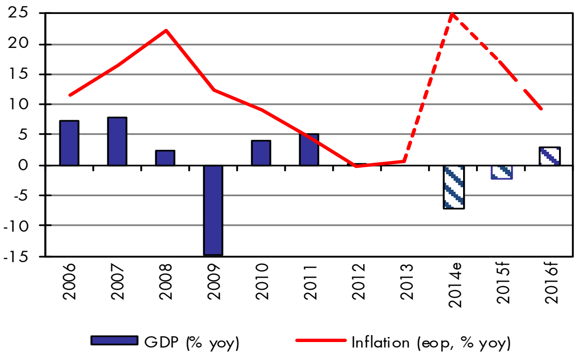
# Ukraine
# Monthly economic review
November 2014

## GDP growth and inflation




*Source: State Statistics Service, Raiffeisen RESEARCH*

# Highlights

- The snap parliamentary elections brought overwhelming victory for the democratic, pro-European parties, albeit the unreasonable delay with the coalition formation increases the risk of major economic and political fallout.
- The situation in Donbass remains tense, without much prospect for fast and peaceful resolution.
- GDP growth print in Q3 came better than expected thanks to the boost in agricultural production.
- The hryvnia lost almost 20% versus USD in the last two weeks as the National Bank started to relax administrative restrictions and had to cut FX intervention volumes, following severe loss of reserves in October.
- The banking system is living through the hard times as the deep economic slump and massive deposit outflows put a lot of banks on the brink.

### Ukraine: Sovereign ratings

| LCY rating | S&P | Moody's | Fitch |
|---|---|---|---|
| *Long-term* | B- | Caa3 | CCC |
| *Short-term* | B- | ... | ... |
| *Outlook* | Stable | Negative | Negative |
| **FCY rating** | | | |
| *Long-term* | CCC | Caa3 | CCC |
| *Short-term* | CCC | ... | CCC |
| *Outlook* | Stable | Negative | Negative |
| *Latest assessment* | Jul-14 | Apr-14 | Aug-14 |

*Source: Thomson Reuters, Cbonds*

### Ukraine: Key economic figures and forecasts

| Real Sector | 2011 | 2012 | 2013 | 2014e | 2015f | 2016f |
|---|---|---|---|---|---|---|
| GDP (UAH bn) | 1302.1 | 1411.2 | 1454.9 | 1512.8 | 1611.5 | 1756.1 |
| GDP (% yoy) | 5.2 | 0.3 | 0.0 | -7.0 | -2.0 | 3.0 |
| Domestic demand (% yoy) | 12.2 | 6.0 | 0.9 | -9.2 | -2.5 | 3.1 |
| Terms of trade (% yoy) | 7.1 | 6.1 | 1.2 | 6.7 | 1.0 | -1.3 |
| CPI (avg, % yoy) | 8.0 | 0.6 | -0.2 | 11.3 | 24,5 | 11,5 |
| CPI (eop, % yoy) | 4.6 | -0.2 | 0.5 | 25.0 | 17.0 | 8.0 |
| PPI (eop, % yoy) | 14.1 | 0.4 | 1.7 | 28.0 | 18.0 | 10.0 |
| Real disposable income (% yoy) | 6.1 | 9.7 | 5.0 | n/a | n/a | n/a |
| **External Sector** | | | | | | |
| C/A Balance (% of GDP) | -6.3 | -8.5 | -9.0 | -3.1 | -3.2 | -3.6 |
| Goods' export (% yoy) | 33.0 | 0.6 | -7.1 | -8.3 | 4.2 | 7.1 |
| Goods' import (% yoy) | 41.4 | 5.4 | -6.5 | -19.3 | 2.6 | 7.9 |
| FDI (USD bn) | 7.0 | 6.6 | 3.3 | 0.0 | 3.0 | 5.0 |
| Total external debt (% of GDP) | 77.3 | 76.5 | 79.0 | 103.9 | 127.2 | 124.1 |
| Gross FX reserves (USD bn) | 31.8 | 24.6 | 20.4 | n/a | n/a | n/a |
| **Fiscal Sector** | | | | | | |
| Fiscal balance (% of GDP) | -4.2 | -5.5 | -6.7 | -10.0 | -6.0 | -4.0 |
| Public debt (% of GDP) | 36.0 | 36.8 | 40.2 | 69.0 | 74.0 | 72..0 |

