AYA Capital

SIDE - NOTE

Scenario analysis of Ukraine's political framework

Mr. Yanukovich presented an ambitious economic reform program in June 2010. In July 2010, he reached an agreement on a stabilization program with the IMF, backed by USD15 bn of credits. Impressively, Ukraine swiftly performed the required preliminary actions, such as tightening the state budget and raising gas prices for consumers. However, that fervor has recently wound down. In his annual address to the Parliament on April 7 2011, the President appeared to have given up on his reform bid, apart from insisting on privatization. Major pension and gas market reforms agreed with the IMF have been postponed, while grain export quotas have been maintained and tax reimbursements stalled. The question is: has hypocracy returned? With this in mind, our research below provides a scenario analysis of further developments. We highlight four scenarios (both more and less probable) that, we believe, may emerge in the coming years…

- We describe four probable political scenarios for the Ukrainian scene in the long run:
  1. ***"Status quo"*** – lack of institutional reforms; bargaining between West and East; domination of populist rhetoric that focuses on slogans appeasing the public and rejects any strategic vision of development.
  2. ***European style democracy*** – essential institutional changes; Ukraine may move towards European integration; this course may be result from either with public protests and subsequent change of regime, or with Mr. Yanukovich's steady progress towards pro-democratic reforms.
  3. ***Power centralization*** – further solidification of the entrenched political elite in power; low probability of institutional reforms; increasing share of foreign investment from the East; long-term chances for the dominant elite to change its strategy from rent-seeking to attracting investments.
  4. ***Social unrest*** – violent anti-oligarch protests, similar to recent ones in some African states; the layout of further rebounding will depend on the political and economic strategy of new elite.
- We assume that **centralization of power is not as black as it is painted for Ukraine**.
- **Almost all political scenarios presuppose short-term pressure on sovereign spreads –** due either rising credit risks or to political uncertainties.
- **Investors may "bundle" limited democracies that are most similar to the MENA region.** We do not think that this is Ukraine's case, so far.

Scenario analysis: summary

Scenario	"Status quo"/Marginal changes	European integration/ Democratic shifts	Eastern-style power centralization	Social unrest
Expected political regime	Semi-consolidated democracy	Full-fledged democracy	"Managed" democracy	Oriented towards full-fledged democracy
Political orientation	Bargaining between West and Russia	Pro-Western (towards EU integration)	Pro-Eastern	Pro-Western
The most probable ruling force	Party of Region	New full-scale coalition	Party of Regions	New coalition
Probability of economic and administrative reforms, proposed by the IMF	Low	Above average	Low	Average
Opposition status	De facto not suppressed	Not suppressed	Suppressed	Not suppressed
Possibility of tensions with Russia	Average	Above average	Low	Average
Economic growth profile	Dependent on heavy metals and agricultural sectors	Dependent on export-oriented sectors (*with steady shift to private consumption stimulation)*	Dependent on export-oriented sectors	Depends on new coalition strategy
Credit spread	More odds for widening in the short and medium term (except the case of further collaboration with the IMF)	Probability of spreads tightening is higher (depends on fiscal policy priorities)	More odds for widening in the short term, tightening in the medium term	Significant widening in the short term
Capital markets volatility	Increases both in the medium term and long term	Increases in the short term, decreases in the medium term	Increases in the short term, decreases in the medium term	Increases sharply in the short term

– common features

- As of July 2011, we see two routes – "Status quo" and "Power centralization" – at average probability. While the former is virtually problem-free for many investors (insofar as hypocracy in Ukrainian policy is a long-standing tendency), the second one may puzzle some investors. **Our side-notes "Positive view on power centralization scenario" and "Possibility of reshaping investors' sentiments within autocratic countries" may help illuminate one crucial investment implication – the influence of regime change on sovereign default probability**

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Scenario analysis and investment implications

Scenario 1. "Status quo"/Marginal changes

Probability as of July 2011: Average (40%)

