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Quarterly Report

Ukraine: Global war by other means

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Executive summary

Below is a summary of our macro view for 2014-15. (It is condensed to three pages in order to detail key information from the report.)

Geopolitics: Ukraine as a brand-new epicentre of the global war. In our view, there are tectonic shifts taking place in the global economy because of the Ukraine-Russia crisis. The global security issue creates a new impetus on the back of the dispute, after key global powers failed to unite to guarantee security to Ukraine, a country that willingly relinquished its nuclear arsenal back in 1990s. Hence, the nuclear non-proliferation issue has become even more prominent than before. The nations that once championed economic rivalry among the global superpowers as a modern-day norm are now re-evaluating their commitments to military expenditures because of the new reality, where military threat is high in general. In particular, the NATO European member states reconsider their defence budgets' commitments to the minimally required 2% of GDP, after a decade-long disarming trend. The economic sanctions, which were formerly applied to "pariah" states only, now embrace more than ever the economy of Russia, which, as a BRIC member, comprises a large chunk of the emerging-market world. This development appears to take the form of modern-day global warfare carried out by other (read: non-conventional) means. In our view, this kind of war is able to capsize the nascent recovery of the Eurozone and EU as a whole. The Russian economy, which we define through our research as the really "sick man of Europe," apparently seeks to resolve its economic rebalancing by shutting itself off from the rest of the world.

As a result, Ukraine is now undertaking the difficult task of learning how to run its economy under the real threat of military invasion, against a foe that has a seemingly inexhaustible appetite for escalation. Prior, Ukraine's economy was under siege by notorious kleptocrats like Mr. Yanukovych. Now it is under siege by the Kremlin as the country runs the risk of a second wave of mainland invasion by the Russian military. In our base-case scenario Ukraine suffers just the Crimea annexation. In the worst-case one, in additionally suffers the annexation of three eastern oblasts (Kharkiv, Luhansk and Donetsk).

Ukraine's economy contracts on annexation, confidence shock, and overdue adjustment. According to our base-case scenario, Ukraine's economy is to experience a 4.3% YoY like-on-like contraction, and together with a 3.7% loss of the annexed Crimea, our total estimated decline of the economy amounts to 8% in 2014. The Kremlin's militarist stance against Ukraine's internal affairs induces a "confidence shock" to businesses which are likely to cut their investment programmes, as well as to consumers. This is, in our view, a key driver of the economic contraction. To a lesser extent, economic activity is being affected by an overdue balancing of the economy and restoration of the creditworthiness, which comes along with the IMF programme. Under the worst-case scenario, the whole year's loss of GDP in 2014 will amount to 29%, of which 25% is due to annexation.

FX adjustment: Went too far, likely to reverse. By year-on-year terms, UAH's real trade-weighted value declined by nearly 30%. It is quite too much, in our view. In the past FX adjustments, like those in 1998, 1999 and 2008, the real devaluation peaked at 36%, 31% and 38% and then recovery followed. Given a mix of projections of inflation and FX rates in the key trade partners allows us to base our macro projections for the 2014-16 period at a UAH FX rate that averages 10.80/USD in 2014, 11.76/USD in 2015, and 12.08/USD in 2016.

State budget: Still unrealistic, requires mid-year revision. In our view, even the recent state budget cuts, made in March, overstate revenue performance and make expenditures bloated (nearly 30% of projected GDP). As it is, the recession will result in underperformance of budget revenues, resulting in a bigger deficit than officials had planned, amounting to UAH89bn, or 6.1% of GDP. With still-high debt stock to be rolled over this year—UAH30.3bn of local-currency debt and US$8.2bn of foreign-currency debt[1]—the government's financing needs for the year are even higher than last year. With sovereign risk of default at a critical level, there is no other game in town than to carry out a sweeping economic reforms programme with financial assistance from the IMF.

Public debt: Recession and devaluation up public debt level to 56% of GDP. Due to the recession, devaluation, and Ukraine's requirement to recapitalise the still loss-generating Naftogaz, state-run banks and other related entities, as well as to resolve the VAT arrears, our base-case scenario is that the state public debt increases towards 56% of GDP at the end of 2014. Under a worst-case scenario, it ups to 79% this December and becomes an excuse for breaching the Russian Eurobond covenant of a 60% public debt level. This could be an opportunity for the Kremlin to complicate Ukraine's economy recovery even further by invading it from the East.

IMF assistance programme: A key balancing factor in Ukraine's economic. In our view, the precarious state of the public finances and very stagnant conditions in the other parts of the economy, the IMF programme (expected to start in April-May) is a key to eliminating the risk of economic depression. IMF and other donors' money—in total US$28bn for two years—covers the BoP gap this year and next, allowing FX reserves to recover to 3.4 months cover of imports this year 4.3 months in 2016.

Naftogaz deficit: On a narrowing path. In 2013, the total natural gas imports bill amounted to US$12bn, dropping from US$14.2bn in 2012. In 2014, it is forecast to reach US$12.1bn, because of a 7% YoY effective price increase. The natural gas tariff increase for consumers (according to our assumed schedule) over the next three years towards the market level allows the gap between Naftogaz imports bill and domestic revenues to amount to US$1.4bn (1.1% of GDP), halving to US$0.7bn (0.5% of GDP) in 2015, and moving it into the black in 2016. A failure to implement Naftogaz deficit elimination would mean an effective exit from the IMF programme, i.e., it goes off track. In the end, it would again heighten the sovereign risk of default towards the extreme level.

Inflation: Accelerating in 2014, and then subsiding. Currency devaluation and regulated tariff (natural gas, heating, etc.) increases provide a ground for CPI acceleration towards 12% YoY this December. With the NBU's stated commitment to inflation targeting, there is a high possibility that the NBU would allow UAH strengthening when demand for the hryvnia appears on the FX market. This currency's strengthening would help keep inflation from accelerating further, i.e., beyond 10% in 2015-16 and towards double-digit territory. If CPI returns to single-digit territory in 2015, then it would be a development that favours the hryvnia. Otherwise, if the NBU fails to deliver its low-inflation commitment, then this would be a key risk to UAH's exchange rate.

UAH: Real devaluation of 1Q14 makes the currency fundamentally cheap. Our calculations show that the UAH devalued by nearly 30% YoY in real and trade-weighted terms. It is undervalued by more than 20%, with the market FX rate at 12.7/USD.

[1] Includes sovereign and quasi-sovereign borrowers.

Due to inflation acceleration seen towards 11% later this year, the UAH's real value should recover somewhat, eroding part of the competitive gains realised since February this year. Our base-case scenario assumes that consumer inflation stays in single-digit territory over 2015-16, but above the 8% level. Because of lower inflation levels projected in the same years among the key trading partners of Ukraine, like the Eurozone, Russia, and China, the UAH's real trade-weighted value has no other option than to head up gradually (appreciate).

This means that competitive gains of 1Q14 and early April, thanks to devaluation, will be, over time, under risk of erosion. Nevertheless, we think the UAH's market value, going forward, recovers in 2014 closer to its fundamental fair value, which is 9.5-10.5/USD now and then evolves to 9.8-10.7/USD this fall. In effect, we forecast the UAH's FX rate at 10.80/USD on average for 2014 and 11.30/USD as a year-end rate. In 2015 and 2016, we forecast the year-end rate at 11.95/USD and 12.15/USD, respectively.

Geopolitics and politics

In this section, we analyze the current geopolitical reality in Ukraine, and provide insight into Ukraine's European identity. Hence, there is a choice for an EU association instead of the Kremlin-led Customs Union.

The Kremlin's plans for re-creating a Soviet "superpower" may be ruined, but, Ukraine and other parts of the global economy, first of all, ex-Soviet states and the entire EU, received a *de facto* invitation to the unofficial "Depression Union." This unofficial union, too, is led by the Kremlin, and embraces other countries against their will, as their economic linkages with Russia have taken their toll due to the ongoing and accelerating economic recession in Russia. The Russians have become adept at cutting back since early 2013, when they cut Mr. Putin's approval rating to a historically low point. The Sochi Olympics did not impress Russian voters much, either; instead, anti-West and anti-Ukrainian rhetoric and the subsequent invasion into Ukraine did the job. Mr. Putin's approval rating is at a multi-year high, and the Kremlin has bought time to divert voters' attention from unpopular economic themes towards external foes.

Under annexation and military threat, Ukraine's economy declines sizably this year. Any recovery of the EU from recession is also at risk if more Western sanctions would be required to stop a militarised Kremlin. Hence, instead of economic recovery, Russia's troubled economy and the Kremlin's ill-fated geopolitical agenda will spawn another economic recession, which could easily turn into a depression.

While our base-case scenario does envisage a permanent presence of the invasion threat from the Kremlin on the country's eastern border, we conclude that official Kiev is likely to fight the invasion if it takes place (a worst-case scenario) on a pure economic basis. While our assessment of the likely GDP loss resulting from Crimea's annexation is estimated at nearly 4%, a possible mainland invasion by Russia and further annexation would be yield a much harder GDP loss (up to 50%).

Regarding Ukraine's politics, we conclude that presidential and parliamentary elections this year are part of our base-case scenario. However, these elections are not likely to ruin the current political consensus that Mr. Yatsenyuk's Cabinet of Ministers governs during the two-year programme of economic reforms under the IMF bailout.

Ukraine as a nation of silent rebels

There is much musing these days by academia and political analysts outside of Ukraine when asked by investors about the current developments in the country, and the likely short- and mid-term outcomes and market implications stemming from the geopolitical play over Ukraine.

Many see the current developments—the ousting of the Yanukovych regime by public protests and a *de facto* Russian military invasion of Crimea Republic, a Ukraine territory—as an extension of the Cold War or, more likely, its next chapter. In this view, Western expansion of the EU and NATO into the backyard of an increasingly sensitive[2] Russia is the cause. This perspective also underscores the delicate relationship between Ukraine and Russia that has existed for ages. The two nations are tangled up in a complex web of unparalleled economic and social relations. Moreover, Russia considers Ukraine as part of

[2] 'Extremely paranoid' is a more appropriate description to this stance since the 2008 invasion by the Russian military into Georgia.

its ancient birth place[3]. Hence, this view asserts that Russia will now play its game for the long term and—thanks to its strong balance sheet with its massive volume of FX reserves at about US$500bn—is ready to pay any price to cement its presence in Ukraine[4]. A recent corollary to this view has been an attempt to portray Maidan as home of ultra-nationalists and anti-Semites.

In our opinion, this view bears a gross misjudgement, as it lacks a full understanding of what has been going on “on the ground" in Ukraine as well as in the minds of Russian officials. The following may add more colour to this picture.

The only Shevchenko

First, the author of this report heard of a debate prior to the 2008 financial crisis between a foreign media investor and his employees. The employees argued for publishing some news about the late Ukrainian poet Taras Shevchenko. The boss argued back that the only Shevechenko that their audience—youth as well as young- and middle-aged professionals--would be familiar with would be Andriy Schevschenko, the footballer for AC Milan and FC Chelsea. This anecdotal evidence is typical of the gross misjudgement of the nation's values even among those who lived in Ukraine for years. (Recently, after the Maidan developments in late 2013 and early 2014, there was renewed respect for Taras Shevchenko and his poetry was once again recognized for its wisdom and widely acknowledged as truly prophetic.)

Breaking the rule by approving Ukrainian language

Second, in early 2013, a local publishing house was about to launch a Ukrainian edition of *National Geographic*[5]. The chief executive of the publishing house deliberated over whether to publish the magazine in Ukrainian or Russian. The choice was difficult; most of the magazines they published were in Russian. Most of the local private print and electronic media market has an informal rule—to use Russian as their working language to communicate with their audience in Ukraine because Russian-language media attract more advertising revenues. In the end, the chief executive did something extraordinary and approved the use of Ukrainian language for the *National Geographic* Ukraine magazine. In part, the decision was based on the premise that a Russian language edition of *National Geographic*, produced in Russia, was already on the market and freely available in Ukraine. Therefore, the new Ukrainian edition of *National Geographic* should be in Ukrainian. With a modest budget, the magazine went into monthly production.

In the spring of 2013, news that such a respected brand name was to appear in Ukraine's media market and be produced in the Ukrainian language produced two intriguing results. First, private businesses were eager to place advertisements in the magazine. Second, the public reaction was near equal to excitement. A gallery event featuring *National Geographic*’s best photos in Kyiv produced unexpectedly long queues of people to see a display of photos with stories in Ukrainian accompanying them. The gallery event was so popular that organisers were forced to extend it a week to accommodate all visitors.

In our opinion, the relative success, albeit small, of the above-mentioned business decision reflects the hunger of the Ukrainian people for more domestically grown accomplishments. This desire has grown while Ukraine has suffered a sort of degradation of its national fabric

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[3] By itself, this statement, which is a cornerstone of Kremlin propaganda, is very controversial if judged from a historical viewpoint.

[4] One of the latest thoughts repeating this view was published in the *Financial Times*, in “GLOBAL INSIGHT: Ukraine crisis: West must show Russia carrot as well as stick," 11 March, 2014 (hyperlink).

[5] Disclaimer: Author's wife is chief editor of this magazine.

since the deep economic recession of 2008-09, and the ensuing poor performance of the Yanukovych-led political regime, which was a kleptocratic one from the very beginning of its rule.

A "European" flavour as a must for success

Since the early 1990s, as the country had been opening itself to the outside world, domestic chatter has embraced new expressions. One of them has been the use of "European" as a superlative indicating that something is of quality and can be trusted.

From the beginning, the usage of the "European" superlative has been attached to one the Ukrainians' favourite practices, renovating one's home. A "European renovation" means a very decent quality of work done, including the materials used. The practice is so wide-spread (even throughout former Soviet Union states) that "European renovation" has the same meaning and is equally desired in the city of Kyiv, the Crimea Republic, and in every inhabited area of Ukraine.

An observation made last year by the author of this report on bread products available in a local grocery store in Kyiv revealed that alongside the low-cost products, there is more expensive bread with the brand name "The European." Surely, the brand name, a marketing ploy, is interpreted by the consumer as a promise of a better quality product.

Similarly, it is well known that football is Ukraine's favourite sport, and beginning a few years ago, domestic private investments created two TV channels totally devoted to football coverage, 24/7. The prime channel of these two hosts a weekly programme with a Russian-born anchor, who moved from Moscow to Kyiv for the job. It features extensive analysis and "exclusive reportage" of Ukraine's championship results (as well as of the leading European championships including Italy, England, Germany, France, and Spain). It is easy to guess the name of the programme: "European Weekend."

A more European Ukraine as a "challenge to Moscow"

Quite long ago, it had become customary that Russia would officially warn and lecture the West about expansion into the eastern part of the European continent. The Kremlin would complain that military expansion by the NATO alliance was a threat to Russia's military security. Then, it struggled hard to swallow a bitter pill when Poland, Hungary, the Czech Republic, Slovakia, and then Bulgaria, Romania, and the Baltic countries all joined the NATO alliance.

In the wake of the so-called Colours Revolutions in the CIS countries (a Rose Revolution in Georgia and an Orange Revolution in Ukraine in the early 2000s), Ukraine and Georgia called for closer relations with NATO under the leadership of decidedly pro-Western Presidents Yuschenko and Saakashvilli, respectively. The Kremlin worked hard to persuade the existing NATO members to water down the initiative. Then, Western expansion was halted by the Great Recession of 2007-08, and especially by Russia's 2008 military invasion into Georgia.

After the 2008 crisis, the West turned inwards due to its own economic problems, and the Kremlin's intolerance of the West developed into something bigger, as its economy, still enjoying high oil prices, continued expanding. Russia has been entirely rejecting any Western move into its self-proclaimed sphere of interest. The Kremlin has been busy trying to create a Eurasian Union as a counterweight to other global geopolitical powers; in other words, a "better version" of the EU, in the Kremlin's words. The Kremlin cultivated the idea very seriously in early 2012 during Mr. Putin's presidential campaign.

In 2013, the Kremlin evolved into direct confrontation with the EU's offer to Ukraine (along with other countries in the former Soviet Union) of a trade pact called an association agreement. The Kremlin effectively outbid the EU, having then President Yanukovych reject the EU trade pact deal and subscribe to the Eurasian Union project.

Then, this January, the most liberal newspaper in Russia, *Vedomosti,* published an op-ed article[6] written by two former foreign affairs officials, now academics. The authors laid down an extensive vision of the evolution of Russian foreign policy over the recent past, and drew a roadmap for its development into the near future. It was very telling that their only reference to Ukraine's affairs (note that Maidan was involved in an active stand-off with the Yanukovych regime when this article was published) was a phrase that the "EU's association offer to Ukraine looked like a challenge to Moscow."

This passage, in our view, reveals that the Kremlin's intolerance of the West has been growing. There are no visible limits to it. The Kremlin's objection to NATO expansion, which was understandable, was followed by quite questionable objection to economic expansion (in the form of very light EU cooperation; in fact, the EU was not going to promise official membership to Ukraine). The risk exists that, without limits, this intolerance will develop into disdain for anything that somehow resembles the West. For instance, by the above-mentioned logic, a citizen of Ukraine knowing a foreign language (other than Russian) could be regarded by the Kremlin as a challenge to its rule.

As a conclusion

The above-mentioned stories provide us an insight as to why Euromaidan has succeeded in its prime tasks,[7] and how Ukraine's 40 million-plus nation will likely cope with the today's geopolitical reality, as of the end of March 2014.

Euromaidan has succeeded because civil activists were ahead of the curve, while politicians of all colours trailed behind it, so to speak. The old rules that applied to policymaking (rigging of elections, high corruption and rent-seeking measures by the wealthy) had been declared outdated by the public. Mr. Yanukovych had attained so much power and wealth under the old rules that he become the epitome of the old system. Moreover, he declared the public's European identification as wrong, and therefore doomed himself to humiliation by the public opinion[8] this February.

This current geopolitical reality is characterised first by a post-Yanukovych interim political regime moving towards complete legitimacy through this May's elections; second, by the Kremlin's annexation of the Crimea Republic and threat to invade mainland Ukraine by massing at least 40,000 soldiers along the Russia-Ukraine border; and third, by the Kremlin eyeing to undermine a post-Yanukovych Ukraine unless its own demands are met (as formulated in the FT article[9]). All the demands—from military neutrality (meaning no NATO membership) to a federal structure of the country, to Russian as an official state language on par with Ukrainian—appear unacceptable. Post-Euromaidan, there is overwhelming public support for—some would call it a requirement of the Ukraine's political leadership—

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[6] 28 January 2014 Sergey Karaganov, Igor Makarov "Russia's turn to Pacific ocean" (in Russian, hyperlink).

[7] Euromaidan's prime tasks, in our view, were (1) to return Ukraine towards the negotiation table with EU and sign the association agreement (the so-called political part of the agreement was sign in late March 2014, or four months after Mr. Yanukovych's rejection of signing this agreement in late November 2013), and (2) bring forward the presidential elections (which were scheduled for end of March 2015, but then rescheduled for the end of May 2014 as former President Yanukovych fled the country).

[8] By being a president who had failed to complete the five-year presidential terms by one year, and escaped the country for fear of facing prosecution for massing wealth while bankrupting public finances, and finally, masterminding the mass killing of the Ukrainians at Euromaidan in January-February 2014.

[9] In the *Financial Times*, "John Kerry warned on 'intimidation' of Ukraine" 31 March1, 2014 (hyperlink).

remaining firm against such provocative demands[10]. The Kremlin knows exactly what it is doing and realises its demands are unacceptable; it is stirring up trouble rather than trying to settle things down.

Why are these demands deemed as unacceptable?

First, military neutrality, in the sense the Kremlin means, blocks Ukraine's ability to become a part of a collective defence system like NATO to defend itself from a Russian invasion. If adopted, such a neutrality would be observed by law-abiding nations, from which this Kremlin's Russia has set itself apart. There is prevailing and valid scepticism in Ukraine that Russia is willing and able to abide to such an international agreement.

Second, the idea of federalism being fostered by the Kremlin raises concerns over the Kremlin's true intentions, and is not a logical progression in Ukraine's political development. Ukraine is a diverse nation; however, this does indicate an urgent need to install a federal system. More likely, the Kremlin's implicit target in this regard is an attempt to balkanise the southeast part[11] of Ukraine and then annex these territories following a Crimea template.

Third, Russian language discrimination in Ukraine is wishful thinking on the part of the Kremlin and has no basis in reality. In the *de-facto* bilingual nation, usage of the Russian language is a widespread habit, and in many cases is dominant in both business and everyday life. For instance, as mentioned above, the media considers Russian to be its working (and business) language and, moreover, advertisers tend to place their ads in Russian-language media. Another example: Russian schools continue to prosper in Ukraine, as there is a continued supply to meet demand for this service; hence, there is no discrimination. And, while the Russian language faces no restrictions in Ukraine, the Kremlin's demand to implement constitutional change to bring the status of the Russian language up to par with Ukrainian is broadly viewed as provocative. By making the above-mentioned demands on Ukraine, the Kremlin continues to underscore that it prefers to foster social controversy in Ukraine instead of encouraging the economic prudence of Ukraine's authorities.

Is a Russia-Ukraine war a reality?

Given the Kremlin's current geopolitical stance toward Ukraine and its quite provocative pre-conditions for the diplomatic settlement of the so-called "Ukraine crisis," it appears that a mainland invasion is likely. Our macro viewpoint in this regard considers two probable developments.

The first has to do with Russia invading mainland Ukraine. The probability of this happening is rather high, with a 40% chance, in our view. This extreme development is part of our worst-case scenario.

The very fact that, after reaching its historical low in 2013[12] Mr. Putin's approval index jumped dramatically following the aggression that started in Crimea suggests that there is a temptation to consolidate such an improvement in the eyes of Russian voters (see Chart 1 and Chart 2 on p.16, the monthly index increase in March was the third largest on record

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[10] There is wide-spread acknowledgement that one should treat an agreement with Russia with a bit of scepticism over Russia's government adhering to its liabilities under this agreement.

[11] Where there exists fertile soil for Russian nationalism due to the directed migration of Russian ethnic people under the Soviets' rule.

[12] In our view, on the back of economic recession that technically started in Russia in the second quarter of 2013 and since then only accelerated further.

since the late 1990s, when Mr. Putin came to power; the largest increase was during the second war with Chechnya). Putin could achieve another record-breaking improvement if the Kremlin expands its invasion imagination towards the unthinkable: seizing a larger chunk of mainland Ukraine in late April, a likely bloody campaign, with a grand aim of staging the Victory Day military parade, routinely held on May 9th, on Khreschatyk, Kiev's main street. This would epitomise today's newborn nationalist spirit in Russia in two ways: first, the restoration of Greater Russia with Kiev, considered by the Kremlin as birthplace of the Russian soul; and second, the military parade would literally bulldoze through the Maidan where Khreschatyk Street crosses over it.

In the latter of the two, a base-case scenario would have no mainland invasion, and hence the Kremlin's military threat remaining on Ukraine's border, their substantial military presence a sort of permanent reminder to the Ukraine's authorities to follow the Kremlin's desired path (including all key elements above: military neutrality, federalisation, and Russian language status). With Russia being sanctioned, the Kremlin is engaged in diplomatic talks with US and EU leaving Ukraine's authorities in limbo. The Kremlin allows limited intergovernmental talks with Kiev officials, and then only to resolve urgent operating issues for its state-run companies and banks. This development, in our view, has a 60% probability of taking place. In this case, Ukraine's authorities would re-ignite the economic environment under this permanent military threat.

Will Ukraine start fighting the mainland invasion?

In our view, yes, it will. True, there is bitterness over Crimea's annexation, where Ukraine's leadership decided to take a pacifying approach to the large-scale deployment of Russian army troops. Moreover, there are issues of Ukraine's army being chronically underfunded, since independence and instances of defectors are possible, too.

Nevertheless, there are three very solid points favouring Ukraine's strong defence against the Russian military invasion.

First, a capable response to the military invasion is by default a necessary commitment by the future president. While all Ukraine's mainstream politicians are speaking in a diplomatic way on Crimea and the threat of greater invasion, their commitment to fight appears unavoidable. Quite illustratively, one of the leading contenders for the presidency this May, Petro Poroshenko, has said he is committed to a military response if Russia invades the mainland. Even Yulia Tymoshenko, if elected president, would be forced to respond with military action. In general, any future president would commit to the fight, because otherwise (if he/she decides to pacify an invader, which is a possibility), they would lose power and be toppled in a snap.

Second, while Crimea's annexation resulted in a nearly 4% loss of GDP for Ukraine, a surrender of the three southeastern oblasts of Kharkiv, Luhansk, and Donestk on top of Crimea's annexation would raise that would-be loss to 23%. Furthermore, if the Kremlin's plan is about creating a defensive belt that would link Crimea and the other disputed pro-Kremlin territory of Moldova (Transdnistria) with Russia through the continental part of Ukraine and provide supplies to these regions, then the Kremlin would extend its military invasion towards other Ukrainian oblasts. These include both Zaporizhya and Dniptopetrovsk (for their industry and resources) and Mykolayiv, Kherson and Odessa (for their direct access from Crimea to Transdnistria). GDP loss from this kind of extended annexation would be nearly 50%. Following Crimea's annexation, it is worth a fight from a purely economic sense.

Third, the patriotic fibre of the nation not only strengthened during Euromaidan, it revealed that it had spread well before, towards the eastern parts of the country. There, the Russian-speaking Ukrainians would join the ranks of those who would lead and face the invasion.

Good-bye to the Customs Union ...

Euromaidan by itself was about breathing new life about the European idea into the country, an idea repeatedly ignored and rejected by Mr. Yanukovych. By default, it also meant that the country rejected the idea of a Customs Union (CU) that was fostered by the Kremlin. As the CU was a personal project of President Putin, his failure to secure Ukraine's participation resulted in the Kremlin playing political hardball with the entire country. For the majority of Ukraine, having witnessed the Kremlin's failure to live up to previous international agreements (the Budapest Memorandum of 1994 that secured Ukraine's nuclear disarmament and its territorial integrity and economic cooperation) was enough to counter any selling points by the CU.

... and say hello to the 'Depression Union'

In our view, it is likely that the Russian economy will officially be announced as "in recession" this year, with official blame assigned to the so-called "Ukraine crisis." However, our own observations of the Russian economic performance yield a conclusion that the Russian economy was already unofficially in recession in 2Q13. However, official mentions at that time were only about a "slowdown," with the R-word ("recession") likely banned from use by public as well as private sector economists and commentators. This poor economic performance (partially) explains why Mr. Putin's approval index touched its low of 24 points over 2013 (the first time was in January, and the last time it was there was in November, see Chart 1 on p.16).

The economic developments in the Russian economy had bitter spillovers into neighboring countries like Ukraine and Kazakhstan (note that the former sends 24% of its merchandise exports to Russia, and the latter exports a 36% share).

Last fall, the Kremlin imposed trade restrictions on a variety of Ukraine's exports, from food to rail cargo wagons. It was explained as a precautionary move to show Ukraine what it would lose if it were to sign an EU association agreement.

In our view, this was an act to defend its markets from more competitive exports, while domestic producers have lost competitiveness. Russia has been undergoing an internal devaluation process since early 2013, when its central bank strengthened its focus on inflation, which was historically higher than its major trade partners. State-run companies and banks were called to trim their costs and investment programmes, an indication that these (previously well-funded) programmes had stemmed corruption and allowed money to seep into the consumer real-estate markets, spurring inflation. In the end, Russian economic competitiveness suffered, depending more and more on oil and natural gas exports proceeds, an unsustainable path, in our view.

Very evident was the decision by Kazakhstan authorities to outplay the Kremlin's economic policy of internal deflation, which was forcing Russia-dependent trading partners to experience declining product demand. Hence, Kazakhstan decided to undertake its own internal devaluation via sizable nominal exchange rate devaluation, which resulted in a 30% real drop in the national currency. In our view, this move by Kazakhstan was to re-gain the competitiveness of its economy by a sizable margin well ahead of its main trading partner, Russia, because the Russian ruble was expected to devalue further. This caused some social upheaval in the country, as there were small rallies against such a drop in the national currency value. However, the country's President Nazarbayev, an autocratic leader, stood firm on the decision, despite some erosion of his vast political capital. This underscores that Kazakhstan decided to undergo some short-lived economic and social pain in order to escape the much more painful situation of a slowly unfolding loss of competitiveness and subsequent recession.

In our view, these two examples of Ukraine and Kazakhstan, which were dealing first-hand with Russia's recession and the resulting loss of Russian demand for their goods, show that economic troubles brewing in Russia have a negative spill over effect on other economies.

From our macroeconomic viewpoint, Mr. Putin's decision-making apparatus has undertaken the Ukraine military campaign as a suitable exercise, which on the one hand is popular (increasing his standing in the eyes of the voters) and on other hand, re-focuses the attention of the public, i.e., Russian voters, from domestic issues to foreign ones, which are very easy to comprehend by the voters. At this point in time, the benefits of this strategy outweigh the costs (i.e., economic sanctions by the West).

Hence, with the Russian economy entering a period of extended recession, its game of geopolitical hardball has been to invite not only ex-Soviet states, but also other global economies, first of all, the EU, towards an unofficial economic union that shares one cause: a concern for fighting the syndrome of depression among businesses and consumers (aka the "Depression Union"). Ukraine is facing economic decline due to Crimea's annexation and a negative shock on business and consumer sentiments from a persistent threat of military invasion of Russia forces[13]. Among other economies, the EU is facing a risk of another recession, if the West extends economic sanctions versus Russia. For instance, business sentiment in Germany would be negatively affected, which would have a spill-over effect on other parts of the EU.

Presidential elections: Who wins, what's next?

This March[14] a group of the highly respected opinion poll companies (Razumkov Centre, Socis, KIIS, and the Rating Sociology Group) carried out a well-grounded poll, surveying a total of 6,200 people from every Ukrainian oblast (600 persons in each oblast and 200 persons in the Zakarpattya oblast), excluding the Crimea Republic.

The poll results showed that:

- In the presidential election race: Petro Poroshenko scored 24.9% and Vitaliy Klitschko and Yuliya Tymoshenko followed with 8.9% and 8.8% respectively. Other candidates followed with lower support rates. While Klitschko effectively endorsed Poroshenko, there are two viable candidates that appear front-runners – Poroshenko and Tymoshenko.
- Out of these two figures, Poroshenko retains a 4.8% (low) negative attitude of the respondents while Tymoshenko has his at 24.1% (high).
- There is still a sizable chunk of voters. 29.6%, who are either undecided, declined to comment, do not support any candidate, or will not vote at all. This allows some ground for changes in the support base in final days of the vote. There could be developments that would change the above mentioned structure of politicians.

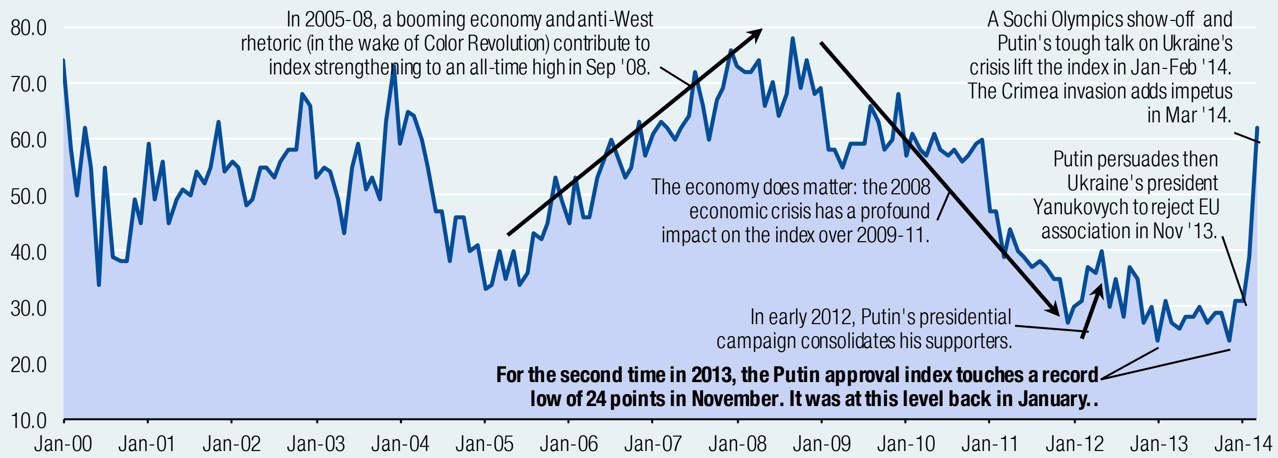
[13] Recent opinion poll, which is described in more detail in the next section, showed that Ukrainians fear most (67% of all respondents) the military aggression from a foreign state. Implicitly, they all meant Russia.