Source: State Statistics Service, National Bank of Ukraine, Ministry of Finance, Raiffeisen RESEARCH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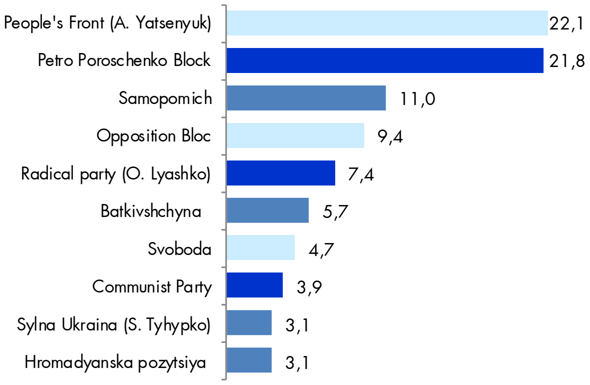
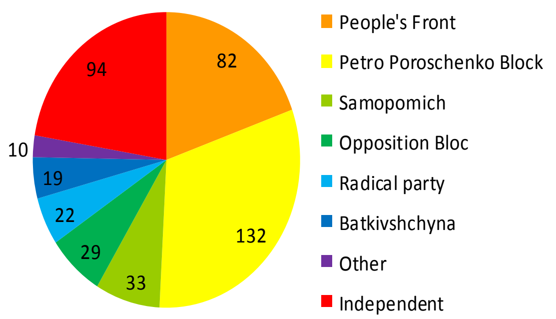
## Parliamentary election results



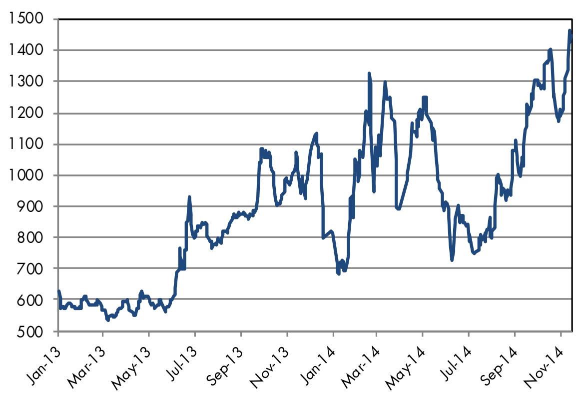

*Source: Central Election Commission*

## The composition of new Parliament (# of seats)




*Source: Interfax-Ukraine*

## Ukraine 5Y CDS (b.p.)




*Source: Bloomberg*

# Politics

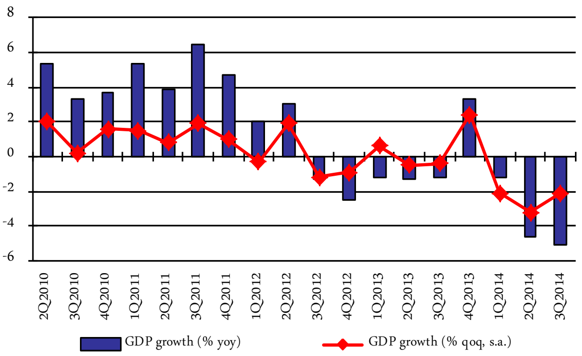
**The snap parliamentary elections brought overwhelming victory for the democratic, pro-European parties, albeit the unreasonable delay with the coalition formation increases the risk of major economic and political fallout.** Parliamentary elections have been held in Ukraine on Sunday, 26 October. Despite the rather tense atmosphere (as some provocations were expected), the voting process has been largely smooth across Ukraine with no substantial incidents reported. The international observers, the authorities and representatives of the political parties did not report on substantial violations during the voting process, thus the elections have been declared free and fair. The voter turnout constituted 52.4%, compared to nearly 60% at snap presidential elections in May 2014 and the last parliamentary elections in October 2012. In most of the regions the turnout exceeded 60% with only few lagging behind, most notably Donetsk and Luhansk, where only a third of voters turned in. In particular, in Donbass the elections took place only in half of electoral districts due to the continued military stand-off.

According to the official results, published by the Central Election Commission on November 10th, People's Front (PF), the party of the incumbent Prime-Minister Arseniy Yatsenyuk, narrowly won the race, getting 22.1% of votes under party list voting. The pro-President Party Petro Poroschenko Block (PPB) came second with 21.8% of votes, followed by the surprising late riser Samopomich with 11%. Three other political forces also managed to get over 5% threshold, while right-wing Svoboda, failed to make it, getting 4.7% of votes. In addition to 225 MPs elected under party list voting, 198 MPs got into the Parliament, based on the voting results in single constituencies. There PPB got more seats than other parties, bringing total number of seats in the new Parliament to 132. It is followed by PF and Samopomich with 82 and 33 seats respectively.