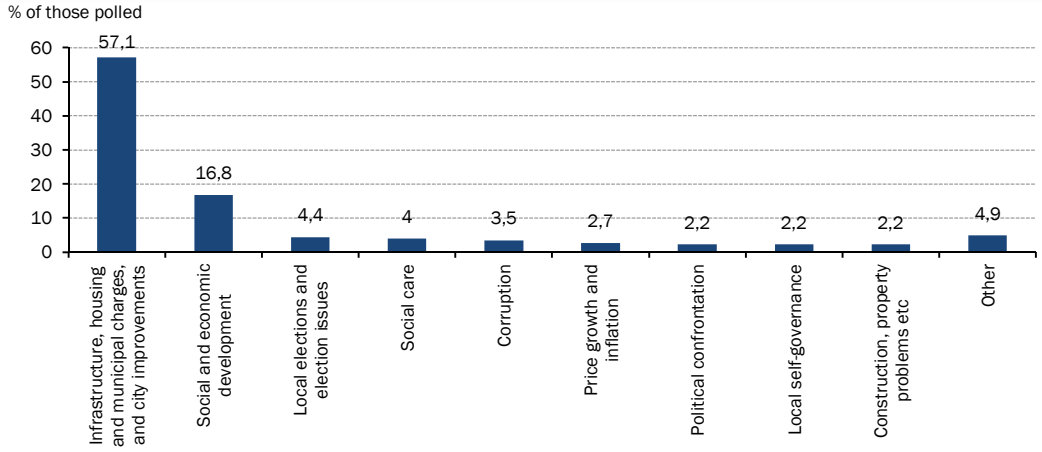
Consequences:

1. EU and IFOs may provide tangible and intangible incentives for democratization (financial aid, trade union etc.)
2. Mr. Yanukovich will conduct de facto cautious internal and external policies, simultaneously bargaining between the West and Russia
3. Semi-consolidated democracy will leave the door open for political competition
4. On the eve of parliamentary and presidential elections, the ruling party will keep its ear to the wind, in terms of populist behavior
5. The pro-Yanukovich coalition will dominate again after 2012 elections, but long-neglected reforms will be suspended again or introduced in "soft mode"

In this scenario, with the population remaining firmly divided between the Russian-speaking East and more nationalist West, **successive governments could be unable to develop and implement coherent macroeconomic or foreign policy**. Moreover, the formal characteristics of such a regime may be as follows: domination of populist rhetoric focusing mainly on slogans appeasing the public and rejecting any strategic vision of development. With no legislative requirement for the parties and candidates to present their election programs, this creates a gap between public needs and election rhetoric.

Domination of populist rhetoric focusing on slogans appeasing the public and rejecting any strategic vision of development

Electorate is still attracted by populistic slogans



Source: Main topics in the 2010 local election campaign. Civic Assembly of Ukraine, Expert assessment of 2010 local election (October 2010)

As a result, **the economy may disappoint investors, at least over a medium term**; its growth will be dependent on the agricultural and heavy metals sectors again. As long as the productivity of basic sectors declines slowly in years of underinvestment, it may trigger a stall in productivity growth and economic underperformance, as compared to emerging peers. Unfortunately, this survival strategy could replicate the risks that would create an environment where strategic asset stripping (in terms of expected privatization plans and public companies' IPOs) and heightened rent-seeking may dominate a system of crony capitalism.

The economy may disappoint investors, at least over a medium term

Given the still-undeveloped nature of the country's institutions, the government will remain susceptible to external shocks, with an accordingly elevated risk premium. Despite the current thaw in relations with Russia, this scenario of bargaining between Moscow and Brussels leaves open the possibility of further spats in affairs with Ukraine's "eastern neighbor" as long as the ruling party may step partially back from its own promises to the East, while haggling with the West.

The government will remain susceptible to external shocks

In any case, **we do not think that the ruling party will reject technical assistance from the West (particularly from the IMF and World Bank)** to maintain market expectations that the authorities are going to prevent unwanted outcomes of sabotaging the country's long-term economic future. Guidance from these organizations could, therefore, provide a blueprint for at least partial reforms, with external sources of monitoring and accountability still rigorous (however limited). However, we assume that the ruling party may implement only those reforms that do not threaten social unrest in this scenario. Moreover, Mr. Yanukovich may even dismiss the current government, in order to save face after implementing any unpopular reforms. That will help the Party of Regions to improve its political ratings on the eve of the 2012 elections.

