STRATEGY

Macro Update 1Q'2015

The Very Moment for Hard Choices

The Ukrainian economy continues to suffer from feverish political developments and an on-going military conflict in the East of the country. However, since the beginning of 2015, the area of military action seems to have stable boundaries. In our base case scenario, we tend to expect that there will be no major military shocks (including loss of territory and production sites) in the near-term. Consequently, the government should be able to focus on reforms of the Ukrainian economy and a potential economic growth trajectory more than on warfare, though our current expectations for 1H'2015 are quite conservative:

In our view, "Marginal changes" became the most likely political scenario. In 2014, the prevailing idea was that Ukrainian government would not have any other options apart from conducting structural reforms in order to receive funding from Western allies. However, institutional barriers we have outlined in our March'2014 report "*Economic Reforms: Aren't we missing the point?*" turned out to be even more significant than was expected. Therefore, we project the government's underperformance regarding radical structural reforms into 2015.

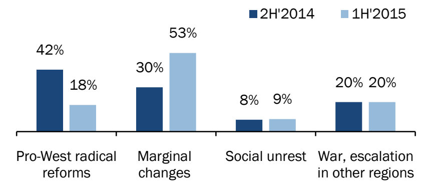
In 2014, IFIs demonstrated reluctance to step beyond their usual business practices in a response to Ukrainian economic geopolitical crisis and we do not expect any fundamental changes in the relations between Ukraine and its donors in 2015. Consequently, instead of "sufficient assistance in exchange for deep reforms" the main theme of 2015 is expected to be "SOME" assistance in exchange for "SOME" reforms" (meaning that there will be no blank check policy).

Given that the epicentre of the economic problems has shifted from the real sector to the financial markets and the banking system, the government's ability to manage fiscal and external financing gaps becomes the key factor in ensuring economic recovery. The recently adopted budget plan for 2015 along with the IFIs statements regarding the amount of financial assistance makes us pessimistic about the government's ability to achieve macrofinancial stabilisation in 2015.

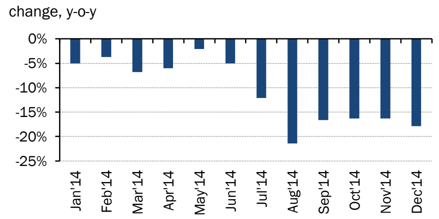
Macrofinancial instability is expected to be the main obstacle on the way to economic recovery. According to our baseline scenario, Ukraine will lose additional 6.9% of GDP mainly due to a contraction of private domestic demand caused by high inflation and further depreciation of national currency.

Our baseline scenario is subject to the two major risks: "Big Bang" style of new financing deals with Ukraine's Western allies on the upside, and further escalation of military conflict going beyond existing boundaries on the downside. We do not consider unlikely restructuring of Ukrainian external debt as a game changer in case it happens (due to a relatively small impact on the size of external funding gap projected for 2015).

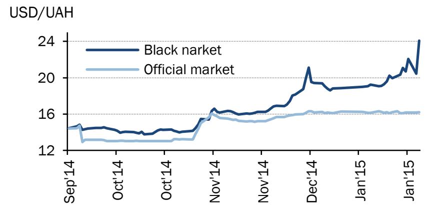
"Marginal changes" became the most probable political scenario



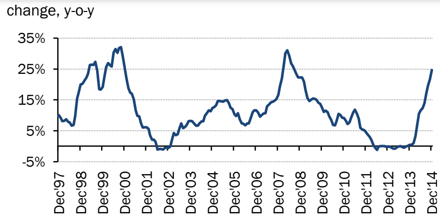
Industrial production decline does not accelerate further



F/X became chronically unstable



Consumer inflation is on the rise



Macroeconomic forecasts for 2015	as of 3Q'14 Baseline scenario ("Sluggish recovery")	as of 3Q'14 Alternative scenario ("Protracted recession")	as of 1Q'15 Baseline scenario ("Macrofinancial instability")	as of 1Q'15 Alternative scenario ("Big Bang")
GDP growth, %	1.7	-9.1	-6.9	2.6
Consumer Price Index, % e-o-p	13.4	18.4	24	16
Consolidated budget balance % of GDP,	-5.7	-10.6	-4.8	-3.8
C/A balance, USD bn	-8.7	-8.7	-1.5	-6.2
C/A balance, % of GDP	-6.5	-8.2	-1.7	-5.6
FX rate, USD/UAH, e-o-p	14.5-15	18-20	24	16
NBU's international reserves, USD bn	19	17	4.6	17.2

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Politics: still in the vicious circle of no reforms

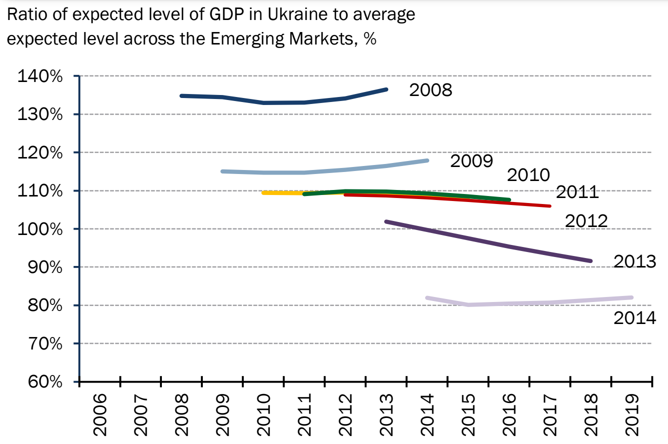
One year after the outbreak of the revolutionary movement, Ukrainian people have gone through a number of unexpected upheavals and setbacks, the most painful of which is certainly Russia's aggression that resulted in Crimea annexation and partial occupation of the territory of Eastern Ukraine. However, despite the fact that the military conflict remains among the primary challenges, it is time to return to the original roots of the EuroMaidan – securing a change of the socio-economic system with the goal of restoring justice and ensuring long-term economic growth. So, what are the chances for fundamental structural reforms in 2015? In our view, Ukraine found itself in the vicious circle of no reform, when the government's inability to perform is depriving the country of getting financial support and this causes macrofinancial instability and further reduces the prospects of reforms.

The ceasefire agreement reached on September 5, 2014 did not stop the Russian aggression in Eastern Ukraine. Nonetheless, the temporary decrease of conflict intensity allowed the Ukrainian army to regroup after the direct intervention of the armed forces of the Russian Federation in July-August and strengthen the front line. However, it seems that **the period of fragile peace has created the illusion of conflict freeze and the rising chances for some kind of diplomatic solution among Ukraine's western partners.** Consequently, since the EU and the US finally introduced third level sanctions against Russia half a year ago, no additional effective measures to ensure compliance with the provisions of Minsk Protocol were taken. That allowed the Russian side to increase its military presence in Eastern Ukraine during the previous months and finally launch the medium-scale offensive action in late January of 2015.

There are high chances that the area of active military action will remain within the current boundaries, but the conflict itself will persist during 2015.

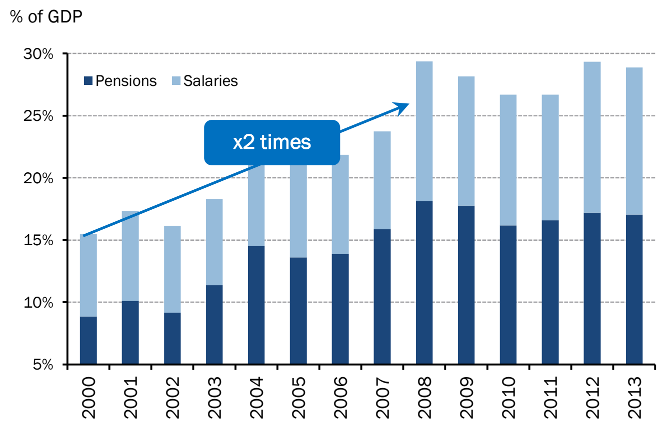
Despite the possible strengthening of economic sanctions against Russia by the EU and the US as a response to January aggression, it is unclear how it would affect Mr. Putin's strategic planning. However, given the long-term nature of this kind of sanctions, it seems reasonable to expect that Ukraine will stand against Russia one-on-one. This implies that **even though according to our expectations the area of active military action will remain within the current boundaries, the conflict itself will persist during 2015 creating mild shocks for Ukraine's already weak economy**.

