

Scenario analysis of Ukraine's political framework

STRATEGY

In anticipation of The War

Ukrainian political landscape has changed dramatically after the Euromaidan and the beginning of the military campaign in the east of the country. The uncertainty of the Ukraine's future have never been so vague ever before. Nevertheless, in order to draw possible paths of further developments in Ukraine we tried to look into historical perspectives to draw some parallels. Although the conflict of its kind can be hardly found in the world history, there are couple of similar stories when two world super-powers clash on the territory of the other state (i.e. war in Afghanistan). The conflict in Ukraine didn't go that far yet, and Ukrainian troops are not yet officially supported by the West, nor are pro-Russian 'rebels' are OFFICIALLY supported by Russia. However, the similarity can be easily drawn. There are number of other parallels that we could draw with other conflicts in the world history. Basing on the overview of those conflicts, we tried to anticipate what could be Ukraine's future if the history repeats.

As of beginning of August, we foresee that there are four most probable scenarios for further developments in Ukraine in the mid-term:

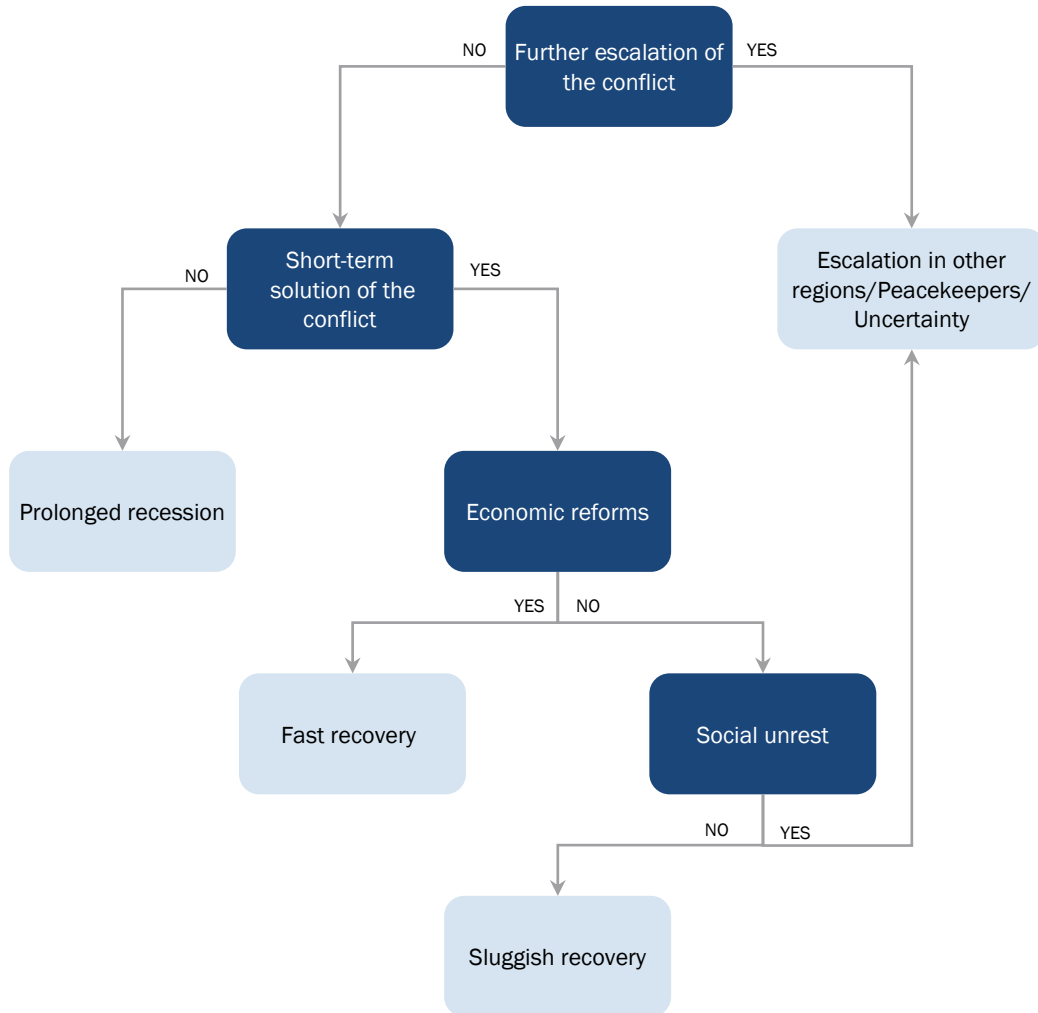
1. **The War** – an escalation of the military conflict. In this case, we anticipate an escalation of the military conflict to other regions (e.g., occurrence of *Casus belli* on the border with Pridnestrovie), possible involvement of Russian 'peacekeepers', full-scale de-jure war with Russia, martial law all over the country, etc.
2. **Social unrest** – an end of the military conflict followed by slow or no structural pro-Western reforms, followed by a spur of social discontent about the 'new' ruling government.
3. **Marginal changes** – after the end of the military conflict but due to a lack of significant reforms, the government will continue making small "steps" towards needed changes.
4. **Pro-West radical reforms** – after an end of the military conflict the government starts the reforms prescribed in the EU-Ukraine Association Agreement and in the IMF program. In addition, we assume that in case of prolonged military conflict at its current state and, as a result, economic recession the government won't have any other options apart from conducting highly-demanded reforms in order to keep on receiving the funding from Western governments and institutions.