There is an alternative, but less probable, route for this scenario. This holds, for instance, that the ruling party will not be re-elected in 2012 and a new ineffective coalition may arise (as long as Mr. Yanukovich can be compelled to appoint a Prime Minister from the winning party). In that case, hypocracy may continue as long as both sides of the coalition will not be keen on implementing unpopular reforms (due before the upcoming 2015 presidential elections). Thus, **gridlock analogous to the Yushenko/Timoshenko - President/Prime Minister relationship may arise again**.

The lockup analogous to Yushenko/ Timoshenko - President/Prime-minister relationship may arise again

Investment implications:

Positive	Negative
1. High chances of re-election of the ruling party, due to possible domination of populist measures (this decreases political uncertainty) 2. In case of further collaboration with the IMF even a partial success in achieving its goals would enhance "credibility" of Ukrainian Gov. and reduce the perception of risk for the country. This would enable further compression in sovereign spread that would then stimulate interest rates contraction and long-term growth in fixed investments.	1. Corrupted "social contract" will be preserved, with low probability of harmful institutional reforms 2. For fixed-income investors, credit risks caused by increasing subsidies and rising public wages could become paramount 3. Volatility of Ukrainian equity market may increase in the long term, due to growing economy's dependence on export sectors vulnerable to commodity market conjuncture 4. Liquidity of Ukrainian capital markets will remain low, due to lack of institutional reforms 5. In the event of suspension of IMF program, Ukrainian Government's "non-credibility" will be increased, which will worsen the country's risk perception

Scenario 2. European integration / Democratic shifts.

Probability as of July 2011: Below average (20%)

Essential institutional changes are the main consequence of that scenario. This means that we don't rule out the possibility that Ukraine may be lead to European integration either by the ruling party or by alternative leaders. For instance, in case of a significant defeat of the Party of Regions after 2012 parliamentary elections, the effective president may appoint a Prime-minister from the opposition and new pro-democratic coalition may arise. Moreover, that scenario borders on the other scenario ("Social unrest"), as long as peaceful demonstrations could subsequently cause a peaceful dismissal of the ruling party and premature presidential elections. Thereby, **this option may develop either with public protests and subsequent change of regime, or with Mr.Yanukovich's steady pass to pro-democratic reforms** just like the below-described route:

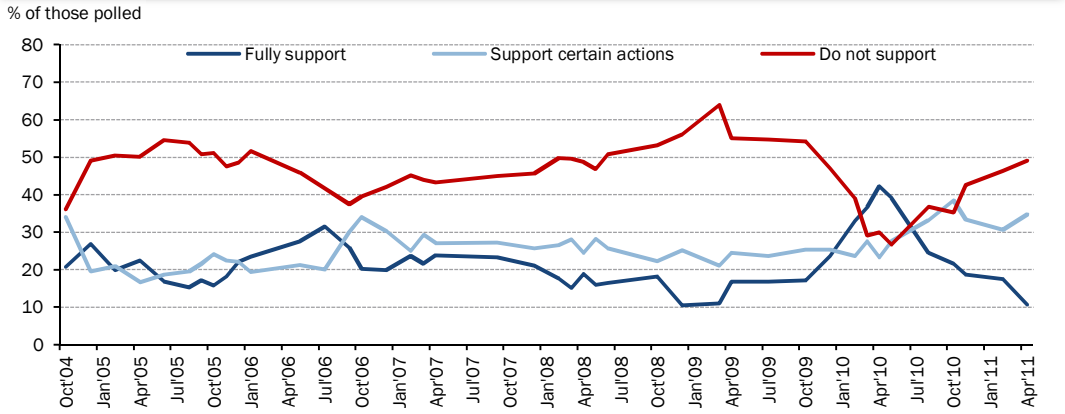
1. Mr.Yanukovich's loyal political base is the pro-Russia electorate in eastern Ukraine, and his open courtship of Moscow might, in fact, be political camouflage for a strategy of movement towards Europe, as demanded by the business interests of his party's supporters
2. While bargaining between EU and Russia for 1-2 more years, existing elites will find a compromise with the opposition and create a coalition between Eastern and Western Ukraine. That may be intensified by the creation of an effective coalition and appointment of a prime minister from the opposition after the 2012 elections. That may be similar to the situation in Spain in 1976, following Franco's death – Spain was a divided nation, but managed to find a compromise
3. Steady shift from pro-Eastern to pro-European policy after the parliamentary elections, supported by corresponding changes in the electoral base