**The election results have been largely as expected**, albeit the last minute surge (compared to the polls) in the support for People's Front and Samopomich at the expense of PPB has been rather surprising. An explanation could be that voters intended not to give the absolute power to the President Poroschenko, fearing a replication of the power usurpation scenario played by former President Yanukovych. The rather limited support for the purely populist Radical Party also looks encouraging, signaling the maturity of the Ukrainian electorate. The former ruling parties – the remains of Party of Regions and Communists – emerged as the major losers of the elections, albeit their support in the East of the country is still visible. In particular, Opposition Block, largely composed of former government officials and members of Party of Regions faction in the previous Parliament, came fourth in the race with 9.4% of votes and will have a faction of 60-70 MPs in the new Parliament (including some independents, elected under single constituencies). The dismal result of the Batkivschina Party signals the steadily declining popularity of Ms. Tymoshenko and she is unlikely to play a significant role in the new Parliament. Finally, Russian media assertions on the dangerous rise of right-wing nationalism and populism in Ukraine proved groundless once again as the combined result of these political forces (Radical Party, Svoboda and Pravyi Sector) did not exceed 14% of total – i.e. much less than what right-wing, populist parties can get nowadays in many European countries.

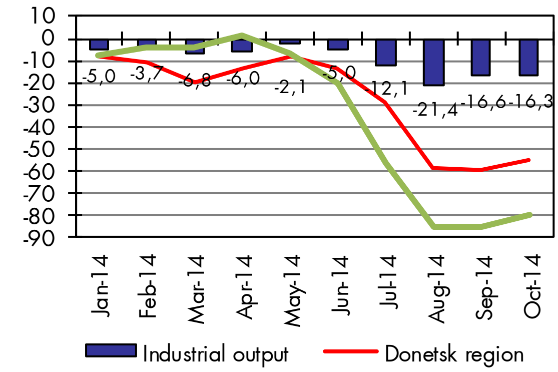
**The elections should be considered a success for the battered country, given the smooth voting process and the expected emergence of a strong, democratic majority in the new Parliament**. In particular, all three winning parties share the similar policy agenda, including the objectives of European integration, decentralization of the political system, anti-corruption measures and judiciary reform etc. At the same time, the problem is that three weeks after the election date the negotiations on the coalition are still going on, reportedly centered on personnel issues, rather than ideological principles. Five parties (i.e. Opposition Block excluded) are officially participating in the coalition talks and the new coalition might potentially have a constitutional majority (300 seats) in the Verkhovna Rada. The incumbent Prime-minister Arseniy Yatsenyuk has very high

**GDP dynamics**



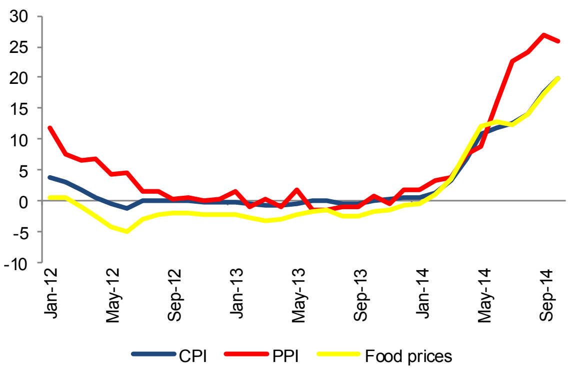

*Source: State Statistics Service*

**Industrial output growth (% yoy)**




*Source: State Statistics Service*

**Inflation (% yoy)**




*Source: State Statistics Service*

chance to retain his position, while PPF will most likely nominate the speaker of the new Rada. Coalition talks are now expected to be concluded within next 7-10 days, which implies that the Parliament will convene for the first plenary session in early December.

**In our view, the delay with the coalition formation is unacceptable, given the near-catastrophic economic situation**. In particular, quick action is required to tackle enormous and immediate economic challenges, such as exchange rate crisis, drafting budget for 2015, saving the banking system etc. Ukraine is set to get nearly USD 4 bn of additional funding from the foreign donors (IMF, World Bank and European Commission) within the next few months, albeit the disbursement is conditional on the number of actions to be performed by the new government. And now, with coalition talks dragging into the 2nd half of November, the authorities apparently have very little chance to get USD 2.8 bn loan tranche from the IMF by the end of this year. Moreover, the unfortunate political bickering, for which Ukraine was (in)famous for at least the last 10 years, bears a significant reputation risk for the incumbent administration, damaging the chances for getting additional financial support from the foreign donors.

