demand for foreign currency by households;

[5] total financing equals to the sum of FDI and borrowings by all segments of the economy (government, central bank, banks and corporations);

[6] ratio of imports coverage by FX reserves, measured in months.

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

Table 3. Worst-case scenario (an attempt to muddle through over 2013-14 towards the elections year of 2015)

ICU's assessment of Ukraine's economy balance of payments in 2013-15 and its external financial needs (US\$m)

Balance of payments	Forecast period				Rollover ratios				Comment
	2012	2013	2014	2015	2012	2013	2014	2015	
Current account balance	-14,761	-10,447	-11,454	-10,039					
ST debt due next 12M¹	-58,352	-63,387	-61,321	-60,639					
Government									
Official lenders (IMF)	-769	-2,586	-2,578	-753	0%	0%	0%	0%	Government pays back to IMF, no new borrowings
Russian banks (VTB)	-2,000	0	0	0	0%	0%	0%	0%	No new borrowings
Eurobonds	-500	-1,000	-1,000	-1,298	970%	225%	0%	0%	No new borrowings in 2H13 and 2014-15
Dom FX bonds ²	-420	-1,913	-838	-1,836	706%	286%	800%	400%	Rollover ratios goes up sharply
Other	589	0	0	0	133%	0%	0%	0%	ICU assumption
Central bank									
Official lenders (IMF)	-2,665	-3,222	-1,061	-482	0%	0%	0%	0%	NBU pays back to IMF, no new borrowings
Other	34	0	0	1	0%	0%	0%	0%	ICU assumption
Banks									
Eurobonds	-1,065	-15	-772	-969	0%	7878%	0%	0%	No IMF, then banks do not borrow from Eurobond market
Other lenders	-13,031	-11,708	-9,518	-7,258	70%	71%	76%	81%	European banks continue withdrawing, at lower pace each year
Corporations									
Eurobonds	-225	0	-1,645	-1,785	244%	N/M*	0%	0%	No IMF, then corps do not borrow from Eurobond market
Loans	-11,762	-11,160	-11,579	-12,199	130%	125%	130%	120%	ICU assumption: pick-up in 2014, retreat in 2015
Trade loans	-17,579	-21,140	-22,249	-23,441	130%	125%	130%	120%	The same as above
Other	-8,960	-10,644	-10,081	-10,621	130%	125%	130%	120%	The same as above
Demand for foreign ccy, net	-7,537	-6,891	-9,130	-7,000					ICU assumption
Total financing needs⁴	-80,650	-80,726	-81,905	-77,678					
FDI, net	6,788	5,142	5,767	6,195					ICU forecast for the period
Borrowings									
Government	7,027	7,729	6,701	7,345					ICU calculations based on debt due this year and roll-over ratios
Central bank	0	0	0	0					ICU calculations based on debt due this year and roll-over ratios
Banks	9,092	9,518	7,258	5,898					ICU calculations based on debt due this year and roll-over ratios
Corporations	50,494	54,180	57,082	55,512					ICU calculations based on debt due this year and roll-over ratios
Total financing⁵	73,402	76,568	76,808	74,950					
FX reserves change	-7,249	-4,157	-5,097	-2,728					
FX RESERVES									
At the start of year	31,795	24,546	20,389	15,292					
At the end of year	24,546	20,389	15,292	12,564					
Change (%YoY)	-22.8	-16.9	-25.0	-17.8					
FX reserves (% of GDP)									
At the start of year	18.2	14.1	11.6	8.3					
At the end of year	14.1	11.6	8.3	6.5					
Change (ppt)	-4.2	-2.5	-3.3	-1.9					
FX res.imports cov⁶ (mth)									
At the start of year	3.6	2.8	2.5	1.9					
At the end of year	2.8	2.5	1.9	1.5					
Change (months)	-0.8	-0.3	-0.7	-0.3					

Notes: [1] Short-term debt due in next 12 month period since beginning of the respective year; [2] domestically issued bonds denominated in foreign currencies (USD and EUR), including USD-denominated Treasury Obligations; [3] N/M – not meaningful, this is because the rollover ratio cannot be applied to a volume that equals to zero, in fact we include into calculation the US\$0.5bn Eurobonds issued by Ukrzaliznytsia in May 2013;

[4] total financing needs equals to the sum of current account balance, short-term debt due next 12 months and demand for foreign currency by households;

[5] total financing equals to the sum of FDI and borrowings by all segments of the economy (government, central bank, banks and corporations);

[6] ratio of imports coverage by FX reserves, measured in months.

Sources: National Bank of Ukraine, Investment Capital Ukraine LLC.

View on UAH: Real appreciation will require nominal correction

Macroeconomic conditions

Internal and external conditions require a weakening of the nominal exchange rate of UAH versus the US dollar.

Weak economy requires monetary stimulus, which is to spur inflation and UAH real rate up...

Ukraine's stagnating economy is mired in deflation and, hence, high real interest rates due to inflexible monetary policy. It requires monetary stimulus, which, in our view, is under way as NBU is purchasing this year a total of UAH60bn of government debt (NBU bought half of this volume in 7M13). Such an injection of liquidity into the economy effectively will provide additional pressure on the UAH exchange rate. And authorities; first reaction to this move will be to impose more regulations that limit demand for FX and add FX supply (for instance, surrender requirement might be increased from current 50% to 75% and in the extreme to 100%). However, this will be a wasteful exercise as base money growth of 18% YoY this December, if maintained into 2014, is likely to spur inflation, causing the UAH real rate to appreciate further. Eventually, this will force authorities to allow a weaker nominal rate of UAH in order to restrain its real appreciation from moving into uncompetitive territory (as measured by ICU's TWIs, see Chart 51, pp.52).

...bringing forward the need for a UAH nominal rate correction

Global factors are negative to Ukraine's economy and UAH, too...

Several factors, like the Fed's indication that it will taper QE this fall, greater confidence among investors in the US economy and its faster recovery compared with other leading, developed-market economies, are resulting in a slow, upward move of the US dollar against the other currencies³⁷. This gradual rally of USD suggests that investors view the US economy to be on its way for sustainable recovery with monetary policy set to normalise, albeit gradually. Nevertheless, the current USD rally resembles the rally in the USD index seen in the second half of 1990s, which ended up with a series of crises in the EM world (South Korea, Russia, and Ukraine itself was forced to default)³⁸. For Ukraine, which did learn the lesson of the Asian crisis-hit countries, the current rally of the USD is a serious risk, which could result in balance of payments and fiscal crises, in our view, if authorities keep intact their rigid monetary policy.

...their effect may become acute, if ignored

ICU's trade-weighted indices

Future real rates of UAH are on an appreciating path

Our most recent forecast update of Ukraine's hryvnia TWIs for the period of 2H13 and 2014-15 under three scenarios yielded us the outcomes that are depicted in charts on pp. 52-53. Under base-case scenario UAH appreciates in real terms; however, it preserves its pro-growth negative misalignment with long-term average of 2-5% (Chart 51). Under a best-case scenario, UAH has a larger real undervaluation (its negative misalignment is bigger than under the base-case scenario). And under a worst-case scenario, UAH's real appreciation reaches 10% in 2014 and then corrects in early 2015 (Chart 53).

ICU's PPP observations

An update of ICU's purchasing-power-parity approach to UAH relative value routinely yields an undervalued UAH versus both the USD and RUB. More details on this are in the Appendix section on pp.67.

³⁷ USD index rose 11.5% between post-2008 crisis low of 72.933 points on 29 April 2011 and its most latest close at 81.287 points on 7 August 2013.

³⁸ Then USD index rallied by 27.8% between mid-90s low of 80.27 points on 18 April 1995 to 102.57 points on 26 August 1998.

Chart 51. UAH's TWIs in base-case scenario in 2000-13 and the 2014-15 forecast: Misalignment of real TWIs versus their 5yr averages (left) and USD/UAH nominal rate vs. the rates implied by ICU's UAH CPI- and PPI-based real TWIs (right)

Indices are rebased at 100 points on December 1999



Source: Investment Capital Ukraine LLC.

Hryvnia per US dollar



Sources: Bloomberg, Investment Capital Ukraine LLC.

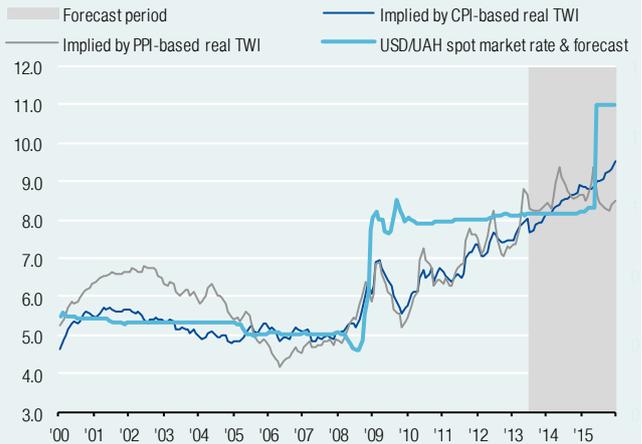
Chart 52. UAH's TWIs in worst-case scenario in 2000-13 and the 2014-15 forecast: Misalignment of real TWIs versus their 5yr averages (left) and USD/UAH nominal rate vs. the rates implied by ICU's UAH CPI- and PPI-based real TWIs (right)

Indices are rebased at 100 points on December 1999



Source: Investment Capital Ukraine LLC.

Hryvnia per US dollar



Sources: Bloomberg, Investment Capital Ukraine LLC.

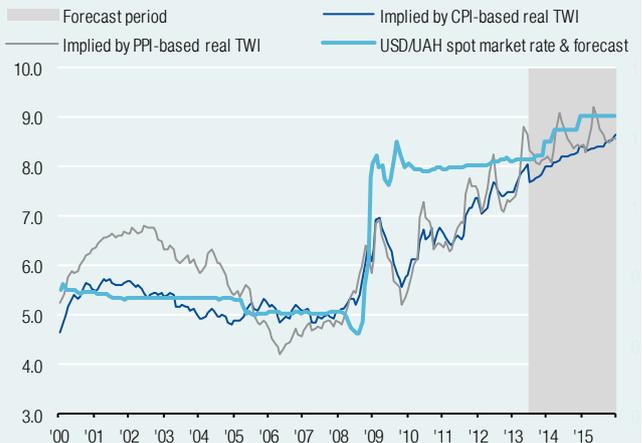
Chart 53. UAH's TWIs in best-case scenario in 2000-13 and the 2014-15 forecast: Misalignment of real TWIs versus their 5yr averages (left) and USD/UAH nominal rate vs. the rates implied by ICU's UAH CPI- and PPI-based real TWIs (right)

Indices are rebased at 100 points on December 1999



Source: Investment Capital Ukraine LLC.

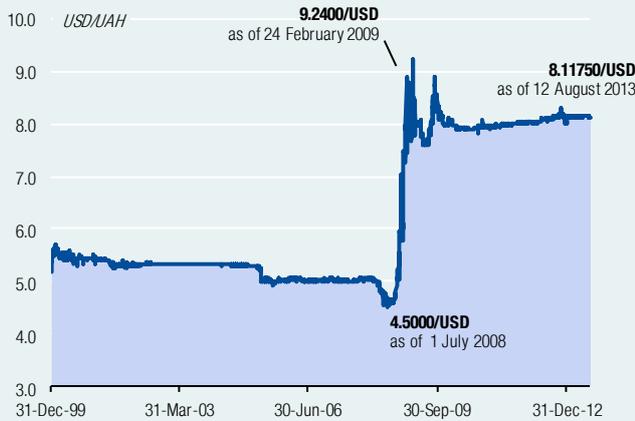
Hryvnia per US dollar



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 54. UAH exchange rate per USD set by the market

Daily history since 31 December 1999 through 12 August 2013



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 55. UAH nominal and CPI- and PPI-based real trade-weighted indices (TWIs), rebased at 100 points on 31 Dec 1999

Daily history since 31 December 1999 through 12 August 2013



Source: Investment Capital Ukraine LLC.