We believe this to be a less probable scenario than that of the "Status quo," as long as there are some objective difficulties in implementing democratic reforms. For instance, the shift to full-fledged democracy should invite influential politicians who would subsequently challenge the power of the country's oligarchs and push through substantial reforms, aimed at improving the underlying business environment.

There are some objective difficulties in implementing full-fledged democratic reforms

Nonetheless, in this scenario even Ukrainian oligarchs may feel inspire higher confidence among international investors in Ukraine's convergence with EU (like most CEE countries). As a result, that may increase foreign investment (mostly FDI). Moreover, **as living standards grow steadily, there may be a greater demand for politicians favoring a more pragmatic course** in the country's external relations. On the other hand, it looks highly probable that in such a scenario, the short-term capital market may be volatile, since political vulnerability (caused by peaceful demonstrations, for example) often aggravates temporary uncertainties.

Mr.Yanukovich's popularity is under the threat



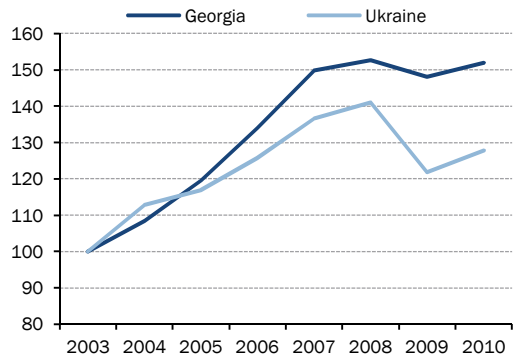
Source: Razumkov Centre
Notes: The question is "Do you support the activity of Mr.Yanukovich?"

Even with the expected pro-democratic reforms, the country is unlikely to join the EU in the near future, due to the Union's current enlargement fatigue. Still, in the end, the EU will keep expanding and Ukraine will remain one of its prime candidates. To approach the EU, the country leaders should try to implement structural reforms. Furthermore, implementation of comprehensive reforms should not be sluggish, which is a challenge for new leaders. Thus, we see higher chances of integration with the EU only in the long-term perspective under such a scenario.

The country is unlikely to join the EU in the near future

Again, **we do not rule out the possibility of democratic shifts with the ruling party, as long as some signs may indicate probability that such a strategy will be adopted by the ruling party.** In 2010, Ukraine started to reform the economy. These reforms are now paying off, as seen in the rather strong economic rebound, slower inflation and financial account surplus. However, the country still needs more fundamental reforms to become more resilient to external shocks. Thus, the authorities may try to explain the necessity of unpopular measures to the general public and concentrate on a short-list of the most pressing issues (like pension reform).

Democratization and reforms lead to higher social standards



Source: HDRO
Notes: Gross net income per capita dynamics (2003=100), AYA calculations

Reforms matter: Ukraine vs Georgia

Source: The World Bank, Doing Business 2010 ranking

On this path, volatility of capital markets may also grow, as tensions with the East may surge. **If the hidden motives of the Party of Regions' strategy match the above scenario, we believe a conflict with Russia to be almost inevitable,** even in the short term. At the moment, cooperation with Russia is going to be extended to transport, gas distribution, energy and aerospace spheres. However, significant inflows of Russian capital may clash with the interests of those Ukrainian business circles that bankrolled Mr. Yanukovich's presidential election campaign. Such events may provoke resistance to the current policy of Ukrainian actors.