**The situation in Donbass remains tense, without much prospect for fast and peaceful resolution**. On the one side, the ceasefire agreement, reached in Minsk in early September, has somewhat reduced the intensity of the military conflict. On the other side, the military clashes between Ukrainian army and the separatists (with alleged support of regular Russian troops) continue on a daily basis. Plus, the local election, held by the separatists at the occupied territories on November 2nd, elevated tensions again, since it apparently violated the Minsk agreement and was not recognized by Ukraine and the international community (even Russia stopped short of officially recognizing the result, apparently fearing another bout of sanctions from EU and US). Also, according to the Ukrainian and NATO evidence, Russia continues to amass troops at the Ukrainian border and is said to have substantially increased armament supplies to the separatists in the last few weeks.

Despite these worrisome developments, **we consider the risk of large-scale military conflict rather low at the moment**. The latest Russian maneuvers might have two main purposes. First is to provide support to the separatists in order to ensure that their rule in Donbass survives through the winter season. It is also believed that the second purpose may be to create a pressure on the Ukrainian authorities and hence add to the economic woes of the country (as uncertainty around Donbass was apparently one of the factors, triggering the confidence crisis at the FX market recently). Thus, the sustainable agreement between Ukraine and Russia seems very far away, given still widely diverging positions of two sides of the conflict. In this respect, we do not see the latest gas agreement between two countries as the first sign of forthcoming reconciliation, because it was mostly pushed through by the EU, which was keen to ensure the safety of gas supplies to Europe for the upcoming winter. Hence, **the conflict might slowly get into the frozen form over the next few months, albeit a major escalation should not be ruled out**.

# Real Economy

**Ukraine's GDP fell by 5.1% yoy in Q32014**, 2.1% qoq (in seasonally adjusted terms). Hence, the slump deepened compared to Q2 (when GDP plunged by 4.6% yoy), but not so dramatically, taking into account near-halt of the production activity in Donbass since August. Most likely it is explained by the statistical base effect in the agricultural industry. Last year, due to the adverse weather conditions the harvesting was mostly shifted to Q4 and agricultural output growth decelerated from 15.4% yoy in H12013 to just 3% yoy in Jan-Sep. This year we have witnessed the notable acceleration in Q3 - from -3.9% yoy as of end-June to +16% as of end-Sep. Correspondingly, in Q4 the statistical factor will play on the other side, providing sizeable negative contribution to GDP growth dynamics. At the same time, there have been some signs of reviving production activity in war-torn



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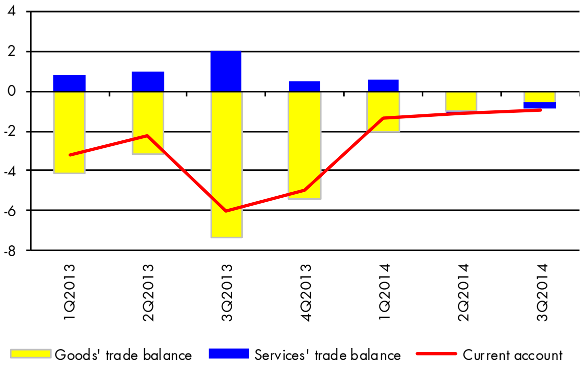
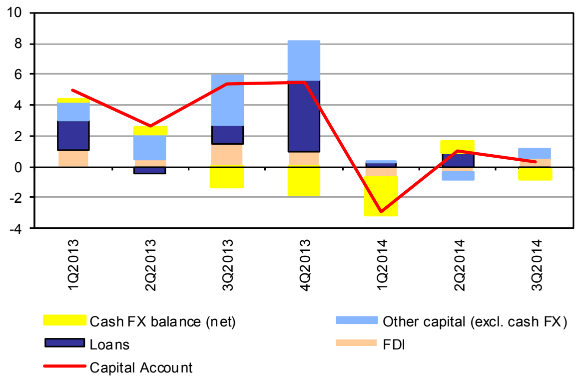
## Current Account Balance (USD bn)



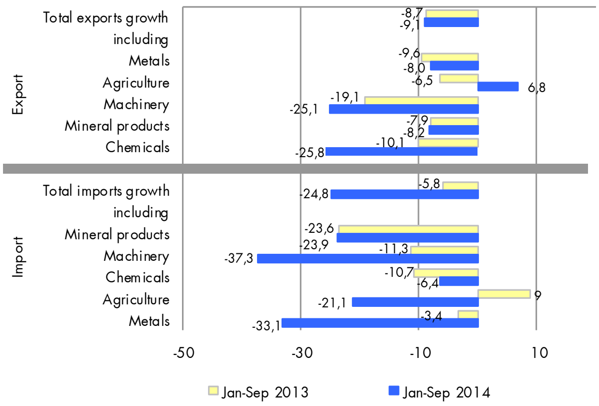

*Source: National Bank of Ukraine*

## Capital Account (USD bn)




*Source: National Bank of Ukraine*

## Goods' export and import growth rates (% yoy)




*Source: National Bank of Ukraine*

Donbass area recently amid (shaky) ceasefire. Nevertheless, **we expect GDP yoy decline in double digits in Q42014, which will bring annual estimate close to our baseline forecast of -7% yoy**.