1. Evolution of the GDP per capita (PPP) forecast for Ukraine compared to Emerging market countries



Source: IMF

2. Government social spending



Source: MoF, SSC, AYA calculations

Further Ukraine's ability to confront Russia in position warfare is heavily dependent on economic and internal political factors, as well as international support, with all three areas being the matters of deep concern. First, we need to remind our readers that Ukrainian economy got into a deep trap long ago. Figures 1 and 2 show how procrastination with structural reforms resulted in major decline

Ukraine's economic problems began a long time ago.

in relative economic perspectives on top of unhealthy increase of social public spending during the last decade. Both problems along with a huge reliance on energy imports and deeply enrooted corruption resulted from "Kleptocratic oligarchy" socio-economic model which was expected to be overthrown by EuroMaidan revolutionary movement early in 2014. Secondly, since the new transitional government was formed it was expected that (i) the Western allies would provide a generous financial aid in the short run to help stabilize Ukraine's economy and (ii) Ukraine's government at the same time would start to implement the long-awaited pro-West radical reforms.

It was perceived that in the aftermath of Russia's aggression toward Ukraine the Western allies would provide a generous financial aid to help stabilize Ukraine's economy.

This scenario meant that the government would start introducing fundamental structural reforms in order to ensure international financial aid flow to Ukraine. This course of events was described as "Pro-West radical reforms" and made our baseline scenario on the set of Ukraine's political and economic scenarios (see side-note "*Scenario analysis of Ukraine's political framework*" as of August 2014), along with the alternatives like "Full-scale war", "Social unrest" and "Marginal changes".

However, the escalation of military action in Eastern Ukraine in July-August and Parliamentary elections in October restricted the government's ability to execute any fundamental structural reforms in 2014. The subsequent experience of building a coalition and adoption of the state budget, in our view, shows that the newly elected government has a hard time to perform any better. The best hope we have is a bottom-up approach to structural reforms at the level of different ministries, with little hope left for the development of the effective strategy of reforms [1].

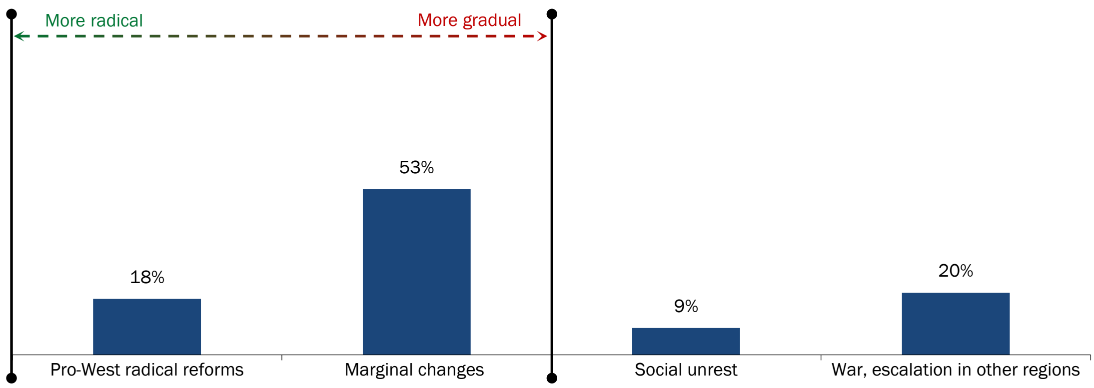
However, it did not happen as planned because of both Ukrainian government's lack of performance and IFIs' unwillingness to step beyond their usual practices.

IFIs and other donors in their turn showed unwillingness to step beyond their usual practices and allow for the difficult situation in Ukraine [2,3]**.** Therefore, the NBU found itself stripped of vital financial resources in the 3Q and that led to increased volatility in currency markets as well as to the second wave of devaluation. Moreover, as in the case with the capacity of the newly elected government to implement reforms, we see no major reason for IFIs to change their behaviour in 2015.

Putting it all together, we see the signs of a very dangerous situation: **instead of "sufficient assistance in exchange for the deep reforms" we get "SOME" assistance in exchange for "SOME" reforms".** The result is a vicious circle: no funding for the macrofinancial stabilization - no way to carry out reforms without liquidity cushion - no reforms - no funding and so on. **Unfortunately, we perceive such development as a baseline scenario for 2015** ("Marginal changes"). The only way to break the circle is the "Big Bang" style of dealing with the IMF and the EU, which will imply a significantly higher amount of financing and, most importantly, change in the way the trenches are administrated. Under this route, NBU should receive up to USD 15-20 billion in one payment in order to stabilize market expectations in exchange for promises of pro-West radical reforms (we estimate the probability of such deal at 18%).

In our view, this is a recipe for disaster for 2015, which may be repeated once again.

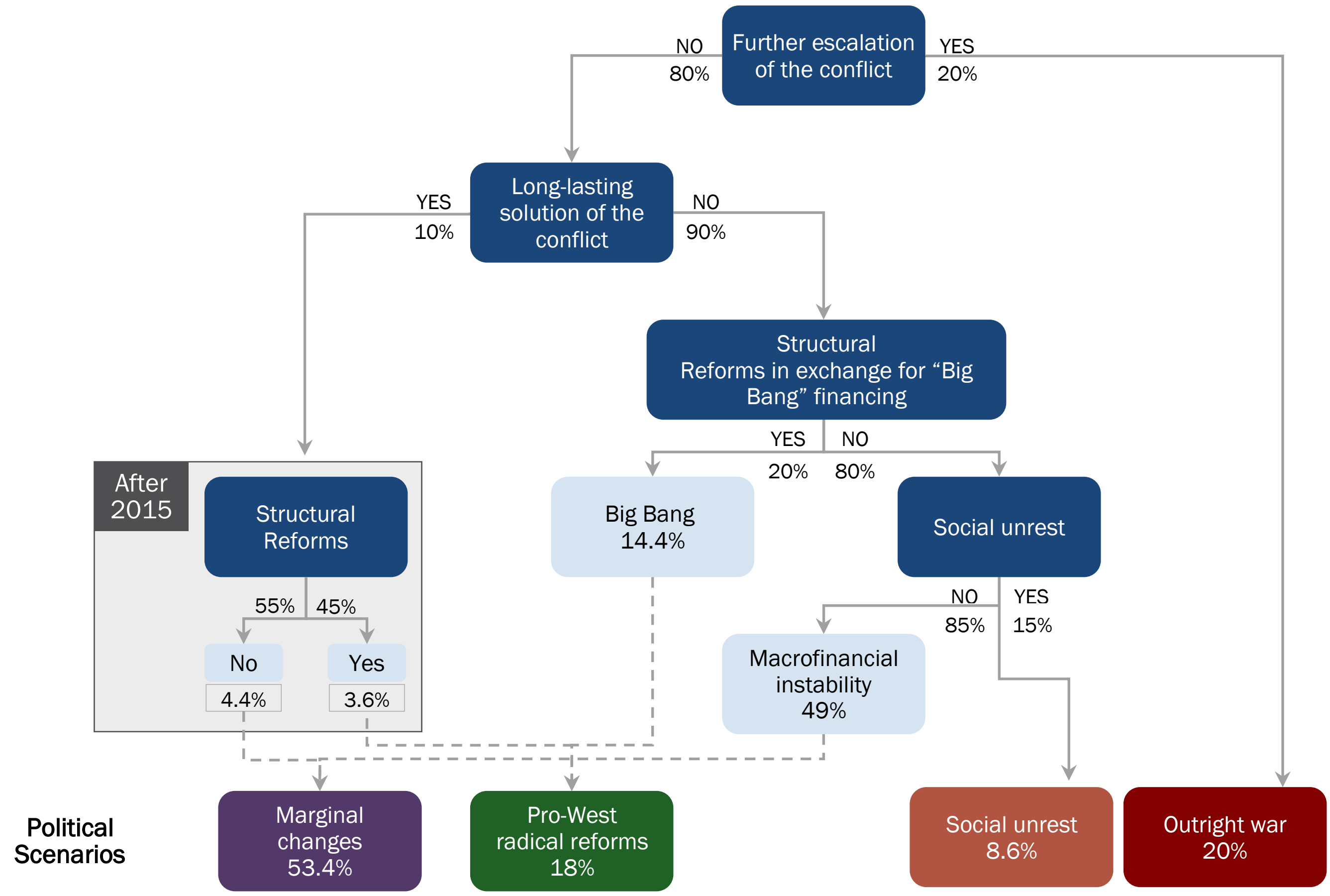
3. Perceived probabilities of political scenarios for 1H'2015



Source: AYA Capital estimations of scenarios' probability
Notes: The probability is estimated by way of assessment of business communities' expectations (mass media analysis, personal discussions etc.)