[14] During 14-19 March, 2014.

- The poll put Olga Bogomolets, a Euromaidan civil activist and doctor by profession, in first place in the ranking of politicians and civil activists whom voters trust most. She is followed by Poroshenko. This means that Bogomolets, who appeared in the poll's ranks of the presidential candidates, may show up a surprise performer as she enters the presidential race, too, alongside with other contenders.
- A 65.8% share of voters, a prevailing majority, does support early parliamentary elections.

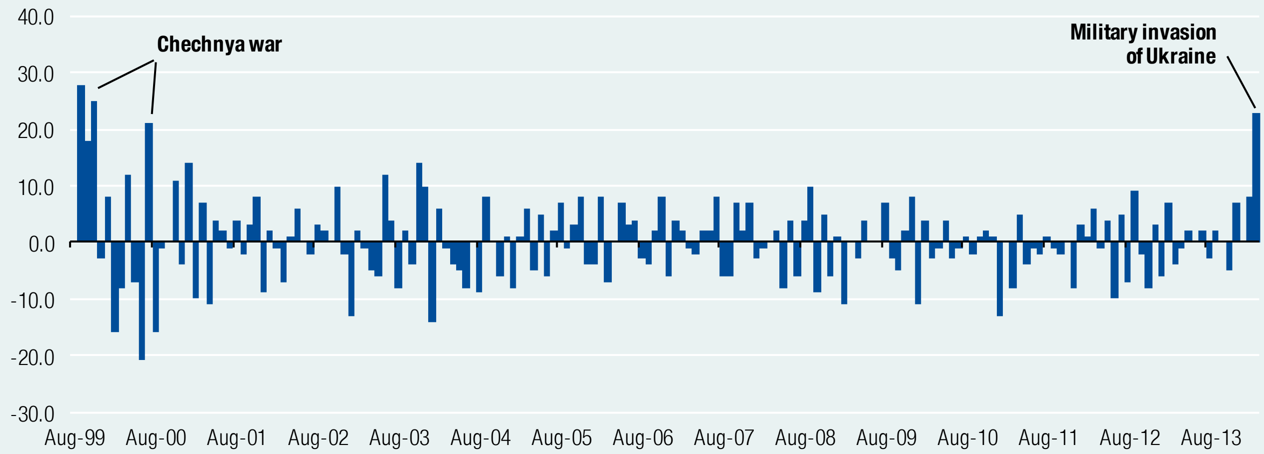
Given the above, our base case scenario envisages that Poroshenko retains the presidency, while Tymoshenko will be eyeing for a return to the politics via parliamentary elections. They are to be held later this year (end of summer or early fall) and at the end they would somewhat diminish the standing of the Party of Regions and the Communist Party. In our view, the pro-reform majority in the parliament will be retained (despite the very likely tensions between Tymoshenko's party and other parties, as they would dissipate), allowing the Yatsenyuk cabinet to govern well within the two-year programme of reforms agreed to with the IMF. In our view, this is a general consensus among the political parties that defeated Yanukoych this winter.

Chart 1. Putin approval index – monthly history from January 2000 through March 2014



Source: Levada.

Chart 2. Putin approval index – monthly history from January 2000 through March 2014



Source: Levada, Investment Capital Ukraine.

Table 1. Assessing how much of Ukraine's economy could be lost due to Russia invasion

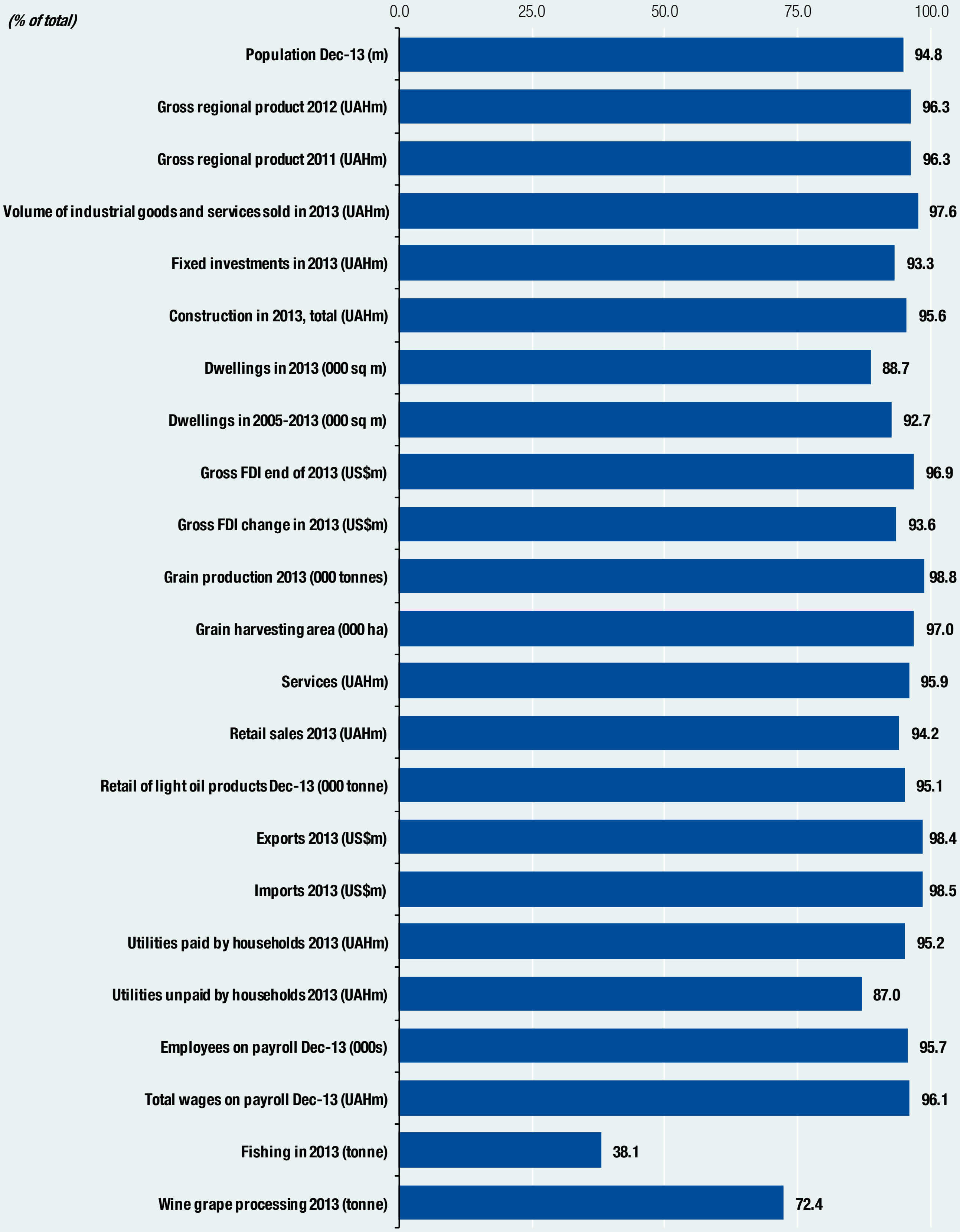
Economic indicator (UAHm, if not otherwise indicated)	Ukraine, total	Crimea & Sevas-topol	3 South-East oblasts[1]	5 South-East oblasts[2]	If Crimea Rep annexed			If Crimea Rep, 3 SE oblasts annexed			If Crimea Rep, 8 SE oblasts annexed		
						Share (%)			Share (%)			Share (%)	
					Remains to Ukraine	Re-mains	An-nexed	Remains to Ukraine	Re-mains	An-nexed	Remains to Ukraine	Re-mains	An-nexed
Population Dec-13 (m)	45,426	2,353	9,321	9,706	43,073	94.8	5.2	33,753	74.3	25.7	24,047	52.9	47.1
Gross regional product 2012	1,459,096	54,427	311,765	316,103	1,404,669	96.3	3.7	1,092,904	74.9	25.1	776,801	53.2	46.8
Gross regional product 2011	1,302,079	47,579	295,089	297,125	1,254,500	96.3	3.7	959,411	73.7	26.3	662,286	50.9	49.1
Vlm of industrial goods sold '13	1,111,269	26,776	336,510	384,655	1,084,493	97.6	2.4	747,983	67.3	32.7	363,328	32.7	67.3
Fixed investments in 2013	247,892	16,569	46,486	43,681	231,323	93.3	6.7	184,837	74.6	25.4	141,156	56.9	43.1
Construction in 2013, total	58,880	2,602	13,021	11,967	56,278	95.6	4.4	43,257	73.5	26.5	31,290	53.1	46.9
Dwellings in 2013 (000 sq m)	11,217	1,268	898	1,360	9,949	88.7	11.3	9,051	80.7	19.3	7,692	68.6	31.4
Gross FDI end of 2013 (US$m)	58,157	1,800	5,540	11,635	56,357	96.9	3.1	50,817	87.4	12.6	39,182	67.4	32.6
Gross FDI change in '13 (US$m)	2,860	183	411	812	2,678	93.6	6.4	2,266	79.2	20.8	1,454	50.8	49.2
Grain production '13 (000 t)	62,997	766	7,704	13,978	62,231	98.8	1.2	54,527	86.6	13.4	40,549	64.4	35.6
Grain harvesting area (000 ha)	15,802	477	2,349	4,943	15,325	97.0	3.0	12,977	82.1	17.9	8,033	50.8	49.2
Services	3,018,169	122,733	390,102	596,461	2,895,436	95.9	4.1	2,505,334	83.0	17.0	1,908,873	63.2	36.8
Retail sales 2013	884,204	51,185	189,270	200,458	833,018	94.2	5.8	643,748	72.8	27.2	443,290	50.1	49.9
Retail of gasoline Dec-13 (000 t)	255	13	36	65	242	95.1	4.9	206	80.9	19.1	142	55.5	44.5
Exports 2013 (US$m)	63,312	1,001	17,939	17,645	62,311	98.4	1.6	44,372	70.1	29.9	26,726	42.2	57.8
Imports 2013 (US$m)	76,964	1,151	8,183	11,747	75,813	98.5	1.5	67,630	87.9	12.1	55,882	72.6	27.4
Utilities paid by households '13	38,425	1,832	9,502	8,737	36,592	95.2	4.8	27,091	70.5	29.5	18,354	47.8	52.2
Employees on payroll Dec-13 (000s)	9,958	429	2,178	2,180	9,529	95.7	4.3	7,351	73.8	26.2	5,171	51.9	48.1
Total wages on payroll Dec-13	408,884	15,945	93,657	85,252	392,939	96.1	3.9	299,282	73.2	26.8	214,030	52.3	47.7

Notes: vlm – volume; t – tonne; [1] Kharkiv, Luhansk and Donetsk oblasts; [2] Dnipropetrovsk, Zaporizhya, Mykolayiv, Kherson and Odesa oblasts.

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

Chart 3. Selected national accounts: Share of Ukraine, excluding Crimea Republic and City of Sevastopol (% of Ukraine's total)

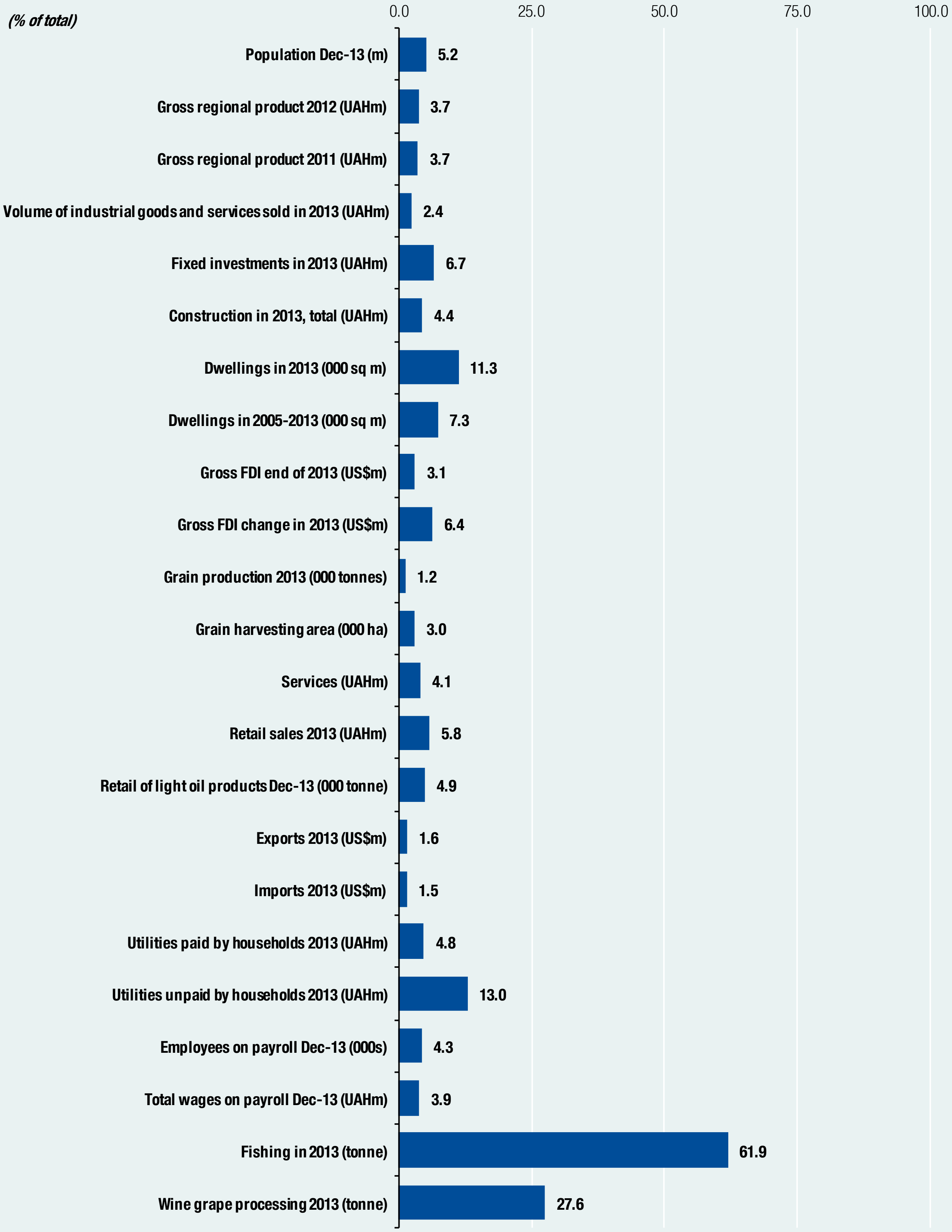
Most recent statistical data



Sources: State Statistics Service of Ukraine, ICU.

Chart 4. Selected national accounts: Crimea Republic and City of Sevastopol (% of Ukraine's total)

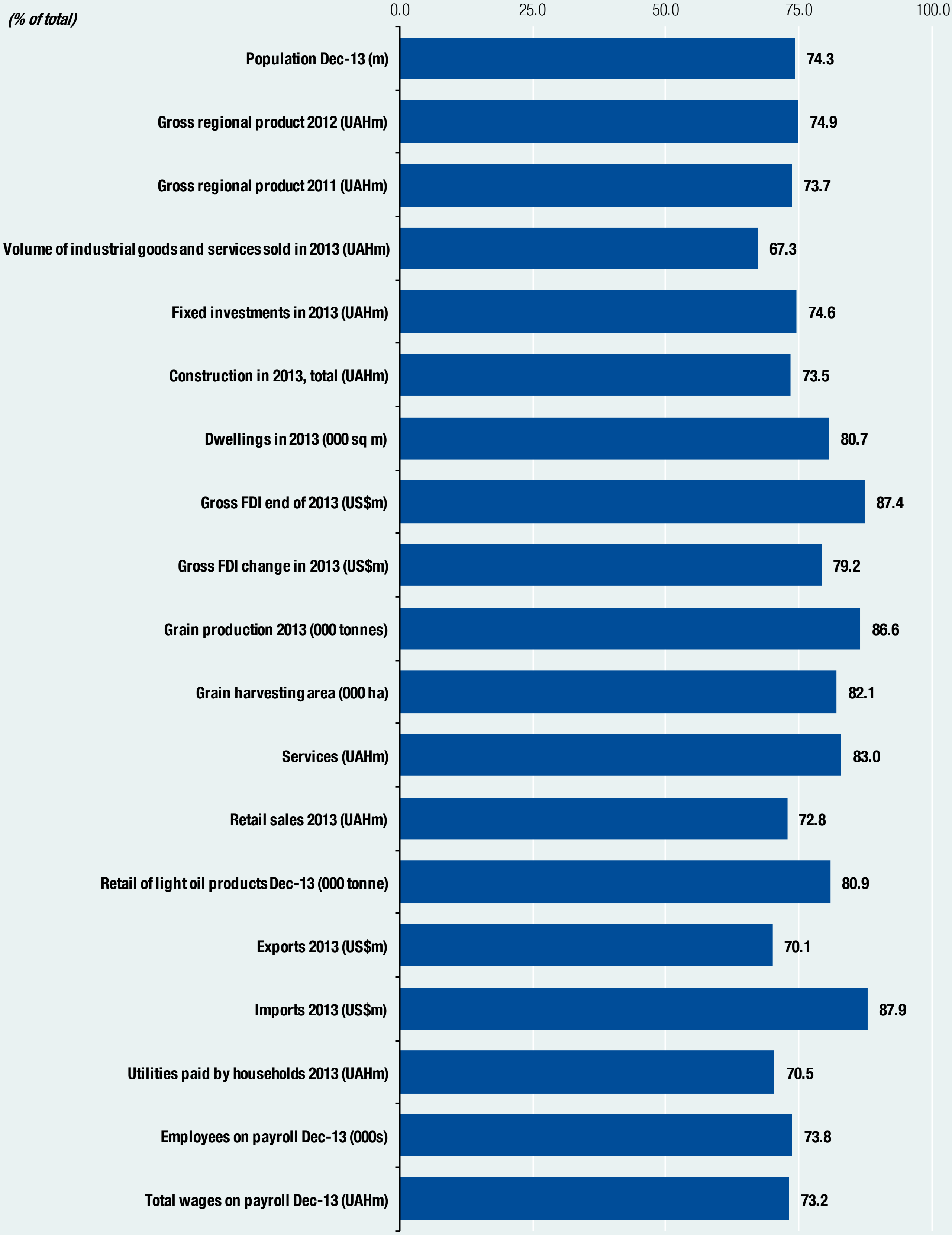
Most recent statistical data



Sources: State Statistics Service of Ukraine, ICU.

Chart 5. Selected national accounts: Share of Ukraine, excluding Crimea Republic and City of Sevastopol and three oblasts of south-east part of Ukraine, which are Kharkiv, Luhansk and Donetsk oblasts (% of Ukraine's total)

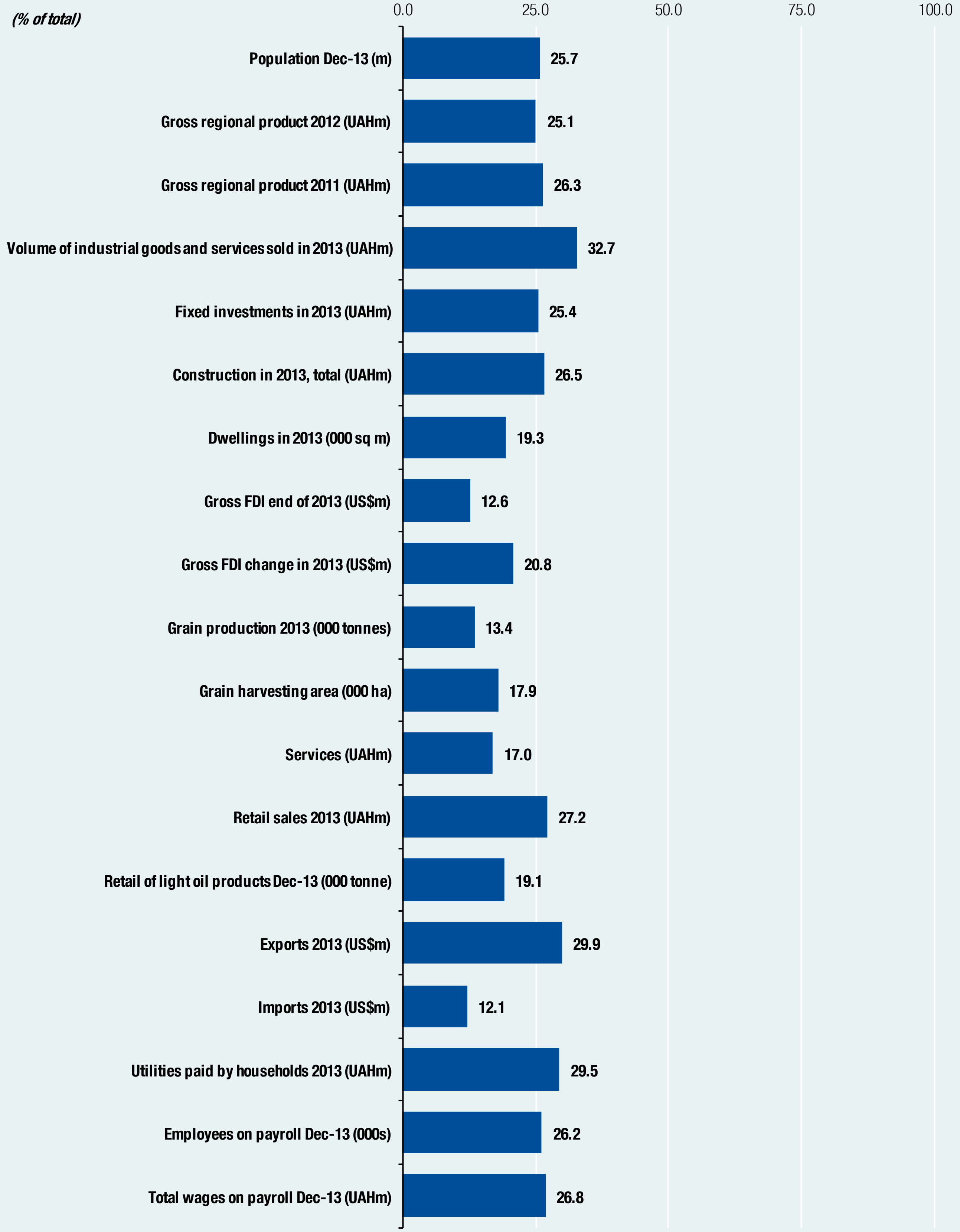
Most recent statistical data



Sources: State Statistics Service of Ukraine, ICU.

Chart 6. Selected national accounts: Crimea Republic and City of Sevastopol and <u>three</u> oblasts of south-east part of Ukraine, which are Kharkiv, Luhansk and Donetsk oblasts (% of Ukraine's total)

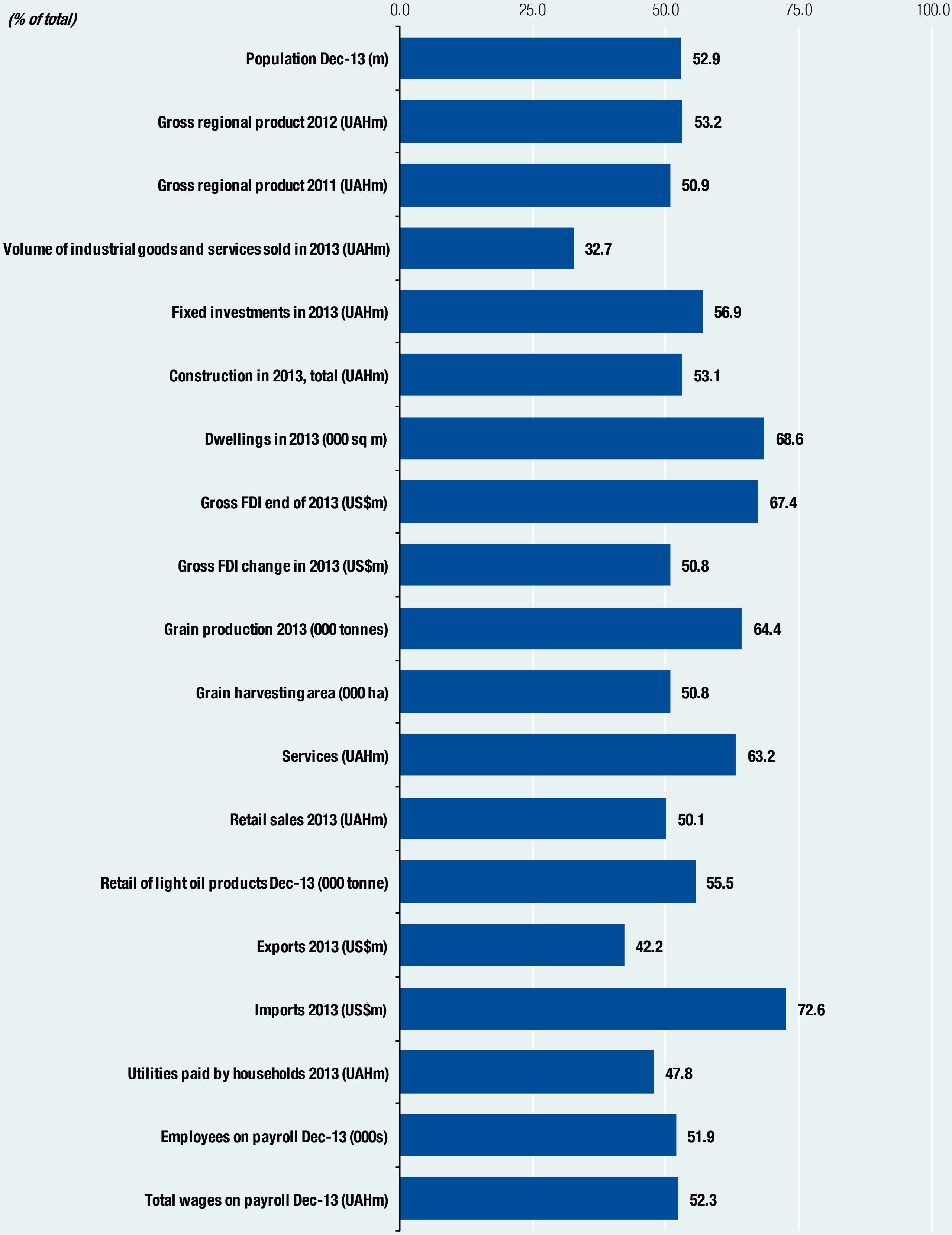
Most recent statistical data



Sources: State Statistics Service of Ukraine, ICU.

Chart 7. Selected national accounts: Share of Ukraine, excluding Crimea Republic and City of Sevastopol and eight oblasts of south-east part of Ukraine, which are Kharkiv, Luhansk, Donetsk, Dnipropetrovsk, Zaporizhya, Mykolayiv, Kherson and Odesa oblasts (% of Ukraine's total)

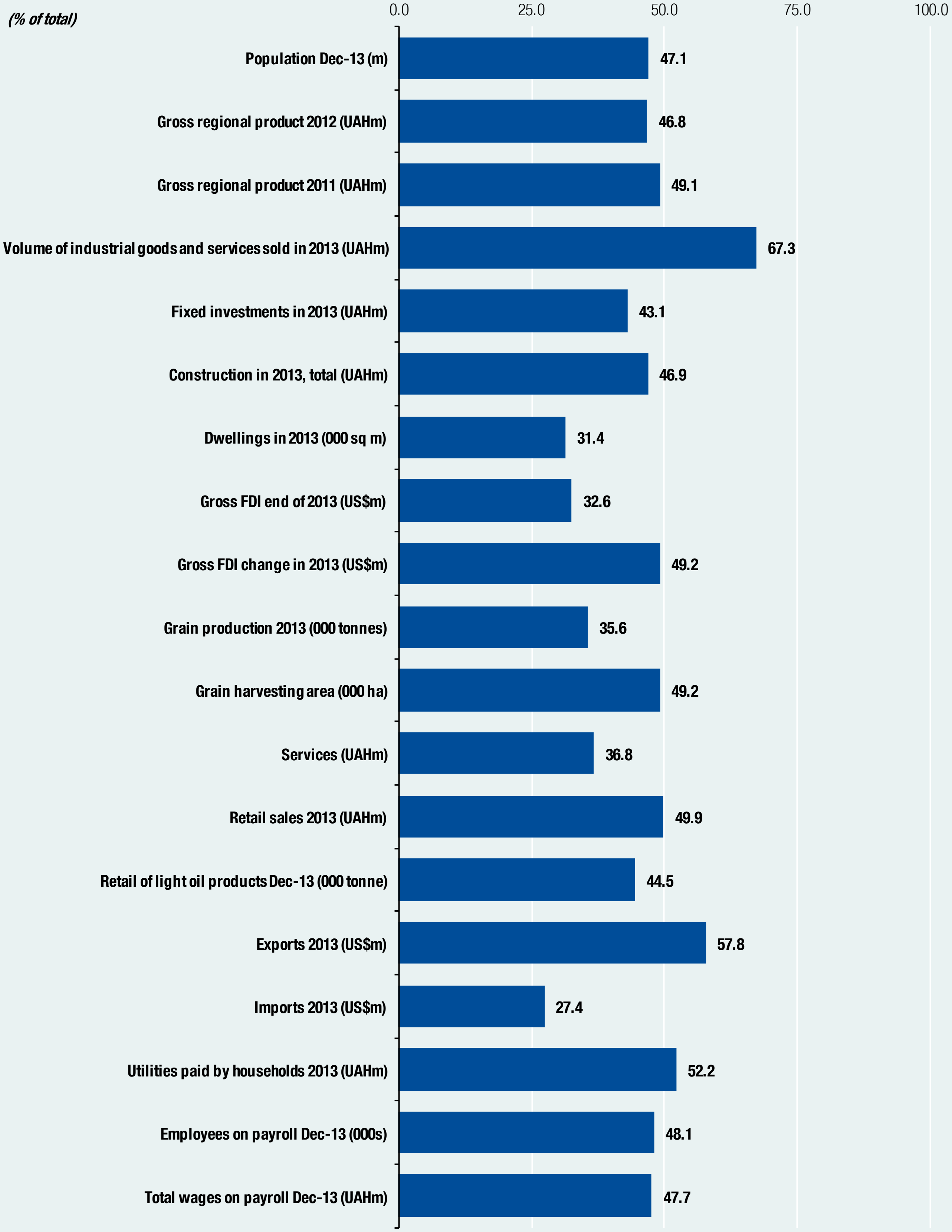
Most recent statistical data



Sources: State Statistics Service of Ukraine, ICU.

Chart 8. Selected national accounts: Crimea Republic and City of Sevastopol and eight oblasts of south-east part of Ukraine, which are Kharkiv, Luhansk, Donetsk, Dnipropetrovsk, Zaporizhya, Mykolayiv, Kherson and Odesa oblasts (% of Ukraine's total)

Most recent statistical data



Sources: State Statistics Service of Ukraine, ICU.