The 'War' scenario is one of the possible paths Ukraine may face in the nearest future. However, if the military conflict fades away in the short-term the government may start radical reforms or keep on 'simulating' reforms to receive conditional financial support from the Western allies

Political scenarios analysis: summary

Scenario	War	Social unrest	Marginal changes	Pro-West radical reforms
<i>Expected political regime</i>	Martial law/Uncertainty	Political crisis/Anarchy sentiments	Slow transformation into full-fledged democracy	Full-fledged democracy
<i>Political orientation</i>	Uncertainty	Deep political crisis with rising anarchy movements	Pro-Western (towards EU integration)	Pro-Western (towards EU integration)
<i>The most probable ruling force</i>	Uncertainty		New coalition	New pro-Western coalition
<i>Probability of reforms</i>	Low		Below average	Above average
<i>Opposition status</i>	Uncertainty		Not-suppressed	Not suppressed
<i>Conflict with Russia</i>	High		Above average	High
<i>Economic growth profile</i>	Deep recession	Deep recession	Prolonged recession followed by slow recovery	Mid-term recession with a fast recovery followed by sustainable growth
<i>Credit spread</i>	Sharp widening	Sharp widening	More odds for widening in the short term	More odds for widening in the short term, tightening in the medium term
<i>Capital markets volatility</i>	Increases sharply in the short term	Increases sharply in the short term	Increases in the short term, decreases in the medium term	Increases in the short term, decreases in the medium term
<i>Hryvnia depreciation</i>	High	Above average	Low	Low

Our Economic Scenario Tree based on political scenarios



Scenario analysis

Scenario 1. The War

Probability as of August 2014: Average (20%)

Description: Within this scenario, we anticipate that the probability of the conflict escalation is relatively high now. Conditions of this scenario include the following:

- Official recognition of Russia’s support of the pro-Russian separatists in the East and weaponry support from the USA (and other Western allies) to Ukraine,

or/and

- involvement of Russian ‘peacekeepers’;
- introduction of martial law all over the country,

or/and

- an escalation of the military conflict to other regions (e.g., full-scale de-jure war with Russia or occurrence of *Casus belli* on the border with pro-Russian territories),
- an introduction of martial law all over the country.

Historical analogy:

- Historical analogies that we could draw in this case go back to the Cold war times when the clashes between the two super-powers – USA and USSR – were conducted on the territory of the third countries (i.e. Afghanistan, Angola, Cuba).
- In this case, we also assume peacekeepers’ mission if the conflict escalates. Russia has already declared its intention to propose to send Russian peacekeepers to the East of Ukraine. The initiative from the Russian side most probably will fail, however, we do not exclude the probability that the UN Security Council will decide to send international peacekeepers mission in case the situation goes out of control.

We anticipate the ‘War’ scenario to be the most damaging for Ukraine.