1. http://ayacapital.com/uploaded/overviews/denied/141202-AYA_Capital-Strategy_of_Reforms_eng.pdf
2. http://www.nybooks.com/articles/archives/2015/feb/05/new-policy-rescue-ukraine/
3. http://www.pravda.com.ua/rus/articles/2014/11/2/7042975/

4. Our Economic Scenario Tree for 1H'2015 and its interconnection with political scenarios



Key Macroeconomic Forecast Indicators

	2014'E	2015'F Macrofinancial Instability	2015'F Big Bang
Real GDP growth, %	(6.7)	(6.9)	2.6
Nominal GDP, UAH bn	1 586	1 921	1 859
Consumer Price Index, % (average)	12.2	28	19
Consolidated budget balance, UAH bn	(78)	(92)	(70)
Consolidated budget balance, % of GDP	(4.9)	(4.8)	(3.8)
C/A balance, USD bn	(5.2)	(1.5)	(6.2)
C/A balance, % of GDP	(4)	(1.7)	(5.6)
FX rate, USD/UAH, e-o-p	15.8	24	16
NBU's international reserves, USD bn	7.5	4.6	17.2

Source: AYA estimates

5. Description of economic scenarios for 2015

Key expectations	Macrofinancial Instability	Big Bang	The War&Social unrest
Probability	49%	14.4%	28.6%
Description	– Active military conflict within existing borders. – Weak external demand. – Neutral (non-contractionary) fiscal policy. – Positive external financing gap (government **will not be** able to secure enough external financing to cover all needs and consequently achieve macrofinancial stabilization).	– Active military conflict within existing borders. – Weak external demand. – Neutral (non-contractionary) fiscal policy. – Negative external financing gap (government **will be** able to secure enough external financing to cover all needs, increase FX reserves and consequently achieve macrofinancial stabilization).	Further escalation of the conflict. Social unrest is also probable amid (i) lack of reforms, (ii) deep social and humanitarian crisis in the conflict areas, (iii) further corruption and poor coordination in the military campaign that leads to fast growing death toll in the army, etc.
Real sector & GDP	– Decreasing domestic demand and lack of investments due to the high inflation and weak business and consumer expectations.	– Investment driven economic growth supported by increase in households spending as a response to a macro financial stabilization, including moderation of inflation (both CPI and PPI).	Uncertainty
Fiscal policy	– Increase of shadow economy. – Increase of inflationary pressure due to the need of funding quasi-fiscal deficits.	– Economic recovery will burst tax collection in real terms. – Proposed measure to de-shadowing economy will be successful due to the increased level of business confidence. – Usage of external donor's funds to cover quasi-fiscal deficits will reduce the inflationary pressure on the economy.	Uncertainty
Monetary policy	– Failure to implement slow shift to the inflation targeting within the proposed IMF plan due to escalated inflation and high risks of devaluation.	– Gradual shift to the inflation targeting.	Uncertainty
External trade	– Trade wars with Russia are continued. – Slow re-shifting to the EU markets. – Increase of gas reverse flows from the EU – Imports decline will outpace exports due to the shrinking domestic demand.	– Trade wars with Russia are continued. – Slow re-shifting to the EU markets. – Increase of gas reverse flows from the EU. – Exports decline will outpace imports decline due to the recovering domestic demand.	Uncertainty
F/X policy	– Further raise of devaluation expectation, depreciation of the official UAH FX rate, retention of multiple exchange rates regime, defencelessness against shocks caused by military conflict due to a low level of FX reserves.	– Decline in devaluation expectations with gradual convergence of black FX market rate to official rate, lifting capital controls, use of FX reserves to stabilize market in the case of shocks caused by military conflict.	Uncertainty
Inflation	– Accumulation of inflationary pressure on the back of UAH depreciation and political instability. Forming of inflation-devaluation spiral.	– Price adjustments following the F/X depreciation taken place in 2014.	Uncertainty
Banking sector	– Further Increase of the number of problematic banks with high pressure on the Deposits Guarantee Fund and no increase of deposits. – External funding will be available only for the most stable banks.	– Successful consolidation in the sector with no bankruptcies of the major banks. – Gradual growth of deposits. – External funding will be available for most of the banks in need of funding.	Uncertainty
Bull factors 	▪ UAH depreciation will further boost exporters' price competitiveness.	▪ Relatively fast improvement of the business and consumer sentiment despite ongoing military conflict. ▪ Financial support from Western allies.	
Bear factors 	▪ Further trade wars with Russia. ▪ Insufficient financial support from Western allies. ▪ Accelerated price growth will push interest rates up and constrain consumption. ▪ Ukraine's investment climate will continue to suffer in the medium-term.	▪ Further trade wars with Russia. ▪ Accelerated price growth will push interest rates up ▪ Ukraine's investment climate will suffer in the medium-term	

Ukraine's economy: bleeding, stressed, alive

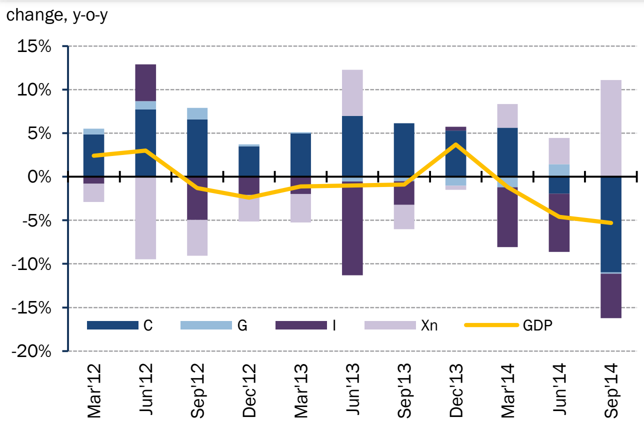
In 2014, Ukraine faced two major shocks against the background of weak external demand and the first major geopolitical crisis in decades. Consequently, Ukrainian economy has fallen into severe economic recession with no obvious prerequisites for a fast recovery in 2015 and beyond. However, given the circumstances, especially the unfortunate reality of a real life replication of the popular on-line game "World of Tanks" in the territory of Eastern Ukraine, the state of affairs could be worse. But since the real sector showed greater resilience than expected, we revised our estimation of 2014 real GDP decline upward to 6.7%.

In the 2H14 Ukrainian economy fell into a full-scale recession with double-digit GDP decline expected for Q4'14 (after 5.3% decline in Q3'14). This implies the total economic contraction of about 6.7% y-o-y in 2014. This result represents a significant deterioration compared to the depth of recent recession (started on Q3'12) with only 0.5% average quarterly decline y-o-y. However, on the other side, it stands not even close to the sharp contraction of 2008-2009 (minus 19.6% in the 1Q'09).

Furthermore, it is worth arguing that the minus 6.7% figure overstates the real slump of the economy because it includes not only the actual loss of output due to the decline of demand and destruction of production sites with the break of production chains, but it also includes the loss of output due to the loss of territories. In this case, it would be more accurate to exclude the temporary occupied territories of Eastern Ukraine as economists (including us) have already done in the case of Crimea. However, additional difficulties arriving from unclear lack of inner regional economic data breakdown make such calculations counterproductive at this time. Nevertheless, if we take into account the estimations of NBU staff[1], we can roughly estimate that the magnitude of economic contraction in 2014 stands only at 2-3%, on non-occupies territories.

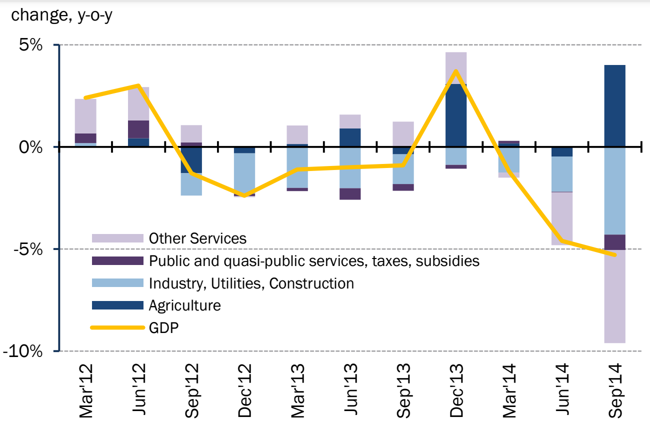
In Q3'14, the composition of GDP decline has shifted from primary gross capital formation (I) to household consumption (C), at the same time the contribution of government consumption (G) remained virtually neutral, while net export (Xn) was the only source of GDP support. In terms of sectoral structure – industry and services became the key negative contributors while agriculture was the only sector showing positive dynamics. Because seasonal impact of agriculture occurred in Q3 compared to Q4 in 2013, the Q414 GDP growth was expected to deteriorate substantially.