Global economy

This section provides our view on the current state of the global economy and its parts, which are important to Ukraine's economy. It includes our discussion on the likely path of the Eurozone economy. The Russian economy is discussed at length, along with our view on the near term future developments.

Introduction to our global economy view

Who is more "sick" in the "sick" Europe?

The "sick man of Europe" term has been in use since 19th century, according to Wikipedia.org[15], referring to a country that grappled with economic difficulties of a profound dimension. It was first used to refer to modern day Turkey, then to the Ottoman Empire. Since then it has been attached to different countries, including 1990s Germany. Very recently it looked like half of the European continent—from Iceland to Ireland, and from Spain to Greece—qualified for this status.

From this viewpoint, Ukraine could also qualify for the tag as it experienced a whopping 15% real GDP contraction in 2009 and has barely recovered since then. These days Ukraine appears as a key trouble spot because so much attention is being paid to it in the media as well as in the public and private talks between government policymakers and military commanders. Indeed, Ukraine has more global attention than ever before thanks to Russia's annexing of Crimea exactly 100 years after the First World War broke out.

However, all the above is well-known and well-documented. Moreover, there are European economies considered gravely sick that are testing the turning points for the better, hence, they are healing. Among them are Greece, Italy, and Ireland to name just few. Ukraine, too, has just recently turned around politically and, in our view, economically too as it at last committed to an IMF-supported programme of macroeconomic changes.

The aim of this chapter is to shed more light onto the economy that has just started to expose its economic problems. This is an economy that has just started to feel the pain of the evolving global economic conditions and has been flexing its brain power to fix the slide, hoping to test the turning point sooner rather than later. To paraphrase, while most of the troubled economies of Europe have been restored to health, another country on the continent has caught the cold. In our view, this economy is Russia.

The structure of the section

Below we focus on the developments in the global economy that are worth prime attention, as they have profound impact on the Ukraine's rather small economy, the section starts with the view on the developed economies, especially to the Eurozone as it bears the brunt of the ongoing global economic adjustment. Then it is followed by the view on the key emerging markets and their adaptive measures. We narrow the focus towards the economic developments of Russia.

[15] Hyperlink.

Developed economies: Whose 'sickness' requires special treatment?

Recent developments in the major developed economies have been somewhat encouraging as there were signs of firming growth in every major part of the global economy, such as US, Eurozone, Japan and UK as well. However, there are still a number of weaknesses present.

US

In the US, its slow lower labour participation rate "feels like recession" according to the Fed chairwoman Ms. Yellen. Despite this expression by the chief of the Fed, it looks like the tapering process continues this year and changing course would be a surprise event to the markets. With monetary conditions still at ease in the US—its Fed's balance sheet is expected to expand, albeit at a slower pace, as QE "tapering" takes place with a US$10bn reduction per FOMC meeting[16] and is further expected to thin out altogether in 4Q14—the still weak US dollar is likely to support competitiveness in the US economy, ultimately allowing economic recovery to continue. However, the downside risk exists due to weakness showed by major trade partners of the US such as Eurozone and China.

Japan

This country's leadership appears determined to succeed in turning economy around after a year-long monetary easing programme that weakened JPY dramatically (by more than 18% over last 12 months, according to BIS[17]). Consumer inflation has been steadily above 1.0% YoY over past half a year (at 1.5% YoY for February). Recent rhetoric from the country's prime minister points out that an additional injection of liquidity is most likely to be undertaken by the central bank. Hence, in relative terms monetary conditions in the country are to stay softer than in the US, providing the ground for supported weakness of the currency from the current below-105/USD level beyond it and towards the 110/USD (see Chart 10, p.26). This development is going to have repercussions for Asia as a whole, where China and South Korea are likely to react with own countermeasures.

Eurozone

In our view, out of all major global economies, the Eurozone is experiencing the most awkward recovery from the ravaging effects of the 2008 financial and debt crises. It is clear that policymakers there have taken the stance that there is no other way out then to undergo macroeconomic adjustment through cutting of domestic demand. One of its major sources of recovery is relying on external demand, thanks to the ever-strong external position of Germany, the major Eurozone economy.

Thus, current account surplus in Germany rose from 5.2% of GDP in mid-2009 to 7.4% at the end of 2013, while over the same period of time Eurozone shifted from a 1% deficit to a 2.2% surplus. This adjustment in the Eurozone has been accompanied by a 4.3ppt increase in the unemployment rate (now at 11.9%). It is well known that the most hard hit from the social point of view were the debt-crisis stricken economies of Italy, Ireland, Spain and Greece, where the unemployment rate topped 5.7ppt, 6.6ppt, 15.6ppt and 20.1ppt, respectively.

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[16] Since April 2014, the Fed adds to its securities holding a total of US$55bn by purchasing securities from the market. Starting with FOMC meeting in December 2013, the Fed was reducing the volume of monthly purchases by US$10bn. Hence, if this pace of US$10bn reduction per FOMC meeting remains intact then Fed's QE3 programme will end by December 2014.

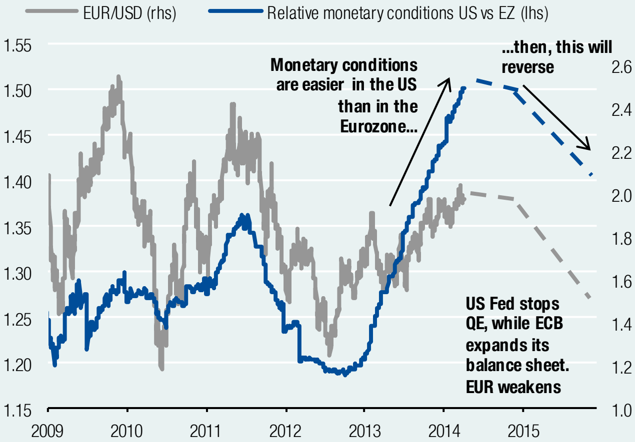
[17] See http://www.bis.org/statistics/eer/index.htm.

Also, Eurozone consumer inflation slowed to 0.5% YoY in March, down from 1.7% YoY a year ago, pointing to quite sluggish domestic demand. Germany's CPI was expected to be at 1.0% YoY this March, revealing that the debt stricken states of the Eurozone are suffering a more severe situation with domestic demand than Eurozone as a whole.

There has been a lively and continued debate on whether ECB should or should not undertake monetary easing with unconventional tools, like the Fed's quantitative easing or the Bank of Japan's quantitative and qualitative easing, which has intensified following the 0.5% YoY CPI this March according to Eurostat. Indeed, while the Fed undergoes QE3 tapering, ECB's shrinking balance sheet is allowing for tighter monetary conditions in the Eurozone relative to the US (see left hand chart below). Hence, this in part provided the ground for EUR's current strength.

Chart 9. US vs Eurozone: Monetary conditions and FX rate

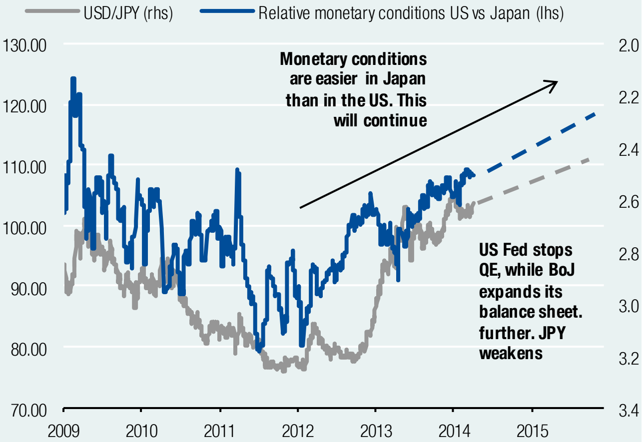
History from 1 January 2009 through 2 April 2014



Note: Monetary conditions are a ratio of US Feb balance sheet size divided by the ECB balance sheet size.
Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 10. US vs Japan: Monetary conditions and FX rate

History from 1 January 2009 through 2 April 2014



Note: Monetary conditions are a ratio of US Feb balance sheet size divided by the BoJ balance sheet size.
Sources: Bloomberg, Investment Capital Ukraine LLC.

In our view, the Eurozone is likely to eventually experience monetary easing by ECB, similar to the US, for the following reasons:

First, there are home-grown issues. The key issue here is the risk of ECB allowing *de-facto* more tightening in the Eurozone if it will continue desynchronizing from the prevailing monetary easing that has been in place in the US, and in Asia, (particularly in Japan and more recently, China). If this risk materializes, it would mean an even stronger EUR than now, increased risk of deflation, worsened growth prospects for the euro area members and, lastly, the entire Eurozone slipping into recession again.

At the same time, there is a more profound home-grown risk in the medium term that would undermine Eurozone recovery if left unaddressed: an apparent lack of convergence of competitiveness among the euro area. on p.76 spectacularly illustrates this development. Thus, since the inception of euro as a currency of the monetary union, the euro members' competitiveness has been gradually diverging. In the run-up to 2008, this global economic process was taken to the extreme. For instance, Ireland was the most divergent, followed by Spain, which was less competitive, while Germany was gaining in competitiveness. Right after the crisis, during 2009, some convergence took place. For instance, Ireland improved its position markedly via sizable internal devaluation. This process continued somewhat during the most severe phase of the 2010-12 Eurozone debt crisis. Then in July 2012, ECB governor Mario Draghi uttered his now-famous "whatever it takes" phrase, which the financial markets translated as his claim to save the Eurozone by every required action. Since then, convergence was swapped for divergence again.

Quite remarkably, Germany has been the most competitive economy of the Eurozone. However, in the mid-1990s, it was Germany that was least competitive and hence it was labelled at the time as the "sick man of Europe". Now having a single currency, one of the elementary paths for Eurozone convergence is through inflation (i.e., more expansionary fiscal policies) in the most competitive euro area members like Germany. However, this path received outright rejection by the policymakers of Germany and other stronger members.

Hence, ECB is left to manoeuvre between very uneven economic prospects (the continued divergence of euro area members provides very patchy economic growth in different parts of the Eurozone) and formulating a monetary policy that fits all members. In the end, in our view, the choice of the extremely cautious ECB will be on the side of carrying its own QE, albeit of less dramatic size than done by US Fed or BoJ.

There are also external issues, though they are less influential than domestic ones with regard to the ECB monetary policy decision. Nevertheless, in our view, there is a risk factor worth mentioning. Eurozone has China and Russia among its main trade partners, which together account for a sizable share of total exports from the Euro area, 6.5% and 4.6% respectively.

Both of these countries have been undergoing a process of economic rebalancing, i.e., adaptation to new global macroeconomic conditions and exhausting the past engines of growth. While China is expected to slow down but still post positive real GDP growth in 2014 (around 7%), Russia's economy is widely expected to experience recession (at least officially). In our view, both of the countries' policies in tackling domestic economic issues have negative spillovers on their neighbours.

In Asia, one prevailing development has been that economies have been experiencing currency devaluations in order to win external demand. Obviously, China's recent devaluation added to this fray. As we show below, China's recent episode with CNY weakness is likely not a temporary thing and it will not follow the international lecturing over its currency undervaluation. Hence, more weakness is likely.

In Eastern Europe, Russia has been playing geopolitical hardball redrawing the borders. In our view, this is a spillover effect from disappointing economic developments in Russia where businesses and households started to cut back. Meanwhile, EU joined US in sanctioning Russia further for another invasion, which adds to the already gloomy conditions in the region. Since 2013, Russian authorities have been imposing trade restrictions to protect imports from flowing into the country under different excuses (from poor sanitary conditions of food producers in Ukraine and Baltic state to the Ukraine's EU association). Such hardball threatens confidence not only in Ukraine but also in the new member states of the EU, for which security issues in relations with Russia are a serious concern.

Hence, in our view, ECB could weigh the already slowly-spreading gloom from the emerging markets into its calculations and somewhat ease monetary conditions.

Emerging economies: Slower growth and real devaluations

Within the BRICS countries, China and Russia are distinct from the rest of the group. In our view, the distinction lies in the heart of the monetary response of the authorities to the ever-changing global macroeconomic environment. In particular, these countries appeared less open to the global capital flows.

In the first wave of the US dollar liquidity glut created by the US Fed, the Russian ruble and Chinese yuan were the least affected out of the remaining currencies. Hence, in 2010 their real appreciation (adjusted for price inflation and trade-weighted) was just 6.7% and 4.4% respectively. At the same time, the currencies of Brazil, India and South Africa responded with higher real appreciation of 7.2%, 10.3% and 11.8%, respectively, absorbing all the negative effects of the international capital inflows resulting from a loss of competitiveness in their economies.

No wonder that these economies were first to feel the chill as they slowed down– Brazil's real GDP slowed by a significant 4.8ppt, from 7.6% in 2010 to 2.8% in 2009; India experienced a 1.7ppt slowdown over the same period, from 9.4% to 7.7% (a still impressive rate); South Africa saw its real growth continue as it was better prepared[18].

Since then, thanks to higher monetary flexibility and subdued inflation (to a great extent, as a result of less tight labour market), these economies underwent real devaluation, i.e., re-gaining in terms of external competitiveness in a very accelerated fashion.

Russia and China instead saw another year of real appreciation due to the rigidity of either monetary policies or the labour market, which fostered inflation at a relatively high level. The table below shows that a clear prospect of growth loss pushed Russian authorities to break from real appreciation (loss of competitiveness) in 2013, allowing Russian currency a 2.2% real devaluation, which is still a modest measure if compared with several consecutive years of real appreciation in 2010-12 and in the pre-2008 crisis period. China's authorities made nearly the same move this year as they widened the band of allowable fluctuation in the FX rate, which produced a nominal decline in the exchange rate from 6.05/USD at the end of 2013 to 6.22/USD at the end of March 2014.

In 2014, the BRICS economies are expected to play the macroeconomic adjustment game, being more open-minded towards monetary flexibility that is able to realize adjustment through the FX markets, albeit with cautiousness. Still, China and Russia do stand out in the BRICS. This time, due to its vast economic weight, China's FX rate moves are closely and jealously scrutinized by its neighbours, which would treat Japan and China as economic super powers playing the same game – devaluing for their own prosperity. Hence, there is risk that this could cause a wave of devaluations of other currencies in the Asian region. In fear of stirring regional economic tensions, China is likely to make very small FX rate moves. As far as Russia is concerned, its FX moves will be too cautious because of a fear of public discontent; the public still follows RUB's exchange rate and a sizable drop in the RUB's value would hit Putin's approval rating.

[18] It is true that South Africa did hold that rule as its real GDP growth rate accelerated by 0.5ppt to 3.6% in 2011. However, it should be noted that at the time the national currency, SAR, was still cheap despite that real appreciation experienced in 2010. Meanwhile Brazilian currency was quite dear due to real appreciation in 2010, and Indian currency was at near all-time high level in real terms.

Table 2. BRICS: economic growth and competitiveness losses and gains

	2010	2011	2012	2013	2014F
Real GDP (%YoY)					
Brazil	7.6	2.8	1.0	2.3	2.5
Russia	4.5	4.3	3.4	1.3	-0.4
India	9.4	7.7	4.8	4.6	4.7
China	10.4	9.3	7.7	7.7	7.4
South Africa	3.1	3.6	2.5	1.9	2.5
Real GDP change (ppt)					
Brazil		-4.8	-1.7	1.3	0.2
Russia		-0.2	-0.9	-2.1	-1.7
India		-1.7	-2.9	-0.3	0.1
China		-1.1	-1.6	0.0	-0.3
South Africa		0.5	-1.1	-0.6	0.6
Competitiveness level as measured by BIS REER (points, eop)					
Brazil	103.6	98.6	90.0	85.0	82.5
Russia	99.8	100.5	106.9	104.6	100.2
India	102.6	92.0	91.8	85.5	87.2
China	101.5	107.8	110.1	118.8	116.4
South Africa	105.3	89.9	88.4	77.2	78.7
Competitiveness loss (+) and gains (-) as measured by BIS REER change (%)					
Brazil	+7.2	-4.8	-8.8	-5.5	-3.0
Russia	+6.7	+0.7	+6.3	-2.2	-4.2
India	+10.3	-10.4	-0.2	-6.8	+2.0
China	+4.4	+6.2	+2.2	+7.8	-2.0
South Africa	+11.8	-14.6	-1.7	-12.7	+2.0

Notes: REER – BIS real effective exchange rate; eop – end of period.
Sources: Bloomberg, BIS, Investment Capital Ukraine LLC.

Why Russia's economy is facing its own reckoning moment

It has been tempting to respond logically to a Russian question – why a net oil exporter, with crude oil price staying above a *hundo*[19] per barrel, has an economy that has become stuck?

Instead of preface

Indeed, here at ICU we started paying more close attention to the Russian economy early last year. (Then, an in-house family of FX trade-weighted indices accommodated the RUB's indices in addition to the UAH's ones.)

Then, in the summer of 2013, the quarterly GDP data series drew our attention along with the prevailing rhetoric of public and private sector economists on the macroeconomic performance over that year. There was inconsistency: while data on the state statistics office web site revealed two consecutive periods of on-quarter economic contraction[20], the talk among Russian economists in their research reports, as well as in the most-read and followed business newspapers like *Vedomosti,* was about a slowdown in the economy. It seemed the R-word ("recession") was banned; a softer term — "slowdown"—was the key

[19] A US$100 note.

[20] In seasonally adjusted terms.

defining term. Our flash inquiry, addressed to a Moscow-based colleague who had just issued a "slowdown" report, regarding the R-word omission, yielded a short explanation, saying that official statistics data had a "seasonal adjustment" bug and hence it was "wrong". Later, indeed, the "wrong data" series was updated (see Table 3, below), effectively eliminating the reason to bother with the R-word. Since then, however, the domestic usage of the "slowdown" term referring to Russia's economy did not disappear, it just continued well into the second half of 2013 and this year, too.

Table 3. The summer 2013 update of the seasonally-adjusted quarterly GDP data

Period	Old data series (before the 3Q13 update)			New data series (after the 3Q13 update)			Difference between new and old data series
	GDP (RUBbn)	Change (% QoQ)	Comment	GDP (RUBbn)	Change (% QoQ)	Comment	
1Q12	10,603.21	-0.3		10,658.97	0.8		55.77
2Q12	10,645.73	0.4		10,717.63	0.6		71.90
3Q12	10,776.92	1.2		10,751.91	0.3		-25.01
4Q12	10,833.15	0.5		10,737.52	-0.1		-95.63
1Q13	10,806.44	**-0.2**		10,760.64	0.2		-45.81
2Q13	10,777.82	**-0.3**	**By old data series recession**	10,804.20	0.4	**By new data series**	26.37
3Q13			**starts in 2Q13**	10,874.39	0.6	**there was no recession**	NR
4Q13				10,970.20	0.9	**in 2013**	NR

Notes: NR – not relevant.
Sources: Federal Statistics Service of Russia, Investment Capital Ukraine LLC.

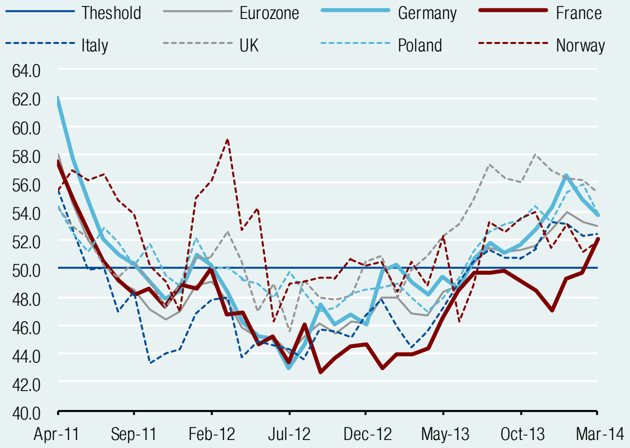
Russia as BRICS outlier in terms of economic growth prospects

If the Russian economy is viewed versus some advanced and even BRICS economies (see charts below), an obvious conclusion comes to mind that the growth path of Russia is an outlier in terms of likely growth prospects in the 1H14. While major developed economies are in the expansion as indicated by national manufacturing PMIs, the emerging ones are struggling to hold to the growth rates seen recently.

However, only Russia, out of the group of BRICS economies, has been in protracted contraction since 2H13. In the above discussion of the relationship between GDP growth and competitiveness (see the section "Emerging economies: Slower growth and real devaluations" above on p.28 and Table 2 on p.29), it was highlighted that all of the BRICS, excluding China and Russia, have been using monetary policy tools at nearly their full extent to restore growth prospects by re-gaining competitiveness. While still these economies did not succeed in lifting the growth prospects high (to enjoy an economic boom of the past), they at least had apparently avoided contraction. While China's growth prospects seem well secured from slipping into contraction, it leaves Russia as the one to contract.

Chart 11. Manufacturing PMIs: Eurozone and selected European economies

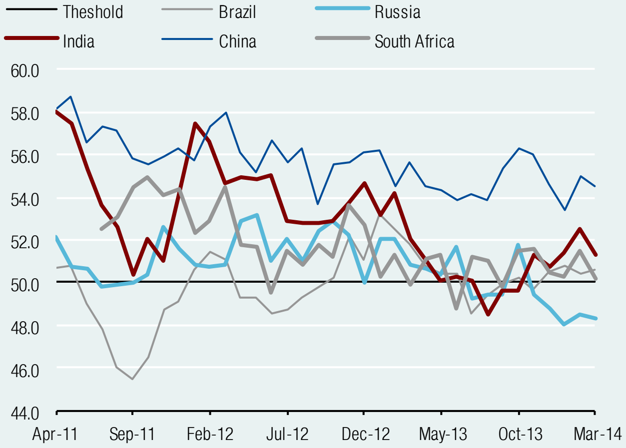
Monthly history from April 2011 through March 2014



Source: Bloomberg.

Chart 12. Manufacturing PMIs: economies of BRICS (Brazil, Russia, India, China and South Africa)

Monthly history from April 2011 through March 2014



Source: Bloomberg.

A likely recession

The March reading of the manufacturing and services PMIs for Russia showed that not only is manufacturing in the contraction mode (its index was at 48.3 points, albeit up from 48.0 points in the previous month, but still below 50 points for the previous three months from November 2013), the services sector, too, slipped into contraction for the first time since July 2013. See Chart 13 on p.34.

While the services sector has been growing in relation to manufacturing, 52% versus 25% for the manufacturing sector, the March PMIs are likely to translate into very weak on-year real GDP growth in the 1Q14 (in our view, at 0%), making the on-quarter growth rate negative. If the services sector continues to underperform in the second quarter along with manufacturing, a plausible assumption, then domestic talk on the economy this year will eventually adopt, albeit reluctantly, the R-word term, referring to recession.

Why is Russia such an outlier? Answer #1: Slowed investments

With hindsight, it is known from the available data that Russia's current economic problems started to surface a couple of years ago. Thus, our proffered indication of the mid-term prospects of an emerging economy—fixed capital investment—has been on the decline in Russia for all of 2012-13. As share of GDP, fixed capital investment slowed from 23.1%--a post 2008 crisis high—to 21.1% at the end of 2013. A noteworthy confirmation of the trend is seen in Russian imports from Germany, which consist of purchases of investment goods as well as of luxury brand cars (see Chart 15 on p.34). They began slowing down in 2011-12 and then were in decline for all of 2013.

Why is Russia such an outlier? Answer #2: Outsized consumption boom

This is contrasted with a booming consumption level that rose from the pre-2008 crisis peak of 69.8% of GDP to an all-time high of 73.7% in 2013. The key victim of the development was the country's ability to maintain a face-saving external balance. It has been deteriorating since the 2008 crisis and the issue had increased in proportion to such an extent as to suggest that Russia is facing a consumption boom far bigger than the one than that took place in the run-up to the 2008 recession. Last year, net export as share of GDP accounted for 7.2%, while in the middle of 2008 it peaked at 8.8%.

Why is Russia such an outlier? Answer #3: Populist policymaking

Another likely destructive force over investments in the economy, in our view, is populist governance by the authorities, which propagate the state capitalism philosophy. This implies tight labour market conditions, dominance of the public sector over the private sector which in turn discourages private investment. Chart 16 (on p.34) shows that since 2012, the year when Vladimir Putin, then a prime minister, was elected president again, the unemployment rate has been steady at a record breaking level of 5.5%, a 0.5ppt improvement, with 6.0% seen in 2007, a pre-2008 crisis high. Moreover, average wage growth in nominal terms has been in double digits most of the time: during the 2004-08 economic boom, it grew by nearly 26% a year on average, and since 2010 it has been growing by more than 12% a year (Chart 17, p.34). This also provides inflexibility in the economy, structural factors which complicate sizably the task of the Russian central bank in targeting low inflation (while an exchange-rate pass-through factor is likely high).

Why is Russia such an outlier? Answer #4: Persistently high inflation

The above mentioned factors—of historically low unemployment rate, and a generous nanny state that maintains high wage growth—provided, in our view, the environment where domestic inflation was persistently above the inflation level of the main trade partners such as EU economies and China, which account respectively for a 45% and 11% share of total trade turnover (exports plus imports). Thus, in March, CPI accelerated to 6.9% YoY from 6.2% a month ago. Meanwhile in Germany, consumer inflation was at 0.8% YoY in February and China's was at 2.3% YoY in the same month.

Why is Russia such an outlier? Answer #5: Sizable loss of competitiveness

Due to the two factors mentioned above—populism of the authorities and persistently high inflation—together with (bad or good) luck, the Russian economy has steadily been a kind of a champion in losing competitiveness. Since 2000, its currency appreciated in real and trade-weighted terms by a factor of two, according to the BIS data[21] (see Chart 19, p.35). This resulted in an over-priced currency since early 2000 that had just a few narrow episodes of being eliminated from this label (i.e., right after the 2008 crisis with financial markets in severe adjustment, RUB real rate decline was so steep that it provided for a brief period a relatively fair valued currency, according to our calculations). Why did the lengthy competitiveness loss not cause an economic problem? Our preferred explanation is the mere fact of crude oil price growth. When the crude oil price was on the rise, the competitiveness issue was not a determining factor. However, it appears that with a stalled crude oil price, the competitiveness issue has become more visible.

As a conclusion: Is Russia another Ireland?

Above are mentioned just a few issues, which in our view, are the key ones to explain the precarious state of the Russian economy. Summing them up, one would ask about the counter measures the Russian authorities could undertake to smooth the future path of the economy. Indeed, they have been undertaking them already, in our judgment, from as far back as early 2013. It was quite revealing that Russian state-run corporate champions were asked by the leadership of the country to cut back in their capital investment programmes, and later in the year they also were asked to cut the budgets of their usually lavish New Year corporate parties. With the corruption level still high and state money being siphoned from numerous infrastructure projects (Sochi Olympics was an outstanding example), such cut backs indicate that the nanny state coffers had started to feel the strain. But first of all, in our view, they undertook these measures to start the process of so-called internal

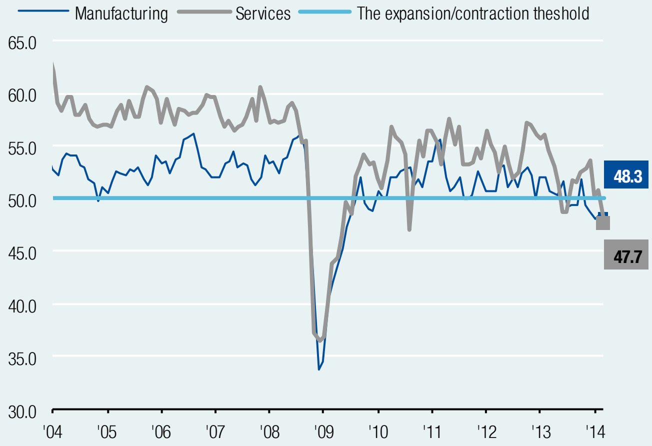
[21] ICU's own calculations of the RUB's real trade-weighted indices confirm this.

devaluation. Re-gaining external competitiveness through complex measures such as cutting back on state expenditures would hold back inflation, and with measured nominal devaluation of the national currency this would yield a needed real devaluation. BIS data show that Russia re-gained competitiveness in 2013 by 2.2% (see Table 2 on p.29). This year, it is expected Russian authorities would be eager to continue this process. However, as mentioned above, Russia's FX pass-through ratio is rather high, giving authorities the task of engineering a required internal devolution. Because of an inflexible labour market, a populist governance will aid in this regard. Hence, Russian authorities should allow more flexibility in the labour market and in the monetary sphere, too (by removing support to RUB in the FX market; likely seen as painful step). Otherwise, the poor competitiveness issue risks become chronic for Russia, an unsustainable path while crude oil price is widely expected to decrease.

Finally, even with last year's real devaluation of 2.2% (a slight improvement) Russia's current competitiveness level resembles Ireland's before its fall in 2008, (see Chart 18 and Chart 19 on p.35). True, Russia has a superb public debt level, however, this could make no difference if financial markets face a surprise shock (like a Lehman bankruptcy). Such a risk has a quite small (low, single-digit) probability these days. Nevertheless, the Russian economy has a wealth of issues explained above. It deserves the tag of "the really sick man of Europe" these days.

Chart 13. Russia's manufacturing and services PMI

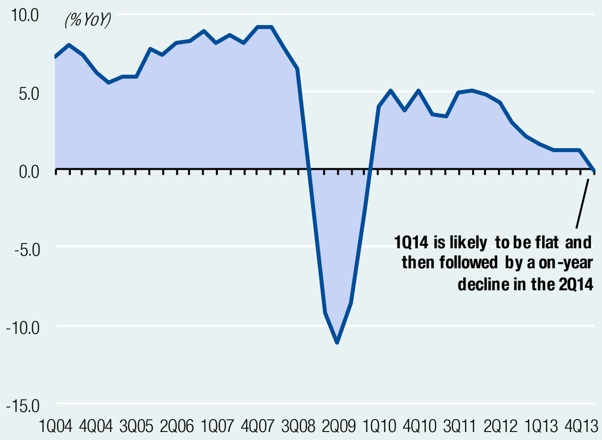
Monthly history from January 2004 through March 2014



Note: Boxes show the latest value for the indices. Sources: HSBC, Standard Bank.

Chart 14. Russia's real GDP growth (%YoY)

Quarterly history from 1Q of 2004 through 1Q of 2014



Sources: Russia Statistics Committee, Investment Capital Ukraine LLC.

Chart 15. Two telling charts on Russia's declining demand: Are businesses and consumers buying German cars, machinery and equipment? Monthly history from January 2000 through January 2014. German side volumes are the data of the Federal Statistical Office of Germany. Russian side volumes are the data of the Russian Customs Service.

Volumes are in billions of EUR and are seasonally adjusted.

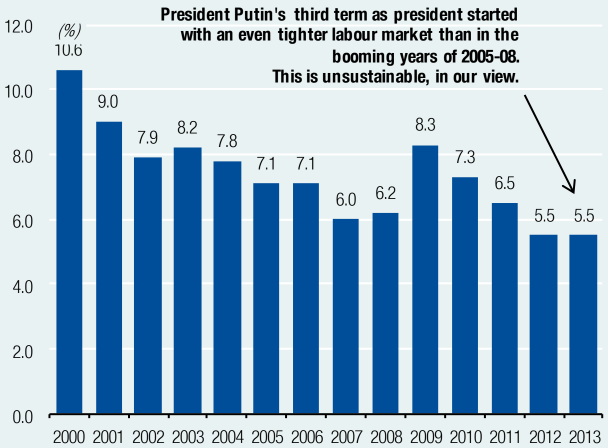
Sources: Bloomberg, Russia Statistics Committee, Investment Capital Ukraine LLC.