**Industrial output sunk by 16.3% yoy in October amid persisting production disruptions in war-torn Donbass area.** At the same time, the output dynamics improved compared to the two previous months (in August and September the output collapsed by 21.4% and 16.6% yoy respectively). It might be explained by the certain revival in production activity in occupied part of Donbass after almost complete cease in August. Specifically, according to the anecdotal evidence, a number of large still mills located there managed to increase the output recently (albeit still operating much below full capacity). As a result, yoy decline in metallurgical output improved from –30% and –28.3% in August and September respectively to –21.1% last month. There have been also minor improvement in mining output dynamics— from –27.1% yoy growth in September to –24.9% in October. On the other side, the slump in machine building industry deepened from -22.8% yoy to -26.1% in October. In cumulative terms, industrial output fell by 9.4% yoy in Jan-Oct and we now expect nearly 11% decline for the full year (which is still much better than 22% industrial production collapse back in 2009).

# Inflation

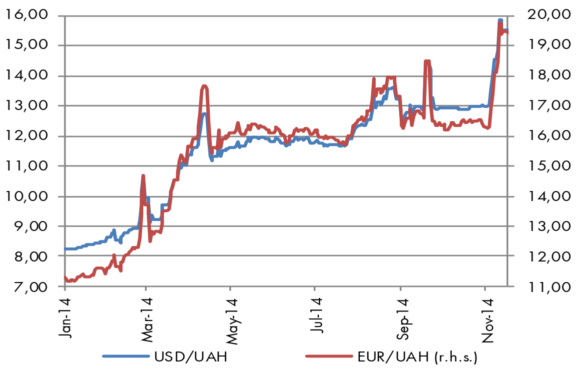
**CPI growth slowed down from 2.9% mom in September to 2.4% mom in October**. At the same time, 12-month inflation growth rate (eop) accelerated to 19.8% yoy at end-October (compared to 17.5% yoy as of end-September). Food prices surged by 2.6% last month amid 4.7% seasonal hike in the prices for vegetables (after traditional summer deflation). Prices for eggs, meat and milk also went up in October - by 13.2%, 3.3% and 3% respectively. On the other hand, sugar and fruit prices decreased by 4.1% and 2.1% respectively. Accross non-food products, clothes prices increased the most (by 6.4% mom), which is apparently reflects resurging depreciation pressures. Gasoline prices fell by 2% last month (for the first time this year) as the slide in the global oil prices offset the negative effect of hryvnia devaluation. Utility prices went up by 2.2% mom in October. Given continued inflation increase and latest exchange rate spike, we revised our inflation forecasts for this and next year. We now expect **Consumer Price Index (eop) to hike by 25% yoy this year and then price growth to decelerate to 17% in 2015**.

PPI fell by 0.7% mom in October on the back of decreasing prices in mining and energy industries. In particular, the prices in extraction of metal ores and oil and gas plunged by 8.1% mom and 7.1% respectively. Energy production prices fell by 5.4% mom. At the same time, manufacturing prices went up by 1.7% due to the substantial price growth in coke production (by 17.3%). 12-month PPI growth decelerated from 26.9% yoy at end-September to 25.8% yoy as of end-October.

# Balance of Payments

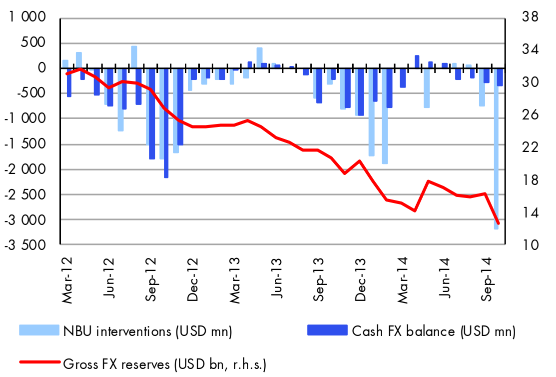
**Balance of payments deficit increased to USD 358 mn in September (after mere USD 42 mn deficit in August) due to the deteriorating trade balance**. C/A deficit increased from USD 91 mn in August to USD 612 mn in September. Due to the ongoing conflict in Donbass and severe trade restrictions imposed by Russia, exports plunged by 16.5% yoy. Machinery and metallurgy exports were hit the most (reduction by 35.6% yoy and 28.9% respectively). At the same time, agricultural exports hiked by 8.3% yoy on the back of increasing exports of fats and oils, meat products and grain. On the import side, non-energy imports went up in mom terms (yoy growth rate improved from -39.7% in August to -31.0% in September) as the resurging depreciation pressures and severe FX shortages triggered the spike in demand for imported durables. In particular, car import growth rate improved from -82.7% yoy in August to -26.3% in September. Total merchandise imports collapsed by 40% yoy in September (after falling by 42.4% in August) mostly due to 56.3% yoy decrease in energy imports (as Ukraine imported just 1 bn cm of natural gas from Europe).