A conflict with Russia to be almost inevitable on this route

Investment implications:

Positive	Negative
1. Investors' sentiment may improve significantly after the implementation of comprehensive reforms by authorities. That should happen, due to institutional improvement and higher confidence among investors in Ukraine's convergence with the EU 2. As political egos of the new and old authorities may get bigger, higher chances are that public liabilities will be re-scheduled. 3. Reform agenda should be an appeal to improved Ukraine's valuation for FDI influx and rising attention of long-term oriented portfolio investors. For instance, even now Ukrainian equity market continues to look undervalued compared to global peers. Possible reform in disclosing and reporting issues of public companies may bring additional value 4. Integration with EU is plausible in the long-term, but total elimination of credit spreads or equity discounts vs European peers is not expected until then 5. Lower intervention in the operation of private businesses will provide incentives for SME activization. That could help diversify the economy and it may bring surprises at least over the medium term (growth will probably depend on private consumption). 6. As long as basic sectors productivity may increase, due to investment influx, that may lead to productivity growth and economy's overperformance.	1. Volatility of capital market may grow temporarily, widening credit spreads (as in 2004 after the Orange revolution), due to political uncertainty in case of numerous peaceful demonstrations 2. In case of tensions with Russia an aggravated risk perception may appear This would temporarily widen sovereign credit spread (as in August 2008 during the conflict between Russia and Georgia) 3. In case of partial populism of authorities on their way to democracy credit risks caused by possible increase in subsidies and public wages could become paramount for fixed-income investors if compared with the power centralization scenario)

Scenario 3. Eastern-type power centralization

Probability as of July 2011: Average (30%)

Consequences:

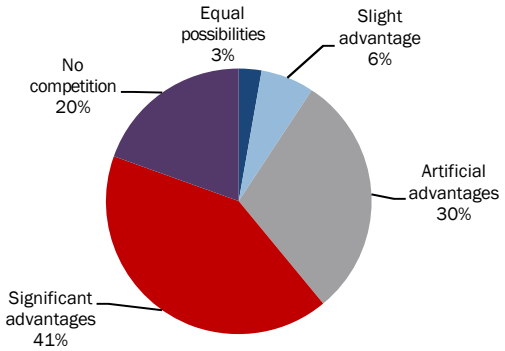
1. Mr. Yanukovich continues to centralize power
2. A stable regime wins the hearts of Ukrainian people
3. EU does not provide visible incentives for European-style democratization
4. Ukraine turns in to a state with a highly centralized power

Since the Constitutional Court's decision that helped the President consolidating his power, the western media's intensive discourse has been that Ukraine has been moving towards centralized presidential power. **Despite the common negative view of this route, we do not consider it as a worst-case scenario for both the country and certain types of international investors.**

We do not consider this route as a worst-case scenario for the country

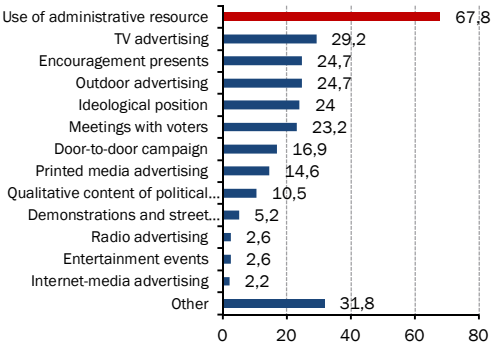
Years of post-"orange" frequent political turmoil instilled a desire for stability above all else. A survey conducted during 2009 political turmoil indicated that 93% of respondents desired "order" as the most wanted condition, and only 25% chose "liberalism". Another poll, in 2006, showed that just 10% of the Ukrainians were willing to give concessions to Russia for cheap gas. This willingness grew to 58.7% in 2010 – an indication for some that Russia had won the hearts of the Ukrainian people. The electorate's **growing apathy towards the political process and their envious looks at the Russian pro-authoritarian regime may open the way to a centralized regime.**

Level of Political Competitiveness



Source: Civic Assembly of Ukraine, Expert assessment of 2010 local election

Determinative factor for winning the elections



Source: Civic Assembly of Ukraine, Expert assessment of 2010 local election
Notes: a number of options could be chosen, therefore the percentage does not total 100%

Despite some negativity, Eastern-type power centralization may help further solidify the entrenched political elite in their power, preventing their dismissal from power is case of further unpopular measures. As the loss of civil liberties scares off Western investors, an increasing share of foreign investment may come from the East. Ukraine may seek greater cooperation with Moscow and other CIS neighbors in political and economic spheres. Kiev's Russia-oriented rulers may also change the ideological and political landscape of the country.