Chart 56. UAH TWIs misalignment to their 5yr and 10yr averages. Daily history since 19 August 2005 through 12 August 2013

UAH's TWIs less their 5-year rolling averages

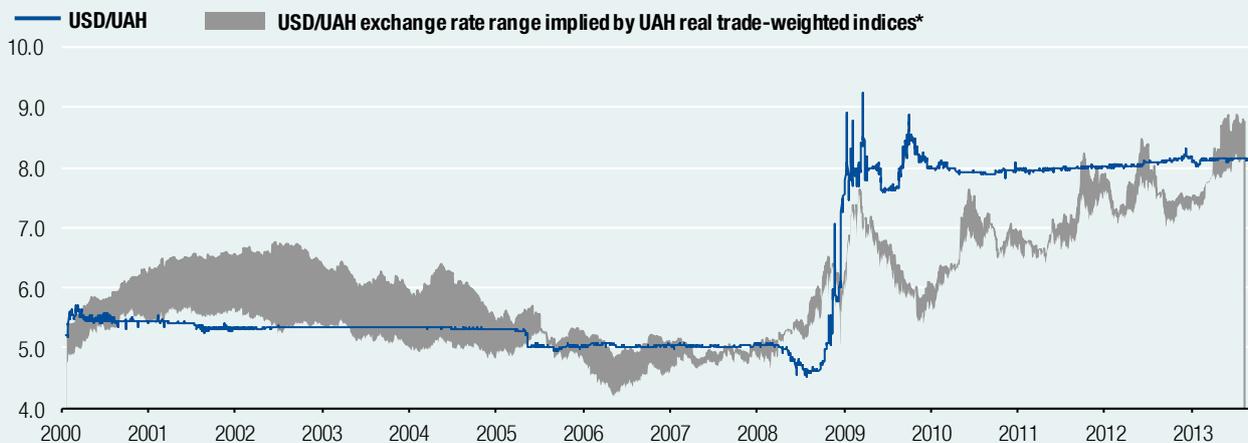


UAH's TWIs less their 10-year rolling averages*



Note: Data on 10-year rolling averages is available starting from 3 January 2005. Sources: Investment Capital Ukraine LLC.

Chart 57. USD/UAH exchange rate vs. the range of real-TWI-implied rates. Daily history since 19 August 2005 through 12 August 2013



Note: * The USD/UAH rate implied by UAH's real TWI is calculated by multiplying UAH/USD market exchange rate by the ratio of misalignment between the real TWI and its 5-year and 10-year long-term averages. The calculation is based on the four series of TWIs: CPI- and PPI based indices and their misalignment with 5-year and 10-year rolling averages of these indices. The grey-coloured area represents the range of exchange rates implied by real TWIs, where the daily high point is the highest implied rate out of the four series and similarly the daily low point is the lowest implied rate out of the four series. Source: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Forecast for 2013-15

The following two pages of statistics provide ICU's detailed view on future key macroeconomic indicators in yearly and quarterly perspectives.

Yearly forecast for 2013-15, base-case scenario

Table 4. Forecast of key macroeconomic indicators for 2013-15 (annual)

	Historical data for 2003-12										Forecast by ICU		
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012E	2013F	2014F	2015F
Activity													
Real GDP (%YoY)	9.6	12.1	2.7	7.3	7.9	2.3	-14.8	4.1	5.2	0.3	0.0	3.0	2.2
Nominal GDP (UAHbn)	267	345	441	544	721	948	913	1,083	1,302	1,409	1,436	1,575	1,734
Nominal GDP (US\$bn)	50	65	87	108	143	184	114	136	163	174	176	184	194
GDP per capita (US\$, ann)	1,044	1,371	1,850	2,319	3,091	3,982	2,474	2,977	3,573	3,830	3,869	4,038	4,265
Unemployment rate (%)	9.1	8.6	7.2	6.2	6.4	6.4	8.8	8.1	7.9	7.5	8.0	7.8	7.8
Prices													
CPI headline (%YoY, eop)	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	1.9	5.4	5.4
CPI headline (%YoY, average)	5.2	9.0	13.6	9.1	12.8	25.3	16.0	9.4	8.0	0.6	0.2	4.3	5.4
PPI (%YoY, eop)	11.2	24.3	9.6	15.4	23.2	21.1	15.3	18.8	17.4	0.4	2.5	6.6	6.2
PPI (%YoY, average)	7.8	20.3	17.0	9.6	20.5	33.6	7.4	21.4	19.9	6.0	-0.3	4.2	6.5
Fiscal balance													
Consolidated budget bal. (UAHbn)	-0.5	-9.9	-7.5	-3.5	-6.1	-11.3	-34.4	-63.3	-18.3	-46.9	-71.1	-84.1	-81.4
Consolidated budget bal. (% of GDP)	-0.2	-2.9	-1.7	-0.6	-0.8	-1.2	-3.8	-5.9	-1.4	-3.3	-5.0	-5.3	-4.7
Budget balance (UAHbn)	-1.0	-10.2	-7.9	-3.8	-9.8	-12.5	-35.5	-64.3	-23.6	-53.4	-60.0	-72.0	-70.7
Budget balance (% of GDP)	-0.4	-3.0	-1.8	-0.7	-1.4	-1.3	-3.9	-5.9	-1.8	-3.8	-4.2	-4.6	-4.1
External balance													
Exports (US\$bn)	29.0	41.3	44.4	50.2	64.0	85.6	54.3	69.3	88.8	89.8	86.4	87.6	89.6
Imports (US\$bn)	27.7	36.3	43.7	53.3	72.2	100.0	56.2	73.2	99.0	104.5	96.3	98.8	99.4
Trade balance (US\$bn)	1.3	5.0	0.7	-3.1	-8.2	-14.4	-2.0	-4.0	-10.2	-14.8	-9.9	-11.2	-9.8
Trade balance (% of GDP)	2.6	7.7	0.8	-2.8	-5.7	-7.8	-1.7	-2.9	-6.2	-8.5	-5.6	-6.1	-5.1
Current account balance (US\$bn)	2.9	6.9	2.5	-1.6	-5.3	-12.8	-1.7	-3.0	-10.2	-14.8	-10.4	-11.5	-10.0
Current account balance (% of GDP)	5.8	10.6	2.9	-1.5	-3.7	-6.9	-1.5	-2.2	-6.3	-8.5	-5.9	-6.2	-5.2
Net FDI (US\$bn)	1.4	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.8	5.1	5.8	6.2
Net FDI (% of GDP)	2.8	2.6	8.7	5.3	6.4	5.4	4.1	4.2	4.3	3.9	2.9	3.1	3.2
C/A bal. + net FDI (% of GDP)	8.6	13.3	11.6	3.8	2.8	-1.6	2.6	2.0	-2.0	-4.6	-3.0	-3.1	-2.0
External debt (US\$bn, eop)	23.8	30.6	39.6	54.5	80.0	101.7	103.4	117.3	126.2	135.1	139.8	142.2	134.8
External debt (% of ann'd GDP, eop)	47.5	47.2	45.6	50.4	55.8	55.3	90.9	86.1	77.4	77.4	79.3	77.5	69.5
FX reserves (US\$bn, eop)	6.9	9.5	19.4	22.3	32.5	31.5	26.5	34.6	31.8	24.5	20.4	21.2	23.1
FX reserves (% of ann'd GDP, eop)	13.8	14.7	22.3	20.6	22.6	17.2	23.3	25.4	19.5	14.1	11.6	11.5	11.9
External debt / FX reserves (x, eop)	3.4	3.2	2.0	2.4	2.5	3.2	3.9	3.4	4.0	5.5	6.9	6.7	5.8
FX reserves imports cov (months)	3.6	3.8	6.4	6.1	6.4	4.5	7.1	6.8	4.5	3.3	2.5	2.6	2.8
Interest rates													
Central bank key rate (% eop)	7.00	9.00	9.50	8.50	8.00	12.00	10.25	7.75	7.75	7.50	6.50	7.00	7.00
3-month rate (% eop 4Q)	17.91	15.03	11.46	9.90	7.58	21.60	17.59	6.12	19.72	25.52	6.00	7.00	7.00
Exchange rates													
UAH trade-weighted index (nominal)	90.78	91.29	105.76	96.33	88.22	62.35	62.62	72.39	77.27	73.96	76.95	73.32	71.21
UAH trade-weighted index (real)	116.76	112.78	129.21	123.61	120.06	100.21	90.26	97.73	98.76	94.72	93.13	92.02	91.24
UAH/US\$ (eop)	5.33	5.31	5.05	5.05	5.05	7.80	8.00	7.97	8.00	0.00	8.20	8.75	9.00
UAH/US\$ (average)	5.33	5.32	5.10	5.03	5.03	5.25	8.03	7.95	8.16	8.68	8.16	8.56	8.93
UAH/€ (eop)	5.60	6.71	7.20	5.97	6.66	7.36	10.90	11.45	10.66	10.36	10.58	11.20	11.52
UAH/€ (average)	6.04	6.62	6.35	6.32	6.89	7.67	11.19	10.54	10.73	11.10	10.61	10.98	11.42
US\$/€ (eop)	1.26	1.36	1.18	1.32	1.46	1.40	1.43	1.34	1.30	0.00	1.29	1.28	1.28
US\$/€ (average)	1.13	1.24	1.24	1.26	1.37	1.47	1.39	1.33	1.32	1.28	1.30	1.28	1.28
Population													
Population (million, eop)	48.0	47.3	47.0	46.6	46.4	46.1	46.0	45.8	45.6	45.5	45.5	45.5	45.5
Population (%YoY)	-0.9	-1.4	-0.8	-0.7	-0.6	-0.5	-0.4	-0.4	-0.3	-0.2	-0.1	0.0	0.0

Notes: eop – end of period; cov – coverage; con'd – consolidated; ann – annualised.

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

Quarterly forecast for 2013-15, base-case scenario

Table 5. Forecast of key macroeconomic indicators for 2013-15 (quarterly)

	4Q12	1Q13	2Q13E	Quarterly forecast by ICU									
				3Q13F	4Q13F	1Q14F	2Q14F	3Q14F	4Q14F	1Q15F	2Q15F	3Q15F	4Q15F
Activity													
Real GDP (%YoY)	-2.5	-1.1	-1.1	0.6	1.7	2.5	2.0	3.5	4.0	2.0	1.5	2.5	2.8
Nominal GDP (UAHbn)	378.6	301.6	348.6	391.3	394.5	324.8	371.9	434.1	444.2	357.7	405.7	480.6	489.7
Nominal GDP (US\$bn)	46.6	37.2	42.8	48.0	48.1	38.9	43.8	50.2	50.8	40.6	45.6	53.4	54.4
GDP per capita (US\$, ann)	3,829	3,844	3,833	3,837	3,871	3,910	3,930	3,978	4,037	4,075	4,115	4,185	4,264
Unemployment rate (%)	7.5	8.0	8.0	8.2	8.0	7.8	7.8	7.8	7.8	7.7	7.8	7.8	7.8
Prices													
CPI headline (%YoY, eop)	-0.2	-0.8	-0.1	0.5	1.9	3.6	4.5	4.8	5.4	5.4	5.4	5.4	5.4
CPI headline (%YoY, average)	-0.1	-0.5	-0.4	0.2	1.5	3.0	4.3	4.7	5.2	5.4	5.4	5.4	5.4
PPI (%YoY, eop)	0.4	0.1	-1.6	-2.3	2.5	4.7	-0.2	5.9	6.6	5.1	8.8	7.2	6.2
PPI (%YoY, average)	0.3	0.2	-0.3	-2.0	0.9	4.7	0.7	4.9	6.6	5.6	6.5	7.8	6.3
Fiscal balance													
Consolidated budget bal. (UAHbn)	-29.2	-5.2	-22.3	-23.3	-20.3	-1.3	-20.4	-23.1	-39.3	0.8	-21.0	-21.8	-39.4
Consolidated budget bal. (% of GDP)	-7.7	-1.7	-6.4	-6.0	-5.1	-0.4	-5.5	-5.3	-8.9	0.2	-5.2	-4.5	-8.1
Budget balance (UAHbn)	-29.0	-4.5	-18.2	-19.6	-17.6	-2.5	-17.4	-19.6	-32.5	-1.1	-18.0	-18.8	-32.8
Budget balance (% of GDP)	-7.7	-1.5	-5.2	-5.0	-4.5	-0.8	-4.7	-4.5	-7.3	-0.3	-4.4	-3.9	-6.7
External balance													
Exports (US\$bn)	22.7	20.3	20.9	22.0	23.2	20.8	21.4	21.9	23.5	21.5	21.9	22.1	24.1
Imports (US\$bn)	27.5	22.6	22.3	25.0	26.4	24.0	23.6	24.3	26.9	24.6	23.7	24.5	26.6
Trade balance (US\$bn)	-4.7	-2.3	-1.4	-3.0	-3.2	-3.3	-2.1	-2.4	-3.4	-3.1	-1.7	-2.4	-2.6
Trade balance (% of GDP)	-10.2	-6.2	-3.3	-6.2	-6.6	-8.4	-4.9	-4.8	-6.6	-7.7	-3.8	-4.5	-4.8
Current account balance (US\$bn)	-4.9	-2.2	-1.6	-3.5	-3.3	-3.2	-2.1	-2.7	-3.4	-3.1	-1.7	-2.6	-2.6
Current account balance (% of GDP)	-10.5	-5.9	-3.6	-7.2	-6.8	-8.3	-4.7	-5.4	-6.8	-7.7	-3.7	-4.8	-4.8
Net FDI (US\$bn)	1.9	0.8	1.1	1.6	1.6	1.3	1.3	1.5	1.6	1.5	1.5	1.6	1.7
Net FDI (% of GDP)	4.0	2.2	2.5	3.3	3.4	3.3	3.0	3.0	3.2	3.6	3.2	2.9	3.1
C/A bal. + net FDI (% of GDP)	-6.4	-3.6	-1.1	-3.9	-3.3	-5.1	-1.7	-2.3	-3.5	-4.1	-0.5	-1.9	-1.8
External debt (US\$bn, eop)	135.1	136.3	137.2	138.5	139.8	139.9	141.0	140.6	142.2	133.7	132.6	133.1	134.8
External debt (% of ann'd GDP, eop)	77.4	77.8	78.6	79.3	79.3	78.6	78.8	77.7	77.5	72.1	70.8	69.9	69.5
FX reserves (US\$bn, eop)	24.5	23.5	22.4	21.4	20.4	20.6	20.8	21.0	21.2	21.7	22.2	22.7	23.1
FX reserves (% of ann'd GDP, eop)	14.1	13.4	12.8	12.3	11.6	11.6	11.6	11.6	11.5	11.7	11.8	11.9	11.9
External debt / FX reserves (x, eop)	5.5	5.8	6.1	6.5	6.9	6.8	6.8	6.7	6.7	6.2	6.0	5.9	5.8
FX reserves imports cov (months)	2.8	2.7	2.7	2.6	2.5	2.5	2.5	2.6	2.6	2.6	2.7	2.7	2.8
Interest rates													
Central bank key rate (% eop)	7.50	7.50	7.00	6.50	6.50	6.50	6.50	6.50	7.00	7.00	7.00	7.00	7.00
3-month rate (% eop 4Q)	25.52	13.38	9.56	7.00	6.00	6.00	6.00	6.00	7.00	7.00	7.00	7.00	7.00
Exchange rates													
UAH trade-weighted index (nominal)	73.96	74.53	75.89	76.87	76.95	75.86	75.06	74.17	73.32	72.43	71.62	71.21	71.21
UAH trade-weighted index (real)	94.72	97.01	98.00	92.36	93.13	91.94	91.69	90.99	92.02	90.67	90.02	89.53	91.24
UAH/US\$ (eop)	8.05	8.14	8.16	8.15	8.20	8.35	8.50	8.65	8.75	8.80	8.90	9.00	9.00
UAH/US\$ (average)	8.12	8.11	8.14	8.15	8.20	8.35	8.50	8.65	8.75	8.80	8.90	9.00	9.00
UAH/€ (eop)	10.62	10.43	10.61	10.60	10.58	10.77	10.88	11.07	11.20	11.26	11.39	11.52	11.52
UAH/€ (average)	11.26	11.39	10.74	10.60	10.58	10.77	10.88	11.07	11.20	11.26	11.39	11.52	11.52
US\$/€ (eop)	1.32	1.28	1.30	1.30	1.29	1.29	1.28	1.28	1.28	1.28	1.28	1.28	1.28
US\$/€ (average)	1.30	1.32	1.32	1.30	1.29	1.29	1.28	1.28	1.28	1.28	1.28	1.28	1.28
Population													
Population (million, eop)	45.55	45.51	45.51	45.50	45.49	45.49	45.48	45.48	45.47	45.51	45.51	45.50	45.49
Population (%YoY)	-0.2	-0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	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, National Bank of Ukraine, Investment Capital Ukraine LLC.

