STRATEGY

Macro Outlook 2012: 2Q Update

Clouds begin to grey

With political and economic risks running high in Ukraine, the current situation increasingly evokes a feeling of "dithering in the dark" for business communities. Deteriorating economic conditions abroad are taking a toll on the economy, which heavily relied on the support of domestic demand to pull growth in 1H'12. The risk of possible future domestic shocks that could derail growth (e.g., panic on FX market) is still considerable. What is more, upcoming elections add a political component to the risk spectrum. The stakes are high for all economic agents, as further external weakening, recession fears and political turmoil in 2H'12 could once again throw Ukraine off the track.

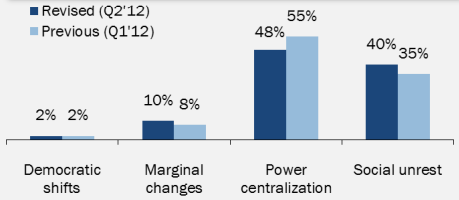
- On the political front, **the 'Power centralization' scenario remains our dominant view, yet risks of "Social unrest" increased**. The ruling elite have increasingly alienated the West by cautious defiance of domestic political issues, while international experts note a deterioration of democratic processes. As a result, probability of economic and political sanctions from abroad increased. Meanwhile, the opposition is trying to revitalize the "Orange revolution".
- **Economic outlook for 2H'12 remains weak.** In our base case, we expect the economy to "muddle through" with growth within the 2-3% range. Growth will remain supported by domestic demand with retail trade as the key driver of expansion. Albeit its pace will slacken. Industrial production will be subdued due to headwinds on global markets. However, an external shock would lead to a significantly lower economy's pace of 0.9% in 2012.
- **We maintain a bearish outlook on the external position and the FX**. Elevated C/A deficit and reduced net inflows on the F/A will put pressure on the BoP and FX reserves. Increased capital flight due to political uncertainty and considerations over the competitiveness of exports increase the chances of a managed devaluation without external funding.
- **Inflation data have surprised on the downside, but the outlook is still negative**. We expect an acceleration of the CPI in 2H'12 owing to loose fiscal policy and a pick-up in food prices. At the same time, the persistent slack in the economy will restrain inflationary pressures to keep the CPI at close to 5%.
- **Fiscal performance is set to deteriorate in 2H'12** due to "sticky" expenditure items, revenue underperformance and increased pre-election spending. However, with the recent placement of Eurobonds (USD 2 bn), sovereign borrowing needs remain substantial and are quite likely to be met by reliance on domestic sources only (in case of "no shocks" scenario). There are already signs of administrative pressure on customs authorities to ramp up tax receipts.

UKRAINE: Major indicators

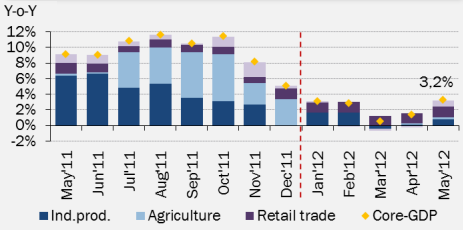
	2008	2009	2010	2011	2012'F 'No shocks'	2012'F 'Depressed growth'
GDP growth, %	2.3	(14.7)	4.2	5.2	2.8	0.9
Consumer Price Index, % e-o-p	22.3	12.3	9.1	4.6	5.1	7.0
Consolidated budget balance, % of GDP	(1.5)	(4.1)	(5.9)	(1.8)	(3.7)	(5.2)
Export of goods and services, USD bn	85.6	54.2	69.3	88.8	91.9	82.4
Import of goods and services, USD bn	100.0	56.3	73.1	98.4	101.7	89.9
FX rate, USD/UAH, e-o-p	7.70	7.99	7.94	8.0	8.1-8.3	8.6-9.0
BoP balance, USD bn	(3.1)	(13.7)	5.0	(2.5)	(4.1)	(9.4)
NBU's international reserves, USD bn	31.5	26.5	34.6	31.8	27.7	22.4

Sources: National Bank of Ukraine, State Statistics Committee, Ministry of Finance, Bloomberg, AYA estimates

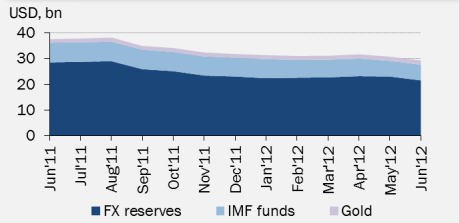
Perceived probabilities of political scenarios



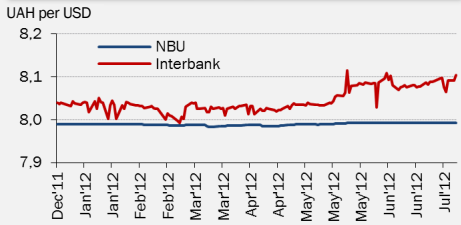
Growth remained expectedly on a weak trajectory in 1H'12, supported by domestic demand...



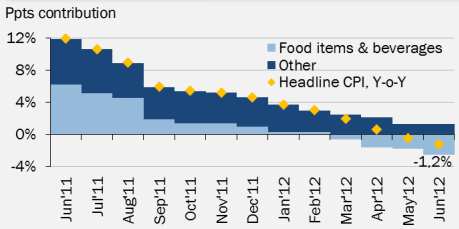
In the absence of sufficient capital inflows, the BoP deficit put pressure on FX reserves...



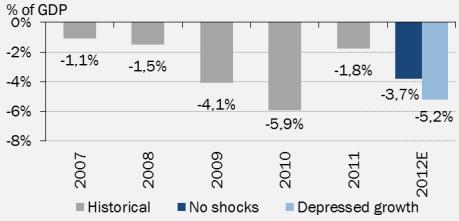
Meanwhile the UAH dynamics have confirmed our base case scenario for the exchange rate...



Falling food prices brought the CPI into deflation zone...



Fiscal performance is set to worsen this year...



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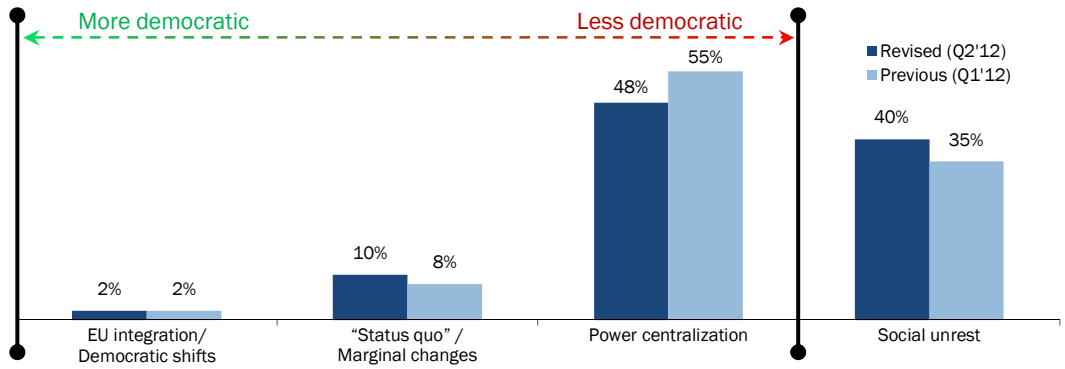
Politics: Definite Uncertainty

Ukraine's present moment in the global spotlight has come about not for all the good reasons. While national football players have nothing to be afraid of being booked twice with yellow cards on EURO-2012, Ukraine on itself may be "fouled out". The confrontation between Mr.Yanukovych Administration and the West intensifies, so we see pretty high probability of economic and political sanctions from the latter side. And even partial economic isolation will be very harmful for open Ukrainian economy with its 54% Export-to-GDP ratio. Notwithstanding this factor, internal political "variables" are also under stress with civil society being more active than it was a year ago and authorities preparing to use strong-arm policies in case of "Maidan" *déjà vu* scenario. Either with or without Mrs.Timoshenko, opposition will probably try to organize ripening social unrest. Overall, how much does such uncertainty cost? Probably a lot: no quick money from the IMF, sluggish FDI inflow, high yields on external borrowings, stagnation of banking sector with subdued consumers' confidence.

With news about rising internal uncertainty and appearance of early trigger for political tensions (due to "language question"), **we see higher chances of 'Social unrest' scenario (40% vs previous 35%)**. Meanwhile, latest increase in opposition's activity may pave the way for proactive self-preservation authorities' actions. If the latter will be more diplomatic ones, we expect more constructive dialogue between ruling force and the opposition - that corresponds to minor increase in "Marginal changes" scenario (10% vs previous 8%). Nevertheless, given dominating political observers' expectations, we put more odds in favor of tougher authorities' reaction, so **'Power centralization' scenario is still the major one**.