6. Contributions to real GDP growth by expenditure components



Source: SSC

7. Contributions to real GDP growth, sectors



Source: SSC

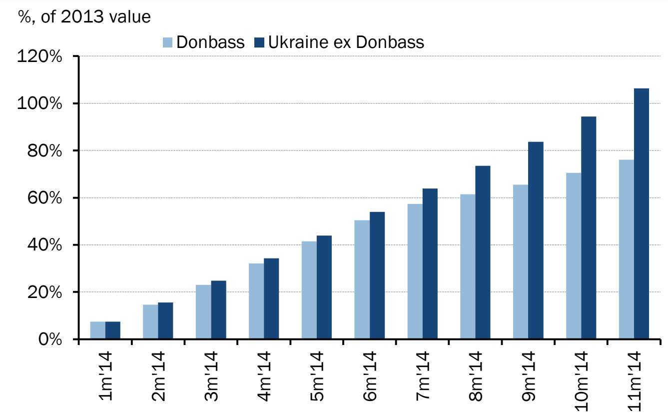
Geographical breakdown of various economic indicators also illustrates resilience of Ukraine's economy to severe shocks of 2014. Since the Donbass[2], usually called the industrial "heart" of Ukraine (in 2013 accounting for 25% of industrial output, 25% of export and 15% in total GDP), is the area of active military conflict, the expected 6.7% country's GDP decline is already a good

1. http://gazeta.zn.ua/macrolevel/monetarnaya-politika-nbu-vchera-segodnya-zavtra-_.html

2. Lugansk and Donetsk regions combined.

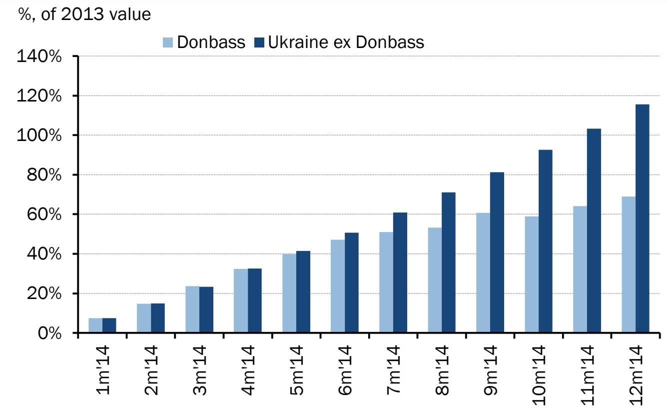
outcome. Likewise, industrial production and retail trade outside this turbulent region show little signs of deep recession. Namely, those indicators in nominal terms were outperforming their 2013 values with retail trade turnover in real terms excluding Donbass fall only 3% in 2014.

8. Industrial production (nominal terms)



Source: SSC

9. Retail trade (nominal terms)



Source: SSC

Russia's military intervention in Eastern Ukraine mainly impacted the mining industry, primarily coal mining and subsequently coke production. Another mostly affected subsector is metallurgy due to both loss of production sites and disruption of production chains. Finally, the loss of thermal coal supply caused a reduction of electricity production. Most other industrial subsectors experienced a limited impact, or had been in recession long before the military shock.

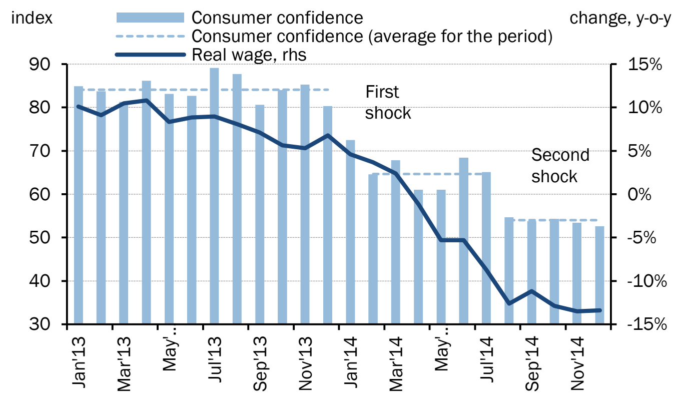
10. Ukraine's industry performance heatmap, changes y-o-y

	2011	2012	2013	Jan'14	Feb'14	Mar'14	Apr'14	May'14	Jun'14	Jul'14	Aug'14	Sep'14	Oct'14	Nov'14	Dec'14
Mining	7%	2%	1%	1%	-2%	-4%	-2%	-2%	-5%	-13%	-27%	-27%	-25%	-29%	-29%
Coal	14%	5%	-2%	-1%	1%	-10%	-5%	-3%	-11%	-29%	-60%	-57%	-61%	-62%	-57%
Oil & Gas	-3%	1%	-3%	-2%	2%	-1%	-2%	-4%	-2%	-1%	-2%	-3%	-2%	-3%	-1%
Ore	3%	1%	5%	3%	-4%	-1%	1%	-1%	-2%	-6%	-15%	-17%	-7%	-12%	-18%
Manufacturing	10%	-2%	-7%	-9%	-7%	-8%	-10%	-4%	-6%	-13%	-19%	-11%	-12%	-12%	-14%
Food processing	7%	2%	-4%	-5%	-1%	1%	3%	12%	9%	0%	-3%	16%	7%	6%	-3%
Light industry	8%	-7%	-6%	-4%	-5%	-4%	-15%	0%	-6%	-8%	-14%	-1%	-5%	-1%	7%
Wood & paper industry	7%	1%	3%	2%	-6%	-3%	-9%	-1%	-6%	-8%	-9%	-5%	-8%	-11%	-8%
Coke and oil production	-4%	-18%	-11%	11%	-2%	-7%	-10%	-3%	-5%	-16%	-50%	-52%	-43%	-41%	-41%
Chemicals	24%	-4%	-17%	-8%	-6%	-3%	-23%	-21%	-22%	-22%	-20%	-6%	-11%	-21%	-12%
Pharmaceuticals	-1%	7%	12%	-6%	4%	2%	-2%	4%	15%	4%	9%	8%	-9%	-14%	-7%
Metallurgy	11%	-4%	-5%	-10%	-11%	-11%	-13%	-2%	-6%	-12%	-30%	-28%	-21%	-20%	-16%
Machinery & equipment	16%	-3%	-13%	-23%	-15%	-17%	-19%	-15%	-21%	-24%	-31%	-23%	-26%	-24%	-25%
Motor vehicles	19%	1%	-20%	-36%	-34%	-32%	-33%	-28%	-34%	-38%	-43%	-41%	-41%	-36%	-41%
Electricity, gas & water	4%	2%	-1%	-1%	3%	-8%	1%	7%	-2%	-8%	-17%	-19%	-17%	-8%	-11%
Industrial output	8%	-1%	-4%	-5%	-4%	-7%	-6%	-2%	-5%	-12%	-21%	-17%	-16%	-16%	-18%
		Recession													
						Impact from the first shock									
											Impact from the second shock				

Source: SSC

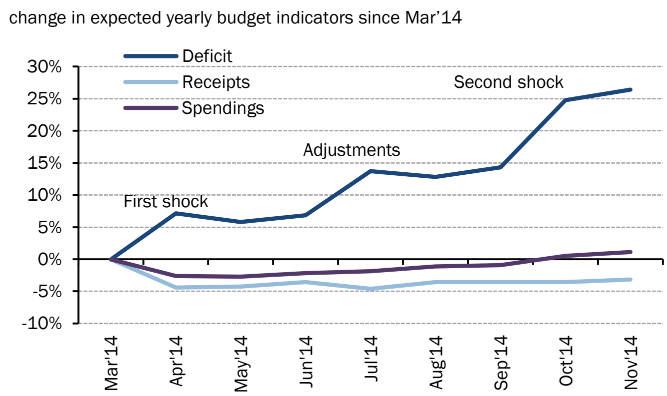
In general, it is useful to see how different parts of the economy (Fig. 11-16) responded to the two major shocks of 2014: the elimination of imbalances accumulated in the previous years multiplied by a sharp decline in confidence caused by the loss of Crimea (first shock) and a partial loss of Donbass (second shock).