Year-on-year growth rates

Sources: Bloomberg, Russia Statistics Committee, Investment Capital Ukraine LLC.

Chart 16. Russia's unemployment rate in 2000-13 (%)

Yearly history from January 2004 through March 2014



Source: Russia Statistics Committee.

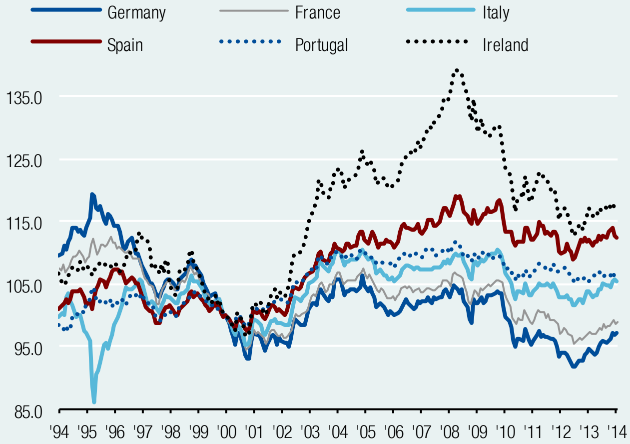
Chart 17. Average wage growth (%YoY)

Quarterly history from 1Q of 2004 through 1Q of 2014

Source: Russia Statistics Committee, Investment Capital Ukraine LLC.

Chart 18. External competitiveness of some Eurozone members

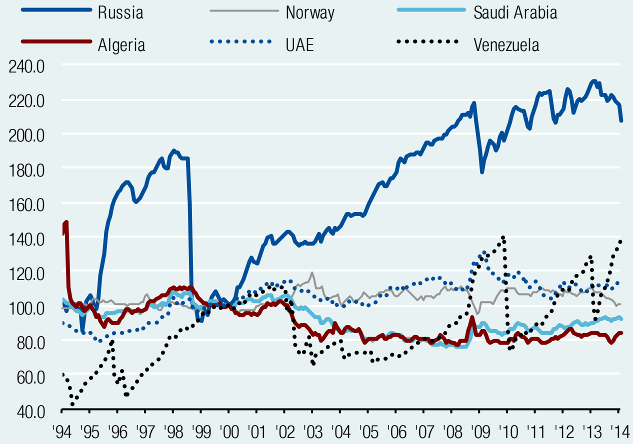
Real trade-weighted indices are rebased at 100 points as of January 2000



Sources: BIS, Investment Capital Ukraine LLC.

Chart 19. External competitiveness of net oil exporters

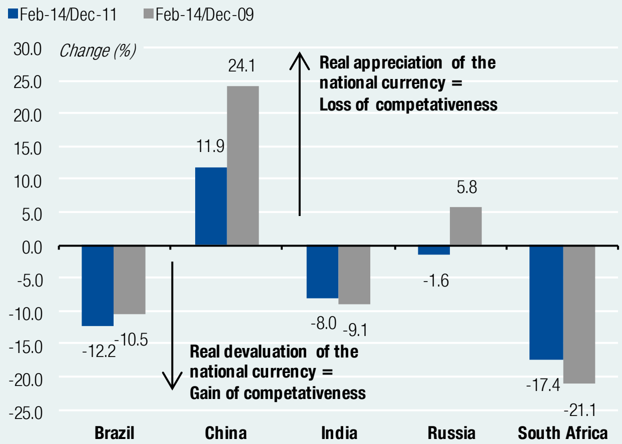
Real trade-weighted indices are rebased at 100 points as of January 2000



Sources: BIS, Investment Capital Ukraine LLC.

Chart 20. Do it like other BRICS... or why China and Russia allowed their currencies to weaken

Change in the BIS real effective exchange rates: February 2014 versus December 2011 and December 2009



Sources: BIS, Investment Capital Ukraine LLC.

Chart 21. External competitiveness of net oil exporters

Real trade-weighted indices are rebased at 100 points as of January 2000

Sources: BIS, Investment Capital Ukraine LLC.

Global macro indicators vital to Ukraine's economy

Growth globally and in Russia

As a regular rule, our global economy view is aligned with the IMF's most recent view. The latest World Economic Outlook by IMF last January, and likely this April's revisions of the forecasts will lift them, albeit by a small margin[22]. Hence, this year real growth of the global economy is projected at 3.8% YoY. This indicates that the gradual recovery of the major economies is accelerating. In 2015, it is set at 4.0% YoY.

In Russia, we disagree with the IMF's January view that forecast a 2% real GDP growth in 2014. This April's revision of the forecast by IMF would flag a downward revised number. As we noted above, Russia's economy has a number of problematic spots, which are being

[22] This, in our view, reflects IMF head Ms Lagarde statement that "global economy is turning the corner of the Great Recession, although overall growth remains too slow and weak".

compounded by the risk of wider economic sanctions by the West (the US and the EU) against Kremlin's militarist stance towards Ukraine.

Under the thick wealth of these issues, Russia's economy is projected to contract by 0.4% YoY this year, effectively in a shallow recession over the first half of the year. Sluggish growth in subsequent years is forecast as Russia strengthens its status as a militarist, revisionist and isolationist regime: 1.3% YoY in 2015 and 2.4% YoY in 2016.

Crude oil

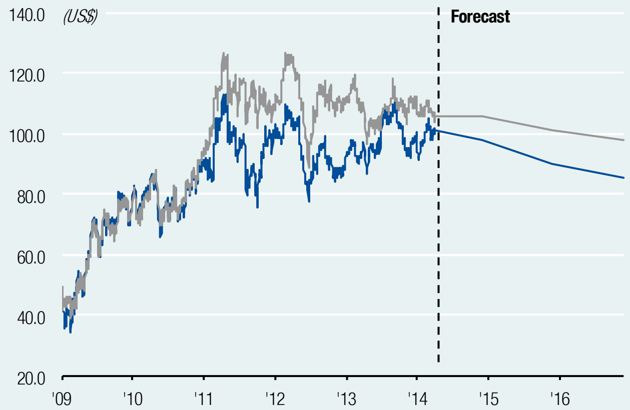
Geopolitical risks are again on the rise due to Kremlin's militarism in Eastern Europe while the Syrian civil crisis continues. Our view on the crude oil price is, once again, about a gradual subsiding from the above 100/bbl threshold towards below that level: US$98 at the end of this year, then at US$90 and US$85 at the end of 2015 and 2016 respectively.

Steel

The steel market has been showing stagnation recently. This is likely to continue over the period of forecast due to China's ongoing (and quite lengthy) rebalancing from investment- into consumption-led growth, a stance from the ICU's *Quarterly Report*s of the previous year that we just reiterate. Hence, this would keep a lid on steel-price increases. Our view on steel prices is that they are to subside gradually over 2014-16 (see Table 4 below).

Chart 22. Crude oil price (US$ per barrel)

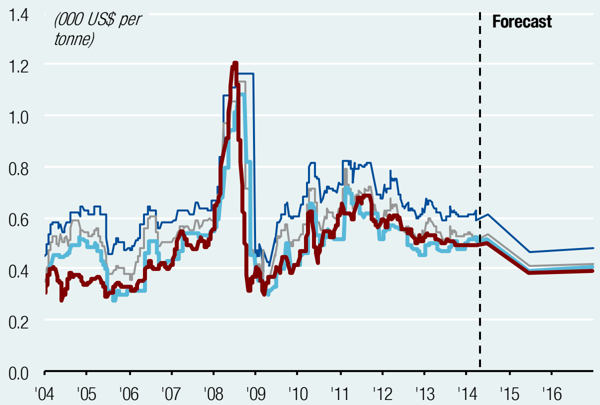
Spot and futures market daily quotations



Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 23. CIS export steel prices (US$ 000s per tonne)

Quarterly averages



Sources: Bloomberg, Investment Capital Ukraine LLC.

Table 4. ICU's 3-year quarterly and yearly forecast for the global economy's key indicators vital to Ukraine's economy, according to our base-case scenario

	Quarterly forecast												Annual forecast		
	1Q14E	2Q14F	3Q14F	4Q14F	1Q15F	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F	2014F	2015F	2016F
World real GDP[1]	3.8	3.8	3.8	3.8	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	3.8	4.0	4.0
Russia real GDP[1]	0.0	-1.0	-0.5	0.0	0.2	1.5	1.5	2.0	2.0	2.5	2.5	2.5	-0.4	1.3	2.4
Crude oil (US$[2])	98.7	98.4	98.2	98.0	96.4	94.8	93.2	90.0	89.0	88.0	87.0	85.0	98.3	93.6	87.3
Steel (US$[3])	531.0	523.0	509.0	516.0	524.0	550.0	550.0	550.0	550.0	550.0	550.0	550.0	519.8	543.5	550.0
EUR/USD (eop)	1.37	1.35	1.33	1.30	1.28	1.25	1.28	1.28	1.28	1.28	1.28	1.28	1.30	1.28	1.28
USD/RUB (eop)	35.17	36.00	37.00	38.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	38.00	40.00	40.00

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

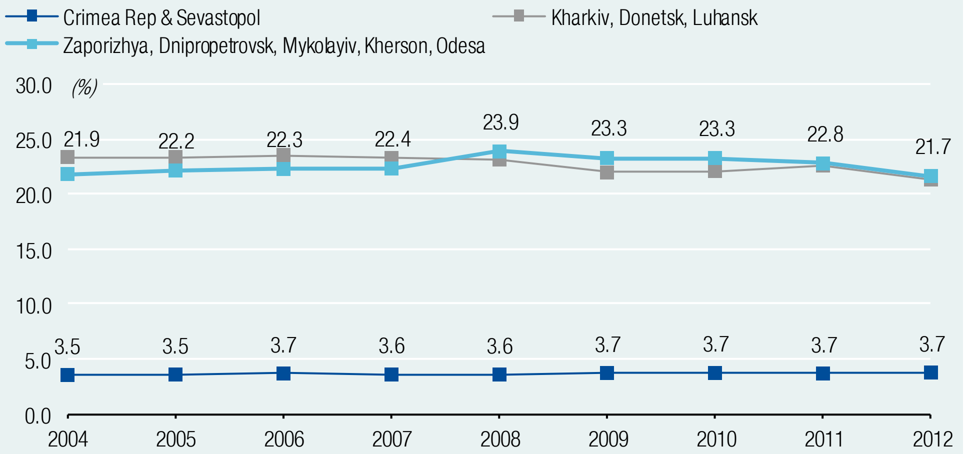
Source: ICU.

Ukraine's economy: Update

Assessing GDP loss due to Russian invasion

While Ukraine's and the prevailing global stance toward the Russian invasion of Crimea is an outright rejection of the aggression and treats the Crimea Republic and the City of Sevastopol as under occupation, official Kiev *de-facto* has lost control over the region. The practice of Moldova and Georgia, which has their own territorial issues with the Kremlin over the parts of their own countries, shows that once these countries have lost control over the governance of the regions, they narrowed the scope of their national accounts towards the territories they do control. The same outcome looks certain for Ukraine over the annexed territory, albeit until the date when Ukraine embraces the Crimea Republic and city of Sevastopol back.

Chart 24. Gross regional product of three parts of Ukraine that are sensitive to Russian invasion (% of the Ukraine's total GDP)

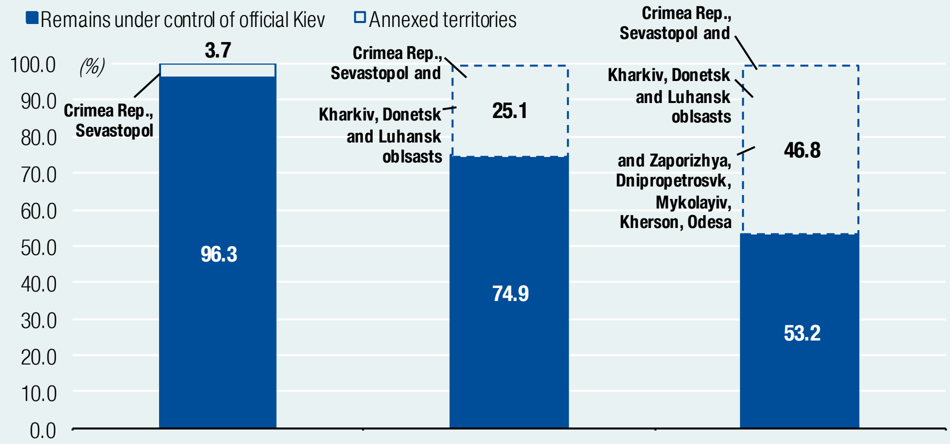


Source: State Statistics Committee of Ukraine, Investment Capital Ukraine LLC.

Crimea Republic and the city of Sevastopol historically accounted for slightly more than a 3.7% share of the nation's total GDP (see Chart 24 above, Chart 25 on p.38 and Table 1 on p.17). Above, in the section "Geopolitics and politics", we assessed the possibility of Russian invasion into the mainland in a bid to annex it by a Crimea template. We concluded that such an aggression from the Kremlin towards Ukraine, if it would succeed in annexation, could cost a massive loss. Thus, if a Crimea template is replicated into the three eastern oblasts of Ukraine—Kharkiv, Donetsk and Luhansk—a GDP loss would amount to 25%. If it extends further to the southern oblasts and central Ukraine's Dnipropetrovs'k oblast, then a loss widens to a massive 47% share of the national total GDP.

Our base-case scenario envisages that Russian invasion is limited to Crimea, hence, a 3.7% loss of GDP due to this fact. It is our worst-case scenario that takes into account the annexation of the three eastern oblasts of Ukraine, which together with Crimea would mean a 25% loss of GDP. In the extreme, this worst-case scenario would evolve into enormous proportions of economic trouble, if the invasion extended further afield into the southern part of Ukraine so that the Kremlin secures a mainland route from Russia to the Moldova's territory of Transdnisria.

Chart 25. What if Russian invasion extends from wave #1, which is into Crimea, to waves #2 and #3, which respectively into three oblasts of the country's east and then into other five oblasts? (% of the Ukraine's 2012 total GDP)



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

Economic activity: Assessing the depth of recession

In our view, Ukraine's economy has been squeezed by three major developments.

First, until recently the economy has been governed unsustainably, i.e., bringing forward the economic crisis at jet speed.

Second, the current rescue package, now being constructed by IMF, international donors and a number of international financial institutions for Ukraine's new government, envisages an austerity programme.

Third, the Kremlin's political and military aggression onto Ukraine itself inflicts depression. Its encouragement of separatist movements as well as the heightened risk of mainland invasion by Russian army undermines the economic reforms agenda of the new Ukraine's government. It depresses business and consumer sentiment in the whole Ukraine, forcing them to cut back as they move from the business-as-usual approach in their day-to-day operations towards the rush-to-safety mode.

Out of all mentioned above, in our view, the bigger weight onto the economy has to be the last one. It is not because of the Kremlin's seemingly inexhaustible appetite for destabilization and carving up of the neighbours' territories. In the case of Ukraine, the Kremlin's tactic is ranging from military invasion to fostering of separatist movements[23] to blatant provocations in every possible sphere. Hence, this makes the security risk a primarily one because it affects public masses and embraces a risk to personal wellbeing as well as a risk to business operations. It shortens horizons of the decision-making from months to weeks or, in the extreme, days.

This is a prime shock to the economy, in our view. The impact of IMF programme of economic adjustment and other factors (like domestic politics) have less negative impact, in our view.

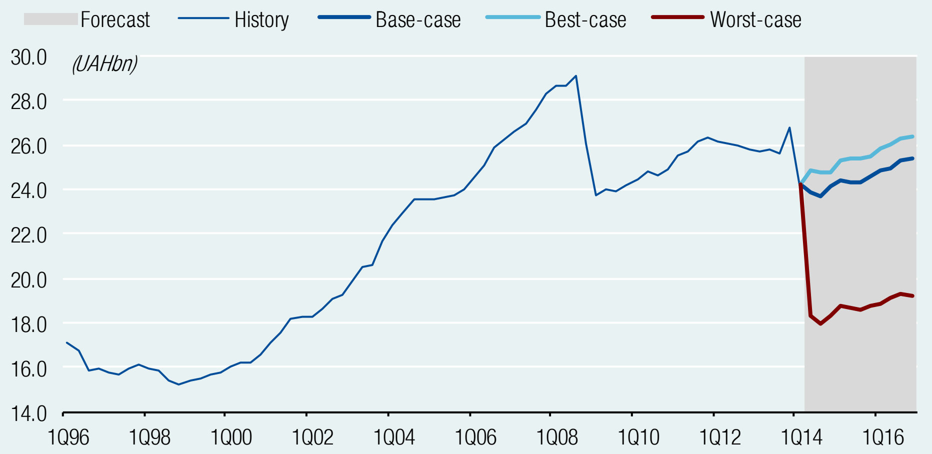
[23] These are perceived to be instigated by pro-Kremlin local activists alongside with so-called Russian tourists, who are Russian citizens and travel by bus to an oblast centre like Kharkiv, Donetsk and Luhansk and mass the rioting.

In our base-case scenario, where official Kiev has *de-facto* lost control over the Crimea Republic and the City of Sevastopol, GDP contracts by 3.7% due to Crimea being annexed and additional contraction in the like-for-like terms of 4.3% comes because of macro-economic factors mentioned above. Hence, in total the economy contracts 8.0% this year.

The worst-case scenario envisages that annexation extends towards the three eastern oblasts of Kharkiv, Donetsk and Luhansk, which house 9.3 million in population and account for a nearly 22% share of the nation's GDP. Hence, if annexation comes, then it would cost the economy a departure of 25% (the total of Crimea and of these three oblasts). Also, due to macro-economic worsening the like-for-like contraction is bigger by 0.5ppt than in the base-case scenario and stands at 4.7%. In total, the economy shrinks 29.8% this year.

In our best-case scenario, a quite small probability ratio of below 5%, official Kiev retakes control over the Crimea and, hence, there is just only a like-for-like contraction of 4.3% in the economy this year.

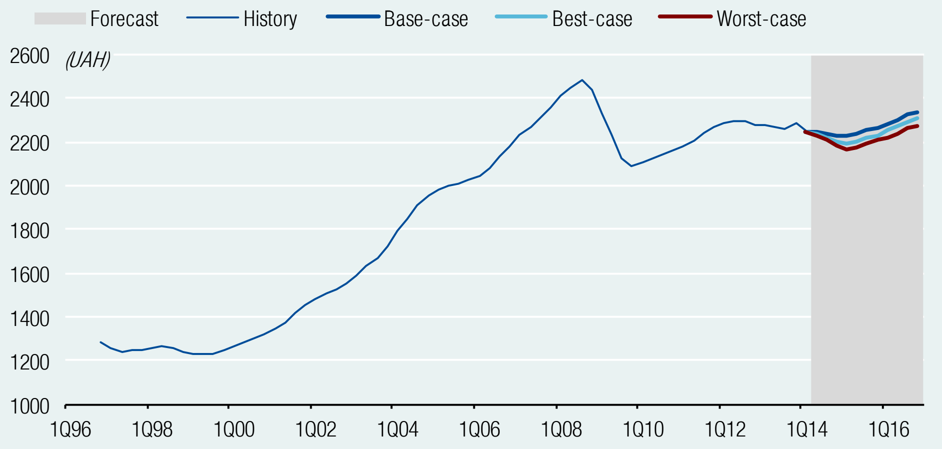
Chart 26. Ukraine's GDP: quarterly volume at constant prices of December 1995 under three scenarios (UAHbn, seasonally adjusted)



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

However, the GDP per capita losses are of less dramatic nature. Our calculations of the indicator in the constant prices of December 1995 show that after this year, recession provides just a 3.5% decline of the GDP per capita according to a base-case scenario. Even under the worst-case, it dropped as much as 4.3% at the end of this year. Next year the indicator recovers on the back of real growth, albeit of small dimension. See Chart 27 below.

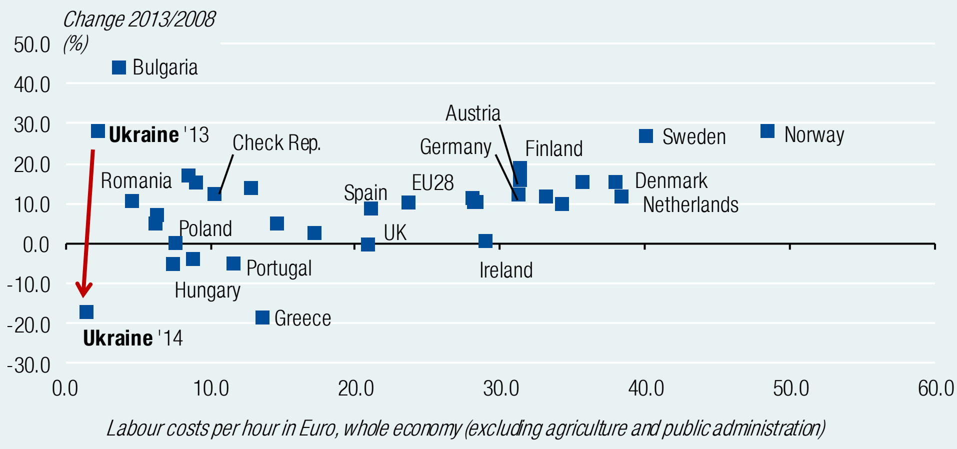
Chart 27. Ukraine's GDP per capita: four-quarter rolling GDP at constant prices of December 1995 under three scenarios (UAHbn, seasonally adjusted)



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

The macroeconomic adjustment of 1Q14 and early 2Q14 is taking its toll on the domestic demand, compressing it; however, a positive development for the economy is that competitiveness of the domestic businesses has increased in early 2014. As the following chart shows, Ukraine's average hourly wage is likely to tumble towards EUR2, down from the 2013 yearly average of EUR2.2. The chart provides evidence that Ukraine's economy that borders EU is, in fact, highly competitive in terms of labour costs. Hence, if barriers to making business are removed and the economy opens itself to cross-border investments, it could become an effective source of economic growth. (More detailed data is provided in the Appendix section called "Average hourly wage in Ukraine versus in European countries", p.64.)

Chart 28. Average hourly wage (EUR per hour) in Ukraine versus the selected EU economies



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

Public finances: Sailing through another recession

State budget balance

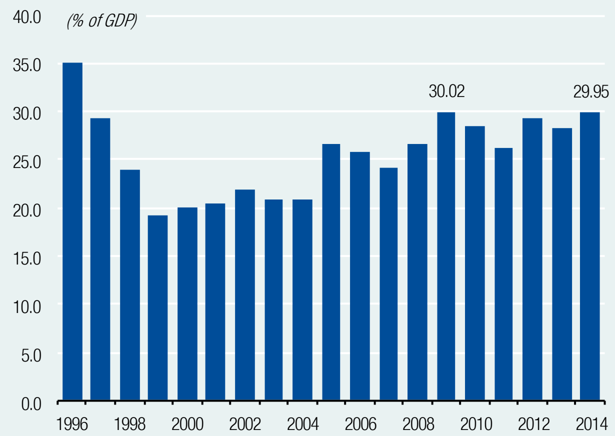
In our view, there is major discrepancy between official macro-economic forecast and ours. Under our base-case scenario, the economy contracts 8.0% YoY due to Crimea annexation and to the like-for-like decline that reflects a Kremlin strategy of spawning economic depression in Ukraine. Our calculations of the nominal GDP in 2014 yield a slightly bigger economy than a year ago – this is mainly thanks to inflation acceleration (CPI is forecast to be slightly above 11% this December) because of currency devaluation and state-regulated tariff increase. It is forecast to stand at UAH1,459bn, which is just 0.2% more than last year. Official forecast of the nominal GDP stands at UAH1,574bn or 7.9% above ours.

Recent sequestration of the state budget in the wake of arrival of new government led by PM Arseniy Yatsenyuk, in our view, showed that Yatsenyuk was cautious and instead of the UAH80bn cut in the expenditures, he delivered a smaller cut that lowered the ratio of planned budget expenditures to nominal GDP to 29.95%-- just a hair short of 30.02%, a peak sought in 2009 by the then Tymoshenko-led government that faced grave economic recession that year. As the following charts show, the actual state budget expenditures in 2009 fell below the plan by 4.5ppt of GDP.

In our view, given the recession this year, it is very likely that a commitment of budget expenditures at nearly 30% of GDP is highly ambitious to deliver. (In our view, a more realistic target for expenditures appears to be at 27.5% of GDP.) With state budget revenues in 2014 amounting to UAH347bn, the central government budget deficit is projected at UAH89bn or 6.1% of GDP. Under our worst-case scenario the deficit level remains the same, i.e., at 6.1% of GDP, while nominal deficit stands at UAH72bn.

Chart 29. Planned state budget expenditures (% of actual GDP)

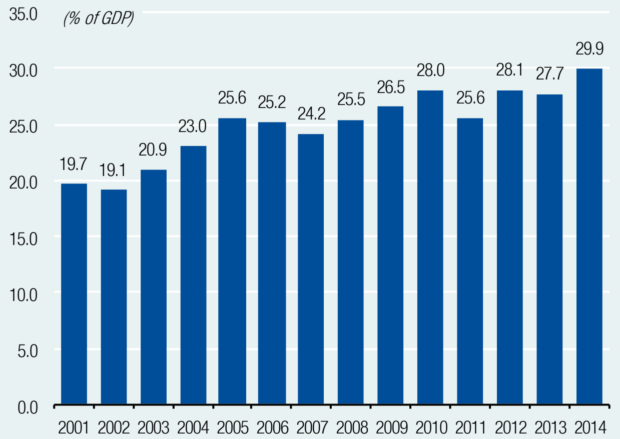
Yearly history from 1996 through 2014



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

Chart 30. In 2014, Ukraine's new government committed for the highest level of state budget expenditures (% of GDP)

Yearly history from 2001 through 2014



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

Primary balance of the state budget

Debt service expenditures have been one of the fastest growing items of the state budget. Now, it amounts to UAH32.9bn in the last 12-month terms or 2.3% of GDP, up 0.5ppt from a year ago. Over the current year, debt service expenditures are forecast to increase up to UAH41.5bn, and at the end of the year to be at 2.8% of GDP (see Chart 33, p.42).

The ratio of the debt service expenditures to revenues was at 9.8% as of February 2014 in the last 12-month period, steadily increasing since early last year from the 7.3% level. Our data on the current public indebtedness shows that this ratio is set to continue rising towards the 12% level. Hence, the ratio will this year cross the 10% threshold, which has been indicated by Ukraine's ministry of finance in the past as an alarm indicator, i.e., undesired achievement by the government. It is to happen due to the increase in the debt servicing as debt stock has been growing while interest rates were not falling. Also, revenues contraction this year due to the recession is also a key contributor to such an outcome. See Chart 31 below.

Chart 31. Ratio of debt service expenditure to revenues (%)

Monthly history from January 2005 through February 2014; forecast for the remaining part of 2014

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

Chart 32. Ratio of debt service expenditure to GDP (%)

Monthly history from January 2005 through February 2014; forecast for the remaining part of 2014

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

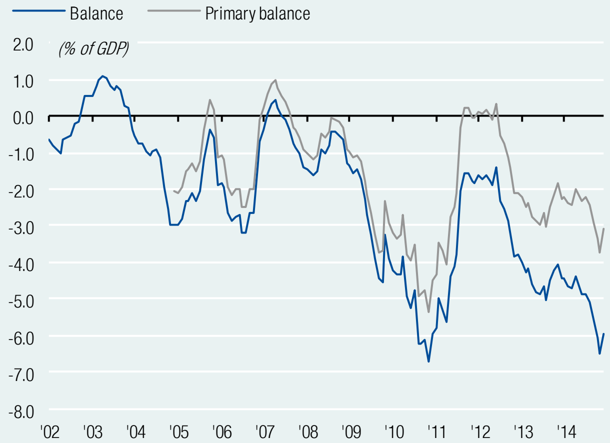
Given the above mentioned increase in the debt service expenditure, the primary deficit of the state budget is expected to evolve from the 2.3% of GDP at the end of 2013 towards 3.2% at the end of 2014.

With IMF programme in place, under our base-case scenario, we expect that primary deficit will subside closer to or even inside of the 0-1% range in 2015. In 2016, the primary balance turns into surplus of 0.7% of GDP, allowing the public debt level to subside.

IMF indicated recently in its statement[24] on Ukraine that on staff-level agreement the programme would seek a 2016 state budget deficit of 2.6%. This means that IMF implicitly forces the Ukraine's government for fiscal prudence and effectively providing a primary surplus in 2016.

Chart 33. The primary balance of the state budget

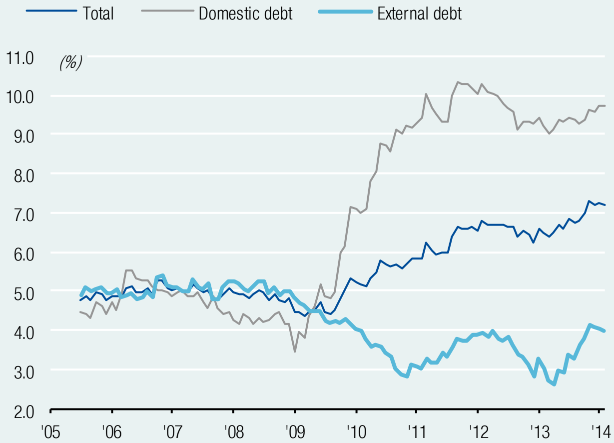
Monthly history from January 2002 through February 2014; forecast for the remaining part of 2014



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

Chart 34. Effective cost of debt (% per annum)

Monthly history from January 2002 through February 2014; forecast for the remaining part of 2014



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

State coffers

They have been nearly empty over the past few months. The balance of FX accounts of the central government was at US$374m in February, up from US$352m in January, and

[24] See http://www.imf.org/external/np/sec/pr/2014/pr14131.htm

US$564m in average over the second half of last year, when access to FX liquidity to the Ukraine's government was denied by the markets.

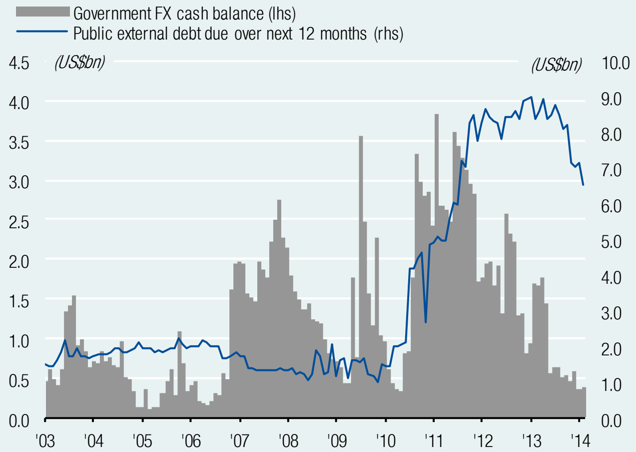
The volume of available FX cash in the hands of the government appears evermore miniscule as the volume of the external debt, which is owed by the official sector (of which the majority of debt is owed by the government) due over the next 12 months, counts for more than US$6bn. Our data on the central government and central bank debt liabilities shows that going forward, i.e., over 2014 and 2015, the volume of external debt due the next 12 months, as of now ranges from US$8.3bn to US$9.0bn, including interest and principal repayments.

As far as short-term external debt is concerned, i.e., what is due over next three months, it amounts to US$3.9bn, according to the latest available data. Hence, coverage of this debt by government's FX cash amounts to just 10%, a multi-year extreme low.