The probability of "Social unrest" scenario is rising



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

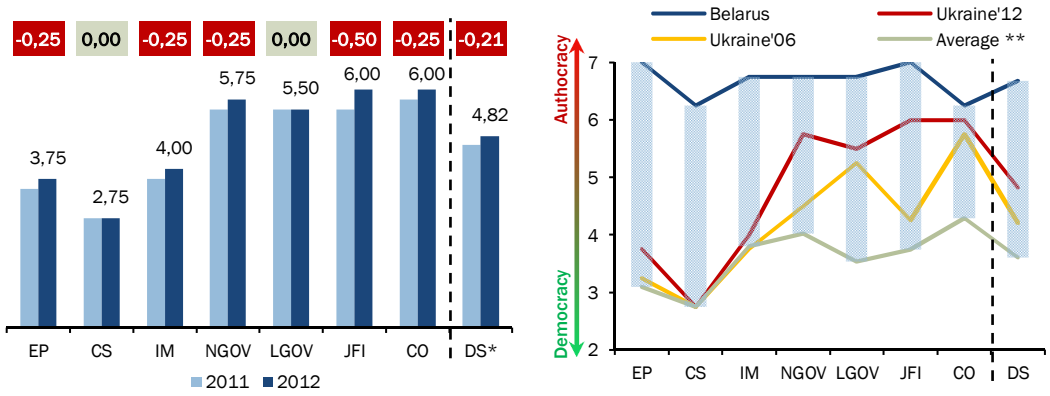
We see higher chances of 'Social unrest' scenario (40% vs previous 35%), though 'Power centralization' remains the major one

It looks like EURO-2012 championship has not helped much in improving Ukraine's image and investment climate in particular. **Fresh reports by Freedom House[1] demonstrate that country's progress in building national democratic governance still "nosedives"**: negative trends of 2011 continue, with Ukraine gradually sliding down to the group of "partly free countries" (see graphs below). International and local experts still focus on changes that are not friendly for investors: worsened transparency in reporting and growing corruption of government institutions; turning the judiciary into a pro-government tool with increased cases of selective prosecution; providing executive authorities with more extensive privileges and powers. Furthermore, foreign investors with assets in Ukraine are raising concerns of the so-called "familization"[2] processes.

[1] "Fragile Frontier: Democracy's Growing Vulnerability in Central and Southeastern Europe" (Jun'12), "Sounding the Alarm Round 2: Protecting Democracy in Ukraine" (Jul'12). Freedom House (USA) is one of the most powerful and proactive institutions for the promotion of democracy in the world.
[2] Foreign business communities especially underline providing abundant privileges to President- and his family-related businesses with consequent significant increase in their "market power". Notably, such elimination of "equal playing rules" precondition usually leads to distraction of foreign direct investments.

Such statements about structural problems in Ukraine appear from different levels more often than in Q1'12 – both from businessmen and top officials (from EU countries and international organizations in particular). **That undoubtedly leads to further destruction of the investment climate in Ukraine**. It is too costly both for private and government sector in the current environment, especially given Ukraine's status of a nation in transit (that could easily slip into the category of a country with a consolidated authoritarian regime in the eyes of foreigners).

Ukraine declines in 5 of 7 Freedom House's criteria in 2012 Y-o-Y, approaching closer to authoritarian level



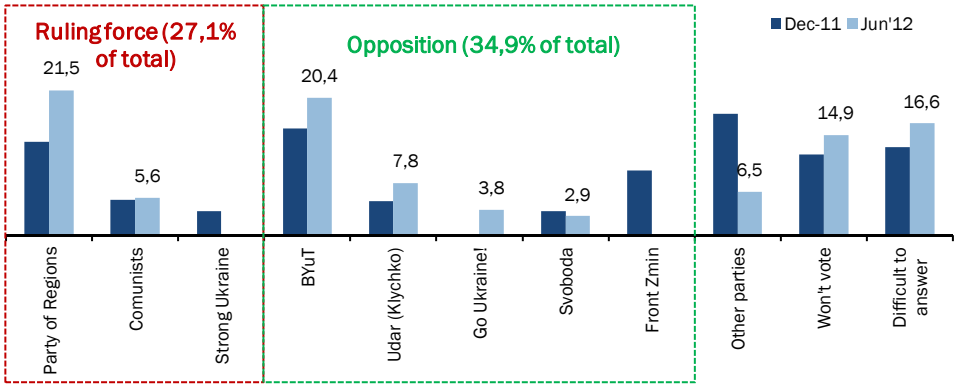
Source: Freedom House, AYA Capital calculations.
*Notes: * - Democracy Score (DS) is an average of ratings for Electoral Process (EP); Civil Society (CS); Independent Media (IM); National Democratic Governance (NGOV); Local Democratic Governance (LGOV); Judicial Framework and Independence (JFI); and Corruption (CO).*
*** - average for CEE and SEE countries (including Ukraine, Belarus and Moldova)*

Moreover, there are signs that the rhetoric-based battle between Mr. Yanukovych and the West could be transformed into more active phase soon. In late Jun'12 the PACE Monitoring Committee supported the recommendation[3] to abandon the idea of calling the upcoming election in Ukraine undemocratic and illegitimate if individual opposition members are not allowed to participate. But if the opposition loses and succeeds in convincing external observers that it did so as a result of authorities' falsification (given opposition's broadly higher ratings according to recent opinion polls), this will trigger a tougher reaction. Thus "fiercer" measures from the democratic world may be on the agenda soon. Many officials have already warned Ukrainian leaders that an attempt to "pinch" the election will ruin the government's relations with the West.

Rhetoric-based "battle" between Ukrainian authorities and the West may be transformed in a "sanctions-based" phase soon

[3] http://assembly.coe.int/CommitteeDocs/2012/amondoc13rev_2012.pdf

If parliamentary elections were to be held next Sunday, what political party would you vote for? (% of respondents)



Source: Razumkov Center's opinion polls

Of late months Ukrainian authorities like to hint at US having so much interest in Ukraine's resources that they may provide Ukrainian government with an exit from international isolation[4]. However, that is a bright example of "wishful thinking", that can be hazardous for the ruling force. First, it's not beneficial for Mr.Obama's hustings to be associated with support of unpopular politician from the Eastern Europe – so the former may condemn developments in Ukraine more actively. Next, recent 'novels' in legislation moving through the U.S. Congress focused on Russia would impose a visa ban and asset freeze against officials involved in gross human rights abuses. **That could, under the latest Senate version of the bill, also be applied to other countries, including Ukraine**: experts say support for such application is growing[5].

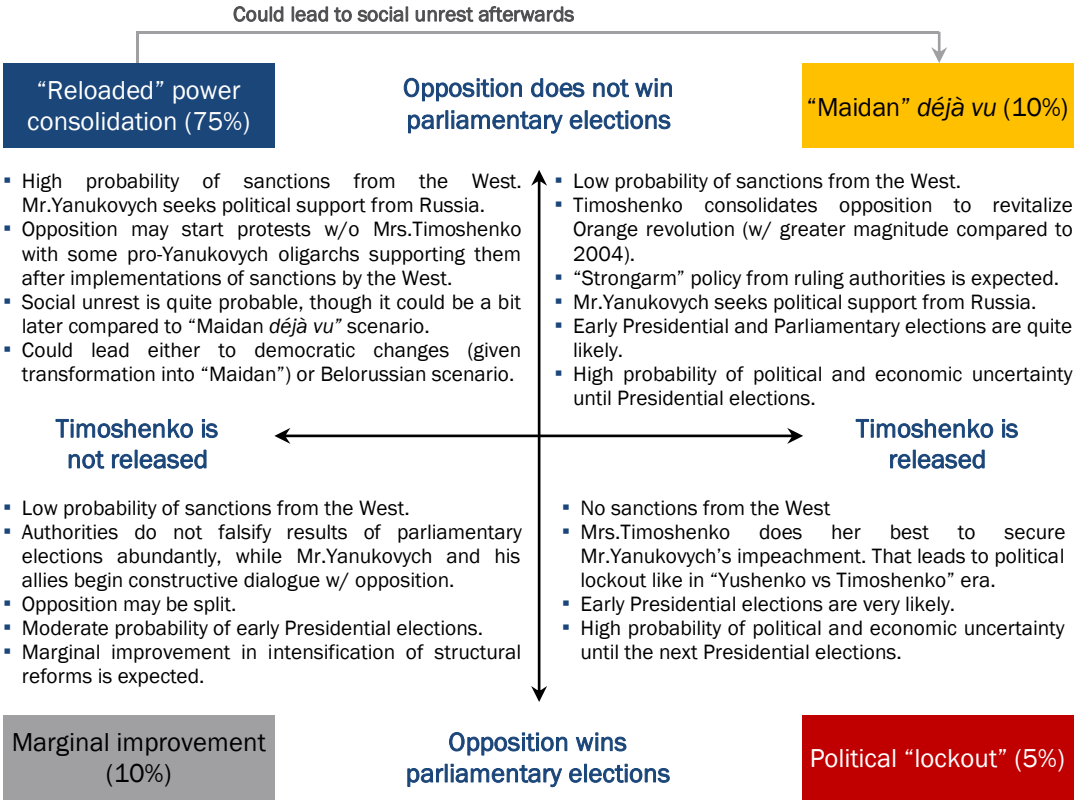
What are the consequences of possible Ukraine's isolation? First, **it will be superficial to expect any financial support from abroad**. Though not officially, IFOs' representatives said in 2011 that renewed cooperation was impossible while democratic norms were not met in Ukraine. Thus, governmental hopes for renewed IMF lending, once Ukraine fulfills its requirements by taking unpopular action after the elections, are unlikely to be true. Actually, even in case of implementation of required gas prices increases, the IMF will probably find other official reasons not to lend money in 2012 (e.g., saying to test public finances first by analyzing annual results of current year as 'condition precedent').