11. Consumption: confidence and real wages



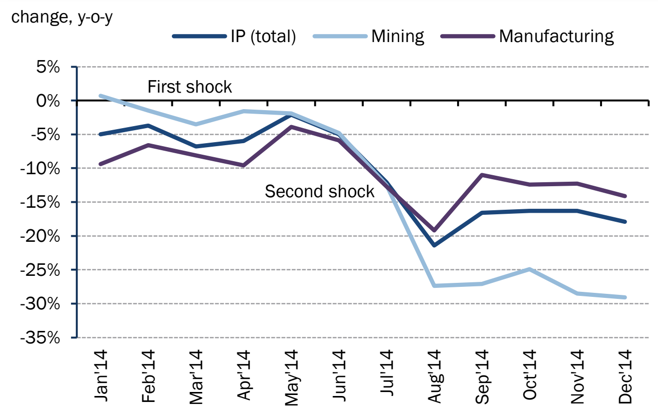
Source: SSC, GfK

12. Government response: consolidated budget



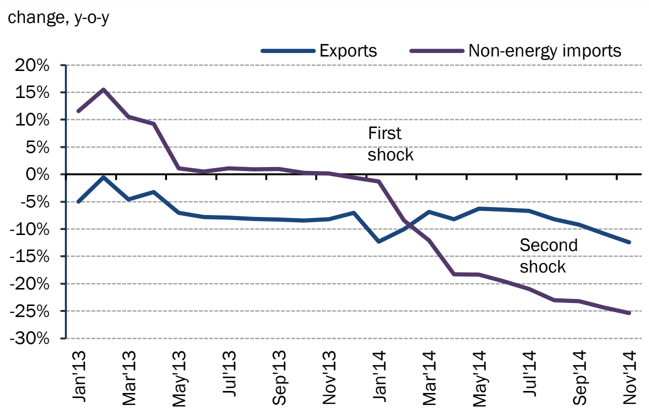
Source: State treasury

13. Real sector



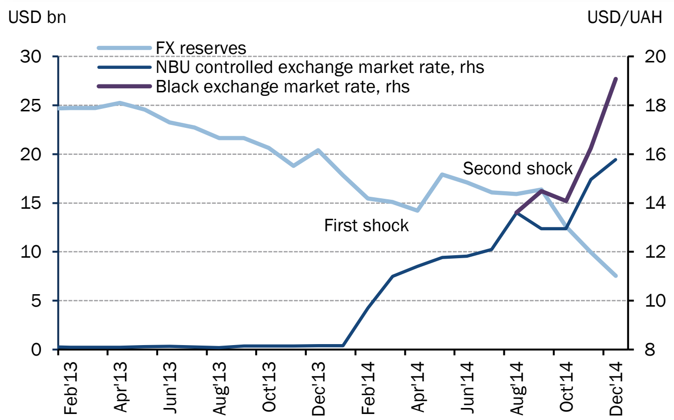
Source: SSC

14. External trade



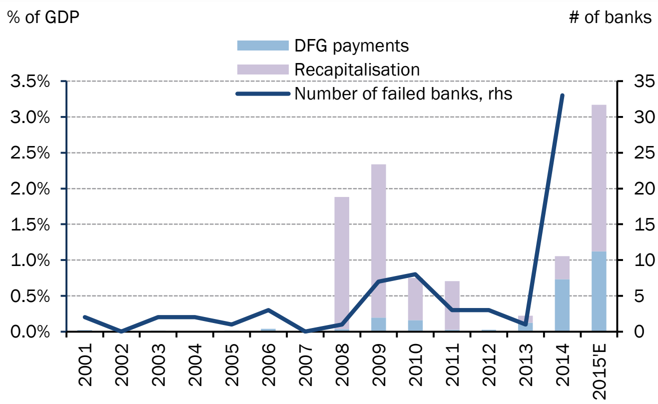
Source: SSC

15. FX market



Source: NBU, finance.ua

16. Banking system



Source: DFG, MoF, AYA calculations

Given the data above, we can make the following conclusions:

Firstly, the propagation of shocks through the real sector of the economy did not cause the formation of self-reinforcing negative tendencies. The economy is not falling apart and without additional shocks of comparable magnitude, we can expect a further stabilization.

Secondly, responding to the unfolding shocks the government decided to postpone structural changes, probably out of fear of "adding fuel" to the fire of economic decline. As a result, the abstinence from Greek-style panic austerity certainly has had a positive impact on GDP. However, it is quite possible that a resulting funding gap had acted as a confidence destruction factor and signalled the failure to fulfil government's obligations in the eyes of IFIs. Moreover, and most importantly, the size of accumulated imbalance in the public sector area is even greater at the beginning of 2015 than it was a year ago.

Thirdly, the confluence of negative factors and shocks that hit Ukrainian financial markets in 2014 can be characterized as a "perfect storm". To assess the extent of the crisis that came upon the banking system and currency market it is enough to mention only two facts. To begin with, this is a very first time since the introduction of national currency in 1996 when the black foreign currency market has become a vital part of the economy (Fig. 15). Further, the current banking crisis is almost certainly the worst in Ukraine's history given the number of failed banks and the amount of funds needed for banks' recapitalisation (Fig. 16). Both crises are the main obstacles on the way to economic recovery due to their negative effect on consumer and business confidence.

Thereby, the key questions and our expectations for 2015 are:

1. What are the chances for the external sector to be the driver of economic recovery, as it was in past recessions?

   The short answer is - very little.

2. Will the government be able to find a right balance between the support of domestic demand through fiscal policy and the need to eliminate the imbalance of already bloated spending?

   The short answer is – the chances are low.

3. Will the government be able to find the needed resources to close the fiscal and external financing gap to stabilize the financial markets and banking system?

   The short answer is – high chances for "fail".

4. What are the chances for the private domestic demand to become a key driver of economic recovery in 2015?

   The short answer is - very little.

External sector: no recovery ahead

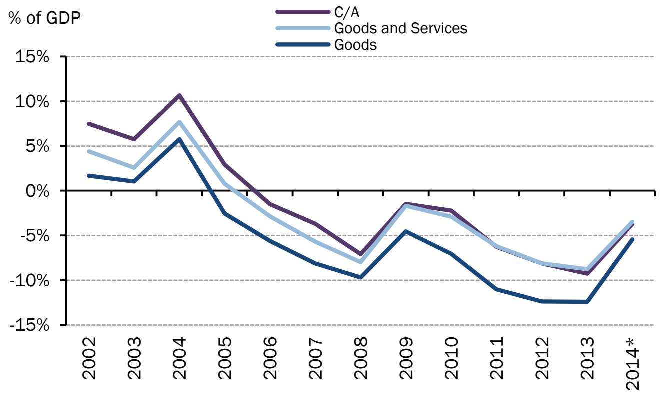
The long-awaited depreciation of hryvnia and the adjustments that followed significantly refreshed the BoP statistics. However, unfolding trade wars with the key trading partner and generally unfavourable conditions in core export markets, in the CIS countries and Asia alike, have prevented the expected growth of export volumes. Since we expect further deterioration of trade relationship with Russia, continued slowdown of emerging market economies and the continuation of the military conflict in Eastern Ukraine, we believe that in contrast to previous recessions, foreign trade will not become a driver of economic recovery despite the partial restoration of competitiveness caused by devaluation.

Excerpts from scenarios	2014'E	2015'F Macrofinancial Instability	2015'F Big Bang
Net Export, USD bn	(5.3)	(1.2)	(6.3)
C/A balance, USD bn (deficit)/surplus	(5.2)	(1.5)	(6.2)
C/A balance, % of GDP (deficit)/surplus	(4.0)	(1.7)	(5.6)

Source: AYA estimates and calculations

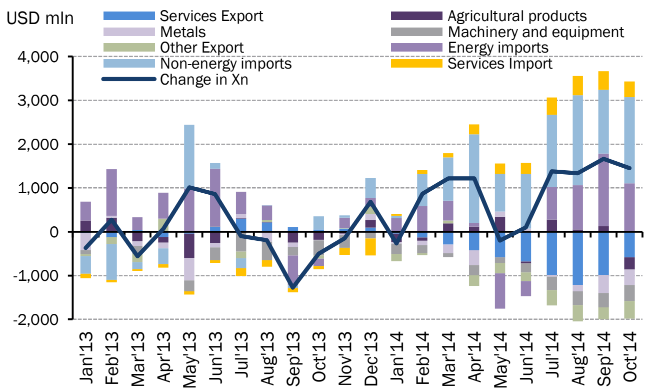
Accumulated external imbalances were finally adjusted in 2014, but negative externalities will prevent net exports to enter positive territory in 2015. The economic crisis of 2014 has little similarities with previous major slumps (1998, 2008) in terms of its origins and the prospects of future recovery. Despite 50% devaluation of national currency, the closing of external trade imbalance (Fig. 17) was solely due to falling imports (Fig. 18). Such unusual pattern can be explained by continued slowdown of Emerging Markets economies and consequent decline in demand for commodities, which leads to falling prices and increasing competition among exporters. Secondly, Ukraine continues to lose CIS countries, especially Russia, as its export market.