Given the forecasted volume of external debt due over next three months (see Chart 37, p.44), which amounts in average to US$1.6bn, the state coffers should maintain a FX cash balance of about 50% in order to properly reduce the risk of sovereign default (from the current level of near 1,000bp as measured by 5-year CDS rate closer towards 500bp), see Chart 36 below. Overall, government is required to be actively borrowing in foreign currency in order to service the debt due or ask creditors to re-profile the repayment of principal by pushing maturities forward (which could be a hectic enterprise given the fact that the so-called "Russian Eurobond" of US$3bn is one of the most sizable items in this debt pile).

Chart 35. Balance of the central government's FX account versus the official sector's[1] external debt payouts[2] due next 12 months (US$bn)

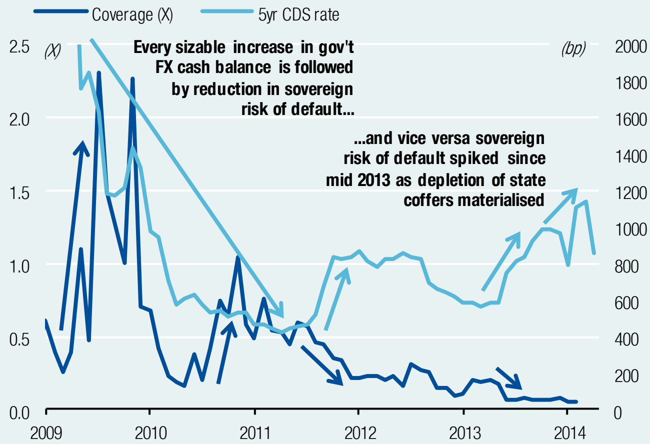
Monthly history from January 2003 through February 2014



Note: [1] includes central government; [2] principal and interest.
Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 36. Coverage of official sector's[1] external debt payouts[2] due next three months by the government's FX cash (X) versus the Ukraine's 5-year CDS rate (basis points)

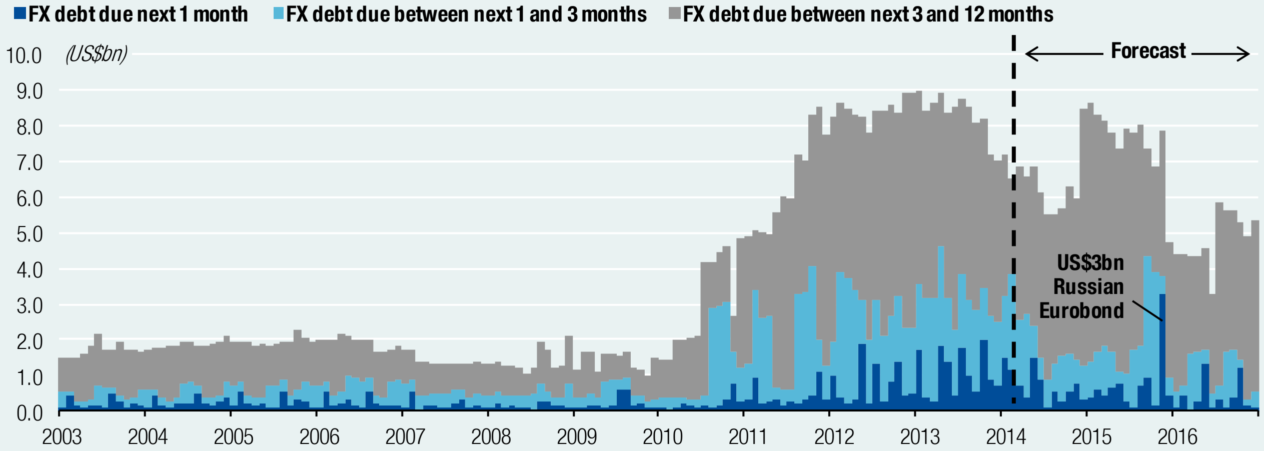
Monthly history from January 2003 through February 2014



Note: [1] includes central government; [2] principal and interest.
Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Chart 37. Breakdown of the official sector's[1] external debt payouts[2] due next 12 months
History January 2003 through February 2014 and forecast from March 2014 through December 2016

Data as of 9 April 2014



Note: [1] includes central government; [2] principal and interest. Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Public debt

Due to like-on-like decline of the economy and the annexation of the territory by Russia, the public debt level is heading up steadily this year, effectively extending the trend of the past year.

Aside from the deficit of the core budget, we doubt that government privatization programme succeeds attracting UAH17bn of proceeds while selling state assets this year; hence, we cut it to UAH10bn instead. Also, we assume that the government issues additional debt via the so-called VAT bonds to address the issue of VAT arrears to exporters. This year, this volume amounts to UAH18bn as was stated by PM Yatsenyuk recently. The government also will be forced to issue more debt this year to recapitalize Naftogaz and state banks. The former is said to enjoy capital injection from the government to the tune of UAH33bn this year. State banks will require injections in order to restore their high capitalization ratios they reported in the post-2008 crisis and through 2013. Because of this year's currency devaluation and economic recession of sizable dimension, the state banks, in our view, require a UAH16bn recapitalization.

In total, under our base-case scenario, the public debt level is set to increase from 40.1% as of end 2013 to 56.2% at the end of 2014.

Under the worst-case scenario, the public debt level reaches 79.1% of GDP at the end of 2014. Hence, Russia's extended military intervention into Ukraine's three eastern borders, if it were to end with annexation of this part of the nation's territory on top of Crimea, would effectively force the Ukraine's government *de-facto* to breach the 60% public debt level in the US$3bn of the so-called "Russian Eurobond".

Naftogaz: Assessing the deficit path

Our back-on-the-envelope projection of the Naftogaz deficit based upon the following assumptions:

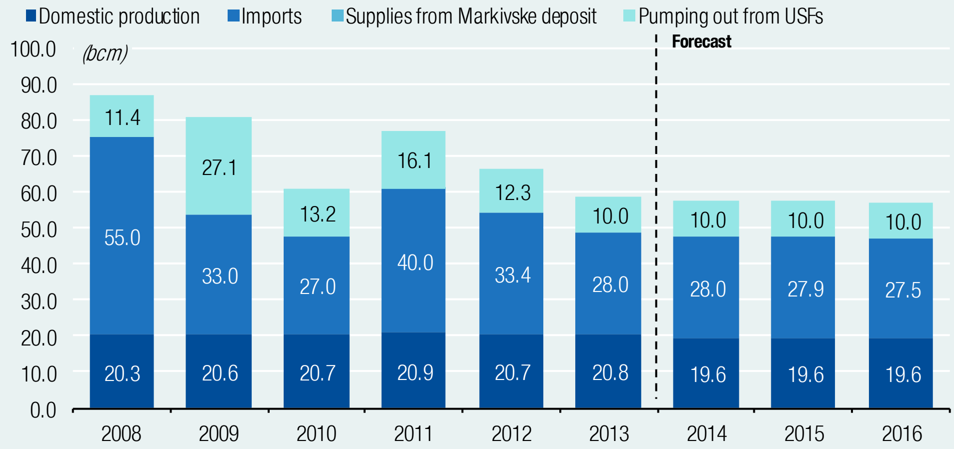
- First, the natural gas balance in 2014-16 remains broadly the same as it was in the previous years (we use the data of the publicly available balance for 2012). We assume that businesses are proceeding with energy-saving technology allowing gradual reduction in volume consumed. Also, households and the communal heating enterprises, too, are gradually decreasing consumption in response of higher energy tariffs they are facing. See Chart 38 below, Chart 39 on p.46 as well as Table 5 on p.47.

- Second, volume of consumption in 2014 is reduced by a ratio that corresponds with annexed territory. Thus, household consumption is reduced by a factor that corresponds to a share of population. The same approach is applied to consumption by communal heating enterprises. Consumption by businesses is reduced by a ratio that corresponds to the exports share of the territory in the country's total exports – this approach considers the exports capacity of the oblast as proxy to natural gas consumption by the businesses.
- Third, the natural gas price for Naftogaz's imports is assumed to equal to the Gazprom charged price, which is a price determined by the 2009 agreement and without a US$100 discount. See Chart 40, p.46.
- Fourth, domestic natural gas tariffs are increased since this year, to bring the US dollar equivalent of the sell price to customers towards the level close to the buy price of imported natural gas. See the price change section in the Table 6 on p.48.
- Fifth, domestic production of natural gas is assumed a departure of production by Chornomorneftegaz (annual production 1.7bcm) out of Ukraine's natural gas balance. Other domestic producers are keeping production at the same level.

The charts and tables provided below are summaries of our view on this matter. Under the base-case scenario Ukraine imports range 27.5-28.0bcm, and thanks to regular tariff increases, the Naftogaz deficit improves from US$1.5bn in 2014 to US$0.7bn in 2015; or from 1.1% of GDP to 0.5% over the same years. In 2016, if a tariff increase continues, Naftogaz is projected to turn into surplus of US$1.3bn (0.8% of GDP).

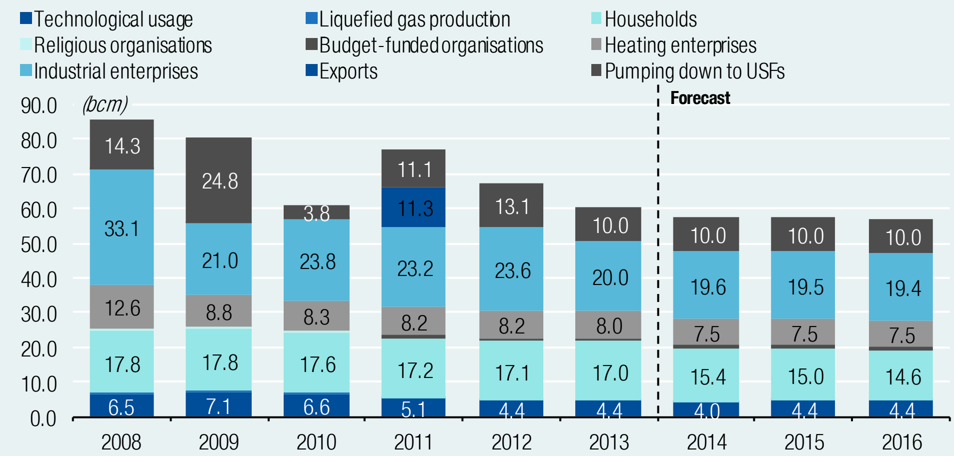
Under worst-case scenario, imports range 22.9-23.3bcm in 2014-16. This yields larger deficits than under base-case, because a chunk of well-paying industrial consumers depart due to annexation. Hence, Naftogaz deficits range US$2.4-3.8bn during the period or 2.6-4.7% of GDP.

Chart 38. Resources of natural gas in Ukraine, yearly data (bcm)



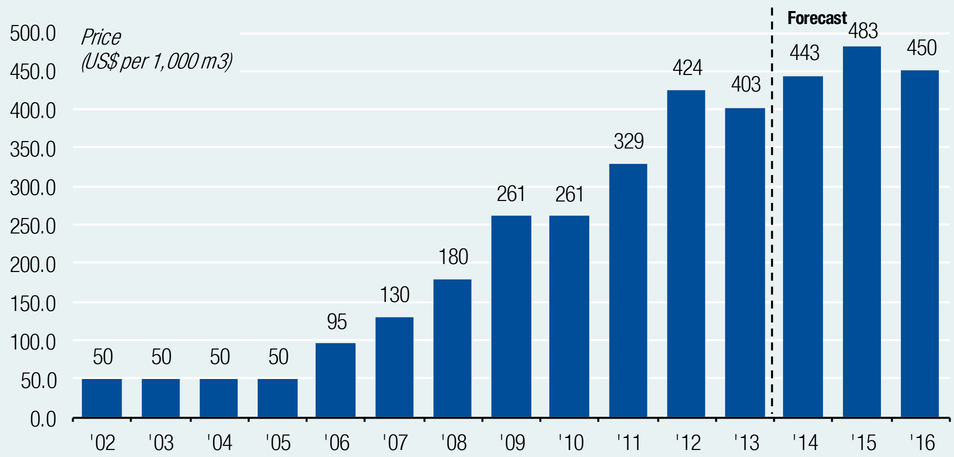
Sources: Ministry of Energy of Ukraine, Investment Capital Ukraine LLC.

Chart 39. Usage of the natural gas in Ukraine, yearly data (bcm)



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

Chart 40. Average annual price of imported natural gas charged by Gazprom (US$ per 1,000 m3)



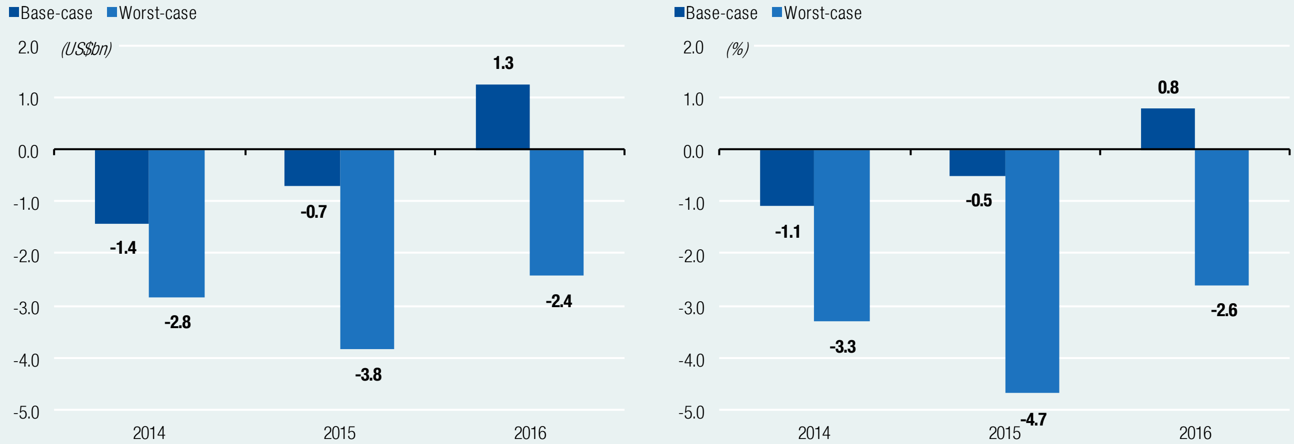
Sources: Ministry of Energy of Ukraine, Investment Capital Ukraine LLC.

Table 5. Natural gas balance – forecast for 2014-16 (million m3)

	2014	2015	2016
Resources	**52,916**	**52,885**	**52,464**
Domestic production	19,588	19,588	19,588
Ukrgazvydobuvannya	15,010	15,010	15,010
Ukrnafta	2,130	2,130	2,130
Chernomornaftogaz	0	0	0
Other producers	2,448	2,448	2,448
Imports	23,328	23,297	22,876
Pumping out the gas from USFs	10,000	10,000	10,000
Uses	**52,916**	**52,885**	**52,464**
Technological usages	4,000	4,400	4,400
Production of luquified gas	200	200	200
Consumption by	38,716	38,285	37,864
Households	13,708	13,365	13,031
Budget-funded organisations	25	25	25
Communal heating enterprises (including Kyivenergo)	817	817	817
Industrial and power generation enterprises	6,678	6,678	6,678
Other	17,487	17,399	17,312
Pumping in the gas into USFs	10,000	10,000	10,000

Notes: USFs –underground storage facilities.
Sources: Ministry of Energy of Ukraine, Investment Capital Ukraine LLC.

Chart 41. Projected Naftogaz balance in 2014-16: nominal volume (US$bn, left chart) and as share of GDP (%, right chart)



Source: Investment Capital Ukraine LLC. Source: Investment Capital Ukraine LLC.

Table 6. Assessing the Naftogaz deficit under base case scenario

	2012	2014	2015	2016
Price (UAH)				
Households	507.63	761.44	1,142.16	1,427.70
Budget-funded organisations	4,186.11	4,395.41	4,395.41	4,395.41
Communal heating enterprises (including Kyivenergo)	1,770.99	2,213.73	2,767.17	3,458.96
Industrial and power generation enterprises	3,852.28	4,430.12	4,873.14	4,873.14
Other	1,362.64	2,043.96	3,065.93	4,598.90
Price change (%YoY)				
Households		50.0	50.0	25.0
Budget-funded organisations		5.0	0.0	0.0
Communal heating enterprises (including Kyivenergo)		25.0	25.0	25.0
Industrial and power generation enterprises		15.0	10.0	0.0
Other		50.0	50.0	50.0
Price (US$)				
Households		68.58	103.01	129.79
Budget-funded organisations		395.89	396.43	399.58
Communal heating enterprises (including Kyivenergo)		199.39	249.58	314.45
Industrial and power generation enterprises		399.01	439.52	443.01
Other		184.10	276.52	418.08
Volume consumed (million m3)				
Households		15,367	14,982	14,608
Budget-funded organisations		916	916	916
Communal heating enterprises (including Kyivenergo)		7,486	7,486	7,486
Industrial and power generation enterprises		19,602	19,504	19,407
Other		29	29	29
Total		**43,400**	**42,918**	**42,446**
Proceeds (US$m)				
Households		1,053.9	1,543.4	1,896.0
Budget-funded organisations		362.7	363.2	366.1
Communal heating enterprises (including Kyivenergo)		1,492.7	1,868.4	2,354.1
Industrial and power generation enterprises		7,821.6	8,572.4	8,597.4
Other		5.3	7.9	11.9
Total		**10,736.1**	**12,355.3**	**13,225.5**
Naftogaz imports				
Volume (million m3)		28,011.8	27,929.7	27,457.6
Price (US$)		433.6	468.1	435.5
Imports (US$m)		12,145.9	13,072.8	11,957.2
Balance (US$m)		**-1,409.9**	**-717.5**	**1,268.3**
Balance (% of GDP)		**-1.1**	**-0.5**	**0.8**

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

Table 7. Assessing the Naftogaz deficit under worst-case scenario

	2012	2014	2015	2016
Price (UAH)				
Households	507.63	761.44	1,142.16	1,427.70
Budget-funded organisations	4,186.11	4,395.41	4,395.41	4,395.41
Communal heating enterprises (including Kyivenergo)	1,770.99	2,213.73	2,767.17	3,458.96
Industrial and power generation enterprises	3,852.28	4,430.12	4,873.14	4,873.14
Other	1,362.64	2,043.96	3,065.93	4,598.90
Price change (%YoY)				
Households		50.0	50.0	25.0
Budget-funded organisations		5.0	0.0	0.0
Communal heating enterprises (including Kyivenergo)		25.0	25.0	25.0
Industrial and power generation enterprises		15.0	10.0	0.0
Other		50.0	50.0	50.0
Price (US$)				
Households		53.75	69.22	86.53
Budget-funded organisations		310.30	266.39	266.39
Communal heating enterprises (including Kyivenergo)		156.28	167.71	209.63
Industrial and power generation enterprises		312.75	295.34	295.34
Other		144.29	185.81	278.72
Volume consumed (million m3)				
Households		13,708	13,365	13,031
Budget-funded organisations		817	817	817
Communal heating enterprises (including Kyivenergo)		6,678	6,678	6,678
Industrial and power generation enterprises		17,487	17,399	17,312
Other		25	25	25
Total		**38,716**	**38,285**	**37,864**
Proceeds (US$m)				
Households		736.9	925.2	1,127.6
Budget-funded organisations		253.6	217.7	217.7
Communal heating enterprises (including Kyivenergo)		1,043.7	1,120.0	1,400.0
Industrial and power generation enterprises		5,468.9	5,138.7	5,113.0
Other		3.7	4.7	7.1
Total		**7,506.7**	**7,406.3**	**7,865.3**
Naftogaz imports				
Volume (million m3)		23,327.6	23,297.4	22,876.3
Price (US$)		443.4	482.8	450.2
Imports (US$m)		10,344.3	11,248.3	10,299.6
Balance (US$m)		**-2,837.6**	**-3,842.1**	**-2,434.3**
Balance (% of GDP)		**-3.3**	**-4.7**	**-2.6**

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

Banking sector: Bracing for a new wave of cleaning-up

Ukrainian banking sector has been heavily hit by the decline of the USD/UAH rate due to its significant short FX position which, according to our estimations is more than UAH35bn. Regulatory capital has declined by UAH13bn during the 1Q14 as the result of losses from the revaluation of foreign currency assets and liabilities and extra provision accruals.

According to the official statistics, 30.0% of the total loans are denominated in the foreign currency, suggesting banks most certainly will face further loan impairment. In addition, the value of collateral, pledged against the FX loans is set in UAH and thus the gap between the exposure and its coverage is going to expand. Bank will be forced to call for additional collateral for the coverage which can be problematic to get at the moment or make additional provision charges.

Similarly to the 2008 crisis, we expect the new wave of the toxic FX assets on the banks' balance sheet. However, this time the hit will have a much smaller effect due to the lower level of FX loan penetration and the regulators measures to prevent issuing loans to entities without FX revenues. Particular banks are currently offering their clients special offers allowing repaying the FX loans using the exchange rate which is significantly below that on the market. We expect further decline of the FX loans share in the long term as the customers will repay them or default, and banks will have to write them off.

According to our estimations, banks will require UAH30bn to UAH40bn of additional capital inflow in order to maintain the same level of capitalization as in 3Q13. We expect moderate impact of the loan impairment on the banking sector performance as the banks have been not very active in issuing loans over the previous two years with the average pace of growth of 8% YoY.

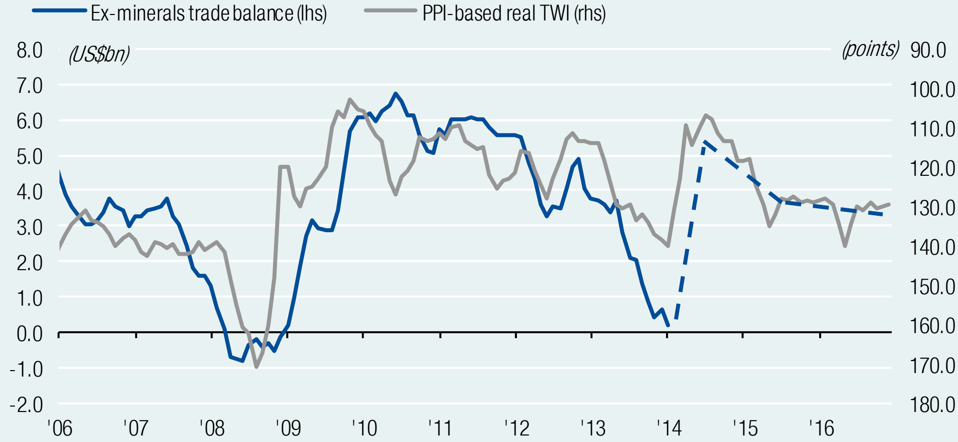
External sector: Adjustment to cut the deficit

Ukraine's economy has been undergoing a macro adjustment thorough real depreciation of the currency – to date it declined this year by 32.8% and 32.7% respectively in CPI- and PPI-based real trade-weighted terms thanks to depreciation of the USD/UAH exchange rate from near 8.24/USD at the end of 2013 towards to 12.71/USD as of 11 April 2014.

Such a real adjustment of the exchange rate bodes well for restoring the ex-mineral trade surplus, which deteriorates each time when domestic demand accelerates alongside real appreciation of the currency, towards the healthier level of US$5bn in the last 12-month period terms. Then, it is going to subside albeit gradually and remain still in the positive territory of US$3-4bn (see Chart 42 below). If the domestic FX market were to value UAH lower than our 2014-16 forecast, which is a part of the projected data shown at the chart below, then the ex-minerals trade surplus would improve, i.e., instead of sliding from US$5bn level in 2014 to US$3-4bn in 2015-16 it would stay in the US$5-6bn range or increase to the US$7-8bn range.

Chart 42. Projected path of the ex-minerals merchandise trade balance of Ukraine: The relationship between UAH's PPI-based real TWI and ex-minerals trade balance has been resiliently strong since 2006

Monthly history from January 2006 through January 2014; forecast through December 2016

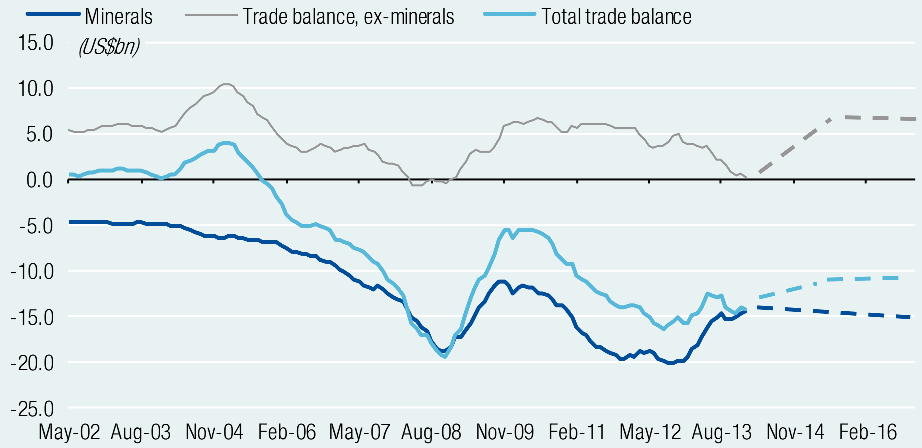


Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Meanwhile, under our base-case scenario, the minerals trade deficit is likely to be significant, at around the US$15bn level, after the natural gas price increase charged by Gazprom and marginal lowering of the volume of natural gas imports due to energy saving policies. Under the worst-case scenario the minerals trade balance lowers in the nominal terms, as Naftogaz buys lower volumes 23bcm (versus 28bcm under the base-case scenario), towards US$10bn.

Chart 43. Projected path of merchandise trade balance and its key components – the ex-minerals and minerals trade balances (US$bn)

Monthly history from May 2002 through January 2014; forecast through December 2016

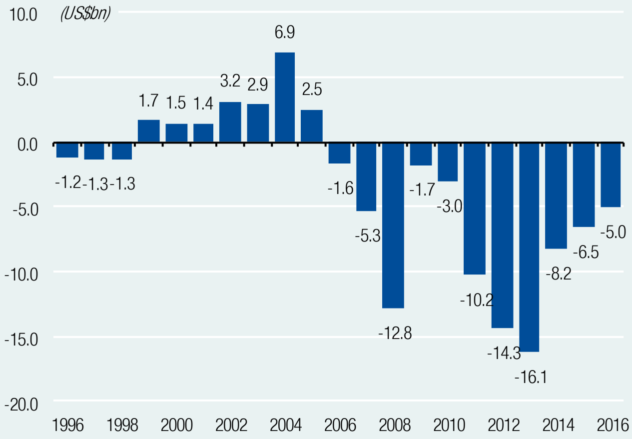


Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Under the base-case scenario, the current account deficit is expected to drop on the demand adjustment to US$8.2bn, effectively declining by half from the previous year. However, in relative terms, it would stand at 6.2% of GDP, down 2.9ppt from the all-time record deficit of 9.1% seen in the 2013.

The worst-case scenario envisages even bigger drops in the currency account deficit from US$16.1bn in 2013 to US$5.9bn in 2014. However, due to lower nominal GDP than in the base-case scenario (because of larger annexation), the current account deficit declines less by 2.2ppt to 6.9% of GDP. Similarly, over 2015-16 the deficit level is bigger than under base-case scenario, because the territories, assumed under annexation, export less than import.

Chart 44. Projected current account balance in 2014-16 under base-case scenario: nominal volume (US$bn, left chart) and as share of GDP (%, right chart)



Source: Investment Capital Ukraine LLC.

Source: Investment Capital Ukraine LLC.

Chart 45. Projected current account balance in 2014-16 under worst-case scenario: nominal volume (US$bn, left chart) and as share of GDP (%, right chart)

Source: Investment Capital Ukraine LLC.

Source: Investment Capital Ukraine LLC.

In our view, market access (at decent rates of 300-400bp over the benchmark) is closed for Ukraine's government unless it successfully realizes the two-year programme of economic reforms under the IMF watch. Hence, the capital account will see foreign capital inflows into the public sector balance sheet thanks to financial assistance of IMF and other official donors. In total, the programme as said amounts to US$28bn for two years, of which the bigger portion of money lent, is in the first year. IMF programme, in our view, arrives with total volume of US$18bn, at the bigger end of the US$14-18bn announced after the Staff-Level Agreement between IMF and Ukraine's government was reached late March. The rest of the volume will be provided by World Bank (US$3bn), EU (EUR2.5bn), Japanese government (US$1.5bn) and US government (US$1bn). This money will be lent to the government as well as to the central bank. In 2014, a total of US$18.5bn is forecast to be lent to authorities in Ukraine. The remaining part of US$9.5bn is sought to arrive in 2015. In 2016, when external debt payouts for authorities subside and the official Kiev exits the IMF programme, Ukraine's government re-gains access to Eurobond markets.

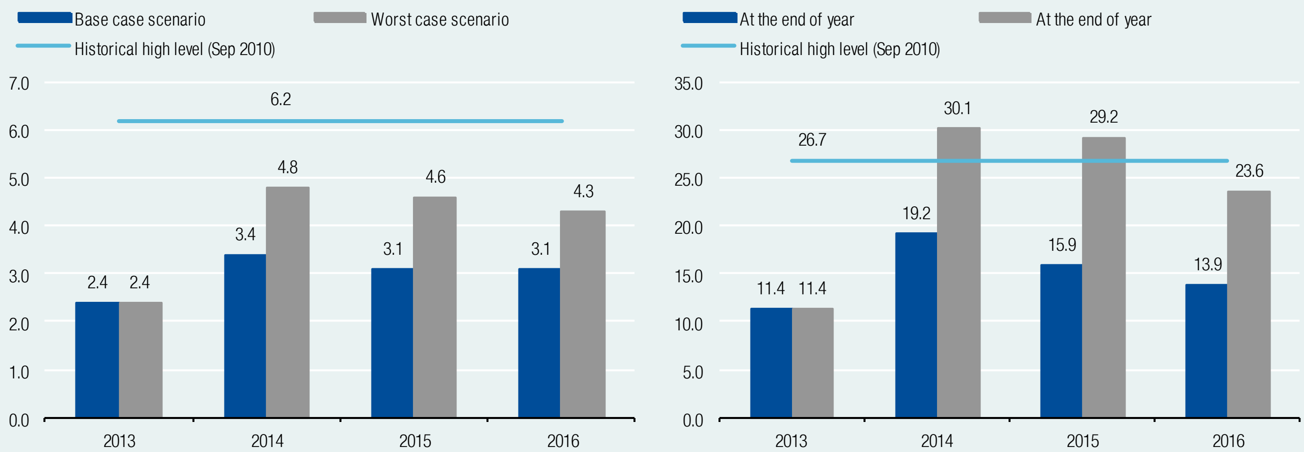
That is why roll-over ratios for government and central bank for our BoP projections (see Table 8 on p.54 below) spike in 2014 and 2015 (in 2013 they were at zero) for the debt owed to IMF and other official lenders. Thus, government rollover ratio in regard to debt owed to official lenders stands at 494% (gross FX borrowing amounts nearly US$13bn) in 2014, followed by 791% rollover ratio in 2015 (for gross FX borrowing of US$6bn).

Banks are expected to continue repaying their past debts (i.e., debt to parent entities, this excludes Eurobonds) gradually – hence, the rollover ratios in 2014-16 are less than 100%; only in the last year does it go up to 102%. Banks are likely to cut off from the Eurobond market in the period when IMF programme is realized.

Corporate borrowings, too, have zero rollover ratio for the Eurobond debt in 2014-15, able to re-gain access only in 2016 as IMF programme completes and sovereign credit rating is upgraded to a more decent level (than current pre-default rating). Rollover ratios for other corporate debt is assigned at 115% in 2014, an indication of the stressful condition of the economy; then it recovers to 120% in 2015-16 as the economy adjusts for a more balanced growth model.

In effect, FX reserves are to recover this year to US$25bn in 2014 or 3.4 months of imports coverage. In the following years, the FX reserves are under pressure, declining by a marginal pace of US$1.9bn and US$0.3bn, while the imports coverage ratio remains above 3.0x.