Governmental hopes for renewed IMF lending, once Ukraine fulfills its requirements by taking unpopular action after the elections, are unlikely to be true

[4] In May'12, two of the world's largest oil companies Royal Dutch Shell plc. and Chevron Corp obtained the right to develop Ukrainian shale gas fields Yuzivske and Oleske. In Sep'12 Exxon Mobil Corp and NJSC Naftogaz signed a preliminary agreement on the development of unconventional hydrocarbons in Ukraine.

[5] We reiterate our base case that the US will be more active regarding Ukraine after the former country's presidential election in Nov'12. Moreover, the White House will traditionally pay more attention to democratic processes in CIS countries if a Republican candidate wins there.

Medium-term political consequences (with assumed probabilities in brackets)



Source: AYA Capital estimations

Second, economic isolation may lead to significant changes in inner boundaries of ruling elite. The richest Ukrainians can be seriously hurt if things come to an open confrontation with Europe. Financial and legal leverage is likely to be employed like in Belorussian scenario. Action may be taken against the bank accounts of Ukrainian oligarchs and their companies, primarily those who are believed to be President-related. Inquiries may be conducted regarding specific purchases or the origin of money paid for real estate across the world. Next, bans may be placed on crossing a border. Of cause, there is an option for such "sufferers" to suddenly disappear abroad, but we doubt they will use this opportunity[6]. The other option is starting to collaborate with opposition – either by way of preceding speaking up for the opposition with the President (*"Marginal improvement" case on the scheme above*) or by way of unnoticeable funding of their protests and distancing themselves from the electoral campaign. We expect the latter decision could be the more probable one, given implemented restrictions on campaigning in SCM companies.

Some President-related oligarchs may start to collaborate with the opposition

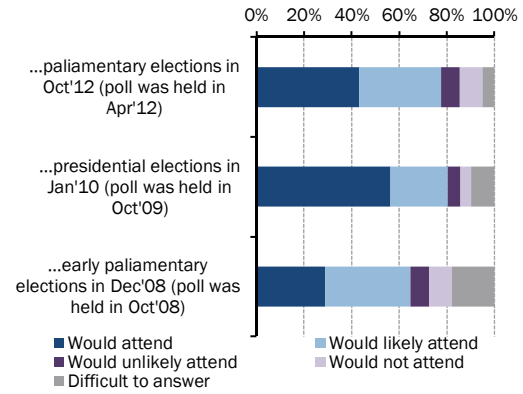
Notwithstanding possible external shocks like economic sanctions and isolation, we still suppose **Ukrainian authorities may be hurt from local tensions due to 'Social unrest' scenario.** Many political observers say civil society is more active now than it was a year ago (despite its "backwardness" in Ukraine). Having the election in Oct'12 provides fuel to that change because this is a specific event coming up, which citizens can focus on (especially given lack on significant news after EURO-2012 euphoria).

[6] In such scenario businessmen will not be able to keep track of their assets in Ukraine. Historical analysis says this may lead to semi-legal changes in assets' ownership, especially given solid track record of "raiding practices" in the country.

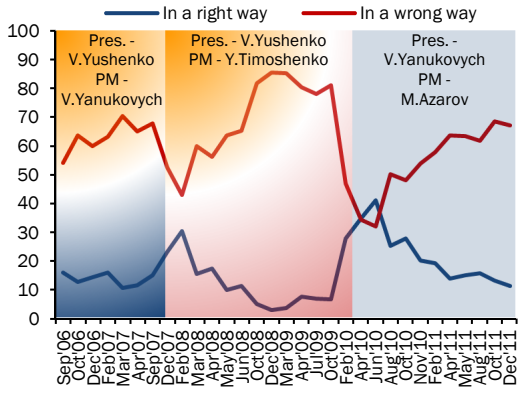
According to recent public opinion polls, more eligible voters are expected to visit parliamentary elections compared to their readiness at doing that on the eve of cancelled early 2008 elections. Next, from 2/3 to 3/4 of the population think that the country is moving in the wrong direction. Within such an environment it should be quite easy for the opposition to recharge "Maidan" scenario, though there are no such prominent popular leaders like in 2004.

Ukrainian authorities may be hurt from local tensions (e.g., recharged "Maidan" scenario)

Will you attend..?



Is the situation in Ukraine developing in a right or wrong way? (% of respondents)



Source: Razumkov Centre

Recent passing of the "language law"[7] have already triggered *de facto* parliamentary crisis that has some chances of exploding into a political one. Mr. Yanukovych has mentioned by himself the possibility of early parliamentary elections, while the opposition is proposing combined parliamentary and presidential ones[8]. We even saw a wave of protests and smashes between activists and police, which could be an 'alarm bell' of revitalizing "Orange revolution". Meanwhile, we do not rule out that the crisis has been started intentionally by authorities. Pro-presidential parties could be interested in a short campaign period. This may give a competitive advantage to the candidates in first-past-the-post constituencies already administered by the Party of Regions - unlike oppositional candidates who are not even determined yet.

Our expectation of unfolding "negative political feedback loop" are confirmed

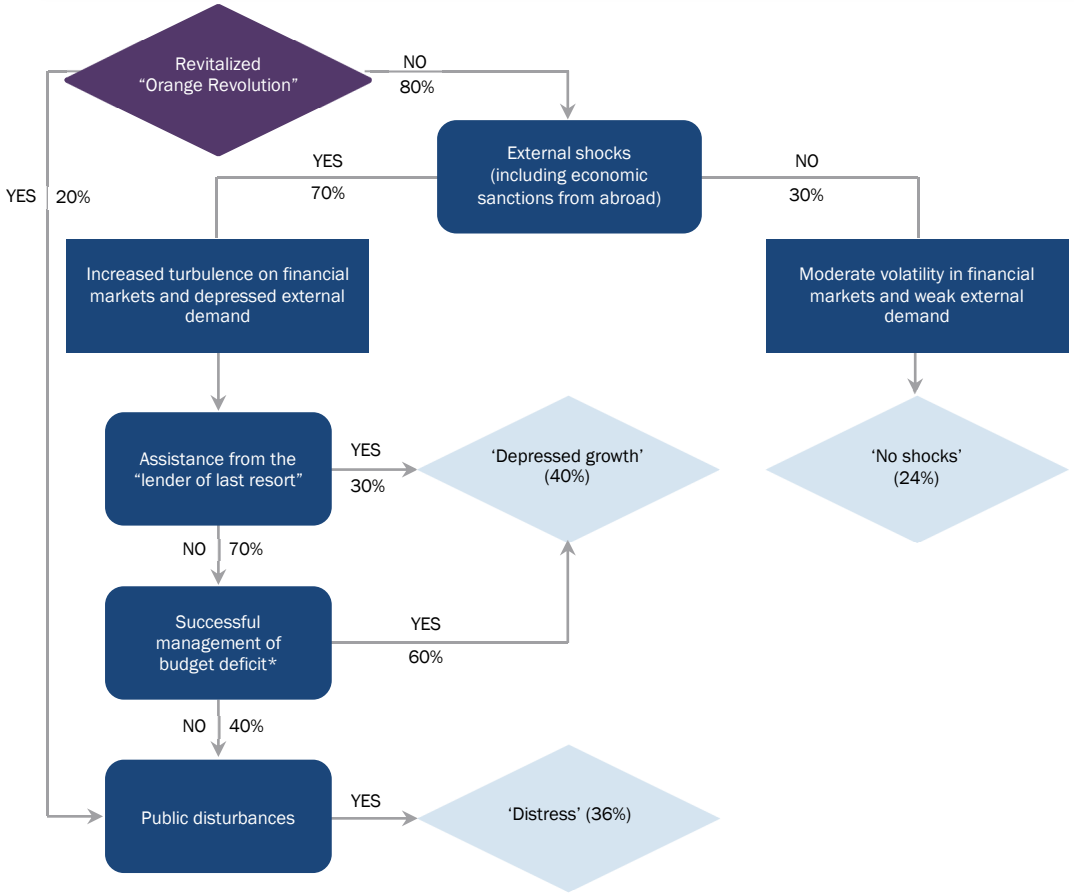
The last and the most intriguing question is: What do Mr. Yanukovych and his close allies intend to do? Currently political observers see both the increase in civil society activity and a number of oppositional organizations facing more pressure. Next, there are signs the President is trying to create his own security force[9]. Moreover, experts underline that the President is building a Russian model of government-society relations in Ukraine. That confirms our expectation of the action of "negative political feedback loop" (*described in the previous issue and a separate side-note*), with correspondent increase of power centralization pressure in different spheres. Without comprehensive changes in Ukraine's economy, there are a lot of fears such way will ultimately lead the country to a repeat of the Belarusian scenario. Furthermore, in case of toughening Western position Russia may stir up its "use and abuse" game with Mr.Yanukovych - providing one hand to pull Ukraine out of foreseeable financial "peat bog" or international isolation, but grasping valuable assets (namely, gas pipe) by the other. **In all circumstances like that, the medium-term future of the country becomes more uncertain with still increasing number of unknowns.**