An increasing share of foreign investment may come from the East

Ukraine's largest trading partner is still Russia and we believe that trade and investments, more than Mr. Yanukovich's political preferences, will keep these neighbors close. Meanwhile, in his attempts to stifle protests from the opposition, Mr. Yanukovich is seen to be mimicking Putin's style. Despite this, he enjoys firm support in certain parts of the country. What seems different is that he would not mirror Putin 100%. For instance, resorting to military force seems highly improbable in case of massive public protests either in Kiev of other regional centers. Therefore, in our view, centralization of power in Ukraine may be lower than in Russia.

Deeply affected by economic crisis and fallen short of implementing necessary reforms, Ukraine was harmed due to continuous gridlock in the government for the past few years. On the one hand, traditional "wise ruler" popular mentality allows a strong leader to implement some long-neglected reforms in power centralization scenario. On the other hand, most required reforms like administrative and energy pricing reform, lower grain market regulation, tax reforms and further business deregulation influence the vested business interests in the parliament – the ruling elite. This allows much fewer chances for the above reforms to implement. Therefore, we foresee higher chances only for those reforms that:

1. Will not hurt vested business interests in the parliament.
2. Will not instigate massive public protests (this assumption correlates with the Party of Regions' defeat controlled by the public during 2004 Orange Revolution , – hence the grounds for some ruling party's to fear a similar situation)

It seems hardly probable for the power to promote anti-oligarch actions and implement all institutional reforms…

It seems hardly probable for the centralized power to promote anti-oligarch actions and implement all the reforms necessary to improve business climate. However, in the end we do not rule out chances for the dominant elite to change its strategy from the rent-seeking to attracting investments. Declined productivity in the basic sectors should stimulate those changes. Moreover, it is noticeable that significant changes that were implemented in top-performing countries with limited democracy paid off a great yield for all that:

…but in the long run we don't rule out chances for the dominant elite to change its strategy

10 best GDP per capita growth rates, 1960-2008

	Per capita growth, 1960-2008	Limited democracy
China	6,1%	Yes
Taiwan	6,1%	Yes
Botswana	6,0%	Yes
Korea, Rep.	5,8%	Yes
Bhutan	5,7%	Yes
Singapore	5,3%	Yes
Oman	5,0%	Yes
Vietnam	4,9%	Yes
Thailand	4,4%	Yes
Cyprus	4,2%	No

Source: Aidwatch (data from World Development Indicators, Polity IV)

Still, **we do not view the centralized power regime as "black" for certain foreign investors as "it is painted".** In another side-note ("*Positive view on power centralization scenario*") we show a higher probability of rescheduling sovereign debt within more democratic regimes. Moreover, foreign firms have bigger chances of a regulatory "carte blanche" under a centralized power regime. History shows that such countries can afford low levels of regulation for businesses (whereas more constrained democratic leaders must offer lower taxes in order to compete).

Investment implications:

Positive	Negative
1. Power centralization regime would be the most politically stable scenario compared to others 2. We see thinner chances of rescheduling external liabilities as long as political actors are not required to resort to populist measures under a centralized power regime. Moreover, the need of vested business interests in the parliament to preserve free access to global capital markets will be an additional incentive against sovereign default. This could enable compression in sovereign spread that would then stimulate contraction of interest rates and long-term growth in fixed investments. 3. In view of temporal disregard of Ukrainian assets by some western investors, the share of foreign investment from the East will increase. That may boost the supply of ruble-denominated debt instruments and trade turnover between Ukraine and Russia 4. Foreign firms are more likely to be offered a regulatory "carte blanche" under a centralized power regime.	1. Despite all easiness in implementing economic and administrative reforms, their probability is rather slim: there is an obvious contradiction between their essence and vested business interests in the parliament. 2. Economy may disappoint investors over the medium term, with its growth dependent on the agricultural and heavy metals sectors again. As productivity in basic sectors slowly declines after years of underinvestment, it may result in a lockup of productivity growth and economic underperformance 3. We expect that investors, concerned with uncertain strategies by the ruling party, would still demand a temporary discount on Ukrainian assets

While it looks most obvious that the country may head directly to a centralized power regime, we offer another low-probability scenario of a shift to its pre-extreme case – the autocracy.