Chart 46. Projected FX reserves ratios in 2014-16: imports coverage (months, left chart) and FX res./GDP (%, right chart)



Source: Investment Capital Ukraine LLC. Source: Investment Capital Ukraine LLC.

Table 8. Ukraine's balance of payments forecast for 2014-16 (US$bn)

Under ICU's **base-case scenario,** Ukraine's authorities agree on a new programme with IMF in mid 2Q14

Balance of payments (US$m)		Forecast period			Rollover ratios			
	2013	2014	2015	2016	2014	2015	2016	Comment
Current account balance	**-16,141**	**-8,201**	**-6,547**	**-5,012**				
Short-term debt[1]	**-64,518**	**-61,657**	**-59,423**	**-56,738**				
Government								
Official lenders (IMF)	-2,600	-2,619	-766	0	494%	791%	0%	2yr US$18bn IMF programme, other IFIs
Russian banks	0	0	0	0	0%	0%	0%	No loans from Russian banks
Eurobonds	-1,000	-1,000	-4,328	-2,250	0%	0%	100%	Since 2016, new Eurobond issue
Domestic FX bonds[2]	-1,988	-1,696	-1,927	-1,408	0%	0%	0%	No FX domestic bonds
Other	0	0	0	0	0%	0%	0%	
Central bank								
Official lenders (IMF)	-3,235	-1,079	-490	0	514%	705%	0%	2yr US$18bn IMF programme
Other	0	0	0	0	0%	0%	100%	
Banks								
Eurobonds	-15	-754	-969	-986	0%	0%	100%	Since 2016, new Eurobond issues
Other lenders	-11,552	-12,180	-11,242	-11,938	92%	97%	102%	European banks continue withdrawing, albeit at
Corporations								
Eurobonds	0	-1,645	-1,785	-750	0%	0%	100%	Since 2016, new Eurobond issues
Loans	-11,683	-10,729	-9,999	-10,392	115%	120%	120%	All-time avg roll-over ratio for corporations
Trade loans	-21,140	-20,615	-19,213	-19,968	115%	120%	120%	The same as bove
Other	-11,306	-9,340	-8,705	-9,047	115%	120%	120%	The same as bove
Other	-68	-5,000	-5,000	-5,000				
Total financing needs[3]	**-80,727**	**-74,857**	**-70,969**	**-66,750**				
FDI, inflows	3,351	3,122	3,236	3,479				ICU forecast for the period
Borrowings								
Government	11,780	12,941	6,059	2,250				
Central bank	0	5,546	3,454	0				
Banks	11,259	11,242	10,938	12,175				
Corporations	50,201	46,787	45,501	45,000				
Total financing[4]	**76,591**	**79,638**	**69,187**	**62,905**				
Use of reserves	**-4,136**	**+4,781**	**-1,783**	**-314**				
FX reserves								
At the start of year	24,551	20,415	25,196	23,413				
At the end of year	20,415	25,196	23,413	23,099				
Change (%YoY)	-16.8	23.4	-7.1	-1.3				
FX reserves (% of GDP)								
At the start of year	14.1	11.4	19.2	15.9				
At the end of year	11.4	19.2	15.9	13.9				
Change (ppt)	-2.7	7.7	-3.3	-2.0				
FX res.imports cov.[5] (months)								
At the start of year	2.8	2.4	3.4	3.1				
At the end of year	2.4	3.4	3.1	3.1				
Change (months)	-0.4	1.0	-0.3	0.0				

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] 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;
[4] total financing equals to the sum of FDI and borrowings by all segments of the economy (government, central bank, banks and corporations);
[5] ratio of imports coverage by FX reserves, measured in months;
[6] 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; [7] the same as above, we include into calculation the US$0.75bn loan obtained by the MoF from Sberbank CIB (Russia) in September 2013.

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

Table 9. Ukraine's balance of payments forecast for 2014-16 (US$bn)
Under ICU's **worst-case scenario,** Ukraine's authorities agree on a new programme with IMF in mid 2Q14

Balance of payments (US$m)		Forecast period			Rollover ratios			
	2013	2014	2015	2016	2014	2015	2016	Comment
Current account balance	**-16,141**	**-5,868**	**-4,668**	**-4,405**				
Short-term debt[1]	**-64,518**	**-61,657**	**-59,423**	**-56,738**				
Government								
Official lenders (IMF)	-2,600	-2,619	-766	0	494%	791%	0%	2yr US$18bn IMF programme, other IFIs
Russian banks	0	0	0	0	0%	0%	0%	No loans from Russian banks
Eurobonds	-1,000	-1,000	-4,328	-2,250	0%	0%	100%	Since 2016, new Eurobond issue
Domestic FX bonds[2]	-1,988	-1,696	-1,927	-1,408	0%	0%	0%	No FX domestic bonds
Other	0	0	0	0	0%	0%	0%	
Central bank								
Official lenders (IMF)	-3,235	-1,079	-490	0	514%	705%	0%	2yr US$18bn IMF programme
Other	0	0	0	0	0%	0%	100%	
Banks								
Eurobonds	-15	-754	-969	-986	0%	0%	100%	Since 2016, new Eurobond issues
Other lenders	-11,552	-12,180	-11,242	-11,938	92%	97%	102%	European banks continue withdrawing, albeit at
Corporations								
Eurobonds	0	-1,645	-1,785	-750	0%	0%	100%	Since 2016, new Eurobond issues
Loans	-11,683	-10,729	-9,999	-10,392	115%	120%	120%	All-time avg roll-over ratio for corporations
Trade loans	-21,140	-20,615	-19,213	-19,968	115%	120%	120%	The same as bove
Other	-11,306	-9,340	-8,705	-9,047	115%	120%	120%	The same as bove
Other	-68	-5,000	-5,000	-5,000				
Total financing needs[3]	**-80,727**	**-72,525**	**-69,091**	**-66,143**				
FDI, inflows	3,351	1,342	1,356	1,445				ICU forecast for the period
Borrowings								
Government	11,780	12,941	6,059	2,250				
Central bank	0	5,546	3,454	0				
Banks	11,259	11,242	10,938	12,175				
Corporations	50,201	46,787	45,501	45,000				
Total financing[4]	**76,591**	**77,857**	67,307	60,871				
Use of reserves	**-4,136**	**+5,332**	**-1,783**	**-1,742**				
FX reserves								
At the start of year	24,551	20,415	25,747	23,964				
At the end of year	20,415	25,747	23,964	22,222				
Change (%YoY)	-16.8	26.1	-6.9	-7.3				
FX reserves (% of GDP)								
At the start of year	14.1	11.4	30.1	29.2				
At the end of year	11.4	30.1	29.2	23.6				
Change (ppt)	-2.7	18.7	-0.9	-5.6				
FX res.imports cov.[5] (months)								
At the start of year	2.8	2.4	4.8	4.6				
At the end of year	2.4	4.8	4.6	4.3				
Change (months)	-0.4	2.4	-0.2	-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] 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;
[4] total financing equals to the sum of FDI and borrowings by all segments of the economy (government, central bank, banks and corporations);
[5] ratio of imports coverage by FX reserves, measured in months;
[6] 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; [7] the same as above, we include into calculation the US$0.75bn loan obtained by the MoF from Sberbank CIB (Russia) in September 2013.

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

View on the UAH: Deep real devaluation, again

Macroeconomic conditions

There are three factors that shape our view.

First, it is geopolitics. Or how far could Ukraine-Russia relations deteriorate? At this moment, the Kremlin's appetite to embrace Ukraine in a bear hug after the Crimea annexation appears insatiable – the Kremlin is not shy to wage a war via the hands of small groups of no-insignia military squads, followed by a full-blown military invasion. Hence, Ukraine's macroeconomic conditions run a risk of a severe worsening of business and consumer sentiments. If a weaker economy emerges if this risk is materialised, then it would require an even weaker currency than now.

Second, it is fiscal issue. This appears even more challenging than in the past year. Our base-case scenario envisages a 6.1% of GDP deficit of the state budget (not consolidated and without Naftogaz), a daunting task for the government to finance. It would be tempting for the authorities to monetise the debt through increased NBU purchases, if it fails to secure financing from the third parties.

Third, it is the current market adjustment of the FX rate. In our view, UAH have adjusted quite a lot over past two months (more details on this below). So far, the UAH's real trade-weighted rate dropped by nearly 33% YTD, more than its peers of ex-Soviet republics like Russia, Kazakhstan, and Belarus.

While the last two factors are manageable, the first one is much less under control.

If Yatsenyuk's government commits to IMF programme from the very start to the end (i.e., a two-year period), then there should be less worries about the second factor. As a general rule, IMF restricts base money growth, i.e., on NBU's money printing, so as to keep down inflation expectations. The third factor, too, is manageable in the way that if inflation remains in the single-digit territory—UAH's real trade-weighted value eliminates the risk of appreciating too fast—then UAH's real TWI is forecast to appreciate, however, at moderate pace. Hence, instead of fast-paced real appreciation, UAH would undergo just a moderate appreciation.

ICU's trade-weighted indices

Our FX valuation approach—through the trade-weighted indices—shows that UAH devalued in US dollar terms by 35.2% (or US dollar rose by 54.2% in the hryvnia terms) since very beginning of the year. This translates into nearly 33% YTD real devaluation, allowing a mid-range negative misalignment of 27% (see Table 10, p.58). The so-called fair-value range, which is determined by CPI- and PPI-based real trade-weighted indices, stood in 9.15-9.45/USD as of 11 April 2014. Hence, the mid-range was 9.30/USD.

Chart 48 below shows the dimension of the UAH's real TWIs devaluation. In year-on-year terms, the CPI- and PPI-based indices dropped respectively by 29.2% and 23.5% as of 11 April 2014. In the 2008-09 recession period, these indices' on-year decline reached a bottom of nearly 38% in early September 2009 (see right-hand part of the Chart 48 on p.58). It is symptomatic that UAH's real TWIs over their history (since January 1995) never dropped by more than they did in 2009 – in the 1998 devaluation, the CPI-based real TWI was down by 36% YoY in the end of September of that year; and the PPI-based real TWI dropped by 31% YoY in mid December 1999. This provides us with a kind of the threshold that in the current market-led correction of the FX rate it's real rate depreciation also would be limited by the 38% ceiling. If the FX market today were to value UAH at a 14.5/USD nominal rate, then it would imply that such a ceiling had reached.

However, such a market development would mean heavily stressful conditions, hence, this is an extreme development. It would last just a few weeks as the economy would correct itself out of such a stress.

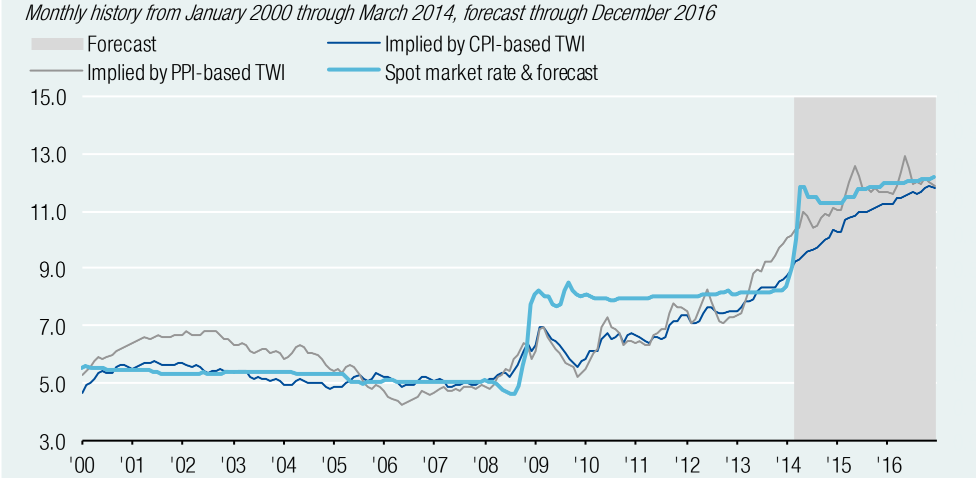
A more probable scenario, in our view, would be the path of the UAH's market FX rate that recovers from the sizable misalignment closer towards the projected trajectory for the FX rate as implied by the CPI- and PPI-based real trade-weighted indices (see Chart 47 below). This approach is based on the projected FX rates and domestic inflation rates for the Ukraine's main trade partners and in Ukraine, too.

It yields that, over 2014, the projected range of the UAH's fair value as implied by the CPI- and PPI-based real TWIs moves from 9.5-10.5/USD now towards 9.8-10.7/USD this fall and 10.3-11.0/USD at the end of the year.

In this regard, the UAH's market (nominal) rate is likely to depart its distressed valuation of 12-13/USD and recovers in value towards the 11.5/USD level in the mid of this year and then ending the year at 11.30/USD. Respectively, in 2015 and 2016 we forecast a yearly average rate of 11.80/USD and 12.10/USD respectively; the year-end rate for these years is forecast at 11.95/USD and 12.15/USD.

Chart 47. Forecast of the UAH's market rate under the projected path of the CPI- and PPI-based real trade-weighted indices for 2014-16

Monthly history from January 2000 through March 2014, forecast through December 2016



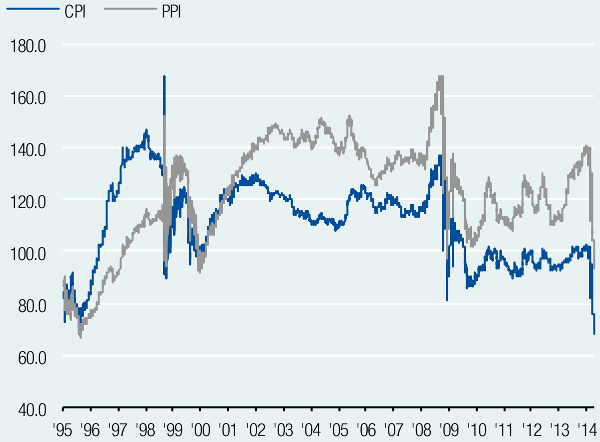
Source: Bloomberg, ICU.

ICU's PPP observations

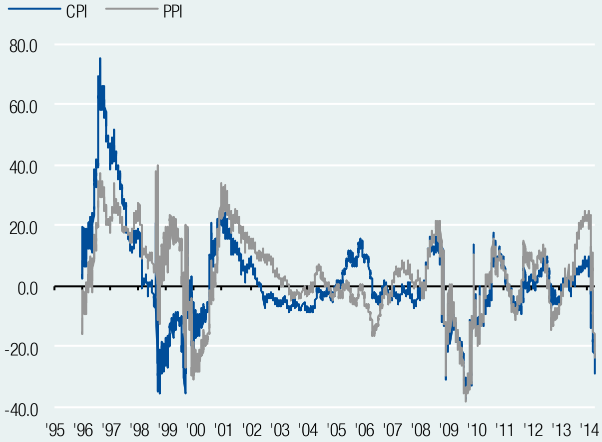
An update of ICU's purchasing-power-parity approach to UAH relative value routinely yields an undervalued UAH versus both the USD and RUB. More details on this are in the Appendix section "ICU consumer basket: Observation of Kiev, New-York and Moscow prices" on p.73.

Chart 48. UAH's CPI- and PPI-based real trade-weighted indices. Daily history since 1 January 1995 through 11 April 2014

The indices (points)



Percentage change over a year ago (% YoY)



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

Table 10. UAH versus the currencies of selected ex-Soviet republics: Year-to-date market performance and misalignment of the real rate[1]

Currency	Market FX rate[2] versus USD	YTD change[3] (%)	Real TWIs[4] YTD (%)		Misalignment[5] (%)			Fair value[6]		
			CPI-based	PPI-based	CPI-based	PPI-based	Mid	CPI-based	PPI-based	Mid
UAH	12.7100	-35.2	-32.8	-32.7	-28.0	-25.6	-26.8	9.15	9.45	9.30
RUB	35.5219	-7.5	-4.3	-4.3	-0.5	29.4	14.5	35.23	45.67	40.45
KZT	182.0400	-15.3	-12.2	-12.2	-48.0	-23.5	-35.8	95.80	139.70	117.75
BYR	9930.0000	-4.2	4.3	4.3	-0.9	1.3	0.2	9867.99	10097.34	9982.66

Notes: [1] real rate is meant a real trade-weighted index either CPI-based or PPI-based TWI; [2] as of 11 April 2014;
[3] change in the currency's value in US dollars; [4] real trade-weighted indices; [5] difference between trade-weighted index and its five-year rolling average value; [6] fair value is obtained through adjustment of the market rate by a misalignment measure.

Sources: Bloomberg, ICU.

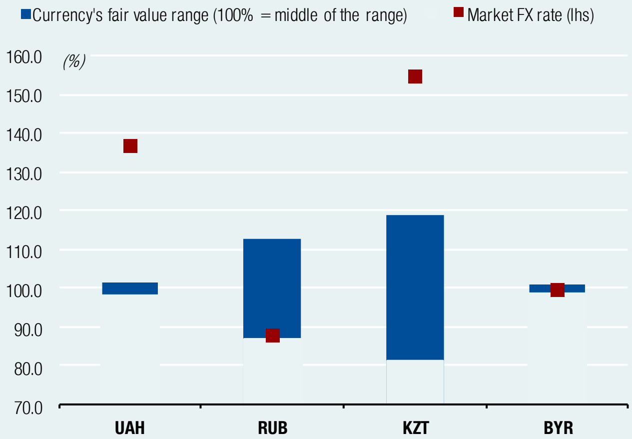
Chart 49. History of FX misalignment:
UAH versus the currencies of selected ex-Soviet republics

Daily history since 3 January 2005 through 11 April 2014

Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 50. FX misalignment – how much?
UAH versus the currencies of selected ex-Soviet republics

Data as of 11 Apr 2014



Source: Investment Capital Ukraine LLC.

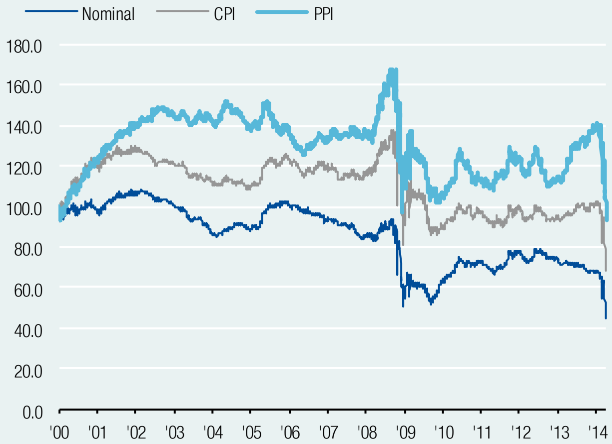
Chart 51. UAH exchange rate per USD set by the market

Daily history since 31 December 1999 through 12 August 2013

Sources: Bloomberg, Investment Capital Ukraine LLC.

Chart 52. UAH nominal and CPI- and PPI-based real trade-weighted indices (TWIs), rebased at 100 points on 31 Dec 1999

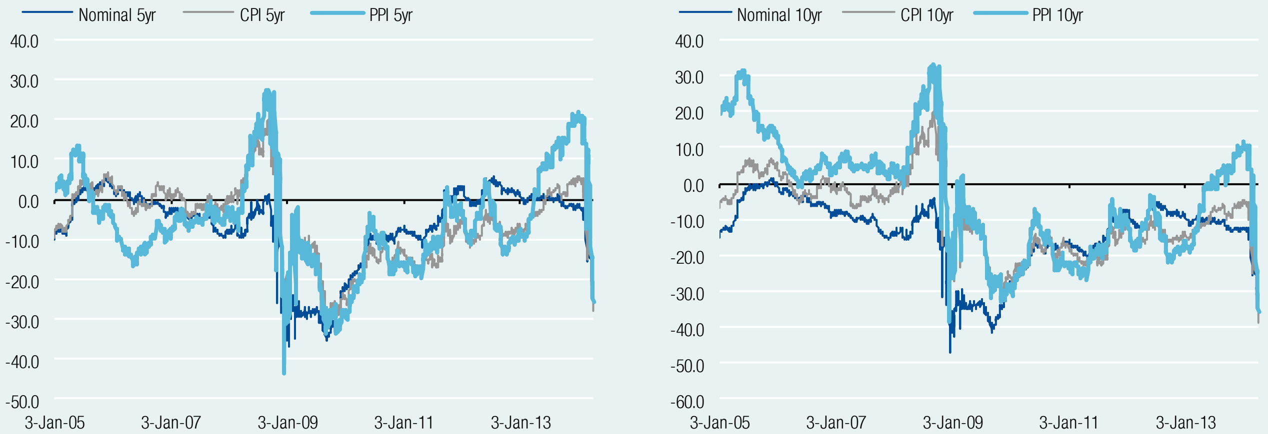
Daily history since 31 December 1999 through 12 August 2013



Source: Investment Capital Ukraine LLC.

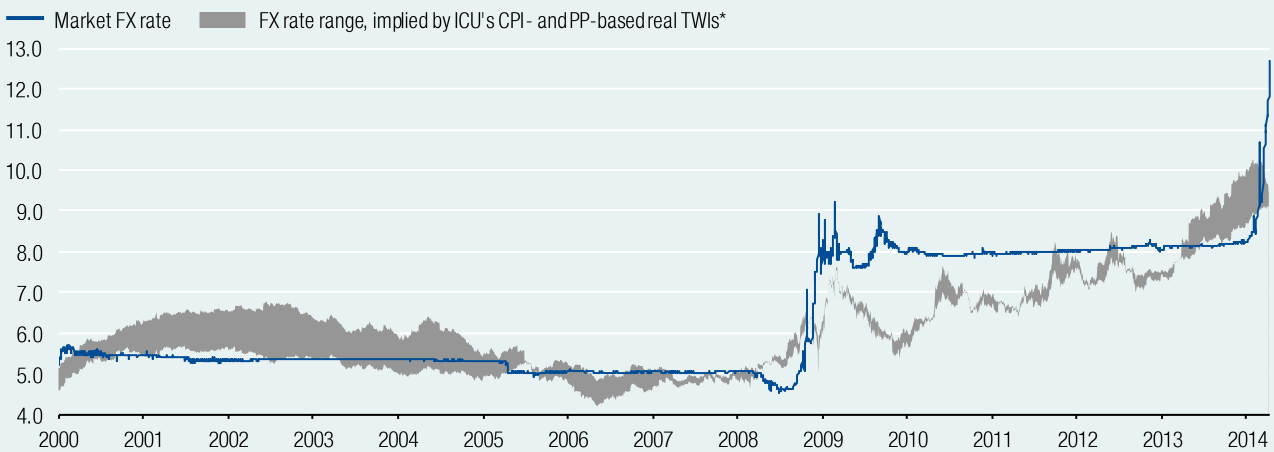
Chart 53. UAH TWIs misalignment to their 5yr and 10yr averages. Daily history since 3 January 2005 through 11 April 2014

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 54. USD/UAH exchange rate vs. the range of real-TWI-implied rates. Daily history since 1 January 2000 through 11 April 2014



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.

Estimates for 2013 and forecast for 2014-16

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

Yearly forecast for 2014-16, base-case scenario

Table 11. Forecast of key macroeconomic indicators for 2014-16 (annual)

	Historical data for 2004-12										Forecast by ICU		
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Activity													
Real GDP (%YoY)	12.1	2.7	7.3	7.9	2.3	-14.8	4.1	5.2	0.2	-0.1	**-8.0**	**2.0**	**3.1**
Nominal GDP (UAHbn)	345	441	544	721	948	913	1,083	1,302	1,409	1,455	**1,462**	**1,635**	**1,832**
Nominal GDP (US$bn)	65	87	108	143	184	114	136	163	174	178	**135**	**139**	**152**
GDP per capita (US$, ann)	1,371	1,850	2,319	3,091	3,982	2,474	2,978	3,572	3,823	3,920	**3,133**	**3,217**	**3,532**
Unemployment rate (%)	8.6	7.2	6.2	6.4	6.4	8.8	8.1	7.9	7.5	8.2	**8.3**	**7.9**	**7.9**
Prices													
CPI headline (%YoY, eop)	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	**12.1**	**9.5**	**9.1**
CPI headline (%YoY, average)	9.0	13.6	9.1	12.8	25.3	16.0	9.4	8.0	0.6	-0.3	**8.3**	**9.4**	**9.5**
PPI (%YoY, eop)	24.3	9.6	15.4	23.2	21.1	15.3	18.8	17.4	0.4	1.7	**10.4**	**6.2**	**6.2**
PPI (%YoY, average)	20.3	17.0	9.6	20.5	33.6	7.4	21.4	19.9	6.0	-0.1	**5.2**	**8.3**	**6.2**
Fiscal balance													
Consolidated budget bal. (UAHbn)	-9.9	-7.5	-3.5	-6.1	-11.3	-34.4	-63.3	-18.3	-46.9	-63.0	**-107.6**	**-58.0**	**-17.7**
Consolidated budget bal. (% of GDP)	-2.9	-1.7	-0.6	-0.8	-1.2	-3.8	-5.9	-1.4	-3.3	-4.3	**-7.4**	**-3.5**	**-1.0**
Budget balance (UAHbn)	-10.2	-7.9	-3.8	-9.8	-12.5	-35.5	-64.3	-23.6	-53.4	-64.7	**-89.6**	**-52.1**	**-21.8**
Budget balance (% of GDP)	-3.0	-1.8	-0.7	-1.4	-1.3	-3.9	-5.9	-1.8	-3.8	-4.4	**-6.1**	**-3.2**	**-1.2**
External balance													
Exports (US$bn)	41.3	44.4	50.2	64.0	85.6	54.3	69.3	88.8	90.0	85.3	**81.2**	**83.2**	**84.9**
Imports (US$bn)	36.3	43.7	53.3	72.2	100.0	56.2	73.2	99.0	104.4	100.8	**89.0**	**89.6**	**89.7**
Trade balance (US$bn)	5.0	0.7	-3.1	-8.2	-14.4	-2.0	-4.0	-10.2	-14.3	-15.5	**-7.7**	**-6.4**	**-4.8**
Trade balance (% of GDP)	7.7	0.8	-2.8	-5.7	-7.8	-1.7	-2.9	-6.2	-8.2	-8.7	**-5.7**	**-4.6**	**-3.2**
Current account balance (US$bn)	6.9	2.5	-1.6	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.1	**-8.3**	**-6.9**	**-5.3**
Current account balance (% of GDP)	10.6	2.9	-1.5	-3.7	-6.9	-1.5	-2.2	-6.3	-8.2	-9.1	**-6.1**	**-5.0**	**-3.5**
Net FDI (US$bn)	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.8	3.4	**3.1**	**3.2**	**3.5**
Net FDI (% of GDP)	2.6	8.7	5.3	6.4	5.4	4.1	4.2	4.3	3.9	1.9	**2.3**	**2.3**	**2.3**
C/A bal. + net FDI (% of GDP)	13.3	11.6	3.8	2.8	-1.6	2.6	2.0	-2.0	-4.3	-7.2	**-3.8**	**-2.7**	**-1.2**
External debt (US$bn, eop)	30.6	39.6	54.5	80.0	101.7	103.4	117.3	126.2	135.1	141.5	**144.2**	**144.0**	**144.0**
External debt (% of ann'd GDP, eop)	47.2	45.6	50.4	55.8	55.3	90.9	86.1	77.4	77.4	79.2	**107.2**	**103.7**	**94.9**
FX reserves (US$bn, eop)	9.5	19.4	22.3	32.5	31.5	26.5	34.6	31.8	24.5	20.4	**25.1**	**23.0**	**22.4**
FX reserves (% of ann'd GDP, eop)	14.7	22.3	20.6	22.6	17.2	23.3	25.4	19.5	14.1	11.4	**18.6**	**16.6**	**14.7**
External debt / FX reserves (x, eop)	3.2	2.0	2.4	2.5	3.2	3.9	3.4	4.0	5.5	6.9	**5.7**	**6.3**	**6.4**
FX reserves imports cov (months)	3.8	6.4	6.1	6.4	4.5	7.1	6.8	4.5	3.3	2.4	**3.4**	**3.1**	**3.0**
Interest rates													
Central bank key rate (%, eop)	9.00	9.50	8.50	8.00	12.00	10.25	7.75	7.75	7.50	6.50	**9.50**	**7.50**	**7.50**
3-month rate (%, eop 4Q)	15.03	11.46	9.90	7.58	21.60	17.59	6.12	19.72	25.52	11.71	**9.00**	**6.00**	**6.00**
Exchange rates													
UAH trade-weighted index (nominal)	91.29	105.76	96.33	88.22	62.35	62.62	72.39	77.27	74.23	67.38	**53.27**	**51.73**	**50.72**
UAH trade-weighted index (real)	112.78	129.21	123.61	120.06	100.21	90.26	97.73	98.76	94.72	100.84	**85.11**	**85.91**	**87.50**
UAH/US$ (eop)	5.31	5.05	5.05	5.05	7.80	8.00	7.94	8.00	8.05	8.24	**11.30**	**11.95**	**12.15**
UAH/US$ (average)	5.32	5.10	5.03	5.03	5.25	8.03	7.94	7.99	8.08	8.16	**10.80**	**11.76**	**12.08**
UAH/€ (eop)	6.71	7.20	5.97	6.66	7.36	10.90	11.45	10.66	10.36	0.00	**14.69**	**15.30**	**15.55**
UAH/€ (average)	6.62	6.35	6.32	6.89	7.67	11.19	10.54	14.21	14.97	15.42	**14.45**	**14.97**	**15.46**
US$/€ (eop)	1.36	1.18	1.32	1.46	1.40	1.43	1.34	1.30	0.00	0.00	**1.30**	**1.28**	**1.28**
US$/€ (average)	1.24	1.24	1.26	1.37	1.47	1.39	1.33	1.34	1.27	1.28	**1.34**	**1.27**	**1.28**
Population													
Population (million, eop)	47.3	47.0	46.6	46.4	46.1	46.0	45.8	45.6	45.6	45.5	**43.1**	**43.1**	**42.9**
Population (%YoY)	-1.4	-0.8	-0.7	-0.6	-0.5	-0.4	-0.4	-0.3	-0.2	-0.1	**-5.2**	**0.0**	**-0.5**

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 2014-16, base-case scenario

Table 12. Forecast of key macroeconomic indicators for 2014-16 (quarterly)