[7] Verkhovna Rada of Ukraine passed the bill on the principles of the state language policy initiated by the Regions Party on 03-Jul'12. The document significantly expands the sphere of use of Russian and languages of other national minorities in the regions where they are used by at least 10% of population. One of the authors of the bill, V.Kolesnichenko, said that the Regions Party wanted to make Russian an official language in Ukraine through the Constitutional Assembly.
[8] http://www.utro.ua/ru/politika/yatsenyuk_obyavil_o_nachale_aktsii_ukraina_bez_yanukovicha_1341651455
[9] http://jurliga.ligazakon.ua/news/2012/6/11/65897.htm

The most probable consequences of current scenario analysis

Fiscal policy	High probability of exceeding the IMF's target for a general budget deficit due to high social spending (on the eve of elections) and no gas price increases. MinFin uses soft form of domestic "financial repression". The Government tries to keep the IMF financing as a first alternative option and Russia's support as a second one, though we doubt the former source will be available in 2012
Monetary policy	High probability of continuous strict policy to suppress excessive FX demand on the eve of parliamentary elections. NBU is likely to keep step to the IMF memorandum targets (to demonstrate at least partial compliance with the IMF's SBA program requirements), while helping MinFin to conduct à la "financial repression" with according regulatory 'novels'
FX policy	More chances of FX rate targeting until parliamentary elections (UAH pegged to USD). High probability of administratively controlled devaluation in 2H'12 exists. Given stagnating FX export proceeds and high volumes of free cash outside Ukrainian banking system, that could create a panic (with revitalized features of banking and economic crisis of 2008-2009)
Domestic capital markets	Low liquidity, lack of significant institutional reforms in the medium-term

Our economic scenarios for 2012



Notes: 1) * - we still expect that in case the government fails to procure financing from an external source, a freeze on certain expenditure items or an engagement of the NBU through debt monetization could provide temporary relief to the budget. When compared with our Dec'11 analysis, we feel ourselves more humble with respect to the effectiveness of such measures (as long as the government has succeeded in c.9% cut of planned 2011 expenditures). However, in our view, debt monetization is still likely to result in higher inflation (see section on Inflation of this report) and devaluation of the local currency in the medium term, which could facilitate public disturbances coupled with political factors.
2) Figures in brackets represent implied probabilities of occurrence.

	2012 'No shocks' scenario	2012 'Depressed growth' scenario	2012 'Distress' scenario
Real GDP growth, %	2.8	0.9	n/f
Nominal GDP, UAH bn	1433.2	1431.9	n/f
USD/UAH rate, e-o-p	8.1-8.3	8.6-9.0	n/f
Current account balance, USD bn (deficit)/surplus	(9.3)	(6.5)	n/f
Current account balance, % of GDP (deficit)/surplus	(5.3)	(3.9)	n/f
Overall BoP, USD bn (deficit)/surplus	(4.1)	(9.4)	n/f
CPI, % e-o-p	5.1	7.0	n/f
Consolidated budget balance, UAH bn (deficit)/surplus	(53.5)	(74.3)	n/f
Consolidated budget balance, % of GDP (deficit)/surplus	(3.7)	(5.2)	n/f

Bull factors

- Boost to domestic demand from the EURO-2012 finals.
- Loose fiscal policy in the run-up to parliamentary election.
- Robust retail trade buoyed by rising purchasing power of incomes

Bear factors

- Unfavorable commodity market dynamics (drop in prices of base metals).
- Downbeat forecast for agriculture exports.
- Reduced external demand on the back of slowing global growth, turbulence on the financial markets, trade wars with Russia.
- Reduced credit availability and higher funding costs.
- Tight domestic credit market conditions.

Source: AYA estimates
Note: n/f/ - no forecast

Ukraine's economy: Bailed out by domestic demand

As we anticipated, Ukraine's economy stepped on a weak growth trajectory in 1H'12, owing mostly to the deteriorating external backdrop. To date, growth has been primarily driven by internal activity, particularly, in retail and wholesale trade. Meanwhile, external developments have been the principal growth-depressants with declining base metals prices, and sluggish demand from key trading partners contributing most to the slowdown. Ukraine's economic outlook will continue to be determined by robust, albeit diminishing, domestic and soft external demand. We maintain that domestic drivers are unlikely to make up for the downshift in exports, thus leading to subdued annual growth in 2012. In our view risks are still tilted to the downside, while we incorporate an additional political threat to the growth perspective, as discussed in the *Politics* section.

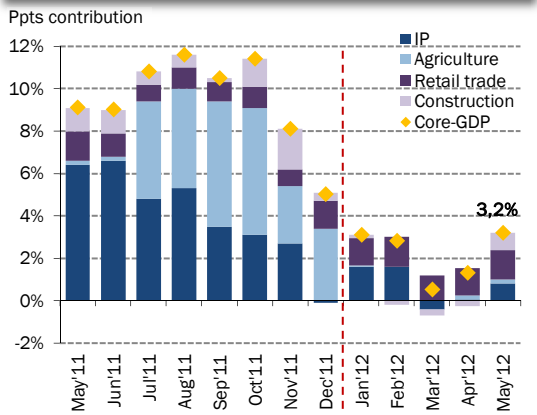
Excerpts from scenarios	'No shocks' scenario	'Depressed growth' scenario
Real GDP growth, %	2.8	0.9
Nominal GDP, UAH bn	1433.2	1431.9

Source: AYA estimates and calculations

Ukraine's economic performance in 1H'12 was expectedly soft – GDP slowed from 4.7% y-o-y in 4Q'11 to 1.8% y-o-y in 1Q'12, as external headwinds pushed growth lower. To a large extent the slowdown was driven by faltering industrial production, particularly in the manufacturing industries which have strong orientation towards exports markets. Sluggish demand from key trading partners and depressed world steel prices (LME billet prices slumped 27% YTD[10]) weighed most on the backbone of the economy. Metallurgy production continued to contract in 1H'12, marking 7 months of consecutive negative growth in May'12. Other industries have fared better, yet the growth rates are mostly on a downward trajectory. Overall, industrial output dropped 1.4% Y-o-Y in Jun'12, and the outlook remains unfavorable due to persistent economic weaknesses abroad.