## UAH exchange rate



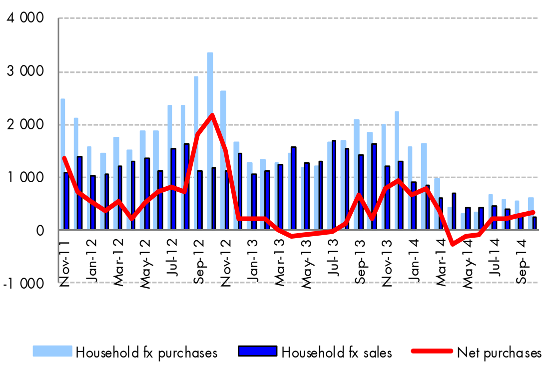

*Source: Bloomberg*

## FX market indicators




*Source: National Bank of Ukraine*

## FX Cash Market (USD mn)




*Source: National Bank of Ukraine*

In contrast, financial account surplus increased in September - to USD 254 mn from USD 49 mn in August – thanks to the disbursement of World Bank loan tranche and net FDI inflows of USD 235 mn. Cash FX outflow amounted to USD 225 mn in September, while the net balance of external borrowings by real and banking sector was negative as well (USD 254 mn and USD 244 mn respectively), also apparently reflecting rising exchange rate pressures.

In total, **the external accounts deteriorated in Q3 (compared to the previous quarter) due to the accelerated capital outflows** - the balance of payments deficit increased from USD 5 mn to USD 663 mn. In particular, the balance of long-term external loans reversed from the surplus of USD 1052 mn in Q2 to the deficit of USD 516 mn in Jul-Sep. Also, cash FX outflow renewed - the volume of cash FX outside banking system increased by USD 680 mn in Q3, while in the second quarter cash FX inflow of USD 748 mn has been registered. At the same time, the positive trends in the last quarter included the reduction in merchandise trade balance deficit (from USD 1 bn in Q2 to USD 567 mn in Q3), despite the collapse in production activity in export-oriented Donbass region, and improving dynamics of FDI flows (after USD 651 mn and USD 314 mn outflows in Q1 and Q2 respectively, the net FDI inflow constituted USD 606 mn in the 3rd quarter).

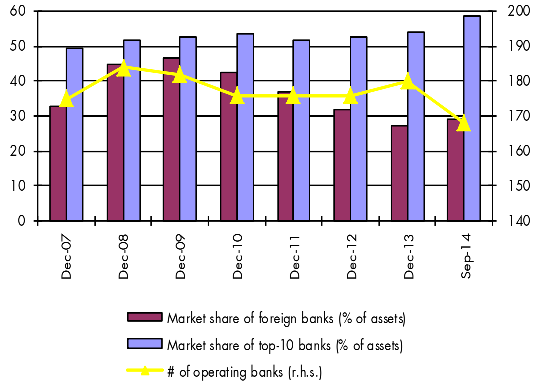
In Jan-Sep 2014 current account posted a deficit of USD 3.3 bn, decreasing by 70% in yoy terms. Merchandise import fell by 24.8% yoy, while export decreased by 9.1% yoy. Financial account deficit reached USD 1.6 bn in the first three quarters of the year (at the same time of last year the surplus amounted to USD 13 bn). As a result, the cumulative balance of payments posted a deficit of USD 4.9 bn in Jan-Sep 2014, compared with a surplus of USD 1.5 bn in Jan-Sep last year.

# Monetary Policy and Exchange Rate

**The hryvnia lost almost 20% versus USD in the last two weeks as the National Bank started to relax administrative restrictions and had to cut FX intervention volumes, following severe loss of reserves in October.** Since early October the National Bank managed to stabilize USD/UAH exchange rate at the level of 12.90-13.00 with the help of regular large-scale FX interventions (selling USD 300 mn per week) and harsh administrative measures (i.e. restrictions on currency purchases and the threats to the banks and their clients not to deviate from the official rate). However, FX demand remained persistently high on the back of looming political and economic uncertainty, while exporters tried to hoard FX proceeds as much as possible. As a result, black market has flourished (with the transaction rate around 5-10% higher than the official) and excess FX demand has been building up. According to some estimates, it reached USD 1.0-1.5 bn as of end-October. Also, the NBU spent USD 1.3 bn for FX interventions last month, which, coupled with the direct FX sales to Naftogas, led to **the drastic reduction in gross FX reserves**. They shrank from USD 16.4 bn at end-September to 9-year low level of USD 12.5 bn as of end-November.