		Forecast by ICU											
	4Q13	1Q14E	2Q14F	3Q14F	4Q14F	1Q15F	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F
Activity													
Real GDP (%YoY)	3.3	**-6.1**	**-7.5**	**-8.6**	**-9.8**	**1.5**	**2.0**	**2.5**	**2.0**	**2.5**	**3.0**	**3.5**	**3.5**
Nominal GDP (UAHbn)	404.3	**297.7**	**349.4**	**401.4**	**413.2**	**336.1**	**391.1**	**449.1**	**458.7**	**374.8**	**438.2**	**504.2**	**514.9**
Nominal GDP (US$bn)	49.2	**32.5**	**30.4**	**35.7**	**36.6**	**29.2**	**33.3**	**37.9**	**38.4**	**31.2**	**36.4**	**41.7**	**42.4**
GDP per capita (US$, ann)	3,921	**3,866**	**3,625**	**3,382**	**3,134**	**3,058**	**3,125**	**3,176**	**3,218**	**3,269**	**3,344**	**3,436**	**3,533**
Unemployment rate (%)	8.2	**8.8**	**8.9**	**8.4**	**8.3**	**8.2**	**8.2**	**8.1**	**7.9**	**7.8**	**7.9**	**7.9**	**7.9**
Prices													
CPI headline (%YoY, eop)	0.5	**3.4**	**9.6**	**11.6**	**12.1**	**10.4**	**8.8**	**8.8**	**9.5**	**9.7**	**9.7**	**9.1**	**9.1**
CPI headline (%YoY, average)	0.2	**1.7**	**8.6**	**10.8**	**11.9**	**11.7**	**8.1**	**8.6**	**9.2**	**9.7**	**9.7**	**9.5**	**9.1**
PPI (%YoY, eop)	1.7	**3.9**	**2.5**	**7.3**	**10.4**	**8.8**	**8.8**	**7.2**	**6.2**	**6.2**	**6.2**	**6.2**	**6.2**
PPI (%YoY, average)	0.7	**3.0**	**1.2**	**6.8**	**9.7**	**10.2**	**8.8**	**7.8**	**6.3**	**6.2**	**6.2**	**6.2**	**6.2**
Fiscal balance													
Consolidated budget bal. (UAHbn)	-29.9	**-8.9**	**-24.7**	**-28.2**	**-45.8**	**2.8**	**-12.7**	**-15.7**	**-32.5**	**11.5**	**-3.0**	**-5.3**	**-20.9**
Consolidated budget bal. (% of GDP)	-7.4	**-3.0**	**-7.1**	**-7.0**	**-11.1**	**0.8**	**-3.2**	**-3.5**	**-7.1**	**3.1**	**-0.7**	**-1.0**	**-4.1**
Budget balance (UAHbn)	-29.5	**-8.2**	**-20.6**	**-23.4**	**-37.3**	**0.6**	**-11.6**	**-13.9**	**-27.2**	**7.2**	**-4.3**	**-6.1**	**-18.6**
Budget balance (% of GDP)	-7.3	**-2.7**	**-5.9**	**-5.8**	**-9.0**	**0.2**	**-3.0**	**-3.1**	**-5.9**	**1.9**	**-1.0**	**-1.2**	**-3.6**
External balance													
Exports (US$bn)	22.3	**19.7**	**19.4**	**20.5**	**21.7**	**20.3**	**19.8**	**20.7**	**22.4**	**20.9**	**20.1**	**21.0**	**22.8**
Imports (US$bn)	27.1	**20.9**	**22.2**	**22.1**	**23.8**	**22.4**	**21.6**	**21.6**	**24.0**	**22.4**	**21.6**	**21.7**	**24.0**
Trade balance (US$bn)	-4.8	**-1.2**	**-2.8**	**-1.6**	**-2.1**	**-2.2**	**-1.8**	**-0.9**	**-1.6**	**-1.4**	**-1.5**	**-0.8**	**-1.1**
Trade balance (% of GDP)	-9.7	**-3.7**	**-9.1**	**-4.6**	**-5.8**	**-7.4**	**-5.4**	**-2.4**	**-4.1**	**-4.6**	**-4.1**	**-1.9**	**-2.7**
Current account balance (US$bn)	-4.9	**-1.2**	**-2.9**	**-2.0**	**-2.2**	**-2.2**	**-1.9**	**-1.2**	**-1.6**	**-1.5**	**-1.6**	**-1.0**	**-1.2**
Current account balance (% of GDP)	-10.0	**-3.8**	**-9.4**	**-5.6**	**-6.0**	**-7.6**	**-5.7**	**-3.1**	**-4.3**	**-4.8**	**-4.4**	**-2.3**	**-2.9**
Net FDI (US$bn)	0.9	**0.8**	**0.8**	**0.8**	**0.7**	**0.8**	**0.8**	**0.9**	**0.8**	**0.8**	**0.9**	**0.9**	**0.9**
Net FDI (% of GDP)	1.7	**2.5**	**2.7**	**2.3**	**1.9**	**2.7**	**2.4**	**2.2**	**2.0**	**2.7**	**2.3**	**2.2**	**2.1**
C/A bal. + net FDI (% of GDP)	-8.3	**-1.3**	**-6.8**	**-3.3**	**-4.1**	**-4.9**	**-3.3**	**-0.8**	**-2.2**	**-2.1**	**-2.0**	**-0.2**	**-0.9**
External debt (US$bn, eop)	141.5	**142.3**	**143.3**	**142.8**	**144.2**	**144.5**	**142.8**	**142.9**	**144.0**	**144.0**	**144.0**	**144.0**	**144.0**
External debt (% of ann'd GDP, eop)	79.2	**81.8**	**89.5**	**96.9**	**107.2**	**110.3**	**106.0**	**104.4**	**103.7**	**102.2**	**100.0**	**97.5**	**94.9**
FX reserves (US$bn, eop)	20.4	**21.6**	**22.8**	**23.9**	**25.1**	**24.6**	**24.0**	**23.5**	**23.0**	**22.4**	**21.9**	**21.4**	**22.4**
FX reserves (% of ann'd GDP, eop)	11.4	**12.4**	**14.2**	**16.2**	**18.6**	**18.6**	**17.8**	**17.2**	**16.6**	**15.9**	**15.2**	**14.5**	**14.7**
External debt / FX reserves (x, eop)	6.9	**6.6**	**6.3**	**6.0**	**5.7**	**5.9**	**5.9**	**6.1**	**6.3**	**6.4**	**6.6**	**6.7**	**6.4**
FX reserves imports cov (months)	2.4	**2.6**	**2.8**	**3.1**	**3.4**	**3.3**	**3.2**	**3.2**	**3.1**	**3.0**	**2.9**	**2.9**	**3.0**
Interest rates													
Central bank key rate (%, eop)	6.50	**6.50**	**9.50**	**9.50**	**9.50**	**8.50**	**7.50**	**7.50**	**7.50**	**7.50**	**7.50**	**7.50**	**7.50**
3-month rate (%, eop 4Q)	11.71	**15.93**	**16.00**	**10.00**	**9.00**	**8.00**	**6.00**	**6.00**	**6.00**	**6.00**	**6.00**	**6.00**	**6.00**
Exchange rates													
UAH trade-weighted index (nominal)	67.38	**57.59**	**50.25**	**52.26**	**53.27**	**53.47**	**52.62**	**51.99**	**51.73**	**51.56**	**51.43**	**51.27**	**50.72**
UAH trade-weighted index (real)	100.84	**87.90**	**78.10**	**81.81**	**85.11**	**86.26**	**85.96**	**85.08**	**85.91**	**86.47**	**87.32**	**87.18**	**87.50**
UAH/US$ (eop)	8.24	**11.38**	**11.50**	**11.25**	**11.30**	**11.50**	**11.75**	**11.85**	**11.95**	**12.00**	**12.05**	**12.10**	**12.15**
UAH/US$ (average)	8.21	**9.16**	**11.50**	**11.25**	**11.30**	**11.50**	**11.75**	**11.85**	**11.95**	**12.00**	**12.05**	**12.10**	**12.15**
UAH/€ (eop)	11.32	**15.66**	**15.53**	**14.96**	**14.69**	**14.72**	**14.69**	**15.17**	**15.30**	**15.36**	**15.42**	**15.49**	**15.55**
UAH/€ (average)	0.00	**12.56**	**15.53**	**14.96**	**14.69**	**14.72**	**14.69**	**15.17**	**15.30**	**15.36**	**15.42**	**15.49**	**15.55**
US$/€ (eop)	1.37	**1.38**	**1.35**	**1.33**	**1.30**	**1.28**	**1.25**	**1.28**	**1.28**	**1.28**	**1.28**	**1.28**	**1.28**
US$/€ (average)	1.36	**1.37**	**1.35**	**1.33**	**1.30**	**1.28**	**1.25**	**1.28**	**1.28**	**1.28**	**1.28**	**1.28**	**1.28**
Population													
Population (million, eop)	45.50	**43.14**	**43.09**	**43.08**	**43.12**	**43.16**	**43.12**	**43.10**	**43.14**	**42.95**	**42.91**	**42.89**	**42.94**
Population (%YoY)	-0.1	**-5.2**	**-5.2**	**-5.2**	**-5.2**	**0.0**	**0.0**	**0.0**	**0.0**	**-0.5**	**-0.5**	**-0.5**	**-0.5**

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.

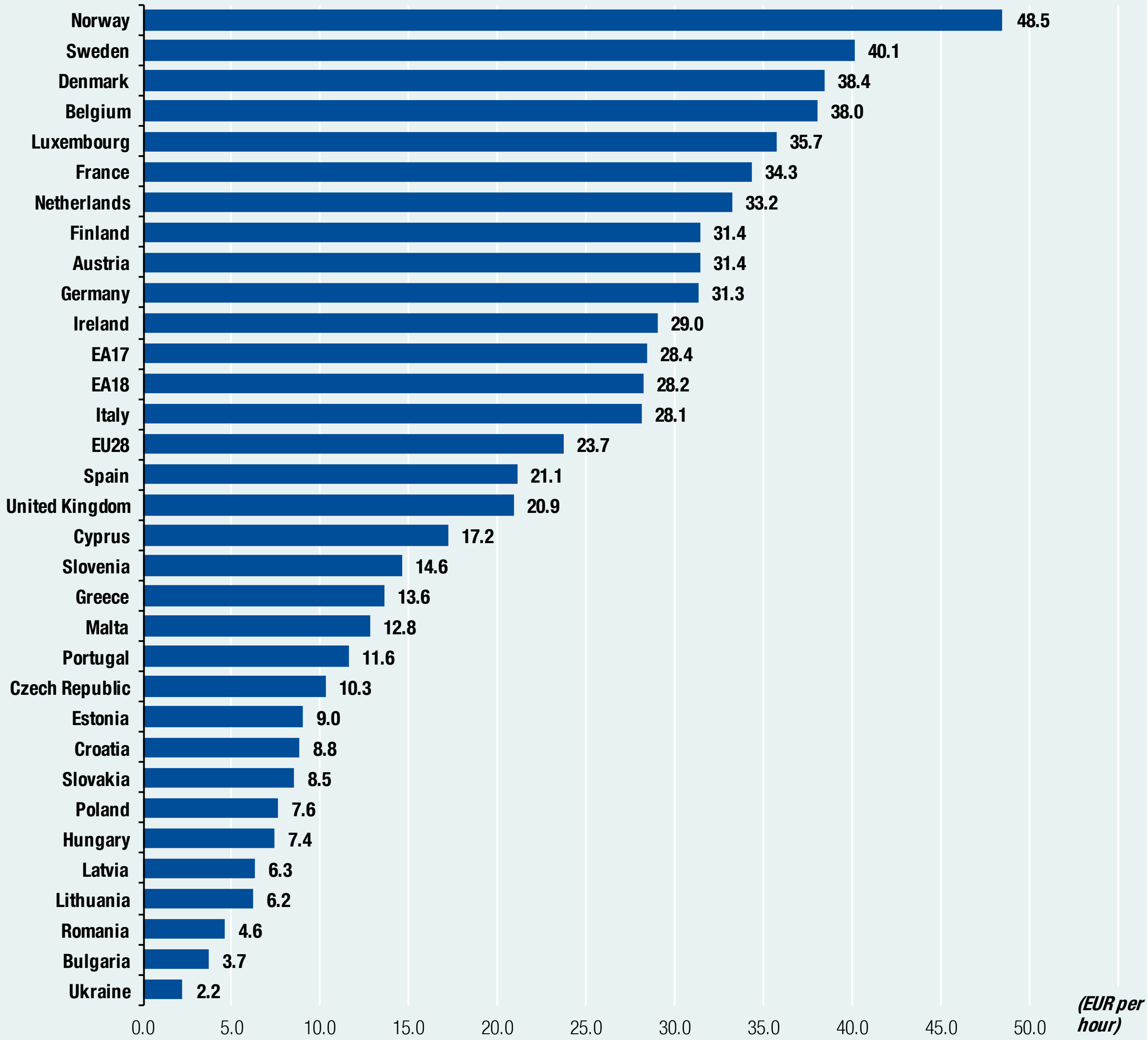
Average hourly wage in Ukraine versus in European countries

Table 13. Labour costs per hour in euro, whole economy, excluding agriculture and public administration (EUR/hour)

Country	2008	2010	2011	2012	2013	Non-wage costs (% of total), 2013*	Change 2013/2008 (%)
Ukraine	**1.7**	**1.6**	**1.8**	**2.2**	**2.2**	**N/A**	**28.2%**
EA17	25.7	26.9	27.5	28.0	28.4	25.9%	10.4%
EA18	25.5	26.7	27.3	27.8	28.2	25.9%	10.4%
EU28	21.5	22.4	22.9	23.4	23.7	23.7%	10.2%
Belgium	32.9	35.3	36.3	37.2	38.0	27.4%	15.4%
Bulgaria	2.6	3.1	3.3	3.6	3.7	15.8%	44.1%
Czech Republic	9.2	9.8	10.5	10.5	10.3	26.8%	12.4%
Denmark	34.4	36.7	37.3	38.0	38.4	12.4%	11.7%
Germany	27.9	28.8	29.6	30.5	31.3	21.8%	12.2%
Estonia	7.8	7.6	7.9	8.4	9.0	26.7%	15.2%
Ireland	28.9	28.9	28.7	29.0	29.0	13.8%	0.5%
Greece5	16.7	17.0	16.2	15.0	13.6	19.1%	-18.6%
Spain5	19.4	20.7	21.2	21.0	21.1	26.6%	8.7%
France5	31.2	32.6	33.6	34.3	34.3	32.4%	9.9%
Croatia	9.2	8.6	8.7	8.7	8.8	15.4%	-4.0%
Italy	25.2	26.8	27.2	27.6	28.1	28.1%	11.4%
Cyprus	16.7	17.7	18.0	18.0	17.2	16.6%	2.6%
Latvia	5.9	5.5	5.7	6.0	6.3	20.6%	7.1%
Lithuania	5.9	5.4	5.5	5.8	6.2	28.5%	5.0%
Luxembourg	31.0	32.9	33.9	34.7	35.7	13.4%	15.4%
Hungary	7.8	7.0	7.3	7.5	7.4	24.6%	-5.2%
Malta	11.3	11.9	12.2	12.5	12.8	8.0%	13.9%
Netherlands	29.8	31.1	31.6	32.3	33.2	24.7%	11.7%
Austria	26.4	28.0	29.0	30.5	31.4	26.7%	18.9%
Poland	7.6	7.2	7.3	7.4	7.6	16.7%	0.1%
Portugal	12.2	12.6	12.6	11.6	11.6	19.3%	-5.1%
Romania5	4.2	4.1	4.2	4.1	4.6	23.2%	10.6%
Slovenia	13.9	14.6	14.9	14.9	14.6	14.7%	4.9%
Slovakia	7.3	7.7	8.0	8.3	8.5	27.4%	17.0%
Finland	27.1	28.8	29.5	30.8	31.4	22.1%	15.9%
Sweden	31.6	33.6	36.4	39.2	40.1	33.3%	26.9%
United Kingdom	20.9	20.0	20.1	21.6	20.9	15.3%	-0.3%
Norway	37.8	41.6	44.5	48.5	48.5	18.9%	28.2%

Sources: Eurostat, State Statistics Service of Ukraine, ICU.

Chart 55. Labour costs per hour in euro in 2013, whole economy, excluding agriculture and public administration (EUR/hour)



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

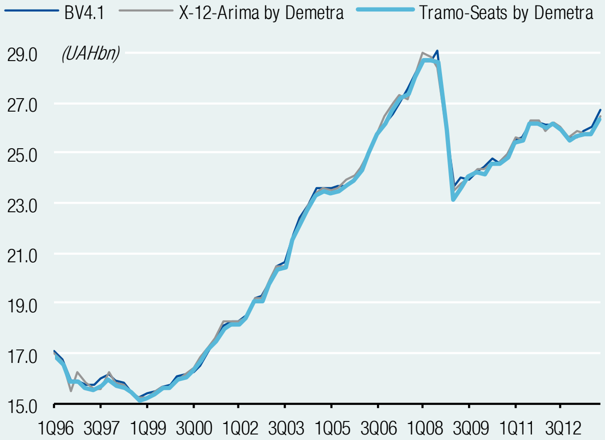
Quarterly GDP: Reported statistics and ICU's calculations

Chart 56. Ukraine's economy from the perspective of quarterly GDP volumes (left) and on-quarter growth rates (right)

History from 1Q96 till 4Q13

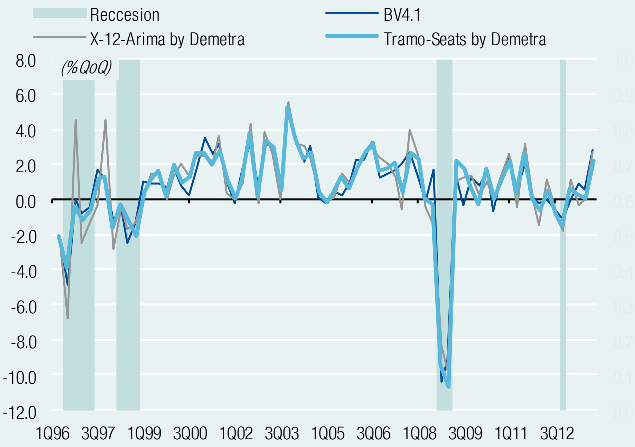
Data is adjusted for inflation and seasonal factors. data is seasonally adjusted by three methods BV4.1, X-12 Arima and Tramo-Seats

Quarterly GDP size in constant prices of Dec-95



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

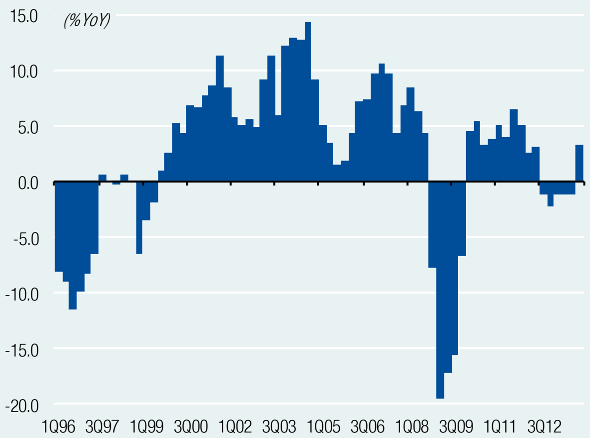
Quarterly GDP growth rates (% QoQ)



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

Chart 57. Reported on-year quarterly GDP growth (% YoY)

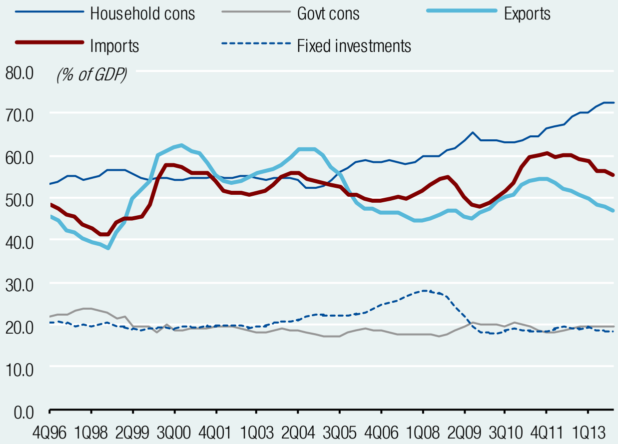
History from 1Q 1996 till 1Q 2013; forecast for 2Q-4Q of 2013



Source: State Statistics Service of Ukraine.

Chart 58. 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.

Table 14. Ukraine quarterly GDP size: History from 4Q96 till 3Q13 (UAHm, if not otherwise indicated)
Reported statistics and ICU calculations of quarter-on-quarter growth in real and seasonally-adjusted terms

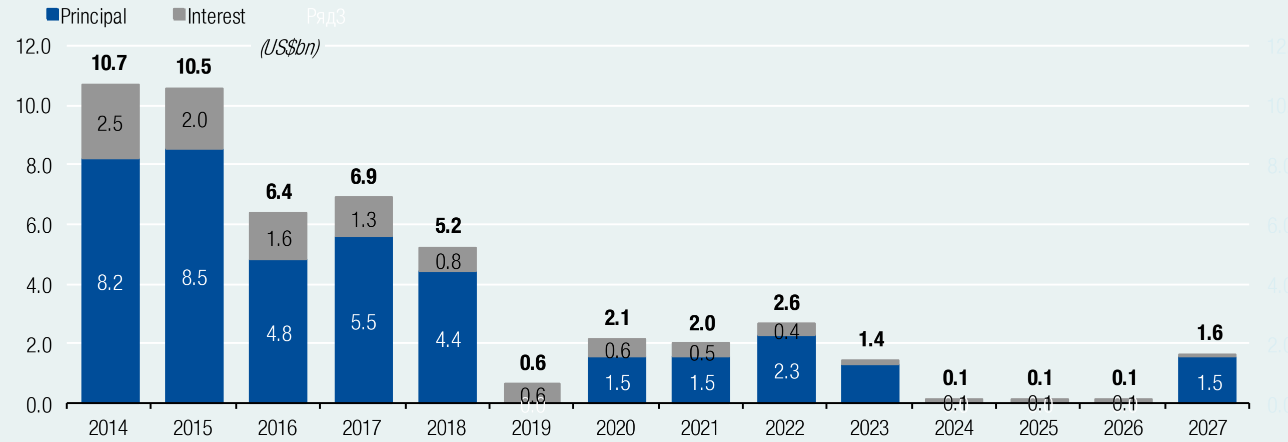
Period	Reported statistics on quarterly GDP				ICU calculations							
	GDP at current prices (UAHm)	Real growth (% YoY, qtly)	Real growth (% QoQ, SA)	Deflator (% YoY)	Real growth (% YoY, ann'd)	GDP at cons prices[1] (UAHm, NSA)	GDP at cons prices[1] (UAHm, SA)			Real GDP growth (%QoQ, SA)		
							BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra	BV4.1	X-12-Arima by Demetra	Tramo-Seats by Demetra
4Q96	24,454	-10.0		40.1	-9.7	17,404	16,075	16,228	**15,824**	0.8	4.6	0.8
1Q97	18,728	-8.3		22.3	-9.8	14,114	15,777	15,780	**15,779**	-1.9	-2.8	-0.3
2Q97	20,485	-6.6		22.7	-9.1	14,117	15,758	15,586	**15,750**	-0.1	-1.2	-0.2
3Q97	26,076	0.5		15.3	-6.2	17,544	16,049	15,531	**15,687**	1.8	-0.4	-0.4
4Q97	28,076	0.0		14.8	-3.7	17,405	16,122	16,258	**15,984**	0.5	4.7	1.9
1Q98	20,871	-0.3		11.8	-1.6	14,068	16,011	15,744	**15,762**	-0.7	-3.2	-1.4
2Q98	23,367	0.5		13.5	0.2	14,188	15,795	15,701	**15,724**	-1.4	-0.3	-0.2
3Q98	28,908	-0.1		10.9	0.0	17,538	15,379	15,435	**15,479**	-2.6	-1.7	-1.6
4Q98	29,447	-6.6		12.3	-1.7	16,256	15,177	15,236	**15,165**	-1.3	-1.3	-2.0
…	…	…	…	…	…	…	…	…	**…**	…	…	**…**
4Q05	128,780	1.9		26.3	3.0	25,257	23,941	24,112	**23,926**	1.0	0.9	0.7
1Q06	106,348	4.3		15.7	2.8	21,937	24,486	24,472	**24,339**	2.3	1.5	1.7
2Q06	126,319	7.2		15.9	3.7	23,023	25,028	25,099	**24,981**	2.2	2.6	2.6
3Q06	152,406	7.3		15.6	5.2	29,301	25,854	25,846	**25,772**	3.3	3.0	3.2
4Q06	159,080	9.6		12.8	7.1	27,659	26,165	26,452	**26,206**	1.2	2.3	1.7
1Q07	139,444	10.6		18.6	8.7	24,253	26,560	26,994	**26,667**	1.5	2.1	1.8
2Q07	166,869	9.7		20.4	9.3	25,260	26,999	27,338	**27,229**	1.7	1.3	2.1
3Q07	199,535	4.4		25.4	8.5	30,592	27,539	27,168	**27,336**	2.0	-0.6	0.4
4Q07	214,883	6.9		26.4	7.9	29,558	28,288	28,239	**28,068**	2.7	3.9	2.7
1Q08	191,459	8.5		26.6	7.4	26,303	28,675	28,972	**28,711**	1.4	2.6	2.3
2Q08	236,033	6.2		33.2	6.5	26,824	28,645	28,840	**28,719**	-0.1	-0.5	0.0
3Q08	276,451	4.3		32.9	6.5	31,892	29,122	28,418	**28,635**	1.7	-1.5	-0.3
4Q08	244,113	-7.8		23.3	2.6	27,233	26,102	26,051	**25,916**	-10.4	-8.3	-9.5
1Q09	189,028	-19.6		22.8	-4.8	21,148	23,697	23,508	**23,156**	-9.2	-9.8	-10.6
2Q09	214,103	-17.3		9.7	-10.6	22,181	24,047	23,734	**23,653**	1.5	1.0	2.1
3Q09	250,306	-15.7		7.4	-15.2	26,886	23,962	24,030	**24,070**	-0.4	1.2	1.8
4Q09	259,908	-6.7		14.1	-15.0	25,412	24,254	24,347	**24,239**	1.2	1.3	0.7
1Q10	217,286	4.5	0.7	10.7	-9.2	21,959	24,435	24,397	**24,155**	0.7	0.2	-0.3
2Q10	256,754	5.4	1.4	15.1	-3.5	23,110	24,827	24,631	**24,577**	1.6	1.0	1.7
3Q10	301,251	3.3	0.4	17.5	1.5	27,539	24,650	24,642	**24,582**	-0.7	0.0	0.0
4Q10	307,278	3.7	0.7	15.6	4.2	25,989	24,944	24,961	**24,867**	1.2	1.3	1.2
1Q11	257,682	5.1	2.0	12.9	4.4	23,066	25,525	25,617	**25,418**	2.3	2.6	2.2
2Q11	311,022	3.9	0.3	16.6	4.0	24,009	25,660	25,509	**25,475**	0.5	-0.4	0.2
3Q11	369,818	6.5	2.5	15.2	4.8	29,347	26,181	26,303	**26,140**	2.0	3.1	2.6
4Q11	363,557	5.0	0.3	12.6	5.1	27,309	26,198	26,305	**26,166**	0.1	0.0	0.1
1Q12	293,493	2.5	-0.8	11.4	4.5	23,584	26,126	25,911	**25,996**	-0.3	-1.5	-0.7
2Q12	349,212	3.1	0.5	9.0	4.3	24,731	26,110	26,192	**26,140**	-0.1	1.1	0.6
3Q12	387,620	-1.3	-1.5	6.2	2.3	28,963	25,956	26,083	**25,919**	-0.6	-0.4	-0.8
4Q12	378,564	-2.3	-0.8	6.6	0.5	26,681	25,663	25,596	**25,512**	-1.1	-1.9	-1.6
1Q13	302,864	-1.2	0.6	4.4	-0.4	23,301	25,664	25,878	**25,677**	0.0	1.1	0.6
2Q13	353,025	-1.3	0.4	2.4	-1.5	24,409	25,882	25,798	**25,757**	0.8	-0.3	0.3
3Q13	394,731	-1.2	-0.1	3.1	-1.5	28,616	26,016	25,784	**25,778**	0.5	-0.1	0.1
4Q13	404,311	3.3	2.1	3.4	-0.1	27,561	26,740	26,489	**26,339**	2.8	2.7	2.2

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 2014-27

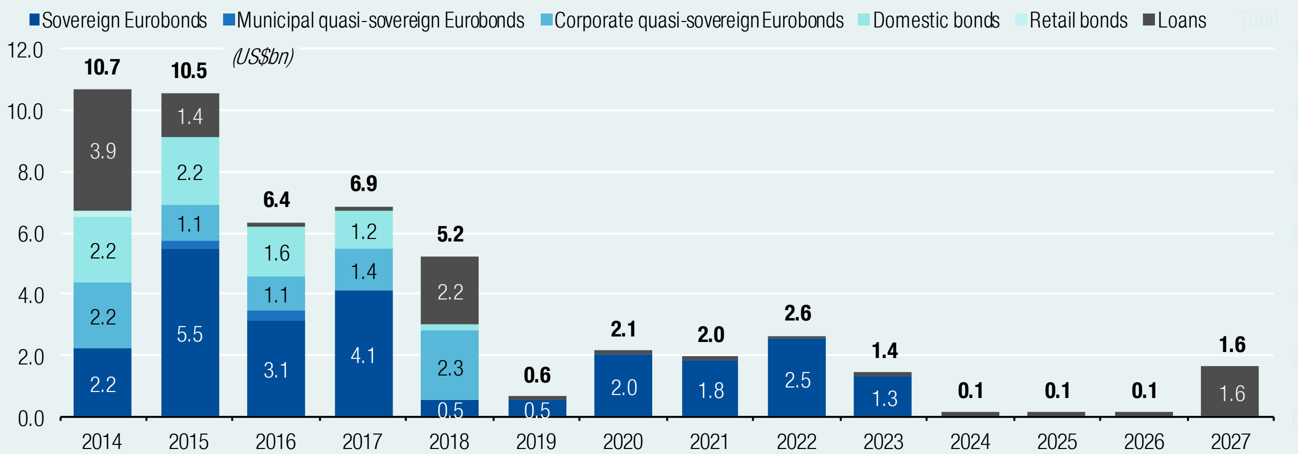
Yearly breakdown of sovereign and quasi-sovereign external debt (charts)

Chart 59. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by cash flow type (US$bn)



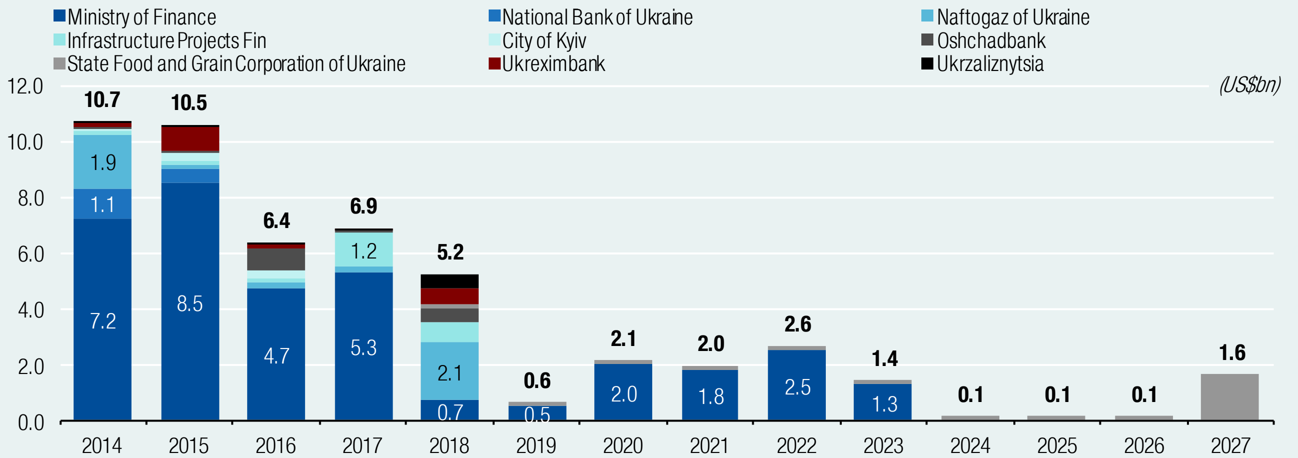
Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 60. Ukraine's sovereign and quasi-sovereign external debt due in 2010-27: Breakdown by ultimate borrower (US$bn)



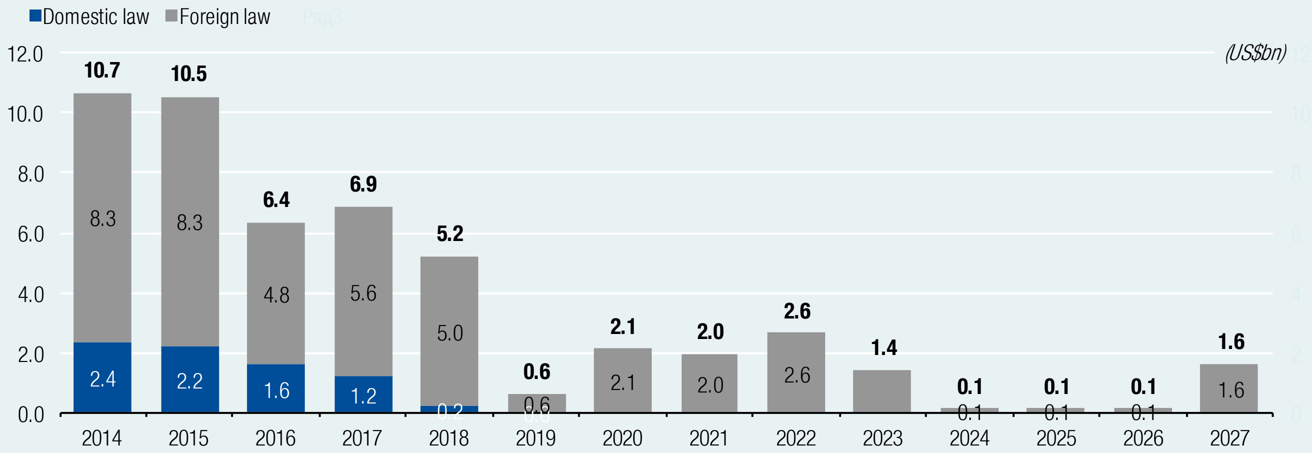
Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 61. 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 62. 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.