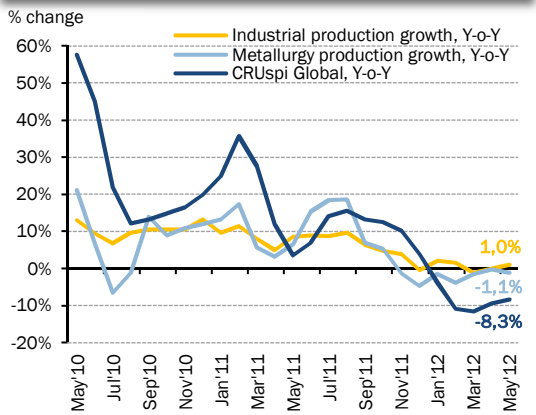
GDP growth remained soft in 1H'12, induced by sluggish external demand

NBU's core-GDP[11] data confirm lower growth trajectory supported by internally-focused industries...



Source: SSC, NBU
Note: Core-GDP figures are presented as Y-o-Y % change
IP – Industrial production

...as mostly export-driven industrial production slackened on external weaknesses



Source: SSC, NBU, AYA calculations
Note: CRUspi – index of world steel prices

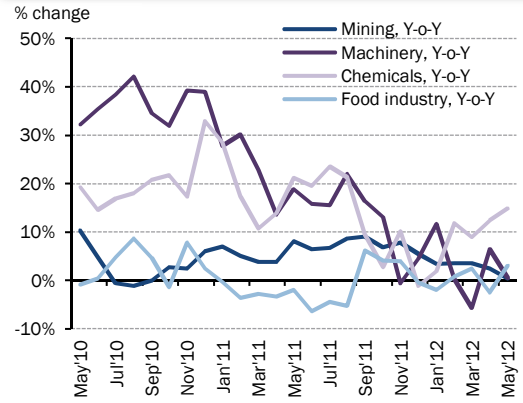
While the export-oriented production faltered, domestic demand kept growth alive. As expected, activity in the retail and wholesale trade has been the chief driver of economic expansion in 1H'12. Steadily declining inflation has boosted the purchasing power of incomes and underpinned strong domestic demand. Election-related fiscal handouts by the government have also boosted private consumption.

Meanwhile, domestic demand drove economic expansion

[10] as of 18.07.2012
[11] **Core-GDP'** is an aggregated index (of production in basic industries) developed by the National Bank of Ukraine to track output performance of the economy's key industries: agriculture, manufacturing, mining, trade and construction

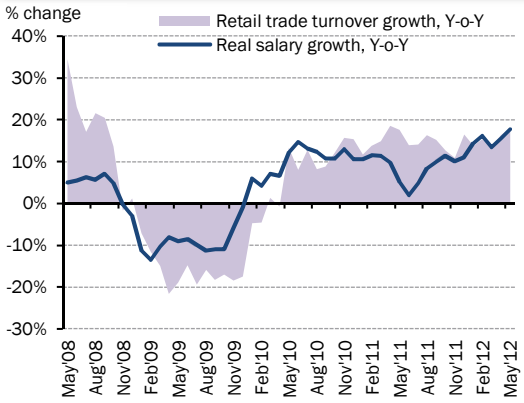
As a result, retail trade turnover continued to expand in double-digits in real terms, growing by 15.5% in Jan'12-May'12 compared to the same period in 2011. Yet, we expect the momentum to slow in the second half of the year, as the stimulating effects from fiscal boost fade, inflation re-accelerates and devaluation fears reignite. Meanwhile, we expect that political and economic factors[12] are likely to further induce households to defer current consumption in 2H'12.

Other manufacturing industries also demonstrated a decelerating pace of growth



Source: SSC, AYA calculations

Retail sales held up well, buoyed by a boost to real incomes from declining inflation rates

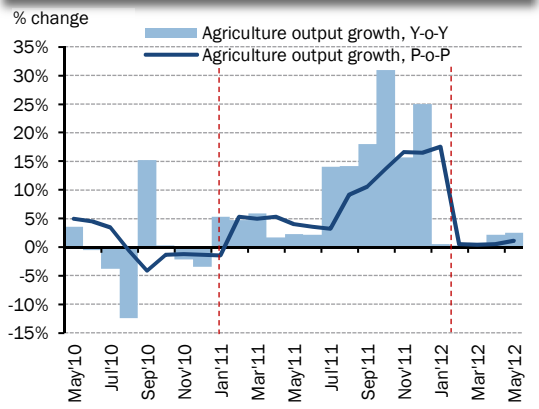


Source: NBU, SSC, AYA calculations

The contribution of agriculture and construction sectors has also been expectedly limited in 1H'12, despite a recent pick-up in activity. The cold spell at the beginning of the year and last year's high base effects will constrain the impact and growth of agriculture output in 2012. Meanwhile, construction has declined and is likely to remain subdued due to the completion of Euro-2012 infrastructure projects and the pre-election expenditure trade-offs.

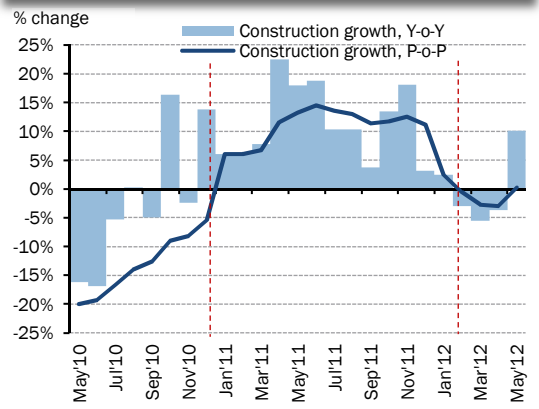
Activity in agriculture and construction sectors was expectedly slow

Agriculture output remained weak in 1H'12 due to unfavorable weather conditions and high base effects



Source: SSC, NBU, AYA calculations

The construction sector also underperformed owing to the completion of major infrastructure projects



Source: SSC, NBU, AYA calculations

At this point, we remain cautious about the outlook for the economy as risks to growth are still weighted to the downside. In our view, the main threats stem from: 1) adverse external shock, which could trigger a global recession affecting Ukraine through trade (collapsed exports, C/A widening) and financial linkages (BoP and FX pressures); 2) domestic political risks and possible sanctions from abroad (elaborated in the *Politics* section). Should such risks materialize, we expect an unfolding of the 'depressed growth' scenario or even a 'distress' outcome. Otherwise, we anticipate Ukraine's economy to "muddle through" in the remainder of 2012, supported by domestic demand with growth within 2%-3% range.

Looking ahead, the main risks to growth are: 1) adverse external shock; 2) political uncertainty

[12] As parliamentary elections approach, uncertainty over their outcome will likely weigh increasingly on consumer sentiment, prompting a shift into "savings mode". Such uncertainty is to a large extent fueled by the widespread skepticism regarding the fair outcome of the vote and will be compounded by fears of a 2008 repeat generated by external 'crisis headlines'.

External balance and FX: Managed devaluation underway

Our views on the outlook for Ukraine's external position and FX remain unchanged – risks are tilted to the downside. While the C/A deficit narrowed in 1H'12, the 'stickiness' of gas prices and a bearish outlook on steel market conditions are likely to keep it elevated in 2H'12. At the same time, reliance on FDIs (mostly offshore local funds) and short-term debt capital to finance the C/A only highlight the vulnerability of the external position. While hryvnia stability may be the government's best policy ahead of the election, increased capital flight due to political uncertainty and competitiveness considerations could pave the way for managed devaluation. Thus far, the exchange rate dynamics appear to confirm our bearish views on the local currency, with hryvnia depreciating against the USD by 1.2% YTD.

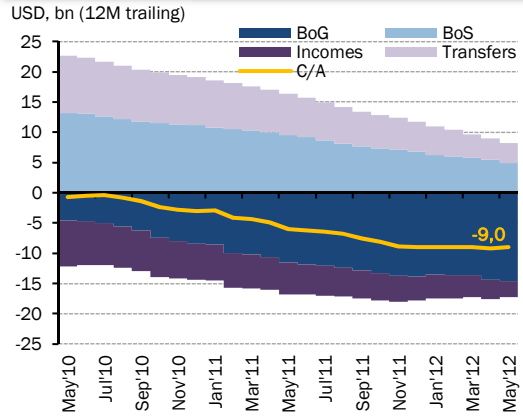
Excerpts from scenarios	'No shocks' scenario'12	'Depressed growth' scenario'12
USD/UAH rate, e-o-p	8.1-8.3	8.6-8.9
Current account balance, USD bn (deficit)/surplus	(9.3)	(6.5)
Current account balance, % of GDP (deficit)/surplus	(5.3)	(3.9)
Overall BoP, USD bn (deficit)/surplus	(4.1)	(9.4)

Source: AYA estimates and calculations

Fundamentally, Ukraine's external position remains weak. The current account deficit improved in 1H'12 but remains elevated at 5.2% of GDP (USD 9.0 bn) in May'12. The improvement stemmed mostly from lower volumes of natural gas imports which fell by 19.9% in 5M'12 (real volumes declined by close to 50%, while prices increased by 54.6%). Meanwhile, the strong exports of agri-products (grain), machinery, and fertilizers have offset the fall in metallurgy exports, keeping the overall C/A largely flat.