Appendices: Thematic charts & tables

The following pages contain the details charted and tabled data for the appropriate sections in this report.

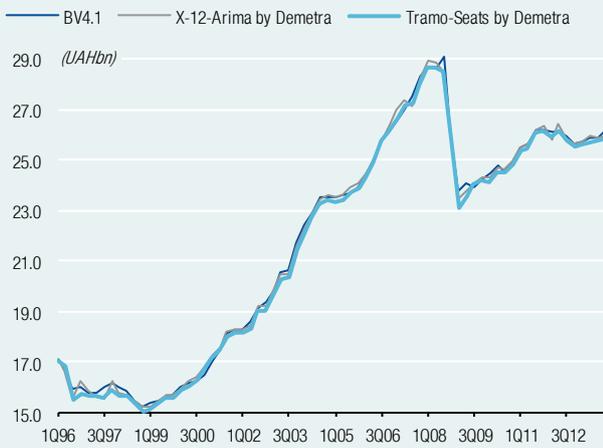
Quarterly GDP: Reported statistics and ICU's calculations

Chart 58. Ukraine's economy from the perspective of quarterly GDP volumes (left) and on-quarter growth rates (right)

History from 1Q96 till 1Q13 forecast 2Q-4Q of 2013.

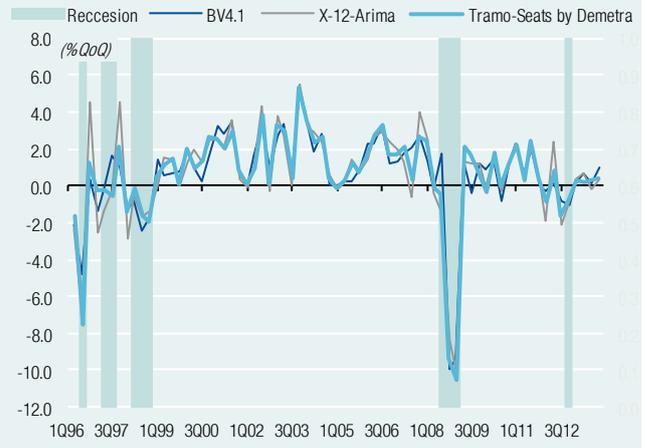
Data is adjusted for inflation and seasonal factors. data is seasonally adjusted by three methods BV4.1, X-12 Arima and Tramo-Seats

Quarterly GDP size in constant prices of Dec-95



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

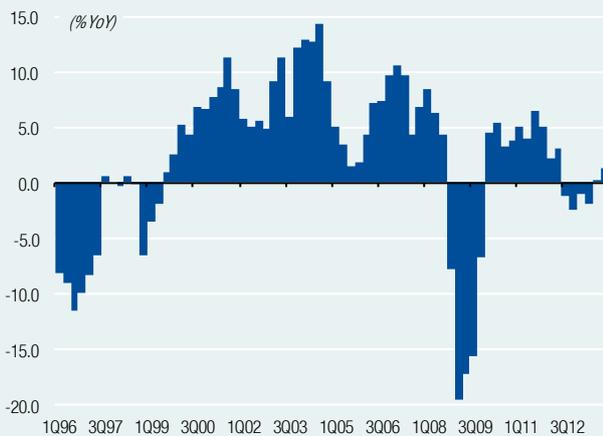
Quarterly GDP growth rates (% QoQ)



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

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

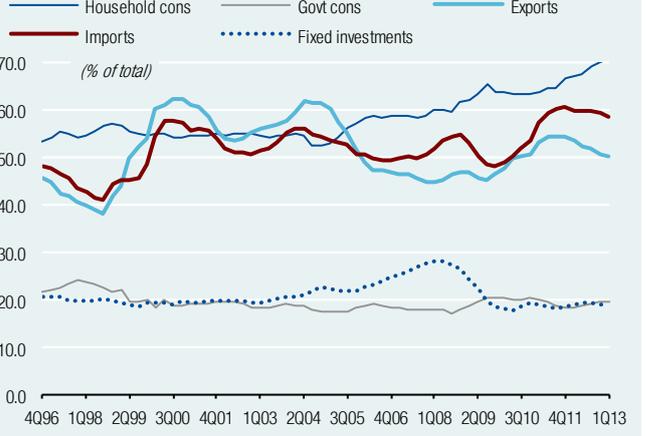
History from 1Q 1996 till 1Q 2013; forecast for 2Q-4Q of 2013



Source: State Statistics Service of Ukraine.

Chart 60. Demand-side components of GDP (% of total, LTM)

History from 4Q 1996 till 1Q 2013



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

Chart 61. Ukraine vs. selected economies of: How they have been recovering from the 2008 economic crisis



Note: Rebased at 100 points as of end of 3Q of 2008. Sources: Bloomberg, Investment Capital Ukraine LLC.



Table 6. Ukraine quarterly GDP size: History from 4Q96 till 2Q13 (UAHm, if not otherwise indicated)

Reported statistics and ICU calculations of quarter-on-quarter growth in real and seasonally-adjusted terms

Period	Reported statistics on quarterly GDP				ICU calculations							
	GDP at current prices (UAHm)	Real growth (% YoY, qly)	Real growth (% QoQ, SA)	Deflator (% YoY)	Real growth (% YoY, ann'd)	GDP at cons prices ¹ (UAHm, NSA)	GDP at cons prices ¹ (UAHm, SA)			Real GDP growth (%QoQ, SA)		
							BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra	BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra
4Q96	24,454	-10.0		40.1	-9.7	17,404	16,075	16,228	15,824	0.8	4.6	0.8
1Q97	18,728	-8.3		22.3	-9.8	14,114	15,777	15,780	15,779	-1.9	-2.8	-0.3
2Q97	20,485	-6.6		22.7	-9.1	14,117	15,758	15,586	15,750	-0.1	-1.2	-0.2
3Q97	26,076	0.5		15.3	-6.2	17,544	16,049	15,531	15,687	1.8	-0.4	-0.4
4Q97	28,076	0.0		14.8	-3.7	17,405	16,122	16,258	15,984	0.5	4.7	1.9
1Q98	20,871	-0.3		11.8	-1.6	14,068	16,011	15,744	15,762	-0.7	-3.2	-1.4
2Q98	23,367	0.5		13.5	0.2	14,188	15,795	15,701	15,724	-1.4	-0.3	-0.2
3Q98	28,908	-0.1		10.9	0.0	17,538	15,379	15,435	15,479	-2.6	-1.7	-1.6
4Q98	29,447	-6.6		12.3	-1.7	16,256	15,177	15,236	15,165	-1.3	-1.3	-2.0
...
2Q05	101,707	3.5		25.1	7.9	21,484	23,617	23,575	23,470	0.2	0.1	0.4
3Q05	122,861	1.5		21.8	4.7	27,306	23,703	23,905	23,766	0.4	1.4	1.3
4Q05	128,780	1.9		26.3	3.0	25,257	23,918	24,111	23,924	0.9	0.9	0.7
1Q06	106,348	4.3		15.7	2.8	21,937	24,462	24,475	24,338	2.3	1.5	1.7
2Q06	126,319	7.2		15.9	3.7	23,023	25,044	25,100	24,979	2.4	2.6	2.6
3Q06	152,406	7.3		15.6	5.2	29,301	25,837	25,843	25,770	3.2	3.0	3.2
4Q06	159,080	9.6		12.8	7.1	27,659	26,172	26,451	26,204	1.3	2.4	1.7
1Q07	139,444	10.6		18.6	8.7	24,253	26,529	26,998	26,665	1.4	2.1	1.8
2Q07	166,869	9.7		20.4	9.3	25,260	26,996	27,339	27,227	1.8	1.3	2.1
3Q07	199,535	4.4		25.4	8.5	30,592	27,572	27,165	27,334	2.1	-0.6	0.4
4Q07	214,883	6.9		26.4	7.9	29,558	28,299	28,236	28,067	2.6	3.9	2.7
1Q08	191,459	8.5		26.6	7.4	26,303	28,656	28,975	28,709	1.3	2.6	2.3
2Q08	236,033	6.2		33.2	6.5	26,824	28,598	28,844	28,716	-0.2	-0.4	0.0
3Q08	276,451	4.3		32.9	6.5	31,892	29,106	28,418	28,633	1.8	-1.5	-0.3
4Q08	244,113	-7.8		23.3	2.6	27,233	26,178	26,045	25,915	-10.1	-8.3	-9.5
1Q09	189,028	-19.6		22.8	-4.8	21,148	23,756	23,506	23,154	-9.3	-9.7	-10.7
2Q09	214,103	-17.3		9.7	-10.6	22,181	24,041	23,746	23,651	1.2	1.0	2.1
3Q09	250,306	-15.7		7.4	-15.2	26,886	23,944	24,023	24,067	-0.4	1.2	1.8
4Q09	259,908	-6.7		14.1	-15.0	25,412	24,229	24,343	24,239	1.2	1.3	0.7
1Q10	217,286	4.5	0.7	10.7	-9.2	21,959	24,448	24,394	24,153	0.9	0.2	-0.4
2Q10	256,754	5.4	1.4	15.1	-3.5	23,110	24,801	24,654	24,575	1.4	1.1	1.7
3Q10	301,251	3.3	0.4	17.5	1.5	27,539	24,580	24,621	24,575	-0.9	-0.1	0.0
4Q10	307,278	3.7	0.7	15.6	4.2	25,989	24,888	24,966	24,873	1.3	1.4	1.2
1Q11	257,682	5.1	2.0	12.9	4.4	23,066	25,480	25,621	25,420	2.4	2.6	2.2
2Q11	311,022	3.9	0.3	16.6	4.0	24,009	25,636	25,552	25,470	0.6	-0.3	0.2
3Q11	369,818	6.5	2.5	15.2	4.8	29,347	26,161	26,217	26,111	2.0	2.6	2.5
4Q11	363,557	5.0	0.3	12.6	5.1	27,309	26,184	26,364	26,200	0.1	0.6	0.3
1Q12	293,493	2.2	-0.8	11.4	4.4	23,584	26,075	25,924	26,010	-0.4	-1.7	-0.7
2Q12	349,212	3.0	0.5	9.0	4.2	24,731	26,117	26,246	26,122	0.2	1.2	0.4
3Q12	387,620	-1.3	-1.5	6.2	2.2	28,963	25,947	25,919	25,798	-0.7	-1.2	-1.2
4Q12	378,564	-2.5	-0.8	6.8	0.3	26,626	25,712	25,723	25,668	-0.9	-0.8	-0.5
1Q13	301,598	-1.1	0.6	3.9	-0.5	23,324	25,693	25,901	25,741	-0.1	0.7	0.3
2Q13	348,585 ²	-1.1	-0.4	0.9 ²	-1.5	24,459	25,969	25,914	25,731	1.1	0.1	-0.04