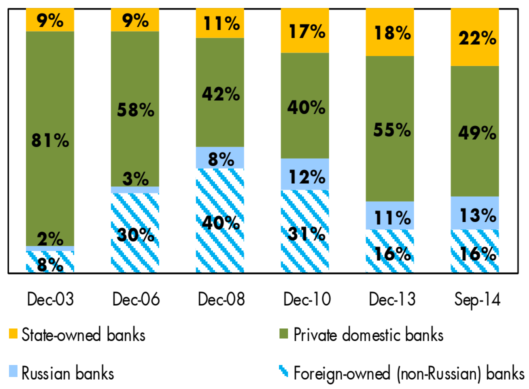
Consequently, at this side of the elections **the central bank had to change its FX market behavior**. First of all, the NBU moved to the new intervention strategy, now holding daily FX Dutch auctions with the total amount of sales limited to USD 5 mn per day. Also, the National Bank started to relax administrative restrictions and cut back the extent of 'moral suasion' measures (namely, the banks are no longer strictly required to keep their rates close to NBU official rates). Given large-scale delayed FX demand and unclear political and economic prospects (i.e. continued stand-off in Donbass, no government is expected until early December), **the loosening of NBU grip on FX market led to the free fall of hryvnia, which weakened by almost 20% in just one week**. Since then the market seemed to found some floor for now at the levels between 15 and 16, albeit it's not clear how long it will hold. On the one side, **the latest dramatic slide in the currency value is not apparently based on the weakening fundamentals**, since the current account has largely adjusted in H1, following almost 40% depreciation. On the other side, **the confidence crisis is in the full swing at the moment** and we do not see how it could be dealt with, given unfortunate dragging with the formation of the coalition,

## Competitive landscape




*Source: National Bank of Ukraine*

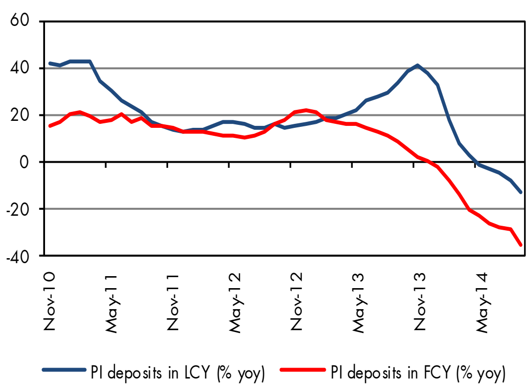
## Market structure by ownership*




** % of total assets*

*Source: National Bank of Ukraine*

## PI deposits growth rates




*Source: National Bank of Ukraine*

which in turn delays the implementation of badly needed reforms and freezes the foreign financial support. Hence, the prospects of the local currency will very much depend on the ability of the policymakers to find a political agreement on the new coalition as soon as possible and perform immediate economic stabilization measures.

**Liquidity conditions in the banking system remain rather stable**, with the volume of banks' correspondent accounts fluctuating in the comfortable range of UAH 28-32 bn for the most of last four weeks. At the same time, it should be noted that this liquidity is rather disproportionately distributed across the banking system and a lot of banks are facing severe liquidity squeeze. As a result, the relatively low level of money market rates does not adequately reflect market conditions, but is rather the product of extreme segmentation of the interbank market. Short-term money market rates ratcheted up recently, following 150 b.p. discount rate hike (see below) and subsequent increase (by the same margin) in the interest rates for deposit certificates. Overnight rate went up from 10 to 11.25%, 1-week money are now quoted at 12% (up from 11%). 1-month KyivPrime rate increased by 100 b.p. to 17%.

**Monetary aggregates took a big hit in October due to Naftogas external debt repayments and strong deposit outflows** (-3.9% mom). Base money plummeted by 5.4% mom and yoy growth rate decelerated from 23.5% at end-September to 15.4% as of end-October. Broad money went down by 3.5% mom, causing the slowdown in yoy growth rate from 14.1% to 9.9%.