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

Table 15. 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 11 April 2014

Year	Principal re-payments							Interest payments							Grand
	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	Total
2013	1,000	0	0	1,988	0	6,585	9,573	1,081	20	493	395	17	334	2,340	**11,913**
2014	1,000	0	1,595	1,696	200	3,697	8,188	1,202	20	561	458	17	218	2,476	**10,664**
2015	4,328	250	750	1,927	0	1,256	8,510	1,162	20	378	297	0	180	2,036	**10,547**
2016	2,250	300	825	1,408	0	0	4,783	897	0	314	187	0	170	1,568	**6,351**
2017	3,300	0	1,088	1,155	0	0	5,543	793	0	281	79	0	170	1,323	**6,866**
2018	0	0	2,190	200	0	2,000	4,390	505	0	93	15	0	212	826	**5,215**
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	**18,378**	**550**	**6,448**	**8,374**	**200**	**15,038**	**48,987**	**7,294**	**60**	**2,119**	**1,431**	**34**	**2,433**	**13,371**	**62,359**

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;
[4] 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 16. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US$m)
By ultimate borrower, data as of 11 April 2014

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	6,338	3,235	0	0	0	0	0	0	0	9,757	1,603	54	20	322	146	80	92	24	0	2,340	**11,913**
2014	5,515	1,079	0	1,595	0	0	0	0	0	8,188	1,709	16	20	322	146	102	114	48	0	2,476	**10,664**
2015	7,020	490	250	0	0	0	750	0	0	8,510	1,465	4	20	170	146	102	82	48	0	2,036	**10,547**
2016	3,658	0	300	0	0	700	125	0	0	4,783	1,085	0	0	170	146	73	47	48	0	1,568	**6,351**
2017	4,455	0	0	0	1,088	0	0	0	0	5,543	872	0	0	170	146	44	44	48	0	1,323	**6,866**
2018	200	0	0	2,000	690	500	500	500	0	4,390	520	0	0	85	26	22	22	24	127	826	**5,215**
2019	0	0	0	0	0	0	0	0	0	0	505	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	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	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	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	127	174	**1,424**
2024	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	127	127	**127**
2026	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	127	127	**1,627**
Total	**33,686**	**4,804**	**550**	**3,595**	**1,778**	**1,200**	**1,375**	**500**	**1,500**	**48,987**	**8,908**	**74**	**60**	**1,238**	**754**	**424**	**401**	**238**	**1,276**	**13,371**	**62,359**

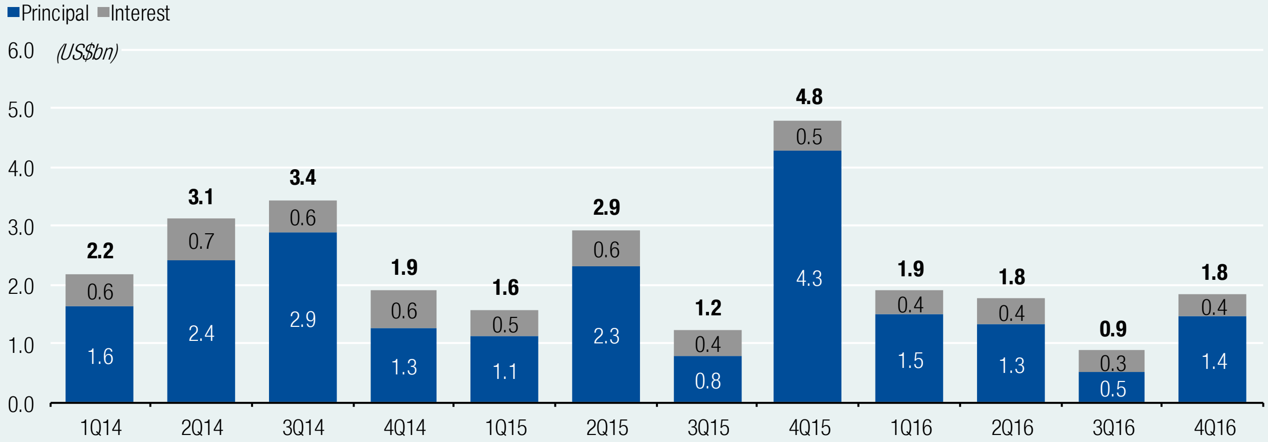
Notes: Notes: [1] City of Kyiv; [2] Financing of Infrastructural Projects (Bloomberg code: UKRINF); [3] State Food and Grain Corporation.

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

Sovereign external debt: Quarterly data on debt due in 2014-16

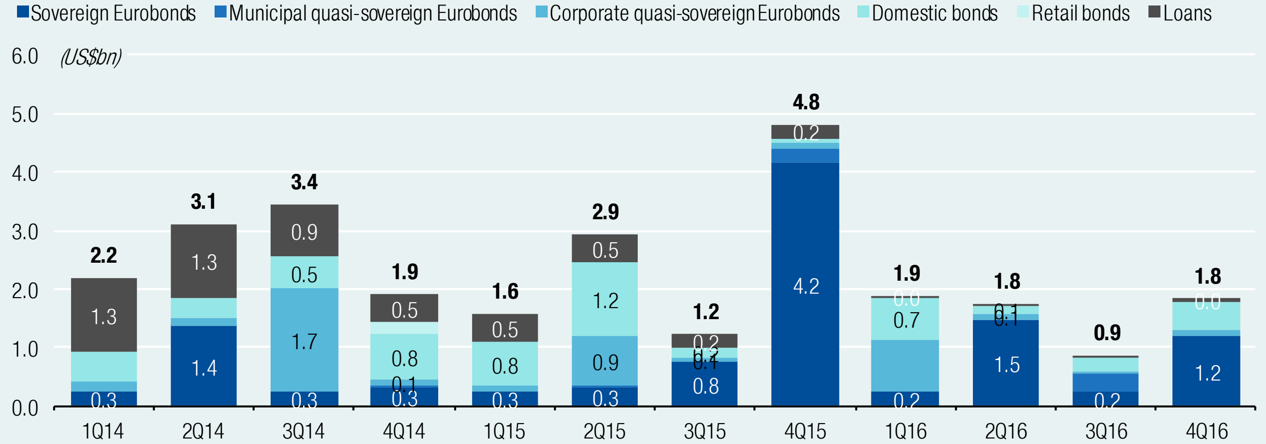
Yearly breakdown of sovereign and quasi-sovereign external debt (charts)

Chart 63. Ukraine's sovereign and quasi-sovereign external debt due in 2014-16: Qtly breakdown by type of cash flow (US$bn)



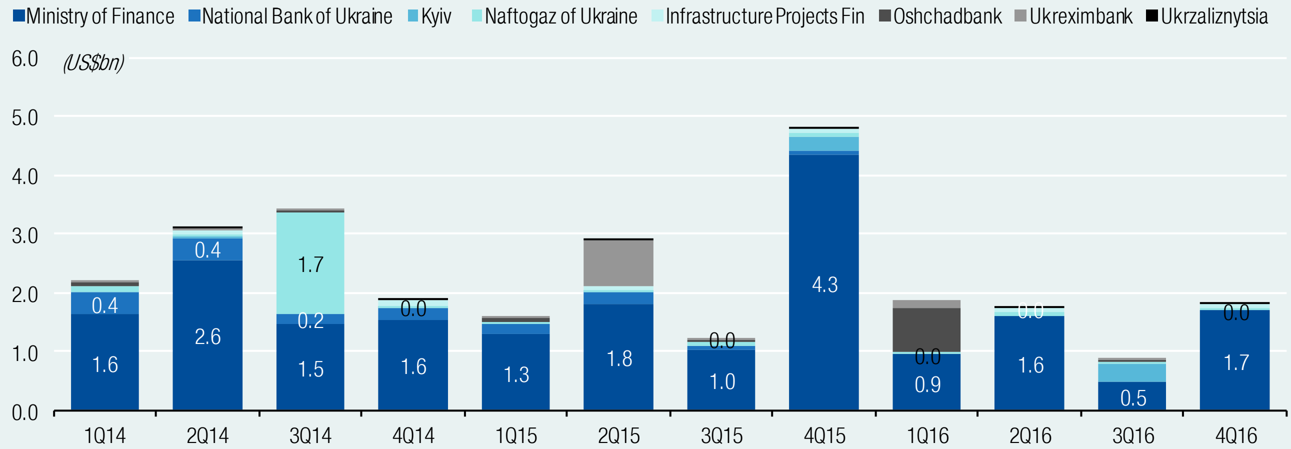
Note: Qtly stands for quarterly. Sources: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 64. Ukraine's sovereign and quasi-sovereign external debt due in 2014-16: Qtly breakdown by type of debt instrument (US$bn)



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

Chart 65. Ukraine's sovereign and quasi-sovereign external debt due in 2014-16 : Qtly breakdown by ultimate borrower (US$bn)



Note: Qtly 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 17. 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 11 April 2014

Year	Principal re-payments							Interest payments							Grand
	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	Total
1Q14	0	0	0	421	0	1,207	1,628	255	0	152	98	0	61	566	2,194
2Q14	1,000	0	0	201	0	1,211	2,412	365	10	128	134	9	57	703	3,115
3Q14	0	0	1,595	446	0	844	2,885	255	0	152	98	0	52	557	3,442
4Q14	0	0	0	629	200	435	1,264	326	10	128	128	9	49	649	1,913
Ttl 2014	**1,000**	**0**	**1,595**	**1,696**	**200**	**3,697**	**8,188**	**1,202**	**20**	**561**	**458**	**17**	**218**	**2,476**	**10,664**
1Q15	0	0	0	686	0	435	1,121	255	0	77	81	0	47	459	1,580
2Q15	0	0	750	1,134	0	435	2,319	326	10	128	104	0	46	613	2,932
3Q15	500	0	0	107	0	193	800	255	0	77	53	0	44	428	1,228
4Q15	3,828	250	0	0	0	193	4,271	326	10	97	60	0	43	535	4,806
Ttl 2015	**4,328**	**250**	**750**	**1,927**	**0**	**1,256**	**8,510**	**1,162**	**20**	**378**	**297**	**0**	**180**	**2,036**	**10,547**
1Q15	0	0	825	659	0	0	1,484	238	0	77	48	0	43	405	1,890
2Q15	1,250	0	0	74	0	0	1,324	230	0	97	60	0	43	429	1,754
3Q15	0	300	0	226	0	0	526	238	0	44	22	0	43	347	873
4Q15	1,000	0	0	448	0	0	1,448	191	0	97	57	0	43	387	1,835
Ttl 2015	**2,250**	**300**	**825**	**1,408**	**0**	**0**	**4,783**	**897**	**0**	**314**	**187**	**0**	**170**	**1,568**	**6,351**

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;
[4] 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 18. Breakdown of the sovereign and quasi-sovereign external debt, including interest payments and principal re-payments (US$m)
By ultimate borrower, data as of 11 April 2014

Year	Principal re-payments									Interest payments									Grand
	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	Total
1Q14	1,266	361	0	0	0	0	0	0	1,628	366	6	0	118	0	51	25	0	566	**2,194**
2Q14	2,051	362	0	0	0	0	0	0	2,412	518	5	10	43	73	0	31	24	703	**3,115**
3Q14	1,112	178	0	1,595	0	0	0	0	2,885	359	3	0	118	0	51	25	0	557	**3,442**
4Q14	1,086	178	0	0	0	0	0	0	1,264	466	2	10	43	73	0	31	24	649	**1,913**
Ttl 2014	**5,515**	**1,079**	**0**	**1,595**	**0**	**0**	**0**	**0**	**8,188**	**1,709**	**16**	**20**	**322**	**146**	**102**	**114**	**48**	**2,476**	**10,664**
1Q15	943	178	0	0	0	0	0	0	1,121	339	2	0	43	0	51	25	0	459	**1,580**
2Q15	1,391	178	0	0	0	0	750	0	2,319	432	1	10	43	73	0	31	24	613	**2,932**
3Q15	733	67	0	0	0	0	0	0	800	309	0	0	43	0	51	25	0	428	**1,228**
4Q15	3,954	67	250	0	0	0	0	0	4,271	386	0	10	43	73	0	0	24	535	**4,806**
Ttl 2015	**7,020**	**490**	**250**	**0**	**0**	**0**	**750**	**0**	**8,510**	**1,465**	**4**	**20**	**170**	**146**	**102**	**82**	**48**	**2,036**	**10,547**
1Q15	659	0	0	0	0	700	125	0	1,484	286	0	0	43	0	51	25	0	405	**1,890**
2Q15	1,324	0	0	0	0	0	0	0	1,324	290	0	0	43	73	0	0	24	429	**1,754**
3Q15	226	0	300	0	0	0	0	0	526	260	0	0	43	0	22	22	0	347	**873**
4Q15	1,448	0	0	0	0	0	0	0	1,448	248	0	0	43	73	0	0	24	387	**1,835**
Ttl 2015	**3,658**	**0**	**300**	**0**	**0**	**700**	**125**	**0**	**4,783**	**1,085**	**0**	**0**	**170**	**146**	**73**	**47**	**48**	**1,568**	**6,351**

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.

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

Table 19. ICU consumer basket as of end of March 2014

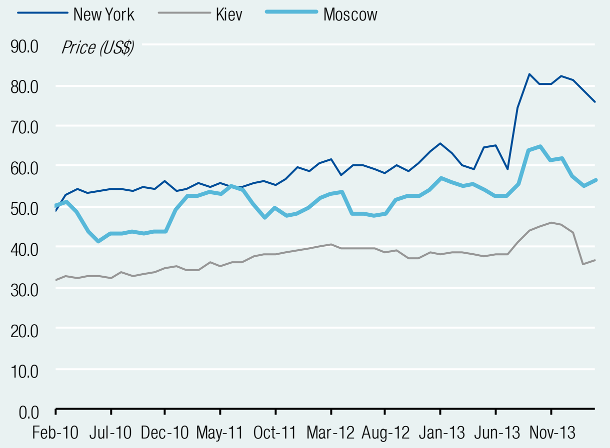
price observation in the urban areas of Ukraine, USA and Russia, i.e., in the countries' most populated cities – Kiev, New-York, and Moscow

Item of the basket	Description	Kiev, central district 31-Mar-14 Price (UAH)	New York metro-politan area 31-Mar-14 Price (US$)	Moscow, central district 31-Mar-14 Price (RUB)
Consumer goods				
Coca-cola (0.5 litre, plastic bottle)	Non-alcohol beverages	6.78	2.00	41.90
Beer Corona Extra (0.33 litre, glass bottle)	Alcoholic beverages	16.63	1.66	93.00
Bunch of fresh bananas (1 kg)	From Ecuador	17.98	1.52	66.90
Pack of milk (1 litter)	Locally produced, soft package, i.e., not glass bottle	8.58	2.03	57.00
Chicken meat (1 kg pack)	Locally produced and branded package, boneless breast	42.97	10.98	169.00
Canned pineapple (0.85 kg, can)	Pineapple circles, Dole brand	23.61	2.40	130.00
Pasta (0.5 kg)	Soft package, produced in Italy	13.12	2.12	53.00
Sugar (1 kg)		12.07	3.99	29.90
Package of table salt (0.5 kg)		5.49	0.71	12.80
Chicken eggs (10 units pack)	White eggs, standard size	17.59	2.80	92.90
Chocolate (100 g)	Made by Craft Foods Corp, Milka brand	10.11	1.77	59.90
Toothpaste (100ml package)	Colgate	25.46	1.55	120.00
Shampoo (200ml package)	Head & Shoulders brand, for normal hair	27.23	3.11	160.00
Toilet paper (4 rolls package)	Kleenex Cottonelle brand, white paper, Regular toilet tissue	19.30	4.32	98.90
Magazine	Men's Health, local edition, A4 format (standard one, not a pocket book format)	28.27	6.99	120.00
Gasoline (1 litre)	Lukiol, regular	13.49	1.03	34.02
Batteries (AA x 4 pack)	A 4-pack of AA Duracell batteries, Alkaline	22.90	5.49	120.00
Coffee (250 g, vacuum pack)	Jacobs Monarch, brick-like vacuum pack	37.59	7.99	145.00
Services				
Underground commute ticket	Within the central part of the city	2.00	2.50	40.00
Cinema ticket	Thursday's night price for the seat with good location, Hollywood film	65.00	11.00	350.00
Total basket value (in local currency)		**416.17**	**75.96**	**1,994.22**
Exchange rate versus US dollar at spot market as of date of observation		11.375	1.000	35.173
Total basket value (in US$)		**36.59**	**75.96**	**56.70**
Overvalued "+" / undervalued "-" (%)				
UAH vs. USD		**-51.83**		
UAH vs. RUR		**-35.47**		
Fair value in the long-run as of observation date				
UAH per USD		**5.479**		
UAH per RUR		**0.209**		

Source: Investment Capital Ukraine.

Chart 66. ICU consumer basket value (US$), from Feb-10 till Oct-13

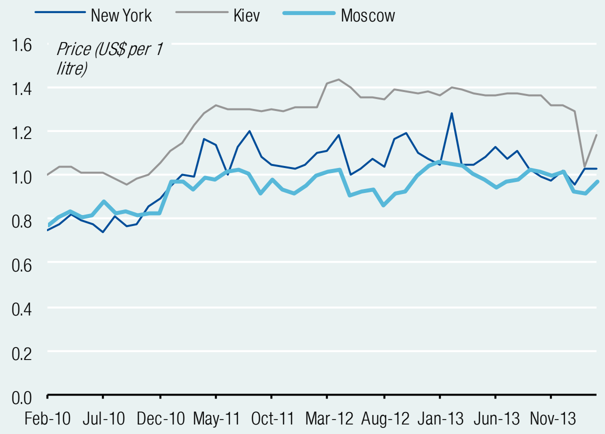
Total value of the ICU basket in US dollar terms



Source: Investment Capital Ukraine.

Chart 67. Gasoline A95 equivalent 1 litre (US$)

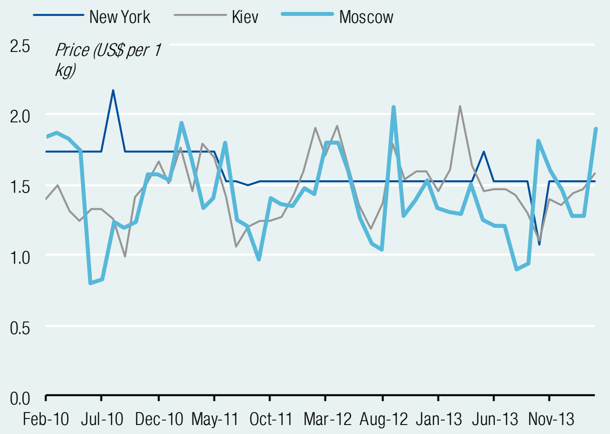
Price history from February 2010 till March 2014



Source: State Statistics Service of Ukraine.

Chart 68. Fresh banana 1 kg bunch (US$)

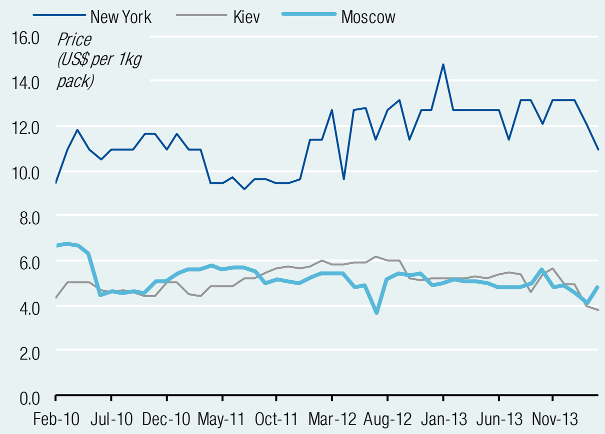
Price history from February 2010 till March 2014



Source: Investment Capital Ukraine.

Chart 69. Chicken meat 1 kg pack of boneless breast (US$)

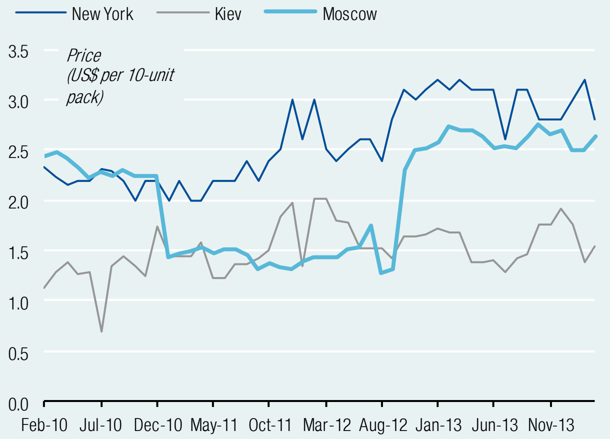
Price history from February 2010 till March 2014



Source: State Statistics Service of Ukraine.

Chart 70. Chicken eggs 10-unit pack (US$)

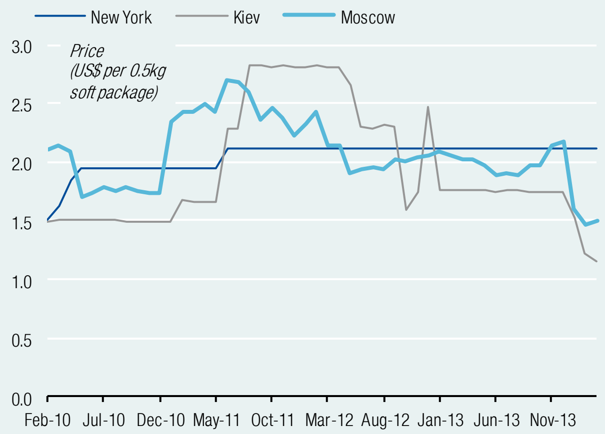
Price history from February 2010 till March 2014



Source: Investment Capital Ukraine.

Chart 71. Pasta 0.5 kg soft package Italy-made (US$)

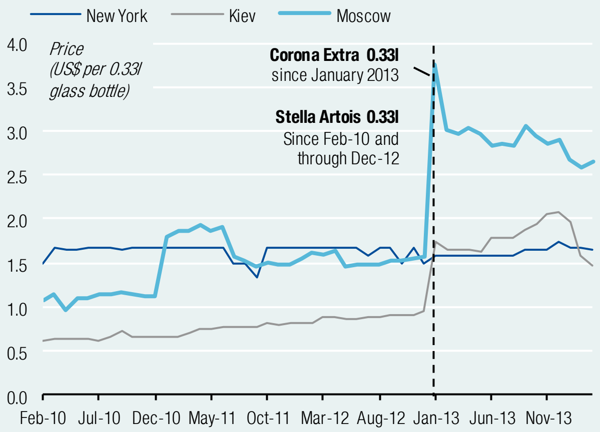
Price history from February 2010 till March 2014



Source: Investment Capital Ukraine.

Chart 72. Beer Corona Extra 0.33 litre glass bottle (US$)

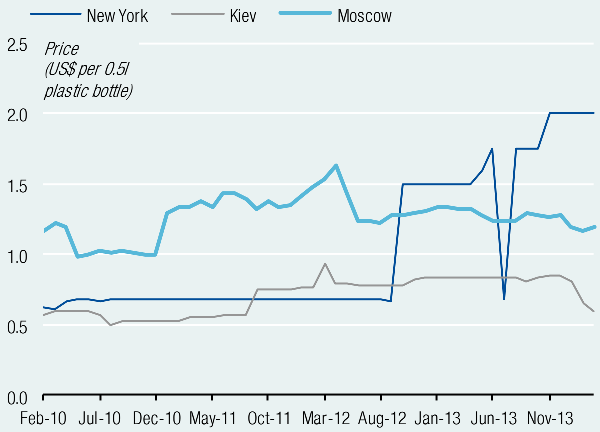
Price history from February 2010 till March 2014



Source: State Statistics Service of Ukraine.

Chart 73. Coca-Cola 0.5 litre plastic bottle (US$)

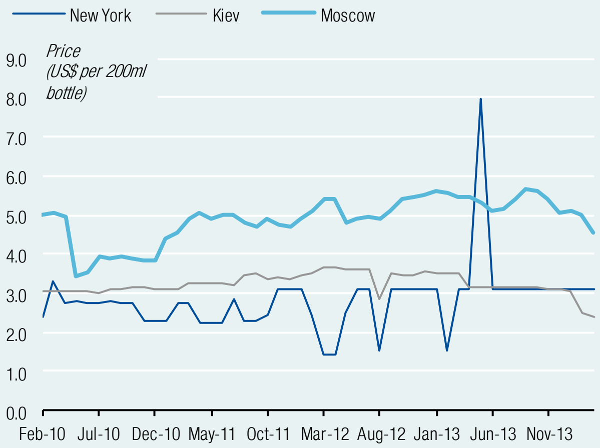
Price history from February 2010 till March 2014



Source: State Statistics Service of Ukraine.

Chart 74. Shampoo 200ml bottle Head & Shoulders (US$)

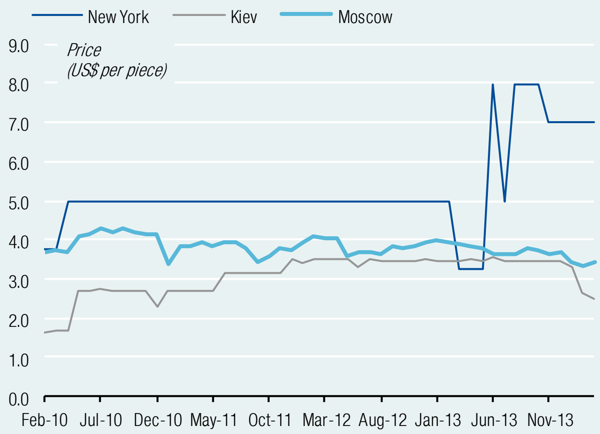
Price history from February 2010 till March 2014



Source: State Statistics Service of Ukraine.

Chart 75. Magazine *Men's Health*, A4 format (US$)

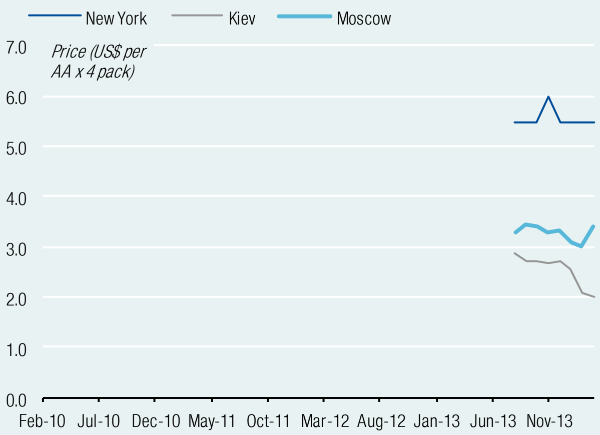
Price history from February 2010 till March 2014



Source: State Statistics Service of Ukraine.

Chart 76. Duracell batteries (AA x 4 pack) (US$)

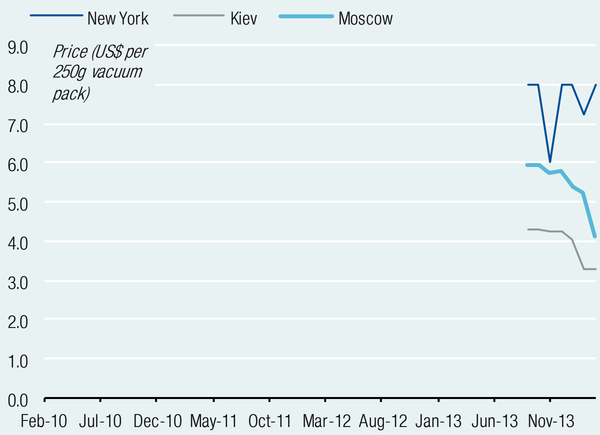
Price history from August 2013 till October 2013



Source: State Statistics Service of Ukraine.

Chart 77. Jacobs Monarch coffee, 250 g vacuum pack (US$)

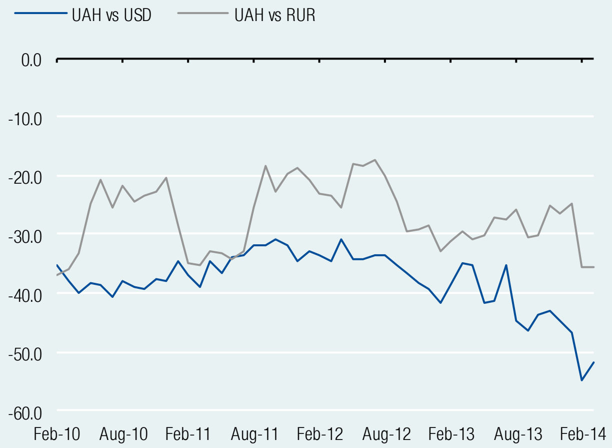
Price history from September 2010 till October 2013



Source: State Statistics Service of Ukraine.

Chart 78. Value gap of ICU basket in UAH vs. USD and RUB (%)

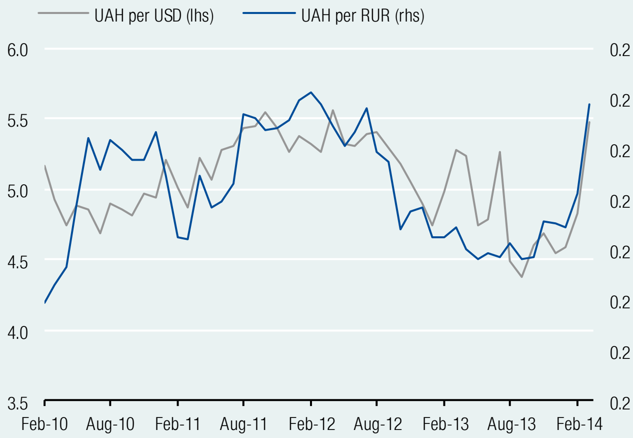
Price history from February 2010 till March 2014



Source: State Statistics Service of Ukraine.

Chart 79. 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 March 2014



Source: State Statistics Service of Ukraine.

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