Consequences in an alternative design:

1. With a consolidated "power vertical" Mr. Yanukovich will implement unpopular reforms (pension, administrative, gas price correction etc.) triggering public protests
2. Public discontent will prompt devaluated political stability
3. A new ultra-right candidate and/or party will arise and win popularity
4. Western governments will fail to promote a pro-democratic candidate
5. A new team will deliver autocracy (a more efficient regime when a new ruling party rises)

This layout looks rather harmful for Ukraine: a possible deadlock within the new coalition. Therefore, reforms may be suspended again and investors will be very cautious. Ultimately, this will drastically underrate Ukrainian assets in foreign investors' portfolios.

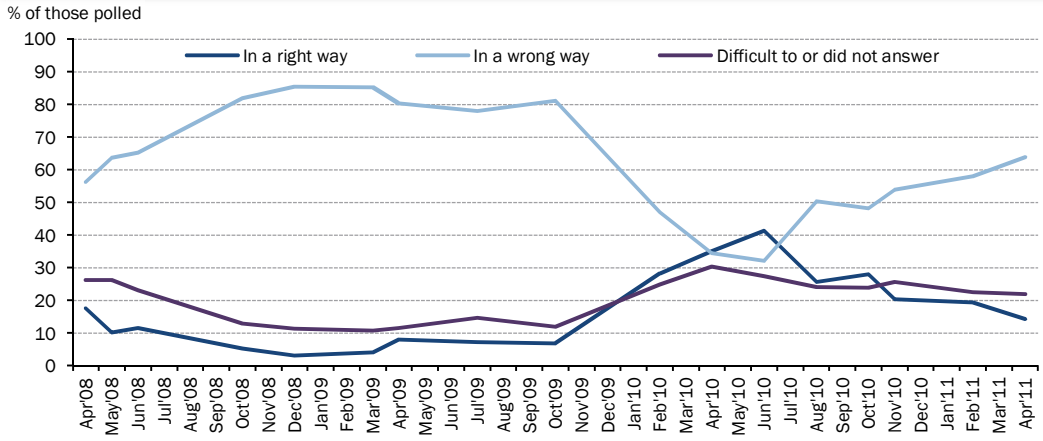
Scenario 4. Social unrest

Probability as of July 2011: Low (10%)

Consequences:

1. Mr. Yanukovich implements unpopular reforms (pension, administrative, gas price correction etc.)
2. Rising unpopularity of the ruling party will feed massive (Egypt-like) protests
3. New pro-Western parties will take a chair

Public opinion on current tendencies in Ukraine



Source: Razumkov Centre
Notes: The question is "Is the situation in Ukraine developing in a right or wrong way?"

A temporary result in this scenario could be violent anti-oligarch protests, similar to those recent ones in some African states. Some believe that social unrest may be triggered by a pension reform and higher utility costs. **We see low possibilities of that cause of quite amorphous behavior of Ukrainian population during latest gas, utilities, petroleum price hikes**.

We see low possibilities of massive unrest cause of quite amorphous behavior of Ukrainian population

Moreover, the probability of eventual revolution largely depends on the opposition's higher capacity and coordination, most unlikely in the medium term. In this regard, Western assistance in the form of international goodwill, financial and technical assistance is a critical condition in bolstering the opposition. As long as the population is moderately passive and EU authorities are not in a deadlock with ruling Ukrainian party now (and do not provide a visible "revolutionary" assistance to opposition), **we see the possibility of such scenario as rather low**.

Investment implications:

Positive	Negative
1. We see insufficient power of early-warning triggers that constituted political unrest in MENA region	1. A revolution will stall the money market, squeeze liquidity of Ukrainian capital markets and flight of deposits
2. The layout of further rebounding will depend on political and economic strategy of new elite	2. Early triggers of unrest will caution direct investors even more. They will re-price political risk accordingly and start a major sell-off of Ukrainian debt and equity assets. Therefore, the central bank may be fighting a losing battle trying to stabilize the exchange rate.

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