We hamper to describe possible outcome and developments of this scenario due to the high level of uncertainty, however the consequence can be outrageously damaging for Ukraine.

Expected consequences:

1. Prolonged geopolitical crisis that could hamper the world’s recovery after the Great Recession.
2. Deep economic recession in Ukraine.
3. “Cold war” with all the implications for the stunned international trade and investment flows.

4. Building-up of weaponry at the expense of other spending from the state budget of Ukraine and countries involved in the conflict.
5. Humanitarian and social crisis in the Donbas region (and in other regions of Ukraine if the conflict escalates there).
6. Martial law in Ukraine (implies power centralization in the hands of the President or the responsible committee).

Scenario 2. Pro-Western radical reforms

Probability as of August 2014: High (41.6%)

Description: Within this scenario, the military conflict ends up in the short term (until the year-end) or persists through the long-term in the passive form (e.g., as a ‘frozen conflict’ if UN Security Council decides to send international peacekeepers to Ukraine). At the same time, the government will not have any other options apart from conducting needed reforms to rebuild the economy and to receive the funding from the Western governments and international institutions.

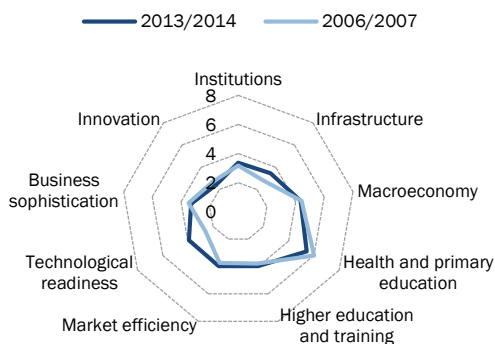
Historical analogy: In this case, we could draw two historical analogies:

- Georgia in 2008 after the war with Russia. The country managed to implement needed reforms and to re-build the economy in conditions of the frozen trade relations with its key trading partner.
- Taking into account high probability of the terrorist attacks and passive phase of the military conflict, we anticipate the fate of Ukraine can replicate Israel’s story. In spite of persistent high risks of the terrorists’ attacks Israel managed to build strong economy (with the Western support) and develop strong national army.

We tend to expect that a short-term solution of the conflict is more probable than persistent long-term passive military campaign. In this regard, we looked into Georgia’s performance after the military conflict with Russia. In 2009, a year after the war, Georgia faced economic downturn up to 3.8% of real GDP decrease (vs -3.6% for CEE region and -6.4% for CIS region) and budget deficit of 6.5% of GDP. In 2010, the country managed to get back on the growth path with real GDP growing by 6.3%. However, the recovery was followed by the accumulation of gross government debt up to 39.2% of GDP in 2010 (after 21.6% of GDP in 2007). Nevertheless, the country managed to introduce the reforms and moved up in the Global Competitiveness rank from 94th place in 2004 up to 77th place in 2014.

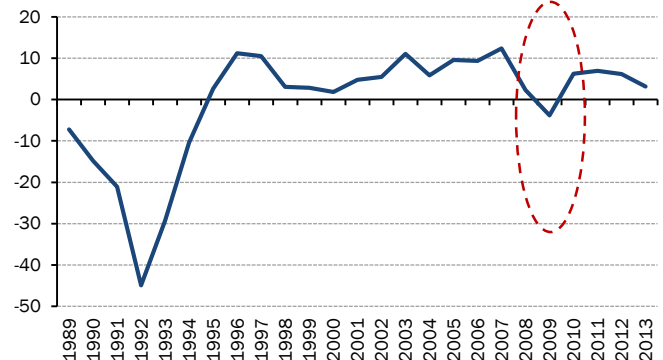
Radical reforms aimed to speed the implementation of the EU-Ukraine Association Agreement and the IMF requirements is highly possible (as far as the government will probably exhaust any source of funding and will not have any other options apart from conducting the reforms).