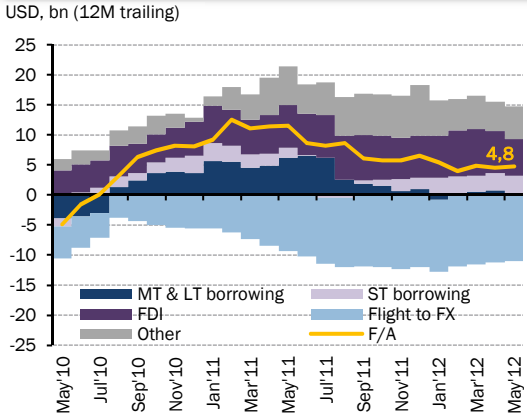
Ukraine's external position is fundamentally weak, with C/A deficit running flat at 5.2% of GDP

C/A deficit stabilized in 1H'12, yet remains elevated at 5.2% of GDP ...



Source: NBU, AYA calculations
Note: BoG – Balance of goods, BoS – Balance of services

...and is financed by repatriated offshore funds and short-term borrowing (F/A balance is shown)



Source: NBU, AYA calculations
Note: F/A – financial account, including capital account

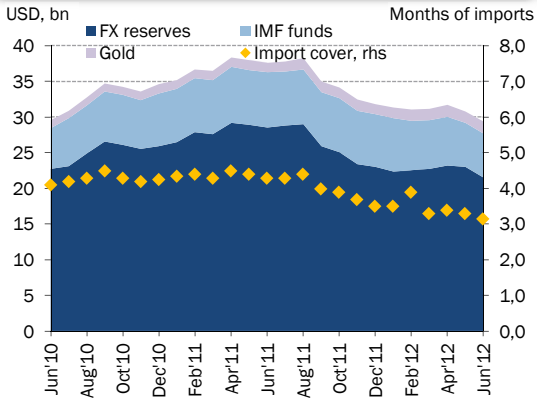
Over the previous 12 months, the deficit on the C/A continued to be financed to a large extent by repatriated offshore funds in the form of FDIs and external debt borrowings. Notably, borrowing in the form of loans and bonds has rebalanced by maturity with short-term flows prevailing in the last 9 months as risk aversion on international capital markets remains high. While collectively these flows were sufficient to finance the C/A deficit, continued flight to hard currency (USD 11.1 bn) remains a major source of pressure on the BoP. As the IMF programme is put on hold, the NBU was forced to finance the residual, leading to a depletion of reserves by USD 7.2 bn (-19%) in 12 months, down to USD 30.8 bn in May'12.

The C/A deficit is financed by repatriated offshore funds and short-term borrowing

Meanwhile, the UAH dynamics have already confirmed our bearish views on the local currency. The hryvnia depreciated against the US dollar by 1.23% YTD (as of 10.07.12), currently trading on the interbank market at the lower bound of our forecasted range (UAH 8.1- UAH 8.3) for the year-end.

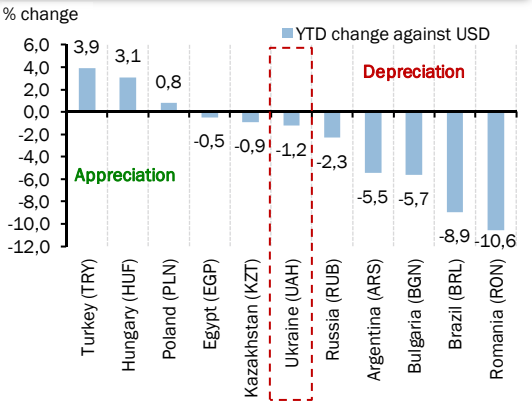
Meanwhile, the hryvnia already depreciated by 1.2% YTD against the USD

The NBU was forced to repeatedly finance the BoP deficits, leading to the depletion of reserves…



Source: NBU, AYA calculations

The NBU has allowed more flexibility to the peg, which led to a mild depreciation of the hryvnia



Source: Bloomberg (as of 10.07.12), AYA calculations

We maintain a bearish outlook on Ukraine's external position and the UAH for the remainder of 2012. Firstly, we do not expect a significant improvement in the C/A deficit due to the "sticky" prices of natural gas imports. Although the government announced cuts in the volumes of gas imports (allegedly in violation of the gas contract with Russia), flat metals exports are unlikely to improve the core-commodity trade position on the whole. Secondly, the persistence of EZ crisis and political risks in Ukraine restrict access to affordable external borrowing on market terms in 2H'12. Finally, the upcoming parliamentary elections and the widespread uncertainty among the broader public over the outcome are likely to trigger intensified domestic capital flight, which coupled with crisis headlines should further strain Ukraine's external position.

Further managed devaluation is still in the pipeline owing to capital flight, reduced external borrowing, and still high C/A gap

For now, hryvnia stability remains the government's best policy in light of the election. Yet weakened fundamentals, increased political uncertainty and possible competitiveness considerations could induce the authorities to allow some flexibility in the exchange rate. While offshore funds to finance the election campaign could buy time, we believe further managed devaluation is in the pipeline without external assistance. Most likely, such course of action will materialize after the elections in Oct'12.

Balance of payments scenarios

	2011		No shocks		Depressed growth	
	USD, bn	*% of GDP*	*USD, bn*	*% of GDP*	*USD, bn*	*% of GDP*
Merchandise balance	(13.8)	(8.4)	(14.2)	(8.1)	(10.8)	(6.5)
Services balance	4.2	2.6	4.4	2.5	3.3	2.0
Income balance	(3.7)	(2.3)	(3.3)	(1.9)	(2.5)	(1.5)
Transfers	3.6	2.2	3.9	2.2	3.5	2.1
Current account balance	**(9.7)**	**(5.9)**	**(9.3)**	**(5.3)**	**(6.5)**	**(3.9)**
Capital account	0.09	0.1	0.2	0.1	0.1	0.05
FDIs	6.6	4.0	5.6	3.2	5.0	3.0
Portfolio investment	0.7	0.5	0.2	0.1	(0.2)	(0.1)
Loans and bonds	2.2	1.3	2.4	1.0	1.8	1.0
Other capital	(2.3)	(1.5)	(3.2)	(1.8)	(9.6)	(5.7)
Financial & capital account balance	**7.3**	**4.4**	**5.2**	**2.9**	**(2.9)**	**(1.7)**
Overall balance	**(2.5)**	**(1.5)**	**(4.1)**	**(2.4)**	**(9.4)**	**(5.6)**

Source: AYA estimates and calculations
Note: certain figures may not add up due to rounding

Inflation: Underestimated outperformance

We have updated our inflation forecast with a downward revision of the CPI figure to 5.1% for the year-end. The persistence of slack in the economy and the carry-over impact of last year's bumper harvest continued to put downward pressure on the general price level in 1H'12. While the recent trajectory has surprised on the downside, we continue to believe a pickup is on the way with risks still mainly on the supply-side. We expect food prices to rise in the 2H'12, induced by low base effects and poorer harvest season in 2012. Election-induced government spending should also contibute to upward pressures, while currency weakness remains a likely risk. However, inflation trajectory is likely to be restrained by the soft growth outlook and falling commodity prices.

Excerpts from scenarios	2012 'No shocks' scenario	2012 'Depressed growth' scenario
CPI, % (e-o-p)	5.1%	7.0%
PPI, % (e-o-p)	8.3%	10.2%

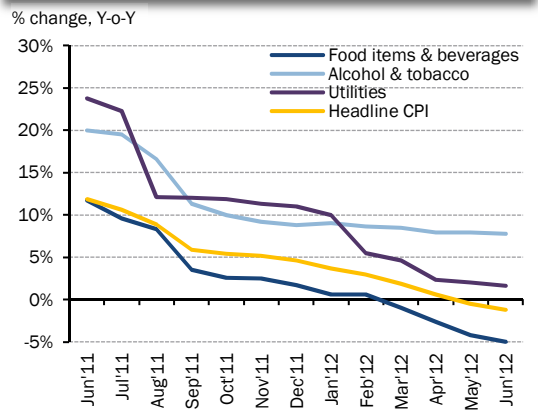
Source: AYA estimates and calculations

We have drastically cut the CPI forecast for the year-end to 5.1% from the previously anticipated 9.0%. It appears we have underestimated the duration of the carry-over effects of last years' bumper harvest and the persistence of the output gap. Collectively, these factors resulted in continued decline of the CPI y-o-y in 1H'12, ending the period with a negligible 0.1% YTD growth. In fact, the CPI has been on a downward trend for the trailing 13 months entering the deflation territory in May'12. The deceleration of CPI has been led by a broad-based decline in prices of its major components, particularly food products and administratively-controlled items.