17. BoP statistics



Source: NBU
* – 9m'14 annualized

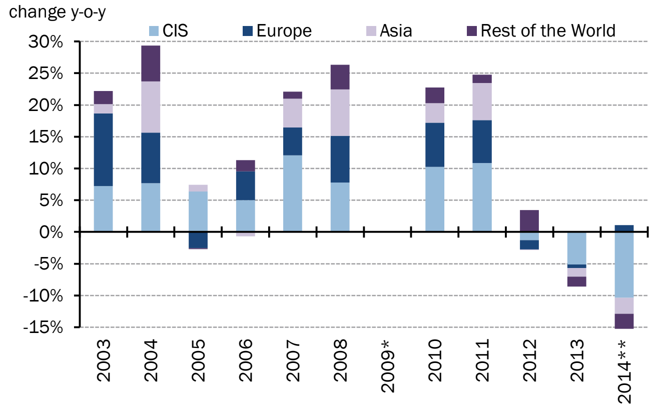
18. Contribution to exports growth



Source: NBU, AYA calculations

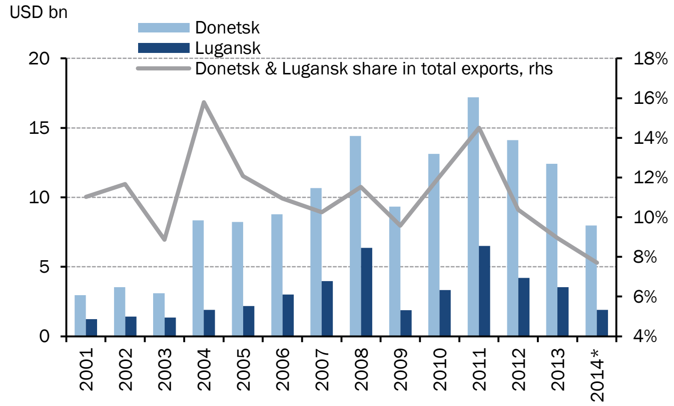
Despite of positive effect from regaining competitiveness through devaluation, the prospects of external trade are expected to worsen further because of continuous trade wars with Russia. CIS countries remain vital trading partners for Ukraine: in 10 months of 2014, the CIS share in the total export accounted for 29% and the Russian share alone was 16%. This is substantially lower than even a few years before (the CIS share of total export was 38% in 2011), however it is still high enough to drag overall export volume down. Given that it is impossible to redirect most of the machinery export in principle and a fair part of commodity (including steel) export in the short run, we expect further contraction of export by 10% in 2015.

19. Contribution to exports growth



Source: SSC, NBU, AYA calculations
* – data excluded given its unrepresentativeness; ** – 10m'14 annualized

20. Regional external trade

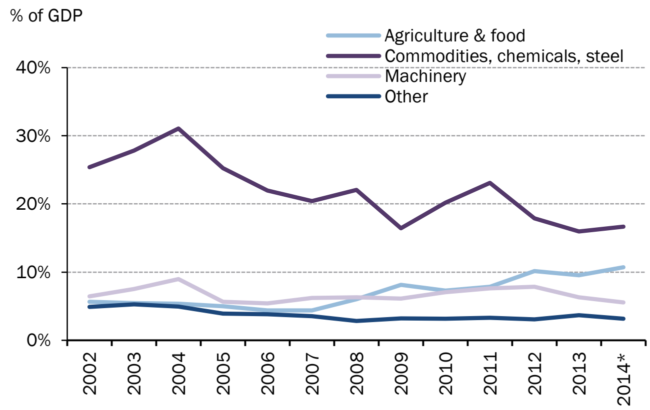


Source: SSC, AYA calculations
* – 11m2014

No small negative contribution to the dynamics of exports was made by the ongoing military conflict: the volume of exports from Donetsk region declined by 30% in 11 months of 2014 while that from Lugansk region – by 42%. Consequently, the Donbass share in total export dropped to 8%.

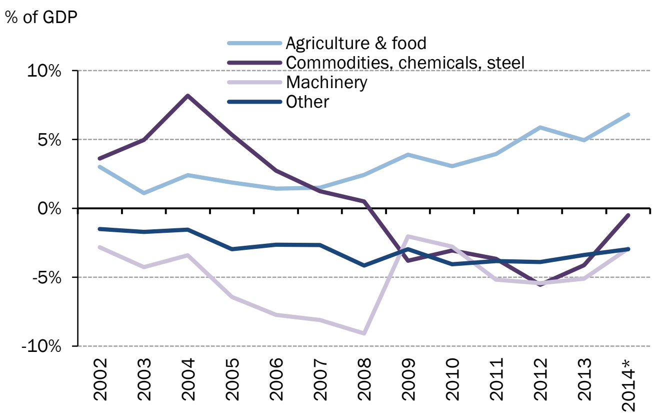
In addition, we have to confirm our previous statement that agriculture that has been the key driving force for the GDP growth, seems incapable to become a "pillow" for the GDP fall next year, even if grain harvest continues to increase.

21. Exports structure



Source: SSC, AYA calculations
* – 10m'14

22. Net exports structure



Source: SSC, AYA calculations
* – 10m'14

Expected further devaluation does not stop the decline of exports, but it nonetheless will negatively affect imports. Consequently, we expect that the C/A deficit will shrink to 1.7% of GDP comparing to the expected 4% for 2014. Regarding the natural gas import, we expect that the natural gas consumption will remain flat in 2015 (42.3 bcm), total imports will increase up to 22.8 bcm (compared with 19.5 bcm in 2014), and the average price will decline to USD 274 per kcm.

Public finances: delaying structural changes at the cost of macroeconomic instability

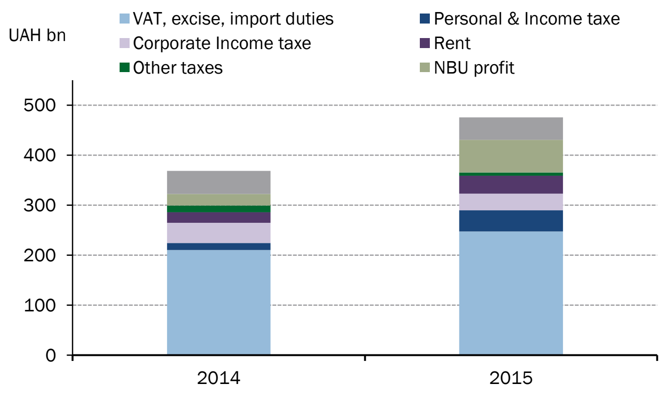
In 2014 the government share of Ukraine's economy rose above 50%, total budget deficit including quasi-government expenditures amounted to roughly 12% of GDP while the public debt to GDP ratio is expected to hit 70% in 1Q'2015. All this became possible not only due to the difficult conditions of 2014, but also because of the government's conscious choice to postpone structural changes in the public domain. The apogee of this decision was the adoption of risky budget for 2015, which in our opinion (even taking into account future adjustments) would lead to increased macrofinancial instability resulting in increased inflation and further devaluation.

Excerpts from scenarios	2014'E	2015'F Macrofinancial Instability	2015'F Big Bang
Budget balance, UAH bn (deficit)/surplus	(72)	(92)	(70)
Budget balance, % of GDP (deficit)/surplus	(4.9)	(4.8)	(3.8)

Source: AYA estimates and calculations

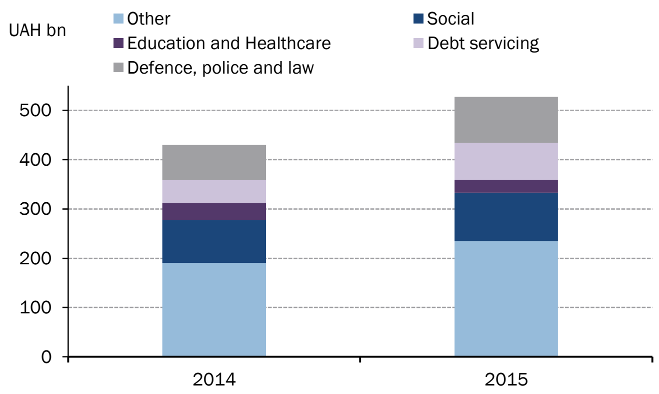
The epic late night adoption of State budget for 2015 on 29th of December, as well as the content of the budget plan, in our view, illustrates two points. Firstly, there was no strategy for comprehensive fundamental structural reforms developed within the last nine months. Secondly, there is no plan for a fiscal consolidation; instead, the government's solution to the crisis is a fiscal expansion. According to an adopted law, the Cabinet of Ministers of Ukraine expects to increase state budget revenue by 33% against the background of its own estimates of only 11% nominal GDP growth (the revenue of consolidated budget according to the plan should increase by 26%). Putting aside the plan for redistribution of personal income tax in favour of State budget and boosted proceeds from the NBU (from UAH 23 bn in 2014 to UAH 65.4), the government expects to increase tax collection by 27% relying on a series of tax hikes and expected de-shadowing of the economy. In addition, the plan includes a traditionally unfeasible plan for privatization, UAH 17 bn this time. All above leads to a conclusion that at least UAH 50 bn of planned budget receipts are at risk and will eventually add up to a budget deficit.