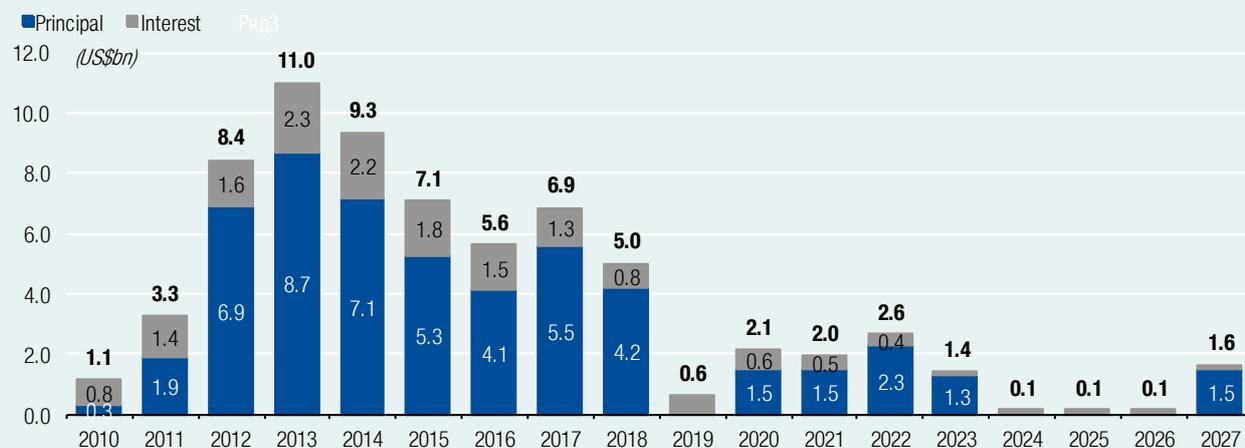
Notes: [1] at constant prices of December 1995; SA – seasonally adjusted data; NSA --- non-seasonally adjusted data; [2] estimated by ICU.

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

Sovereign external debt: Yearly data on debt due in 2013-27

Yearly breakdown of sovereign and quasi-sovereign external debt (charts)

Chart 62. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by cash flow type (US\$bn)



Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 63. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by ultimate borrower (US\$bn)



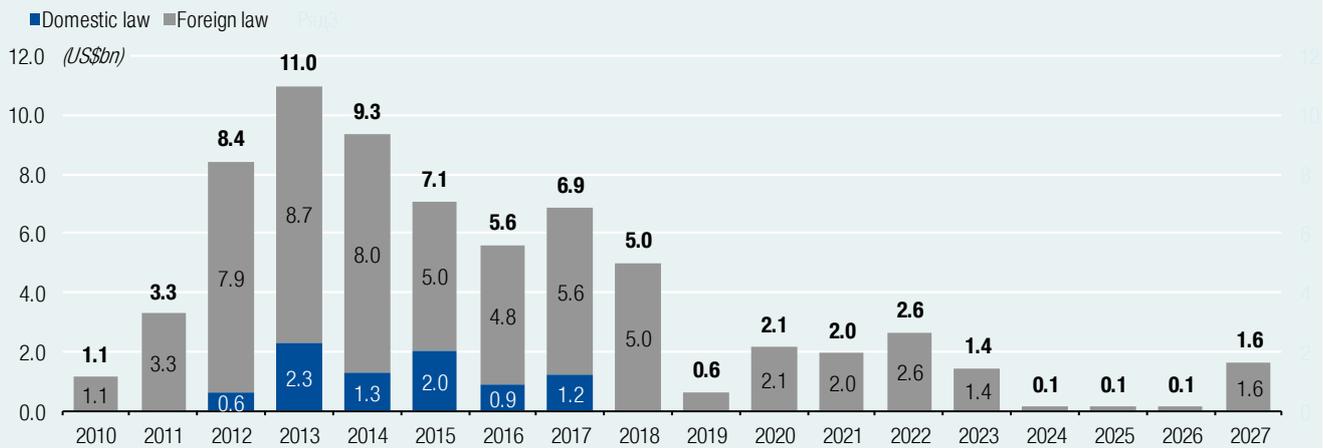
Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 64. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by ultimate borrower (US\$bn)



Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 65. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by governing law (US\$bn)



Notes: Debt raised under domestic law means government bonds in foreign currencies issued at the domestic bond market.
Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 66. Ukraine's sovereign and quasi-sovereign external debt due in 2013-27: Increase of debt over past 6 months (US\$bn)



Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Yearly breakdown of sovereign and quasi-sovereign external debt (tables)

Table 7. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US\$m)

By type of debt instrument, data as of 14 August 2013

Year	Principal re-payments							Interest payments							Grand Total
	Sovrgn Euro-bonds ¹	Muni-cipal Euro-bonds ²	Corpo-rate Euro-bonds ³	Local bonds ⁴	Local retail bonds ⁵	Loans ⁶	Total	Sovrgn Euro-bonds ¹	Muni-cipal Euro-bonds ²	Corpo-rate Euro-bonds ³	Local bonds ⁴	Local retail bonds ⁵	Loans ⁶	Total	
2013	1,000	0	0	1,912	0	5,784	8,696	1,081	20	493	372	17	298	2,281	10,977
2014	1,000	0	1,595	738	200	3,603	7,137	1,050	20	561	344	17	217	2,208	9,345
2015	1,222	250	750	1,817	0	1,222	5,261	1,010	20	378	219	0	180	1,806	7,067
2016	2,250	300	825	734	0	0	4,109	897	0	314	118	0	170	1,499	5,608
2017	3,300	0	1,088	1,155	0	0	5,543	793	0	281	64	0	170	1,308	6,851
2018	0	0	2,190	0	0	2,000	4,190	505	0	93	0	0	212	811	5,001
2019	0	0	0	0	0	0	0	505	0	0	0	0	127	632	632
2020	1,500	0	0	0	0	0	1,500	505	0	0	0	0	128	633	2,133
2021	1,500	0	0	0	0	0	1,500	329	0	0	0	0	127	456	1,956
2022	2,250	0	0	0	0	0	2,250	269	0	0	0	0	127	397	2,647
2023	1,250	0	0	0	0	0	1,250	47	0	0	0	0	127	174	1,424
2024	0	0	0	0	0	0	0	0	0	0	0	0	128	128	128
2025	0	0	0	0	0	0	0	0	0	0	0	0	127	127	127
2026	0	0	0	0	0	0	0	0	0	0	0	0	127	127	127
2027	0	0	0	0	0	1,500	1,500	0	0	0	0	0	127	127	1,627
Total	15,272	550	6,448	6,357	200	14,109	42,936	6,989	60	2,119	1,117	34	2,396	12,715	55,651

Notes: [1] sovereign Eurobonds; [2] municipal Eurobonds issued by City of Kyiv, which are considered as quasi-sovereign external debt; [3] corporate Eurobonds issued by state-run banks and non-bank entities, which are considered as quasi-sovereign external debt; [4] foreign-currency sovereign bonds issued on the domestic bond market; [5] USD-denominated sovereign bonds issued domestically with special purpose to be sold to retail investors; [6] IMF loans extended to MoF and NBU.

Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Table 8. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US\$m)

By ultimate borrower, data as of 14 August 2013

Year	Principal re-payments										Interest payments										Total	
	MoF	NBU	Kyiv ¹	Nafto-gaz	Ukr-Inf ²	Osch-ad-bank	Ukr-exim-bank	Ukr-zaliz-nytsia	Food& Grain ³	Total	MoF	NBU	Kyiv ¹	Nafto-gaz	Ukr-Inf ²	Osch-ad-bank	Ukr-exim-bank	Ukr-zaliz-nytsia	Food& Grain ³	Total		
2013	5,487	3,209	0	0	0	0	0	0	0	8,696	1,545	54	20	322	146	80	92	24	0	2,281	10,977	
2014	4,491	1,050	0	1,595	0	0	0	0	0	7,137	1,442	16	20	322	146	102	114	48	0	2,208	9,345	
2015	3,784	477	250	0	0	0	750	0	0	5,261	1,235	4	20	170	146	102	82	48	0	1,806	7,067	
2016	2,984	0	300	0	0	700	125	0	0	4,109	1,015	0	0	170	146	73	47	48	0	1,499	5,608	
2017	4,455	0	0	0	1,088	0	0	0	0	5,543	857	0	0	170	146	44	44	48	0	1,308	6,851	
2018	0	0	0	2,000	690	500	500	500	0	4,190	505	0	0	85	26	22	22	24	127	811	5,001	
2019	0	0	0	0	0	0	0	0	0	0	505	0	0	0	0	0	0	0	0	127	632	632
2020	1,500	0	0	0	0	0	0	0	0	1,500	505	0	0	0	0	0	0	0	0	128	633	2,133
2021	1,500	0	0	0	0	0	0	0	0	1,500	329	0	0	0	0	0	0	0	0	127	456	1,956
2022	2,250	0	0	0	0	0	0	0	0	2,250	269	0	0	0	0	0	0	0	0	127	397	2,647
2023	1,250	0	0	0	0	0	0	0	0	1,250	47	0	0	0	0	0	0	0	0	127	174	1,424
2024	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	128	128	128
2025	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	127	127	127
2026	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	127	127	127
2027	0	0	0	0	0	0	0	0	1,500	1,500	0	0	0	0	0	0	0	0	0	127	127	1,627
Total	27,702	4,736	550	3,595	1,778	1,200	1,375	500	1,500	42,936	8,252	73	60	1,238	754	424	401	238	1,276	12,715	55,651	

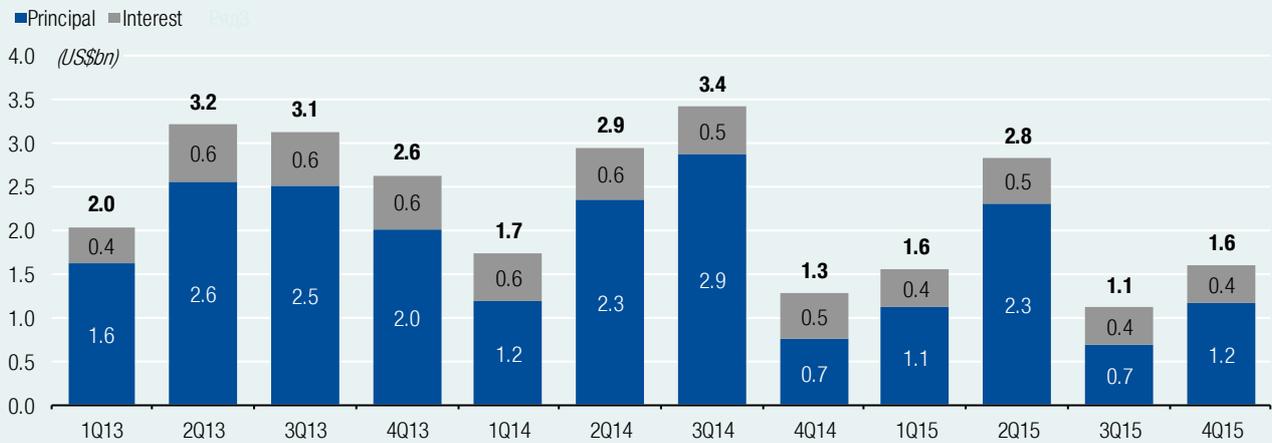
Notes: Notes: [1] City of Kyiv; [2] Financing of Infrastructural Projects (Bloomberg code: UKRINF); [3] State Food and Grain Corporation.

Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Sovereign external debt: Quarterly data on debt due in 2013-15

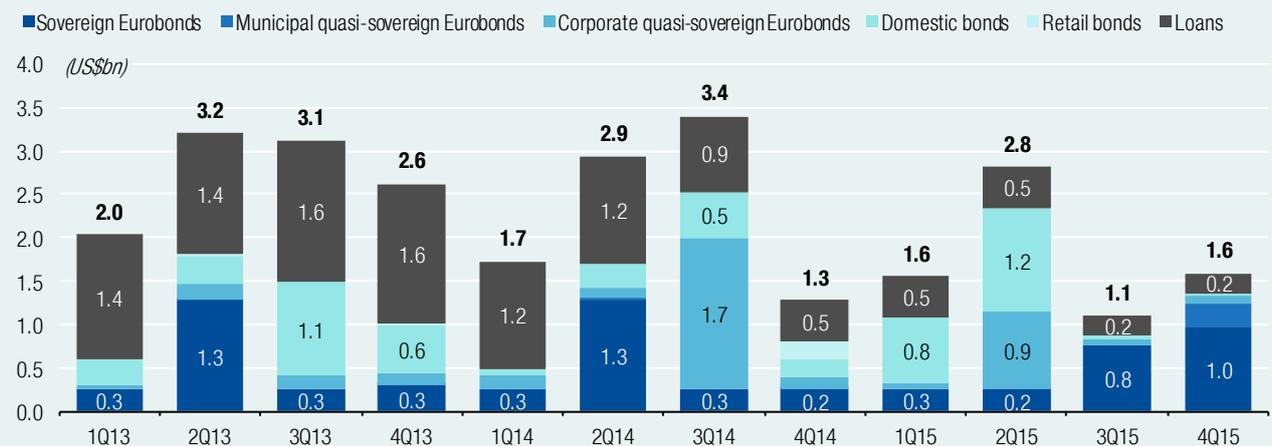
Yearly breakdown of sovereign and quasi-sovereign external debt (charts)

Chart 67. Ukraine's sovereign and quasi-sovereign external debt due in 2013-15: Qtlly breakdown by type of cash flow (US\$bn)



Note: Qtlly stands for quarterly. Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 68. Ukraine's sovereign and quasi-sovereign external debt due in 2013-15: Qtlly breakdown by type of debt instrument (US\$bn)



Note: Qtlly stands for quarterly. Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 69. Ukraine's sovereign and quasi-sovereign external debt due in 2013-15 : Qtlly breakdown by ultimate borrower (US\$bn)



Note: Qtlly stands for quarterly. Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Quarterly breakdown of sovereign and quasi-sovereign external debt (tables)

Table 9. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US\$m)

By type of debt instrument, data as of 10 July 2013

Year	Principal re-payments							Interest payments							Grand Total
	Sovrgn Euro-bonds ¹	Muni Euro-bonds ²	Corp Euro-bonds ³	Local bonds ⁴	Local retail bonds ⁵	Loans ⁶	Total	Sovrgn Euro-bonds ¹	Muni Euro-bonds ²	Corp Euro-bonds ³	Local bonds ⁴	Local retail bonds ⁵	Loans ⁶	Total	
1Q13	0	0	0	261	0	1,350	1,611	255	0	32	51	0	83	422	2,033
2Q13	1,000	0	0	235	0	1,323	2,558	281	10	180	88	9	77	645	3,203
3Q13	0	0	0	960	0	1,555	2,515	255	0	152	122	0	72	602	3,117
4Q13	0	0	0	457	0	1,555	2,012	289	10	128	111	9	66	613	2,625
Ttl 2013	1,000	0	0	1,912	0	5,784	8,696	1,081	20	493	372	17	298	2,281	10,977
1Q14	0	0	0	0	0	1,179	1,179	255	0	152	84	0	61	552	1,731
2Q14	1,000	0	0	171	0	1,179	2,350	289	10	128	92	9	56	584	2,934
3Q14	0	0	1,595	446	0	822	2,862	255	0	152	84	0	52	543	3,405
4Q14	0	0	0	122	200	423	745	250	10	128	84	9	49	529	1,274
Ttl 2014	1,000	0	1,595	738	200	3,603	7,137	1,050	20	561	344	17	217	2,208	9,345
1Q15	0	0	0	686	0	423	1,109	255	0	77	66	0	47	445	1,554
2Q15	0	0	750	1,129	0	423	2,302	250	10	128	79	0	45	512	2,814
3Q15	500	0	0	2	0	188	690	255	0	77	39	0	44	414	1,104
4Q15	722	250	0	0	0	188	1,160	250	10	97	35	0	43	434	1,594
Ttl 2015	1,222	250	750	1,817	0	1,222	5,261	1,010	20	378	219	0	180	1,806	7,067

Notes: [1] sovereign Eurobonds; [2] municipal Eurobonds issued by City of Kyiv, which are considered as quasi-sovereign external debt; [3] corporate Eurobonds issued by state-run banks and non-bank entities, which are considered as quasi-sovereign external debt; [4] foreign-currency sovereign bonds issued on the domestic bond market; [5] USD-denominated sovereign bonds issued domestically with special purpose to be sold to retail investors; [6] IMF loans extended to MoF and NBU.

Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Table 10. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US\$m)

By ultimate borrower, data as of 10 July 2013

Year	Principal re-payments									Interest payments								Grand Total	
	MoF	NBU	Kyiv ¹	Nafto-gaz	Ukr-Inf ²	Osch-ad-bank	Ukr-exim-bank	Ukr-zaliz-nytsia	Total	MoF	NBU	Kyiv ¹	Nafto-gaz	Ukr-Inf ²	Osch-ad-bank	Ukr-exim-bank	Ukr-zaliz-nytsia		Total
1Q13	851	760	0	0	0	0	0	0	1,611	329	18	0	43	0	29	4	0	422	2,033
2Q13	1,812	746	0	0	0	0	0	0	2,558	397	15	10	118	73	0	31	0	645	3,203
3Q13	1,664	851	0	0	0	0	0	0	2,515	395	12	0	118	0	51	25	0	602	3,117
4Q13	1,161	851	0	0	0	0	0	0	2,012	424	9	10	43	73	0	31	24	613	2,625
Ttl 2013	5,487	3,209	0	0	0	0	0	0	8,696	1,545	54	20	322	146	80	92	24	2,281	10,977
1Q14	827	352	0	0	0	0	0	0	1,179	351	6	0	118	0	51	25	0	552	1,731
2Q14	1,998	352	0	0	0	0	0	0	2,350	399	4	10	43	73	0	31	24	584	2,934
3Q14	1,094	173	0	1,595	0	0	0	0	2,862	345	3	0	118	0	51	25	0	543	3,405
4Q14	572	173	0	0	0	0	0	0	745	346	2	10	43	73	0	31	24	529	1,274
Ttl 2014	4,491	1,050	0	1,595	0	0	0	0	7,137	1,442	16	20	322	146	102	114	48	2,208	9,345
1Q15	936	173	0	0	0	0	0	0	1,109	324	2	0	43	0	51	25	0	445	1,554
2Q15	1,379	173	0	0	0	0	750	0	2,302	331	1	10	43	73	0	31	24	512	2,814
3Q15	625	65	0	0	0	0	0	0	690	295	0	0	43	0	51	25	0	414	1,104
4Q15	844	65	250	0	0	0	0	0	1,160	285	0	10	43	73	0	0	24	434	1,594
Ttl 2015	3,784	477	250	0	0	0	750	0	5,261	1,235	4	20	170	146	102	82	48	1,806	7,067

Notes: Notes: [1] City of Kyiv; [2] Financing of Infrastructural Projects (Bloomberg code: UKRINF).

Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Ukraine vs. other countries: Evolution of corporate tax rate in 2006-13

Table 11. Ukraine versus selected economies: Evolution of corporate tax rates between 2006 and 2013 (%)

Location	2006	2007	2008	2009	2010	2011	2012	2013
Argentina	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0
Armenia	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Aruba	35.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
Australia	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Belarus	24.0	24.0	24.0	24.0	24.0	24.0	18.0	18.0
Brazil	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0
Bulgaria	15.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
China	33.0	33.0	25.0	25.0	25.0	25.0	25.0	25.0
Czech Republic	24.0	24.0	21.0	20.0	19.0	19.0	19.0	19.0
Egypt	20.0	20.0	20.0	20.0	20.0	20.0	25.0	25.0
Estonia	23.0	22.0	21.0	21.0	21.0	21.0	21.0	21.0
Finland	26.0	26.0	26.0	26.0	26.0	26.0	24.5	24.5
France	33.3	33.3	33.3	33.3	33.3	33.3	33.3	33.3
Georgia	N/A	15.0						
Germany	38.3	38.4	29.5	29.4	29.4	29.4	29.5	29.6
Greece	29.0	25.0	25.0	25.0	24.0	20.0	20.0	26.0
Hungary	16.0	16.0	16.0	16.0	19.0	19.0	19.0	19.0
Kazakhstan	30.0	30.0	30.0	20.0	20.0	20.0	20.0	20.0
Korea, Republic of	27.5	27.5	27.5	24.2	24.2	22.0	24.2	24.2
Latvia	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Lithuania	15.0	15.0	15.0	20.0	15.0	15.0	15.0	15.0
Mexico	29.0	28.0	28.0	28.0	30.0	30.0	30.0	30.0
Philippines	35.0	35.0	35.0	30.0	30.0	30.0	30.0	30.0
Poland	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Romania	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0
Russia	24.0	24.0	24.0	20.0	20.0	20.0	20.0	20.0
Serbia	10.0	10.0	10.0	10.0	10.0	10.0	10.0	15.0
Singapore	20.0	20.0	18.0	18.0	17.0	17.0	17.0	17.0
Slovak Republic	19.0	19.0	19.0	19.0	19.0	19.0	19.0	23.0
Slovenia	25.0	23.0	22.0	21.0	20.0	20.0	18.0	17.0
South Africa	36.9	36.9	34.6	34.6	34.6	34.6	34.6	28.0
Turkey	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Ukraine¹	25.0	25.0	25.0	25.0	25.0	25.0	21.0	19.0
United Kingdom	30.0	30.0	30.0	28.0	28.0	26.0	24.0	23.0
United States	40.0	40.0	40.0	40.0	40.0	40.0	40.0	40.0
Africa average	30.8	30.6	28.7	28.8	28.4	28.6	29.0	28.6
North America average	38.1	38.1	36.8	36.5	35.5	34.0	33.0	33.0
Asia average	29.0	28.5	28.0	25.7	24.0	23.1	22.9	22.4
Europe average	23.7	23.0	22.0	21.7	21.5	20.9	20.5	20.7
Latin America average	29.1	28.3	28.0	28.0	27.5	29.0	28.3	27.6
Oceania average	30.6	30.2	29.6	29.2	29.0	28.6	28.6	27.0
EU average	25.0	24.1	23.3	23.2	23.0	22.8	22.6	22.7
OECD average	27.7	27.0	26.1	25.7	25.8	25.5	25.2	25.4
Global average	27.5	27.0	26.1	25.4	24.7	24.5	24.4	24.1

Notes: [1] 16% since 1 January 2014.

Source: KPMG.

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

Table 12. ICU consumer basket as of end of July 2013

price observation in the urban areas of Ukraine, USA and Russia, i.e., in the countries' most populated cities – Kiev, New-York, and Moscow

Item of the basket	Description	Kiev, central district	New York metro- politan area	Moscow, central district
		31-Jul-13 Price (UAH)	30-Jul-13 Price (US\$)	31-Jul-13 Price (RUR)
Consumer goods				
Coca-cola (0.5 litre, plastic bottle)	Non-alcohol beverages	6.76	0.68	40.90
Beer Corona Extra (0.33 litre, glass bottle)	Alcoholic beverages	14.49	1.58	94.40
Bunch of fresh bananas (1 kg)	From Ecuador	11.99	1.52	39.90
Pack of milk (1 litre)	Locally produced, soft package, i.e., not glass bottle	8.07	2.03	64.90
Chicken meat (1 kg pack)	Locally produced and branded package, boneless breast	44.56	11.42	159.00
Canned pineapple (0.85 kg, can)	Pineapple circles, Dole brand	23.52	1.50	170.00
Pasta (0.5 kg)	Soft package, produced in Italy	14.30	2.12	62.90
Sugar (1 kg)		8.22	3.18	36.90
Package of table salt (0.5 kg)		10.03	0.71	13.30
Chicken eggs (10 units pack)	White eggs, standard size	10.46	2.60	83.90
Chocolate (100 g)	Made by Craft Foods Corp, Milka brand	9.66	2.15	57.38
Toothpaste (100ml package)	Colgate	23.98	2.00	120.00
Shampoo (200ml package)	Head & Shoulders brand, for normal hair	25.62	3.11	170.00
Toilet paper (4 rolls package)	Kleenex Cottonelle brand, white paper, Regular toilet tissue	18.36	4.32	98.90
Magazine	Men's Health, local edition, A4 format (standard one, not a pocket book format)	28.27	4.99	120.00
Gasoline (1 litre)	Lukiol, regular	11.14	1.07	32.02
Services				
Underground commute ticket	Within the central part of the city	2.00	2.25	30.00
Cinema ticket	Thursday's night price for the seat with good location, Hollywood film	40.00	12.00	350.00
Total basket value (in local currency)		311.43	59.23	1,744.40
Exchange rate versus US dollar at spot market as of date of observation		8.130	1.000	33.004
Total basket value (in US\$)		38.31	59.23	52.85
Overvalued "+" / undervalued "-" (%)				
UAH vs. USD		-35.33		
UAH vs. RUR		-27.53		
Fair value in the long-run as of observation date				
UAH per USD		5.258		
UAH per RUR		0.179		

Source: Investment Capital Ukraine.