The CPI continued to decelerate in 1H'12 led primarily by food products and administratively –controlled items

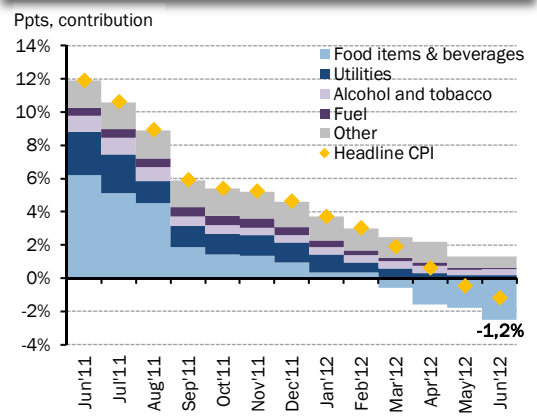
The CPI's steady decline into the negative territory is primarily due to the longer- and steeper-than-expected disinflationary path of food prices. The bumper harvest of 2011 has had a lasting impact on food prices as storage facilities have been improved, allowing for longer preservation of harvested produce. This translated into steadily declining food prices throughout the previous 12 months, and even during the off-season winter period.

CPI has been on a downward trajectory for 13 months in Jun'12, entering the deflation zone in May'12...



Source: SSC, AYA calculations

... as decelerating food prices contributed most to the declining rate of change of the price index



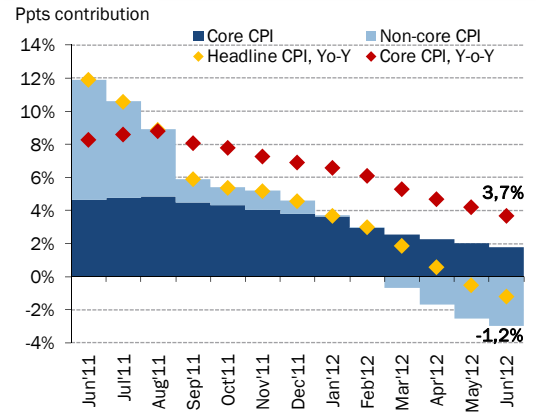
Source: SSC, AYA estimates and calculations

The downward inflationary path has also been abetted by administrative forbearance, as authorities resisted calls by the IMF to hike utility tariffs. Meanwhile, concerns about global economic prospects outweighed political risks in the Middle East, leading to a decline in oil prices, which further eased pressure on the CPI.

Administrative forbearance also contributed to the deceleration of the CPI

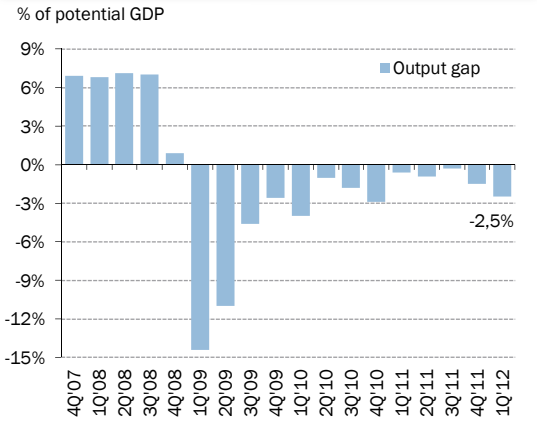
Most strikingly, however, core inflation has also followed the downward trajectory which points to the persistent presence of a negative output gap. In fact, according to the NBU's recent estimates the output gap stood at -2.5% in 1Q'12.

Strikingly, the core CPI dynamics have also followed a downward path…



Source: SSC, AYA calculations
Note: Core and headline CPI figures are presented as Y-o-Y change

… as persistent output gap kept demand pressures low

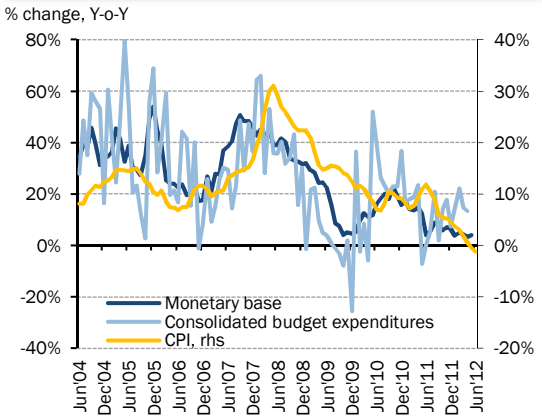


Source: SSC, AYA calculations
Note: Output gap estimates are provided by the NBU and expressed as % of potential GDP

Core-CPI has also decelerated owing to the presence of a negative output gap and restrictive stance of the NBU

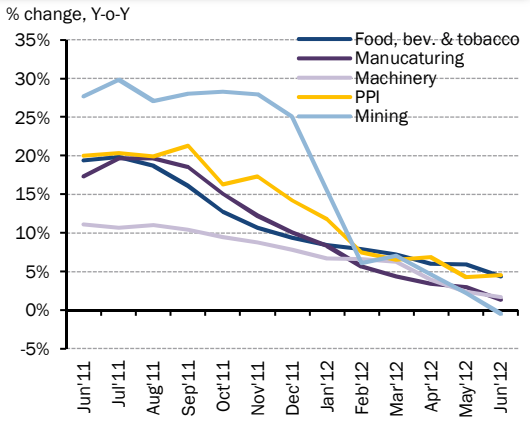
At the same time, the NBU's restrictive monetary position also contributed to the decline in the core and headline CPI. Low growth rates of monetary base kept a lid on the monetary-induced pick-up in demand. Meanwhile, consistently slowing growth of producer prices appears to lend further credibility to our view on the presence of a negative output gap.

Tight monetary position of the NBU restrained the growth of money supply, thereby limiting demand



Source: SSC, NBU, AYA calculations

Slowing producer prices is a further testament to the presence of slack in the economy



Source: SSC, AYA calculations

Given our soft growth outlook and the likely persistence of slack in the economy, we expect moderate inflationary pressures in the 2H'12. In our view, the upward pressure on the general price level should arise mainly on the supply side due to a pick-up in food prices. Furthermore, we anticipate the recent election-related increase in budget expenditures to feed through into higher prices in 3-4 months. Meanwhile, low base effects of 2011 should also contribute to the expected rise, and local currency weakness is an additional risk factor, particularly under our "depressed growth" scenario.

We expect an acceleration of the CPI in 2H'12 owing to loose fiscal policy and a pick-up in food prices

Public finances: Funding quest 2H'12

Ukraine's fiscal performance is set for a slippage this year. The government has already ramped up social expenditures as the political cycle is in full swing ahead of the elections. Meanwhile, certain revenue collections have been rather robust in spite of the weaker growth environment, which in our view is suggestive of increased administrative pressure. Thus far, the government has relied mostly on domestic funding due to a lack of affordable access to external markets and a freeze on the IMF programme. Costly Eurobond placement in Jul'12 has also provided temporary relief. Yet there are significant upcoming redemptions both in 2012 and 2013. Thus, we expect the government to continue attracting internal funding (mostly through financial repression of local banks and NBU-subsidized funding), while searching for the irreplaceable external support. Nonetheless, we believe domestic political processes will undermine any renewal of cooperation with the IMF this year.

Excerpts from scenarios	2012 'No shocks' scenario	2012 'Depressed growth' scenario
Budget balance, UAH bn (deficit)/surplus	(53.5)	(74.3)
Budget balance, % of GDP (deficit)/surplus	(3.7)	(5.2)

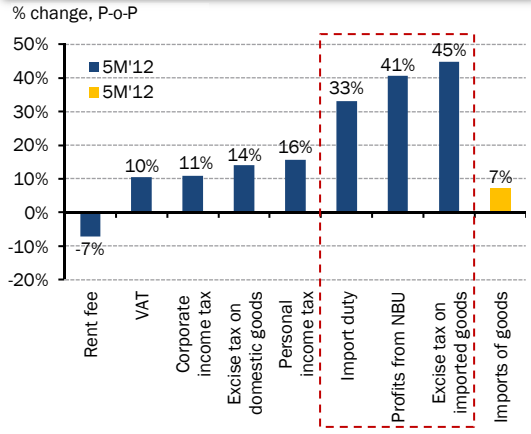
Source: AYA estimates and calculations

The President's 'social initiatives' are gaining pace as the parliamentary election approaches. The state-owned bank is repaying deposits of the USSR State Savings Bank, the subsidized mortgage program was launched (yet remains largely unused) and pensions were increased. Meanwhile, these additional expenditures have not derailed Ukraine's fiscal performance with the budget deficit close to 1.4% of GDP in May'12.