23. State budget revenues



Source: www.rada.gov.ua

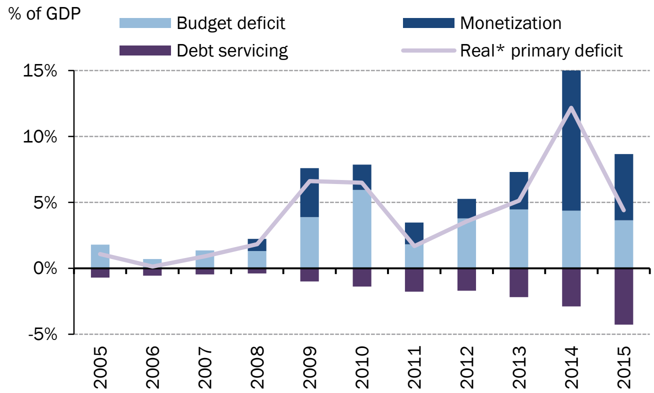
24. State budget expenditures



Source: www.rada.gov.ua

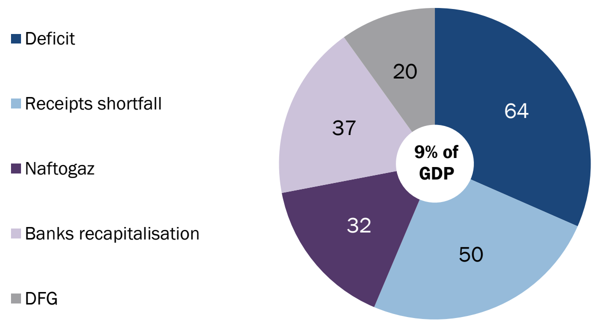
To make matters worse, the fiscal plan provides for at least UAH 88 bn of quasi-fiscal spending, which could be a conservative figure, because on January 23 the government already authorized the UAH 31.5 bn injection into Naftogaz capital (the total plan for 2015 is UAH 35 bn). The structure of total budget deficit presented in Fig. 26 amounts to UAH 202 bn (12% of government's estimated nominal GDP). Even if we exclude the shortfall in budget revenues, the fiscal gap is expected to reach 9% of GDP, which is much higher than 5.8% target previously outlined by IMF for 2015. Definitely, we expect that the government will have to revise spending downward to get a new IMF program, however even deep cuts from such high base may leave a fiscal gap too big to avoid money printing in 2015, which certainly will result in inflation acceleration.

25. Debt financing and primary deficit



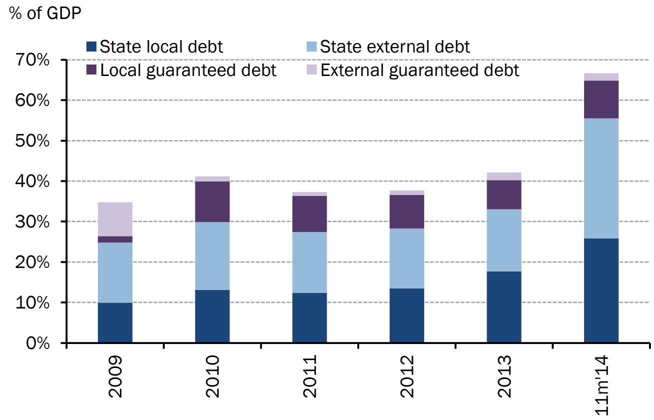
Source: MoF, NBU, AYA estimates and calculations
* – including quasi-government spending

26. Expected structure of total budget deficit for 2015, UAH bn



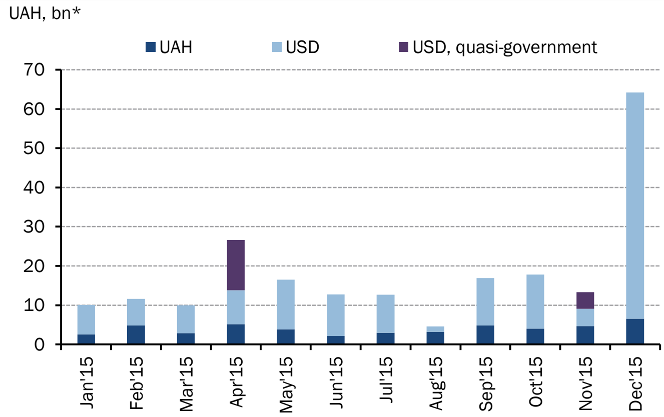
Source: www.rada.gov.ua, AYA estimates and calculations

27. Government debt



Source: MoF

28. Expected debt servicing and repayment schedule



Source: MoF, AYA estimates and calculations
* – based on government assumption of USD/UAH at 17

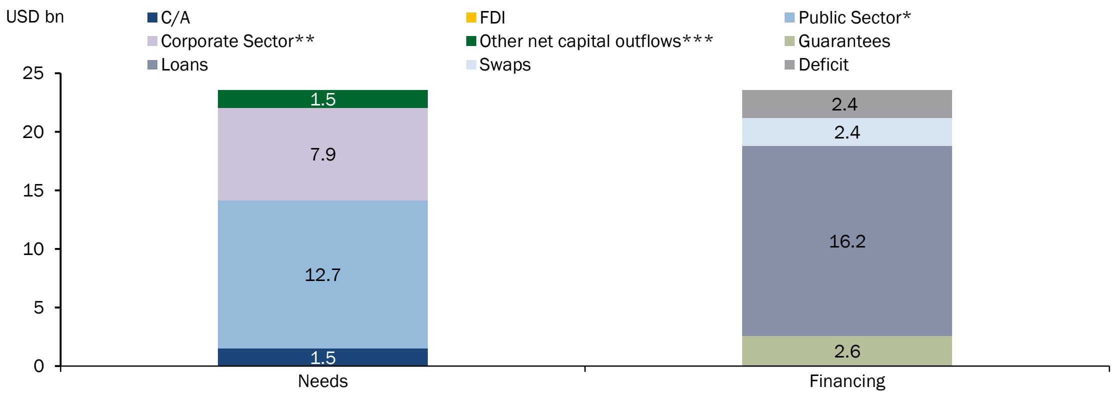
External funding gap: insufficient assistance, lack of confidence and no private investment flows

According to our baseline scenario, we expect that Ukraine's external funding gap in 2015 will remain unfilled by the Western allies and other donors. The size of the gap stands at manageable USD 2.9 bn and could be covered with remaining FX reserves. However, the lack of safety cushion will make the government vulnerable to even minor shocks and indefensible against the swings of market sentiment. Consequently, we expect further currency depreciation. We also expect that the National Bank will eventually be forced to abandon the practice of multiple currency regime, thus the official exchange rate will converge to the black market rate. On the contrary, in our best case scenario government will secure USD 30.5 bn of external funding (compared to USD 21.2 bn in the baseline scenario) which will be sufficient to stabilize expectations and facilitate net investment flow followed by currency appreciation. Such extreme outcomes raise the question of filling the external funding gap by a real game changer.