Georgia’s progress with reforms – indices of competitiveness



Source: Global Competitiveness Report (2013/2014 and 2006/2007)

Georgia’s real GDP growth, Y-o-y in %



Source: World Development Indicators

Expected consequences:

1. Economic recovery in the short/mid-term.
2. In case of ‘frozen conflict’ we expect high probability of rare terrorist attacks’ occurrence outside Donbas region.
3. Current conflict with Russia will be transformed into stunned bilateral trade relations and investment flows from Russian financial institutions.
4. Building-up of weaponry at the expense of other spending from the state budget of Ukraine.

Scenario 3. Marginal changes

Probability as of August 2014: Average (30%)

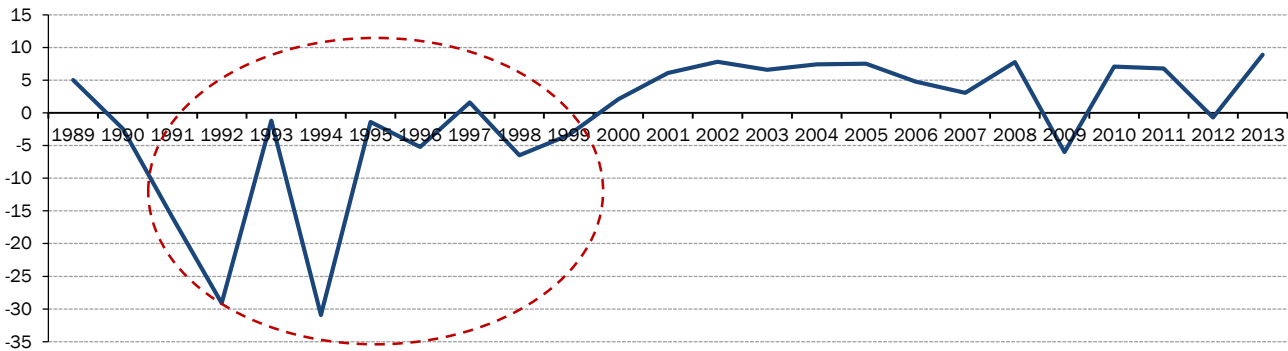
Description: Within this scenario, we anticipate that after the end of the military conflict the political landscape in Ukraine will not face big challenges with key oligarchs keeping the majority stake in Ukrainian parliament and, thus, opposing to any kind of radical reforms. In this case, Ukraine will make only minor moves towards reforming and rebuilding the economy.

Historical analogy: We tend to compare this scenario to the developments in Moldova’s after the war in Transnistria. The conflict was short-lived - from March 1 till July 27 in 1992 – but with long-term implications for the country. In addition, the country failed to perform fast reforms and fell into deep political crisis and economic recession.

After the war, Moldova faced economic downturn (also caused by the collapse of USSR and economic adjustments), growing C/A deficit (up to 16.3% of GDP in 1993) and price growth almost 8 times as much. Stable recovery was observed only after 2000 – 7 years later after the active phase of the military conflict. Moldova did not show significant progress in introducing the reforms and moved down in the Global Competitiveness rank from 82th place in 2005 down to 87th place in 2014.

Ukrainian policy-makers, if still ruled by the oligarchs, may shift to its traditional practice of pretending performing the reforms with only minor moves towards structural changes.

Moldova's real GDP growth, Y-o-y in %



Source: World Development Indicators

Expected consequences:

1. Prolonged recession followed by slow recovery.
2. Unpopular (but urgently needed reforms) will be delayed with only minor moves in the right direction in order to 'feed the eyes' of the financing parties (like IFIs or the IMF).

Scenario 4. Social unrest

Probability as of August 2014: Low (8.4%)

Description: Within this scenario, we anticipate an accumulation of social discontent that can lead to a new social unrest on the back of prolonged military campaign and lack of economic reforms.

Historical analogy: We hamper to find any historical analogies of this kind when the geopolitical conflict is followed by the social unrest in the country from the contemporary history. The close analogue could be the transition from the February Revolution to the October Revolution in 2017 with well-known consequences.

Expected consequences:

1. Rising unpopularity of the ruling regime due to the lack of prudent economic reforms.
2. Deep political crisis.
3. Rising anarchy movements and domestic tension within individuals and political groups.
4. High level of uncertainty.

In case the military conflict is over and the government fails in performing prudent economic reforms, the social discontent can lead to a new social unrest – Maidan 3.0.

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