While large tax revenue items have grown largely in line with nominal GDP growth (~11%-12%), certain items have displayed unusually high growth rates. Interestingly, collections related to imports increased at the fastest pace in the 5M'12 (30%-45%). These figures are particularly striking given that imports of goods only increased by 7.3% over the same period, while no new revisions to the tax base or rates have been implemented. Such dynamics, in our view, are illustrative of the increased administrative pressure on the customs and tax authorities to ramp up tax receipts and de-shadow certain activity that has bypassed the authorities earlier. The data also offer important insights into the fiscal course in 2012.

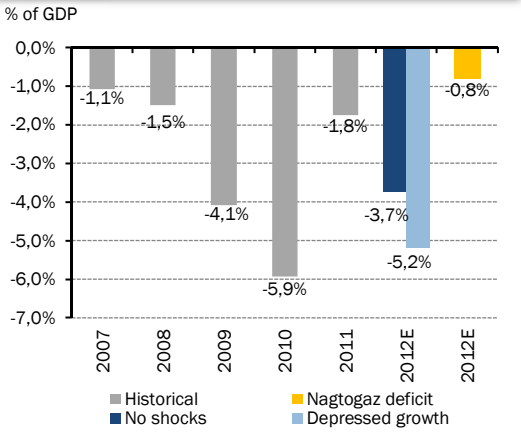
Tax collections are suggestive of increased administrative pressure to ramp up tax receipts

Tax collection dynamics are suggestive of increased administrative pressure on customs authorities



Source: Treasury, MoF, NBU, AYA calculations

We continue to expect the budget deficit to overshoot the government's projections under both scenarios



Source: Treasury, MoF, AYA estimates and calculations

Firstly, with lower real GDP growth and inflation, nominal revenues are likely to fall short of the government's projections (based on 3.9% real GDP growth and 7.9% inflation rate). At the same time, curtailing expenditures seems like an impossible task due to the presence of "sticky" items (e.g. pensions, benefits) and the pre-committed social spending ahead of the election. Thus, the year-end budget deficit will likely overshoot the government's target of 1.8% of GDP. Accordingly, our own projections call for the budget deficit widening to 3.7% under the "no shocks" scenario and rising further to 5.2% of GDP should economic performance turn out worse. Secondly, with an increased probability of a budget deficit overshoot, certain expenditure items are likely to remain underfinanced by the year-end and increase the government's arrears. The final outcome will be largely determined by the sovereign's borrowing environment.

Ukraine's fiscal course is set to worsen owing to the presence of "sticky" expenditure items, increased pre-election spending and revenue underperformance

To date, **the government has relied mostly on the local bond market to meet its funding needs,** raising close to USD 6.1 bn via domestic issuance (in Jan'12-Jun'12). A lack of affordable access to external borrowing, failed negotiations with Russia, and frozen IMF programme left the government no other alternative. Thus, the Ukraine repaid part of the VTB loan (USD 0.5 bn), a Eurobond in Jun'12 and first installments of the IMF loan without external assistance. The total repayments stood at USD 5.5 bn, leaving the difference to partially finance the budget deficit.

The key question is whether Ukraine's funding self-reliance could be sustained for the remainder of 2012. Roughly 50% of the upcoming redemptions ex-interest (USD 2.3 bn) are due to the IMF, while the remaining amount (USD 2.3 bn) is mostly owed to local banks. In addition, the government will have to finance the residual of the targeted budget deficit (USD 5.1 bn) till the year-end as planned.

The tough stance of the IMF on conditionality and the lack of political will to implement it prior to the election effectively close the funding window at least until the end of the parliamentary elections. Even then, as argued in our *Politics* section, **the re-opening of credit lines from the IFOs, namely the IMF, is not guaranteed** simply upon the fulfillment of the required benchmarks, but also depends much on the political developments. Thus, views held by high-ranking officials on the high probability of renewing cooperation with the IMF could prove overly confident and illusory. As mentioned previously, in case political processes turn for the worse, the IMF may adopt a tougher position on meeting conditionality and delay the allocation of loan tranches (see *Politics: Definite Uncertainty*).

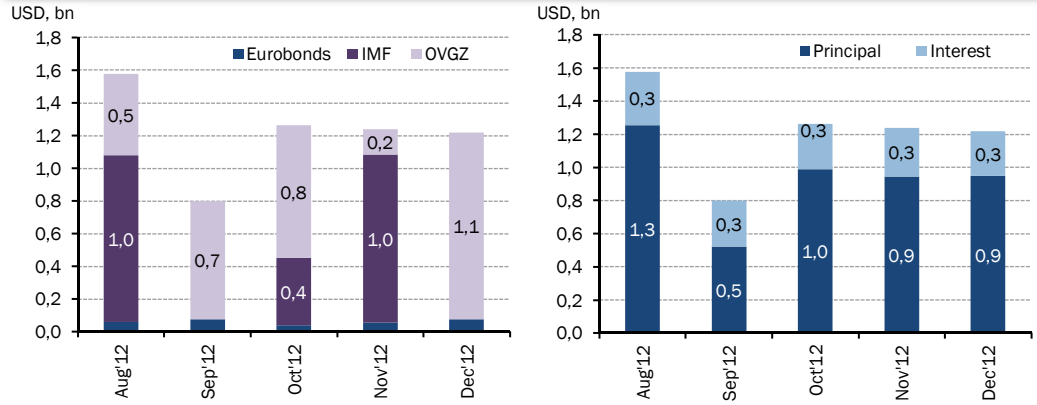
Re-opening of credit lines from the IFOs, namely the IMF, is not guaranteed

Going forward, **we believe the sovereign's funding mix will be determined by external financial conditions and the unfolding of political processes in the country**. We expect the external borrowing environment to remain challenging in 2H'12 with a probable renewal of the EZ sovereign tensions. Perhaps in recognition of these challenges, the government used the current window of opportunity to tap the international capital markets, placing a 5-year Eurobond worth USD 2 bn in Jul'12 despite a higher interest rate (9.25%) than had been targeted previously (below 9%). The borrowing costs are also considerably higher than during the last placement of the 5-year Eurobond (6.25%) in Jun'11, and justifiably reflect the increased premium for the rising economic and political risks. The placement effectively covers the sovereign's foreign-debt redemptions until the year-end and eases the borrowing burden, yet does not fundamentally affect Ukraine's fiscal course in 2012, in our view. Ukraine still faces substantial budget deficit financing needs and local debt redemptions.

We thus maintain our previous view that the **sovereign will continue to rely on a combination of financial repression of local banks to ensure purchases of government securities, regulatory easing for banks on holdings of certain sovereign issues, and NBU-subsidized funding**. Thus far, the banks were most willing to absorb the government's USD-denominated securities, while the demand for UAH issues sagged. We believe the government could ensure further take-up in 2H'12 with the help of NBU funding and regulatory preferences for holdings of government securities denominated in FX. While regulatory pressure could keep up the appetite of banks to purchase government bonds, their ability to do so will be an entirely different matter.

The sovereign's will continue to rely mostly on the domestic markets via financial repression and NBU-subsidized funding

Borrowing needs for the remainder of the year are less burdensome, yet borrowing conditions could turn for the worse, making it difficult to meet the sovereign's funding needs



Source: Bloomberg, IMF, MoF, AYA estimates and calculations
Note: calculations of government's refinancing needs include only the most significant items of direct state debt

On balance, we believe that the government's funding needs in 2H'12 (USD 7.4 bn), accounting for the recent placement of Eurobonds, could be met through the domestic market only with the aid of NBU-subsidized funding. In case external conditions deteriorate substantially, pressure on the government to search for external sources will be high. Otherwise, the government will face increasing arrears and an underfinancing of certain expenditure items seems highly likely.

Finally, should political processes unravel to the point that economic sanctions ensue and IFOs hold out on cooperation, while the economic conditions deteriorate, we do not rule out a possibility that local authorities could "surrender" to Russia as the lender of last resort. In such circumstances, Russia's political gains will be substantial and Ukraine's concessions material (e.g., integration into customs union, change in ownership of gas transportation system, etc).

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