Chart 70. ICU consumer basket value (US\$), from Feb-10 till Jul-13

Total value of the ICU basket in US dollar terms



Source: Investment Capital Ukraine.

Chart 71. Gasoline A95 equivalent 1 litre (US\$)

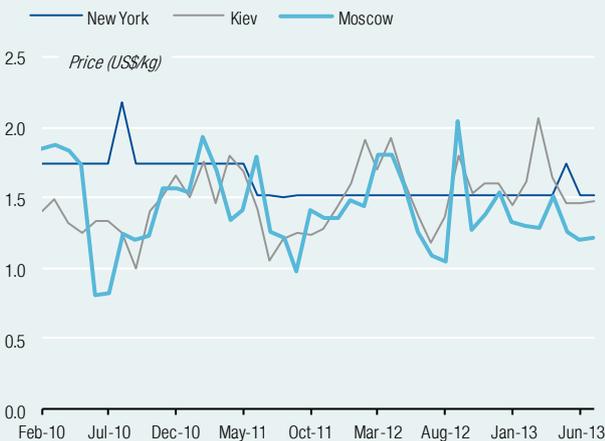
Price history from February 2010 till July 2013



Source: State Statistics Service of Ukraine.

Chart 72. Fresh banana 1 kg bunch (US\$)

Price history from February 2010 till July 2013



Source: Investment Capital Ukraine.

Chart 73. Chicken meat 1 kg pack of boneless breast (US\$)

Price history from February 2010 till July 2013



Source: State Statistics Service of Ukraine.

Chart 74. Chicken eggs 10-unit pack (US\$)

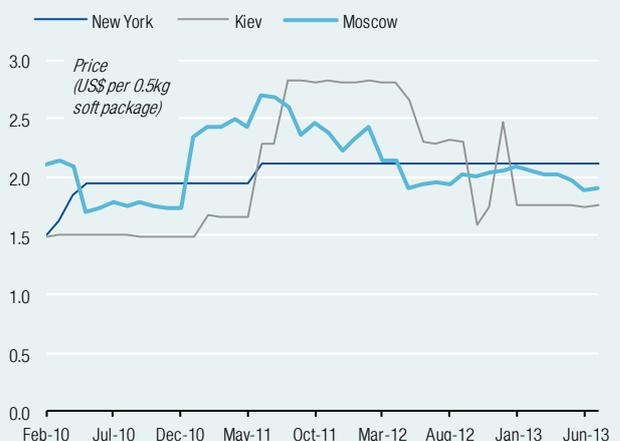
Price history from February 2010 till July 2013



Source: Investment Capital Ukraine.

Chart 75. Pasta 0.5 kg soft package Italy-made (US\$)

Price history from February 2010 till July 2013



Source: Investment Capital Ukraine.

Chart 76. Beer Corona Extra 0.33 litre glass bottle (US\$)

Price history from February 2010 till July 2013



Source: State Statistics Service of Ukraine.

Chart 77. Coca-Cola 0.5 litre plastic bottle (US\$)

Price history from February 2010 till July 2013



Source: State Statistics Service of Ukraine.

Chart 78. Shampoo 200ml bottle Head & Shoulders (US\$)

Price history from February 2010 till July 2013



Source: State Statistics Service of Ukraine.

Chart 79. Magazine Men's Health, A4 format (US\$)

Price history from February 2010 till July 2013



Source: State Statistics Service of Ukraine.

Chart 80. Value gap of ICU basket in UAH vs. USD and RUB (%)

Price history from February 2010 till July 2013



Source: State Statistics Service of Ukraine.

Chart 81. 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 till July 2013



Source: State Statistics Service of Ukraine.

Methodology update: ICU's family of currency trade-weighted indices

The reasons for our update are given below:

Since inception on 22 July, 2009³⁹, ICU's family of trade-weighted indices (TWIs) was primarily devoted to Ukraine's hryvnia (UAH). We have extended our calculations to include Russia's ruble (RUB). Below, while describing the indices' methodology, we refer to Ukraine and Russia, the home-countries of the currencies for which we calculate the TWIs.

In our view, these improvements, will allow us to better analyse the fundamentals of valuations of these currencies: Ukraine's hryvnia (UAH) and Russia's ruble (RUB).

Brief description: ICU's family of currency trade-weighted indices (TWIs) consists of TWIs for Ukraine's hryvnia (UAH) and Russia's ruble (RUB). For each currency, the indices consist of a nominal trade-weighted index (nominal TWI) and two real trade-weighted indices, of which the former is based upon Consumer Price data (CPI-based real TWI) and the latter is based upon Producer Price data (PPI-based real TWI).

The nominal TWI is a measurement of the currency's trade weighted exchange-rate developments against the key trade partners of the home-country, for which currency the indices are calculated (Ukraine and Russia). The CPI- and PPI-based real TWIs are derived by adjusting, respectively, the nominal TWI by the CPIs and PPIs of the home country (Ukraine and Russia) and its key partner trading countries. These indices could also be referred to, interchangeably, as nominal and real effective exchange rates (NEER and REER). However, our preferred way is to name them as trade-weighted indices. Our calculation of the indices is made on a monthly and daily basis for each currency.

The basics of index compilation

Our in-house method of calculating the currency trade-weighted indices takes into account the following inputs. First, merchandise trade statistics published by the official statistics agency of the home-country on a monthly basis, which is used to determine a basket of key trading partners of Ukraine. Second, foreign-exchange market data on the movements of national currencies of the key trading partners of the home-country against the US dollar, the key anchor currency in the global FX market. And third, data on inflation rates, including Consumer Price indices (CPIs) and Producer Price indices (PPIs), which are the monthly CPIs and PPIs of the home-country and its main trading partners, presented as the percentage change in inflation versus the previous month (ie the month-on-month inflation rates).

The *monthly* TWIs—nominal index, CPI-based index, and PPI-based index—are calculated on the monthly data. They use the trade and inflation data are reported on a monthly basis as an input data. In addition, the data on the exchange rates are the monthly averages of exchange rates versus the US dollar of the home-country currency as well as of the national currencies of the main trade partners to the home-country.

³⁹ Please refer to our first publication of the ICU's UAH trade-weighted index methodology made in the *Quarterly Report* "Ukrainian jigsaw puzzle," on 22 July, 2009.

The *daily* TWIs—the nominal index, CPI-based index, and PPI-based index—are calculated using the monthly data on trade and inflation (these are the same data series as used in monthly TWIs' calculation), while the exchange rates represent the daily FX market closing rates versus US dollar of the home-country currency as well as the currencies of the main trade partners to the home-country.

Trade partners

For each home-country a basket of main trade partners is determined upon the official statistics on merchandise trade. The basket includes as many trade partners as to represent at least 75-80% share of total trade turnover in the US dollar terms.

The trade weightings are calculated upon the following formula:

$$W_i = \frac{X_i + M_i}{\sum_{i=1}^n X_i + \sum_{i=1}^n M_i} \quad \sum_{i=1}^n w_i = 1,$$

where X_i and M_i are annualised volume of exports and imports respectively of i country and n is a number of main trade partners that form the basket.

Exchange rates

The history of exchange rates (national currencies against the US dollar) is sourced from Bloomberg. Then, the data on exchange rates is used to construct a chain of cross-rates (via the US dollar) of key trading partners' national currencies against the home-country currency.

The obtained cross-rates are used to calculate the exchange-rate index in the following formula:

$$I_i = \frac{R_i^t}{R_i^b},$$

where I_i – nominal exchange rate index of the currency of i country against the currency of the home-country; R_i^t – exchange rate of the currency of i country against the home-country's currency at t period; R_i^b – exchange rate of the currency of i country against the home-country's currency at base period (January 1995).

Monthly averages of exchange rates are used for monthly TWIs, while daily market closing data for the respective exchange rates is used for daily TWIs' calculation.

Inflation

The monthly history series of CPI and PPI data (in month-on-month as well as in year-on-year terms) is maintained for the range of countries⁴³, which form the basket (see above). This data is sourced from Bloomberg, and if not available at Bloomberg, it is retrieved from the national sources like the state statistical agency or central bank.

The on-month series of CPI and PPI data is used to calculate the price levels, which start at 100 points as of December, 1993 for each country in the basket and for the home-country.

Upon the calculated data of monthly CPI and PPI indices, then, the following two adjusting factors are calculated.

First, the CPI-based adjusting factor:

⁴³ Month-on-month data is maintained since January 1994. While the year-on-year data is calculated upon the month-on-month data and, hence, starts from January 1995.

$$P_i^{CPI} = \frac{CPI_i}{CPI_{home}}$$

where P_i^{CPI} – relative inflation level in i country versus the home-country; CPI_i – Consumer Price Index of i country; CPI_{home} – Consumer Price Index in the home-country.

First, the PPI-based adjusting factor:

$$P_i^{PPI} = \frac{PPI_i}{PPI_{home}}$$

where P_i^{PPI} – relative inflation level in i country against versus the home-country; PPI_i – Producer Price index of i country; PPI_{home} – Producer Price index in the home-country.

Nominal trade-weighted index

Nominal trade-weighted index of a currency is calculated upon the following formula:

$$Nominal\ TWI = \prod_{i=1}^n (I_i)^{w_i}$$

Real trade-weighted index

The CPI-based real trade-weighted index of a currency is calculated using the following formula:

$$Real\ TWI^{CPI} = \prod_{i=1}^n \left(\frac{I_i}{P_i^{CPI}} \right)^{w_i}$$

The PPI-based real trade-weighted index of a currency is calculated using the following formula:

$$Real\ TWI^{PPI} = \prod_{i=1}^n \left(\frac{I_i}{P_i^{PPI}} \right)^{w_i}$$

Results

The following sections provide the results of the calculations of the trade-weighted indices of the two currencies—Ukraine's hryvnia (UAH) and Russia's ruble (RUB)— in nominal and real terms. The indices are rebased at 100 points as of the end of 1999.

Lagging statistical data and revisions

The inflation data is retrieved from national statistical agencies and from Bloomberg. As a rule, this data set is published with a one-month lag. Moreover, every country has its own publication date of the price statistics (for instance, Ukraine publishes inflation statistics in early days of the month, while USA and UK publish it in the midst of the month).

The foreign trade data of each home-country—Ukraine and Russia—is published with a two-month lag.

There is no lag for the data on the exchange rates, as it is available on a daily basis.

Hence, on a rolling basis, the last two-month period of the indices is subject to revision in the future, ie when official statistical data on inflation and foreign trade is published.

In the periods for which the official statistics on foreign trade is lagging, the following approach is applied:

- 1) Calculation of the monthly indices assumes: a) trade data for the lagging (and future periods) remains constant to the latest published official data; and b) inflation and exchange rates data for the lagging (and future periods) is forecasted⁴⁴.
- 2) Calculation of the daily indices assumes for the lagging data that the most recently published foreign trade and inflation remains constant. It does not extend into the future periods.

Approach to assessing currency misalignment

Our approach to determining whether the nominal value of the currency at the FX spot market is in misalignment with its trade-weighted value consists of the following steps.

Averages

First, given the obtained data series of ICU's nominal and real TWIs, the mid- and long-term averages are calculated. These include the long-term averages, the 10-year averages and the 5-year averages.

The long-term averages span from 31 December 1999 (at this point the indices are rebased at 100 points) and through the last data point in the series of indices. The 10-year averages are the 10-year rolling averages, which starts at the beginning of 2004. The 5-year averages are the 5-year rolling averages, which starts at the beginning of 2000.

Trade-weighted indices versus their averages

Then each of the trade-weighted indices is measured versus its average (long-term, 10-year and 5-year) via subtracting the average value from the index's value.

If the result is positive, the currency is positively misaligned from its trade-weighted value and is being overvalued.

If the result is negative, then UAH is treated as negatively misaligned and undervalued.

Going forward, these misalignments tend to narrow via the effect of inflation and changes in the nominal exchange rates in the home-country as well as in its main trade partners. This narrowing may take a lengthy time period. However, literature on exchange rate economics concludes that such period fall between 5 and 10 years. This is because an economy tends to undergo structural shifts and changes through the cycles, which are observed to last 5-10 years.

As far as Ukraine's hryvnia (UAH) and Russia's ruble (RUB) are concerned, we tend to rely on the view that each economy is undergoing fundamental changes through a 5-year time span. Hence, we measure currency misalignment via the 5-year averages of the trade-weighted indices due to an assumption that Ukraine and Russia tend to have 5-year economic cycles.

⁴⁴ For Ukraine, ICU's own forecast on inflation and USD/UAH exchange rates is used. For other countries and currencies, we use inflation forecasts by the IMF in its most recent *World Economic Outlook*, and for exchange rates, we combine Bloomberg's data from the NDF markets and forecasts by the most proficient FX research houses (ie, the bulge-brackets investment banks).