Excerpts from scenarios	2015'F Macrofinancial Instability	2015'F Big Bang
C/A balance, USD bn (deficit)/surplus	(1.5)	(6.2)
Net FDI	0	4.5
Financing needs	(23.6)	(17.9)
IMF, EU finding	13.7	21
Other funding	7.5	9.5
External funding gap, USD bn	(2.9)	12.6
NBU's international reserves, USD bn	4.6	17.2
USD/UAH rate, e-o-p	24	16

Source: AYA estimates and calculations

29. The structure of external financial needs and expected sources in our baseline scenario



Source: AYA estimates and calculations

* – Including payments of Ukreximbank, City of Kiev and Naftogaz deficit
** – Rollover rate at 80%
*** – Including purchases by households

Private domestic demand: inflation and uncertainty postpone recovery

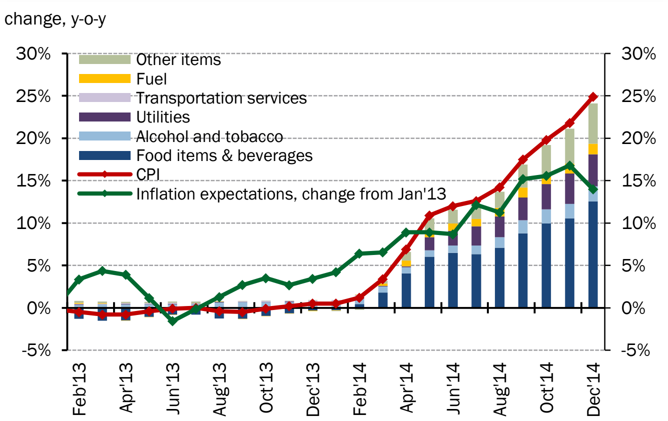
In a situation when the external sector is no longer capable of being a major driver of economic recovery (as in previous recessions) and the public sector has yet to undergo a deep restructuring, only a private domestic demand can act as a source of economic growth. The main prerequisite of such scenario is the issue of macrofinancial stabilisation, without which the weak business sentiment will withhold investments, while high inflation will consume households' disposable income and any savings-based consumption growth. Since our baseline scenario starts from preconditions of macrofinancial instability, we expect that in 2015 private domestic demand will deteriorate further, with real households' consumption acting as a main negative contributor to GDP growth.

Excerpts from scenarios	2014'E	2015'F Macrofinancial Instability	2015'F Big Bang
CPI, % (average)	12.9	28.0	19.0
Households consumption, %, real	(7.8)	(6.3)	1.7
Investments, %, real	(33.3)	(17.2)	4.0

Source: AYA estimates and calculations

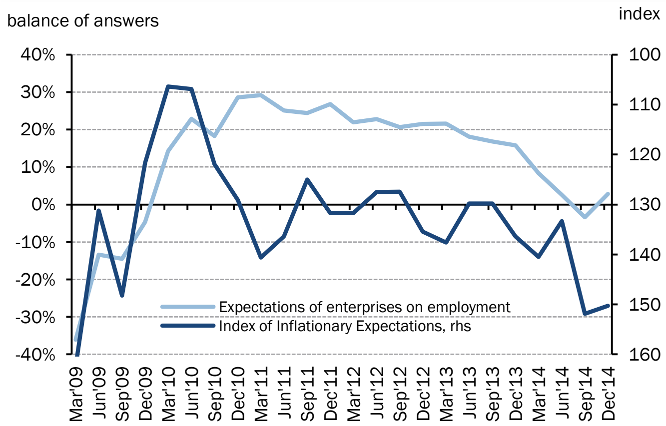
Due to a 50% devaluation (64% in the current black market exchange rate) and utility tariff hikes, consumer price index change reached 25% y-o-y in Dec'14. Given our expectations of further devaluation, the existing high level of inflation expectations (Fig. 31) and a new series of tariff hikes, we expect CPI growth to rise above the level of 30% and to remain above 20% by the end of the year. What is more, we use a very conservative scenario regarding retail natural gas prices where tariffs are supposed to be raised up to market level during the next three years. Our forecast is based on the old IMF program, which implies that gas and heating tariffs for end-users will be raised by 40% in 2015.

30. Contributions to CPI growth



Source: SSC, AYA calculations

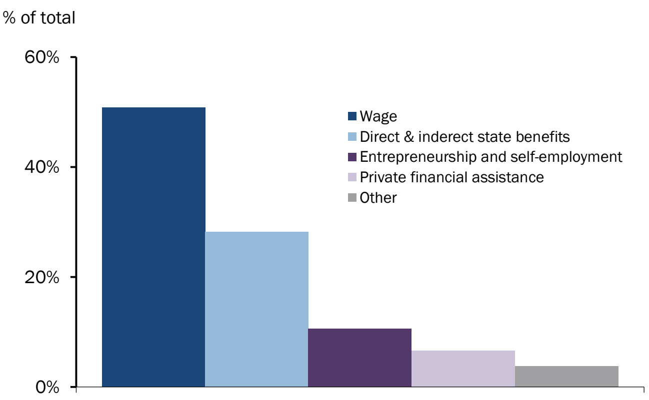
31. Employment and inflationary expectations



Source: GfK, NBU

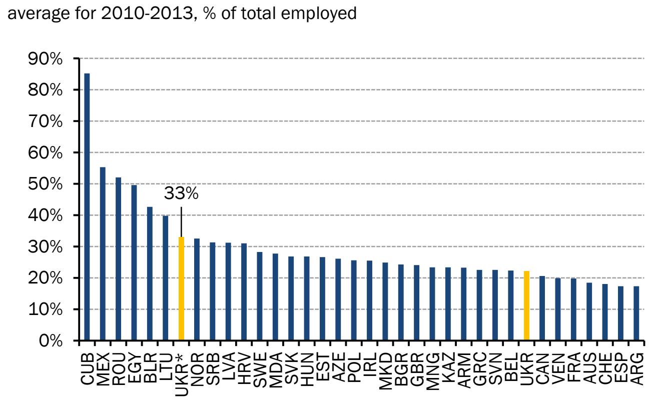
While high inflation will certainly dampen consumption though income effect, we do not expect a significant increase in unemployment due to a relatively small amount of layoffs in the public sector and rise of the share of shadow employment as a way to tax optimisation in the private sector. Additionally, the abstinence from austerity policy regarding pensions and salaries of public employees will have a limited but supportive impact on incomes and consequently on consumption. The latter is possible on the condition that at least one third of employees are employed in the public sector, thus the government provides at least 45% of consumer income. This enables us to expect that in case of a significantly lower inflation rate (as presumed in our alternative "Big Bang" scenario) there is a significant chance for a positive contribution of household consumption to GDP in 2015.

32. Sources of consumers income in 2013



Source: SSC

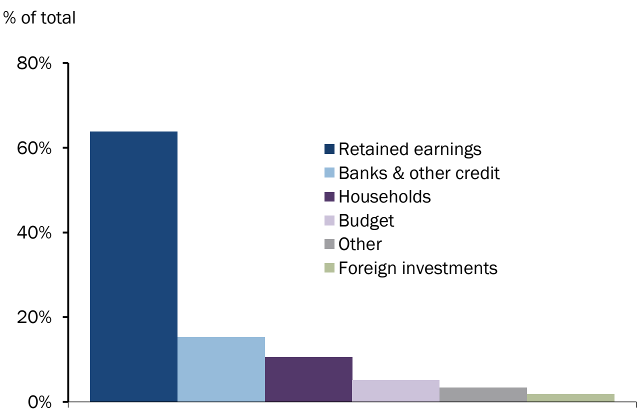
33. Employment in the public sector



Source: ILO, AYA calculations
* – including quasi-government employees in health care and education

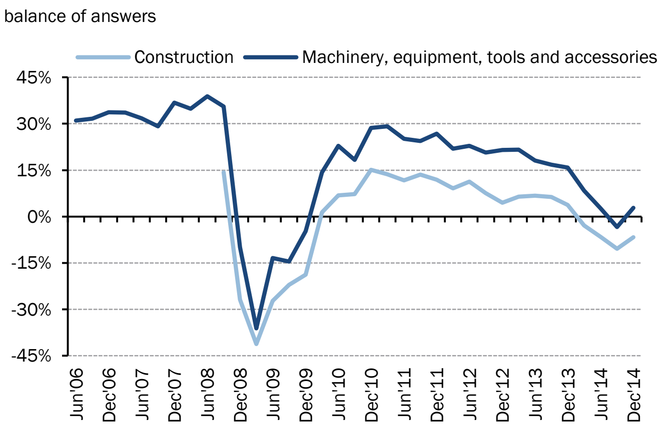
The same holds true regarding the prospects of investment-driven demand growth: restoration of macrofinancial stability (as presumed in our alternative "Big Bang" scenario) should lead to an increase in private sector investments and vice versa (as presumed in our baseline scenario). The positive outcome may become possible despite of problems in the banking sector because the main source of investment spending is retained earnings rather than bank loans and given that the expected need for investments in the next 12 months is much higher than in the previous recession.

34. Sources of investment financing in 2013



Source: SSC

35. Business expectations: the need of investment in the next 12 months



Source: NBU

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