Ukraine's hryvnia (UAH): Input data and the indices

Input data: Trade partners, inflation and FX rates

This calculation is based on a basket of 26 countries that are Ukraine's key trading partners, which account for a 80.8% share of total merchandise trade turnover (exports and imports) for the last 12-month period to May 2013 (see Table 13 on page 74).

Inflation and exchange rates data are also used for the same 26 countries (see Chart 82-Chart 83 on page 75)

The UAH trade-weighted indices

Calculation results are presented in the tables and charts on pp.76. Averages of the indices are depicted on pp.77. UAH's misalignment is depicted on pp.78.

Table 13. Ukraine's key partners by merchandise trade turnover and their weights in the basket used for calculation of ICU's family of trade-weighted indices of Ukraine hryvnia, data as of May 2013

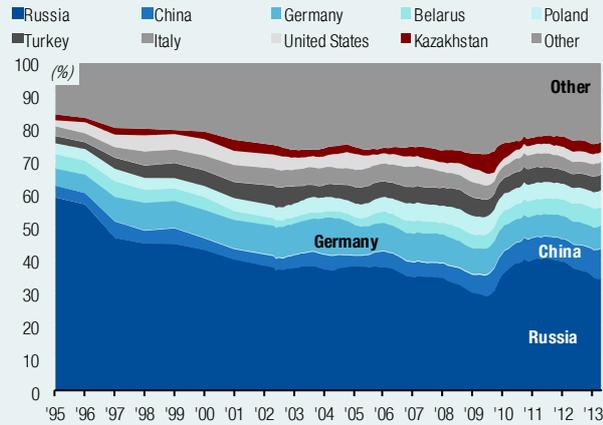
Country	Trade turnover* as of May 2013 (US\$m)	Share in total turnover as of May 2013 (%)	Weight as of May 2013 (%)	Average weight, May 2002 till May 2013 (%)	Average weight, 1995-2013 (%)
Russia	41,188.91	27.80	34.40	36.47	40.46
China	10,846.74	7.32	9.06	5.11	4.59
Germany	8,396.03	5.67	7.01	8.51	8.28
Belarus	6,831.74	4.61	5.71	3.67	3.75
Poland	6,207.99	4.19	5.19	4.90	4.36
Turkey	5,727.30	3.87	4.78	4.88	4.51
Italy	4,609.78	3.11	3.85	4.91	4.58
United States	3,717.82	2.51	3.11	3.43	3.73
Kazakhstan	3,517.38	2.37	2.94	2.98	2.61
India	3,107.99	2.10	2.60	1.79	1.49
Egypt	2,727.37	1.84	2.28	1.32	1.12
Hungary	2,718.47	1.83	2.27	2.55	2.46
France	2,389.76	1.61	2.00	1.91	1.79
Spain	2,303.88	1.55	1.92	1.36	1.22
Netherlands	2,078.23	1.40	1.74	1.91	1.68
Czech Republic	1,824.37	1.23	1.52	1.66	1.63
United Kingdom	1,794.20	1.21	1.50	1.86	1.79
Korea, South	1,440.67	0.97	1.20	1.61	1.33
Romania	1,398.48	0.94	1.17	1.53	1.32
Slovakia	1,310.62	0.88	1.09	1.36	1.51
Austria	1,264.67	0.85	1.06	1.41	1.44
Japan	1,227.42	0.83	1.03	1.36	1.16
Moldova	1,000.37	0.68	0.84	1.23	1.21
Brazil	880.09	0.59	0.74	0.87	0.77
Singapore	657.27	0.44	0.55	0.51	0.42
Sweden	554.85	0.37	0.46	0.90	0.79
Total basket	119,722.39	80.80	100.00	100.00	100.00
Total trade turnover	148,165.49	x	x	x	

Notes: * total turnover is sum of annualised exports and imports.

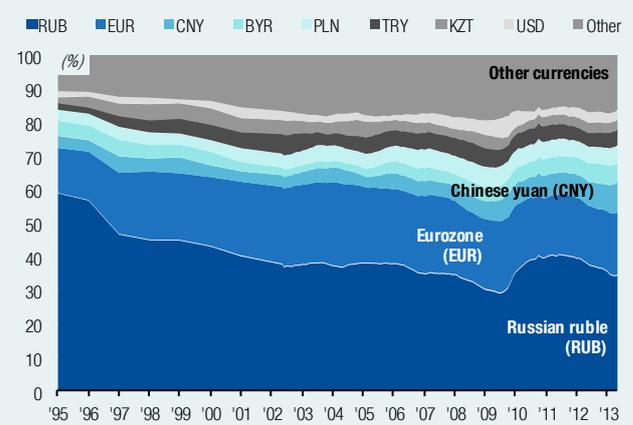
Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 82. Historical breakdown of the ICU trade basket – history from January 1995 through November 2012 (% of total)

Breakdown by countries



Breakdown by currencies

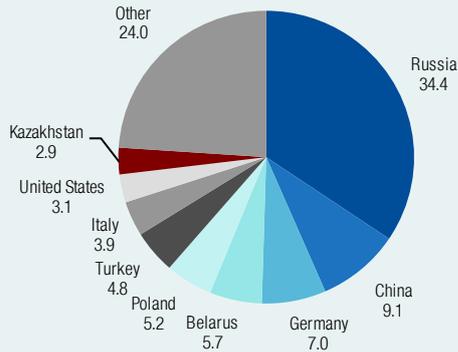


Sources: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

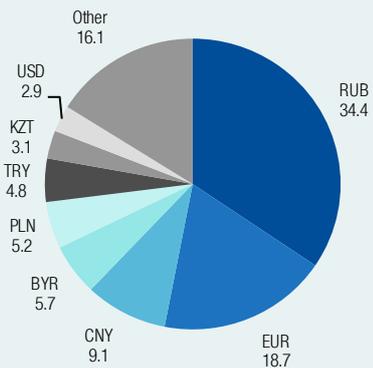
Source: State Statistics Service of Ukraine, Investment Capital Ukraine LLC.

Chart 83. Breakdown of the ICU trade basket as of November 2012 (% of total)

Breakdown by countries



Breakdown by currencies



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

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

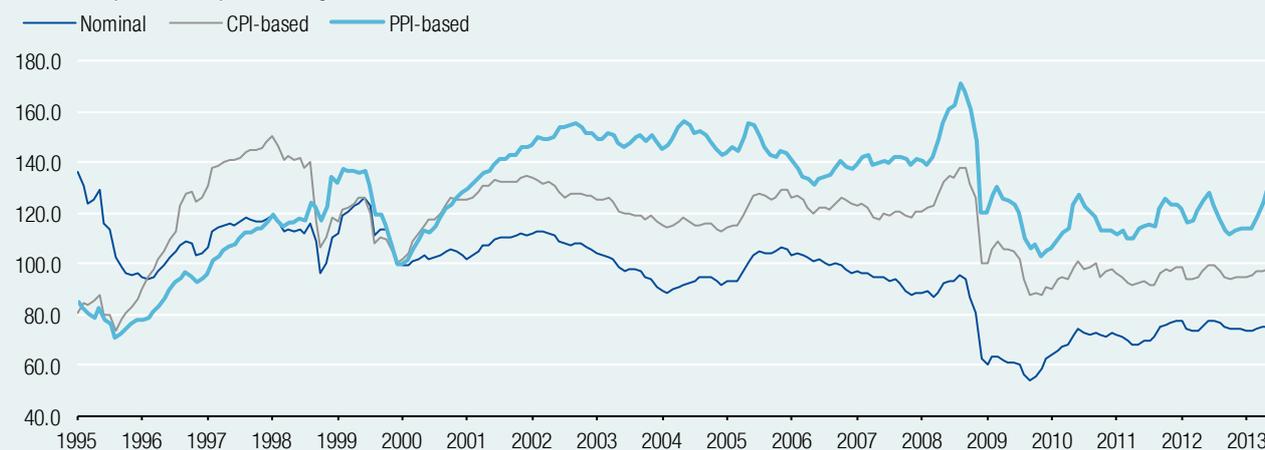
Table 14. Selected values of the ICU's monthly trade-weighted indices of Ukrainian hryvnia (UAH)

Date	Jan-95	Dec-99	Dec-03	Dec-07	Dec-11	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12	Jun-13
Nominal	135.9	100.0	90.8	88.2	77.3	77.4	77.3	76.3	74.7	74.1	74.3	74.0	75.9
CPI-based	80.4	100.0	116.8	120.1	98.8	99.1	98.2	96.2	93.9	92.7	92.6	92.0	98.0
PPI-based	84.8	100.0	148.4	141.3	123.0	131.5	127.6	126.4	124.2	121.3	121.5	119.2	127.2

Source: Investment Capital Ukraine LLC.

Chart 84. Monthly data of ICU's family of UAH trade-weighted indices

All-time history from January 1995 through June 2013



Source: Investment Capital Ukraine LLC.

Table 15. Selected values of the ICU's daily trade-weighted indices of Ukrainian hryvnia (UAH)

Date	2-Jan-95 ...	31-Dec-99	3-Jan-00	4-Jan-00	5-Jan-00 ...	2-Aug-13	5-Aug-13	6-Aug-13	7-Aug-13	8-Aug-13	9-Aug-13	12-Aug-13
Nominal	138.5 ...	100.0	99.1	99.4	95.4 ...	73.0	73.2	73.2	73.3	73.1	73.2	73.3
CPI-based	81.9 ...	100.0	101.4	101.7	97.6 ...	98.2	98.5	98.5	98.6	98.3	98.4	98.6
PPI-based	86.4 ...	100.0	99.4	99.7	95.7 ...	127.5	127.8	127.8	127.9	127.6	127.7	128.0

Source: Investment Capital Ukraine LLC.

Chart 85. Daily data of ICU's family of UAH trade-weighted indices

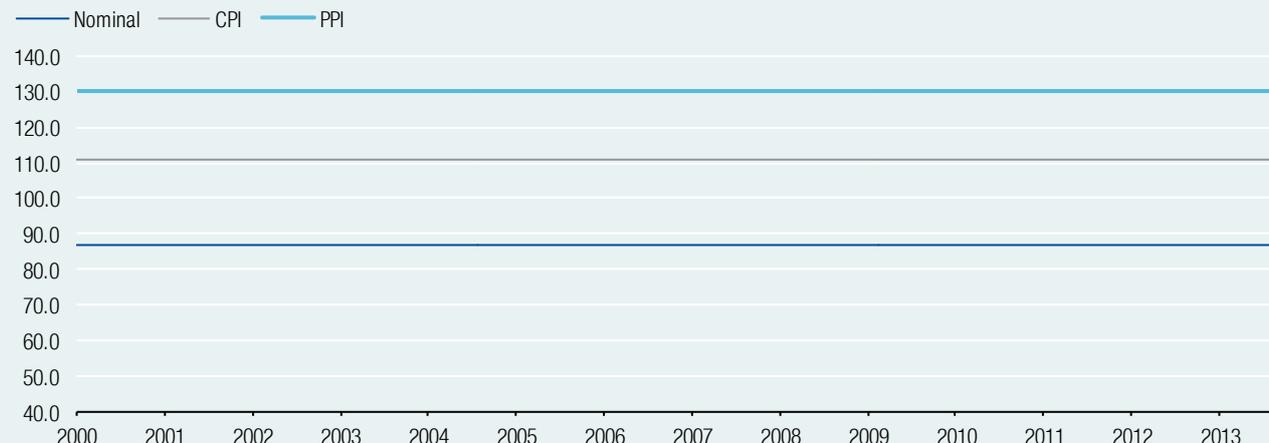
All-time history from January 1995 through 12 August 2013



Source: Investment Capital Ukraine LLC.

Chart 86. Long-term averages of the ICU's family of UAH trade-weighted indices (based on daily indices)

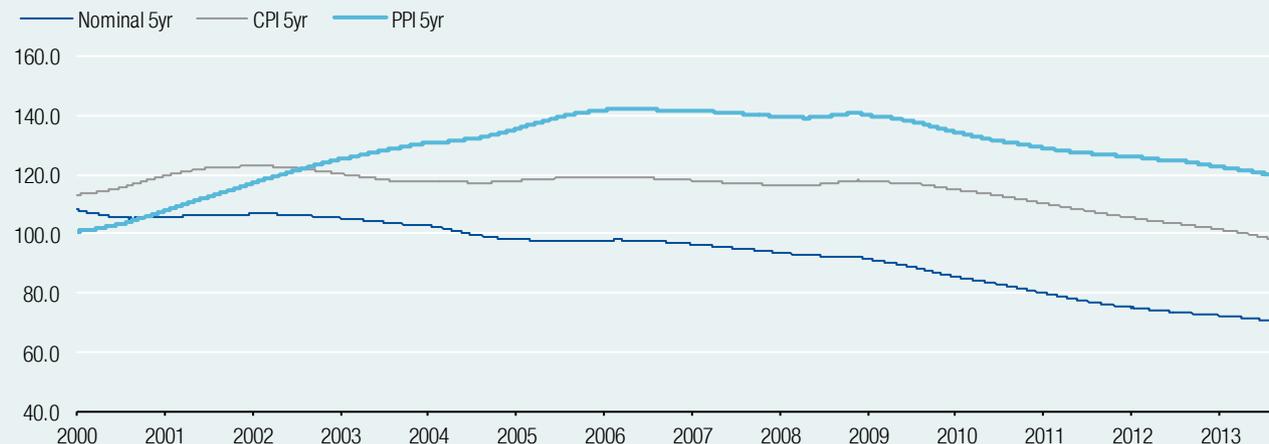
All-time history through 12 August 2013



Source: Investment Capital Ukraine LLC.

Chart 87. 5-year averages of the ICU's family of UAH trade-weighted indices (based on daily indices)

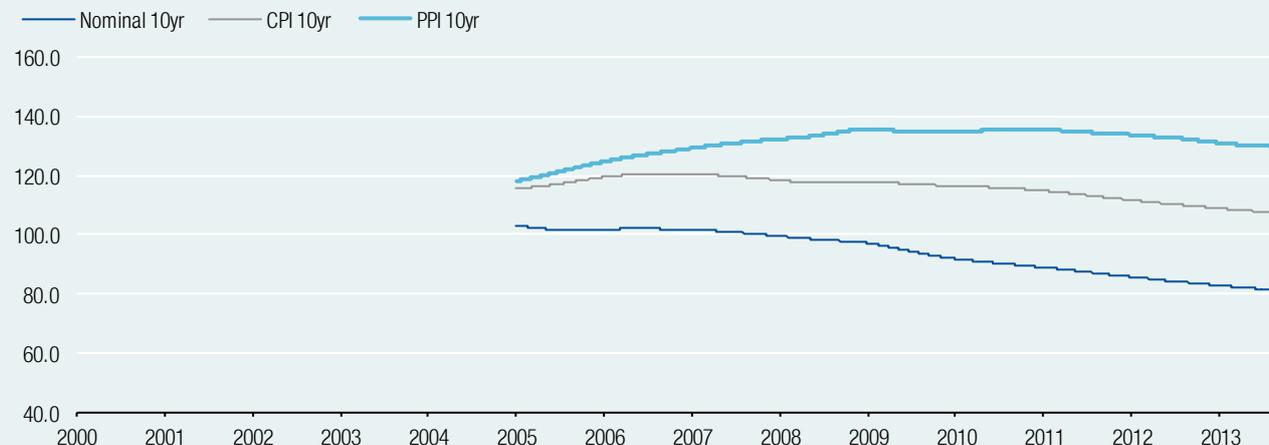
All-time history through 12 August 2013



Source: Investment Capital Ukraine LLC.

Chart 88. 10-year averages of the ICU's family of UAH trade-weighted indices (based on daily indices)

All-time history through 12 August 2013



Source: Investment Capital Ukraine LLC.

Chart 89. UAH misalignment vs. long-term averages of the ICU's UAH TWIs (based on daily indices)

All-time history through 25 January 2013



Source: Investment Capital Ukraine LLC.

Chart 90. UAH misalignment vs. 5-year averages of the ICU's UAH TWIs (based on daily indices)

All-time history through 25 January 2013



Source: Investment Capital Ukraine LLC.

Chart 91. UAH misalignment vs. 10-year averages of the ICU's UAH TWIs (based on daily indices)

All-time history through 25 January 2013



Source: Investment Capital Ukraine LLC.

Russia's ruble (RUB): Input data and the indices

Input data: Trade partners, inflation and FX rates

This calculation is based on a basket of 20 countries that are Russia's key trading partners, which accounts for a 78.3% share of total merchandise trade turnover (exports and imports) for the last 12-month period to June 2013 (see Table 16 on page 79).

Inflation and exchange rates data are also used for the same 20 countries (see Chart 92-Chart 93 on page 80).

The RUB trade-weighted indices

Calculation results are presented in the tables and charts in Table 17 and Chart 94, pp.81. Averages of the indices are depicted in the left part of Chart 95, pp.81. The right part of the same chart depicts RUB's misalignment through June 2013.

Table 16. Russia's key partners by merchandise trade turnover and their weights in the basket used for calculation of ICU's family of trade-weighted indices of Russia's ruble, data as of June 2013

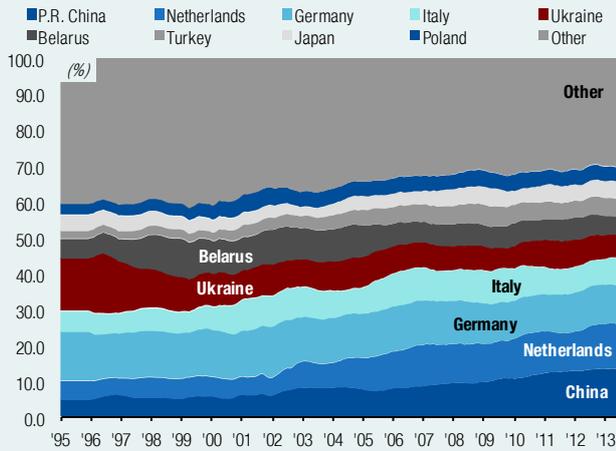
Country	Trade turnover* as of June 2013 (US\$m)	Share in total turnover as of June 2013 (%)	Weight as of June 2013 (%)	Average weight, May 2002 till June 2013 (%)	Average weight, 1995-2013 (%)
P.R. China	87,298.51	10.45	13.36	9.74	8.03
Netherlands	79,767.19	9.55	12.20	10.04	8.16
Germany	71,998.71	8.62	11.02	11.91	12.44
Italy	50,698.64	6.07	7.76	8.10	7.46
Ukraine	40,628.81	4.87	6.22	7.45	9.04
Turkey	33,211.37	3.98	5.08	4.84	4.02
Belarus	33,017.90	3.95	5.05	6.72	7.29
Japan	32,324.91	3.87	4.95	4.02	3.89
U.S.	26,279.84	3.15	4.02	5.25	7.10
Poland	26,202.48	3.14	4.01	4.35	4.18
Kazakhstan	25,455.20	3.05	3.89	3.65	4.15
Korea	25,160.44	3.01	3.85	2.85	2.31
U.K.	24,187.30	2.90	3.70	3.83	4.15
France	24,137.19	2.89	3.69	4.01	3.66
Finland	17,612.76	2.11	2.69	3.67	3.97
Switzerland	12,721.69	1.52	1.95	3.28	3.67
Belgium	11,697.91	1.40	1.79	1.55	1.62
Spain	11,011.79	1.32	1.68	1.51	1.31
India	10,146.37	1.22	1.55	1.56	1.61
Czech Republic	10,073.31	1.21	1.54	1.68	1.93
Total basket	653,632.33	78.27	100.00	100.00	100.00
Total trade turnover	835,080.57	x	x	x	x

Notes: * total turnover is sum of annualised exports and imports.

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

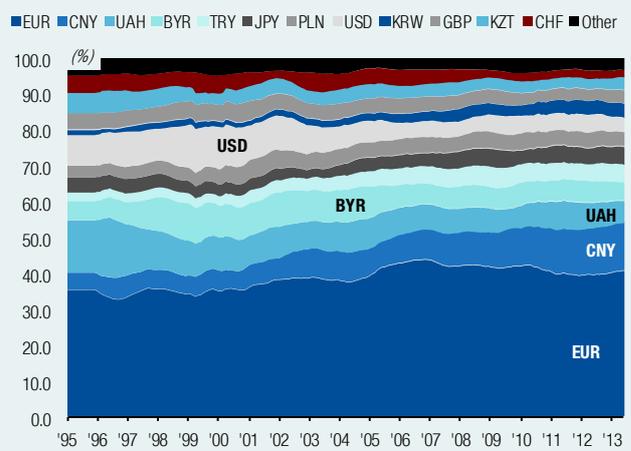
Chart 92. Historical breakdown of the ICU trade basket for Russia's ruble – history from January 1995 through June 2013 (% of total)

Breakdown by countries



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

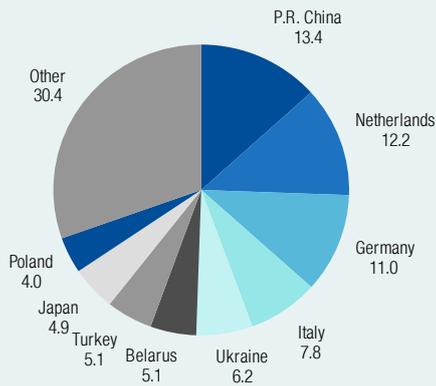
Breakdown by currencies



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

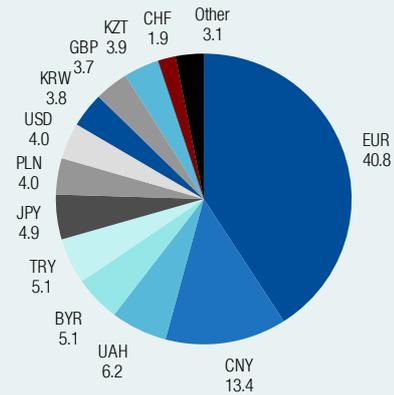
Chart 93. Breakdown of the ICU trade basket for Russia's ruble as of June 2013 (% of total)

Breakdown by countries



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

Breakdown by currencies



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

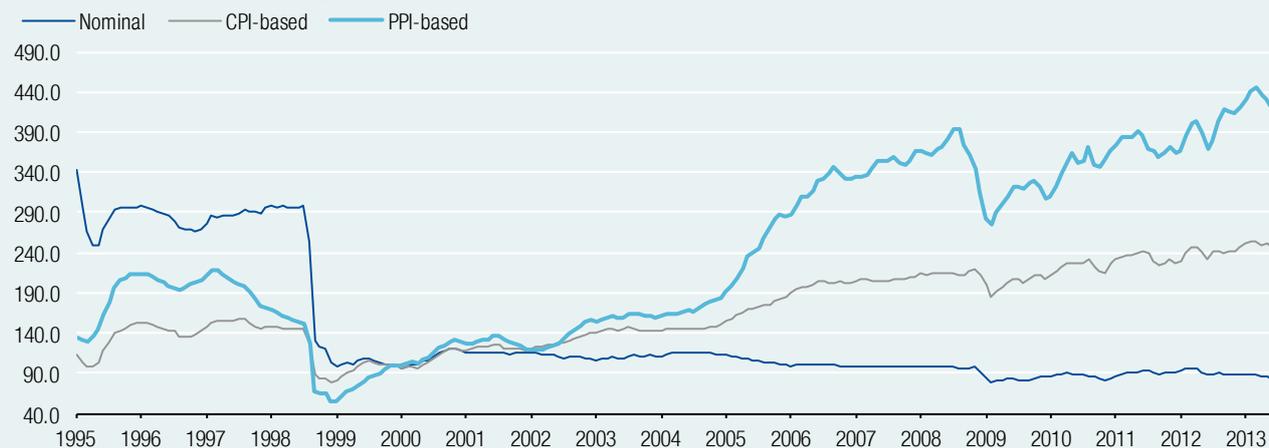
Table 17. Selected values of the ICU's monthly trade-weighted indices of Russia's ruble (RUB)

Date	Jan-95	Dec-99	Dec-03	Dec-07	Dec-11	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12	Jun-13
Nominal	342.7	100.0	110.2	99.2	91.2	88.0	88.9	89.7	88.8	88.7	88.2	88.1	81.7
CPI-based	113.7	100.0	141.8	210.7	227.2	232.0	240.5	241.6	240.3	241.3	241.8	246.0	243.1
PPI-based	134.7	100.0	158.7	366.0	363.4	370.1	379.7	402.6	419.0	416.1	413.3	421.4	419.8

Source: Investment Capital Ukraine LLC.

Chart 94. Monthly data of ICU's family of RUB trade-weighted indices

All-time history from January 1995 through June 2013

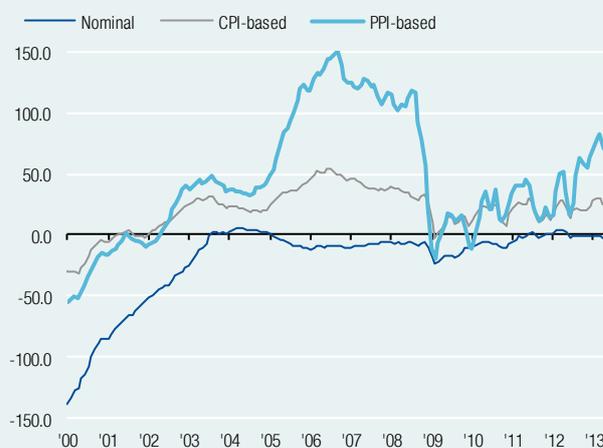


Source: Investment Capital Ukraine LLC.

Chart 95. Russian ruble: 5-year averages of the ICU's UAH TWIs (left) and RUB misalignment (right), history from Jan-2000 through June-13



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



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

Disclosures

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