On 13 November, **the National Bank hiked its key rate by 150 b.p. to 14%**. The rates on NBU CD facilities were adjusted accordingly, while overnight lending rate remains at the level of 17.5%. The interest rate move was apparently motivated by the accelerating inflation in the last few months as inflation rate is now expected to reach 25% in 2014, well exceeding NBU actual forecast of 19%. Given basically non-functioning monetary transmission mechanism, NBU interest rate decision is mostly symbolic and will have no much impact on other interest rates and economic dynamics. At the same time, the NBU should definitely move in the direction of more active interest rate policy in the context of preparation to inflation targeting regime (although, it is still at least few years away).

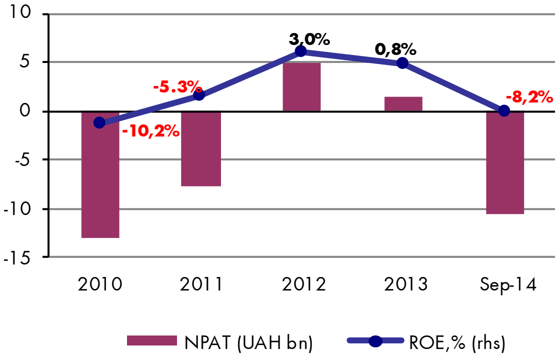
# Banking Sector

As of end-September 2014, there were 168 banks operating in Ukraine, down from 180 at the beginning of the year. **The consolidation in the banking system is slowly moving on** as the small and mid-sized banks are the major victims of the banking crisis at the moment. The share of top 10 banks in total assets reached the historical high of 58.8% at end-September, up from 54.2% as of end last year.

The ownership structure of the local banking system has also changed in 2014, as the major trend of the previous few years has been reversed. Namely**, the share of private Ukrainian banks declined from 55% of assets to 49% since the beginning of the year**. The major winners were state-owned banks, which combined market share increased from 18% to 22%. Somewhat surprisingly, Russian-owned banks also gained the market share (it increased from 11% to 13%), but it is mostly explained by the revaluation effect, following massive exchange rate adjustment (since Russian banks had a higher share of FX assets in their balance sheets). Foreign-owned (non-Russian) banks retained market share at the level of 16% this year as 'flight to quality' effect was offset by the extremely cautious market strategies of these banks.

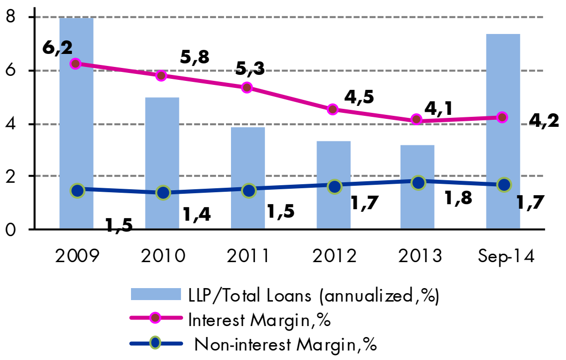
**The sharp deterioration of the economic situation and high willingness of the new NBU management to clean up the banking system led to the substantial increase in the number of insolvent banks this year**. As of now, the NBU put 26 banks under receivership in 2014, which accounted for 7% of assets of the banking system at end-2013. Also, the stress test and asset quality review, conducted for top 35 banks earlier this year, revealed the total capital need of UAH 66 bn (4.5% of GDP). However, the stress-testing methodology was based on rather mild macroeconomic assumptions and did not account for Donbass effect. Hence, according to our estimates (implicitly assuming exchange rate of 14-15), de-facto capital needs might be at least twice as higher, putting the total bill close to 9-10% of GDP. This is

## Profit and ROE




*Source: National Bank of Ukraine*

## Loan Loss Provisions and Margins




*Source: National Bank of Ukraine*

likely to bring few systemic banks on the brink, and in case the owners will not be able to fill the gap, the government might have to step in and nationalize the failing institution.

**Temporary FX market stabilization in October helped to halt private deposit outflow from the banking system**. PI hryvnia deposits fell by 1.2% mom in October, after plunging by 3.8% mom in September. The same tendency has been observed for private FX deposits – 3.1% mom outflow last month, improving from 8% mom decrease in September. On the loan side, CO hryvnia loan portfolio expanded by 0.8% mom in October, bringing yoy growth rate to -2%. PI local currency loan volume is falling on the monthly basis 8th month in a row (0.9% decrease last month), declining by 4.9% in yoy terms as of end-October.

**The banking system posted the loss of UAH 10.6 bn in Jan-Sep 2014**. Average return on equity deteriorated from 0.8% in 2013 to -8.2% as of end-September. Banks' financial results dramatically deteriorated in the 3rd quarter (in H12014 the banking system posted the profit of UAH 1.2 bn), which should not only be attributed to the worsening macro picture in Jul-Sep, but also could be explained by the fact that the several banks have been apparently forced to recognize large losses, revealed by the stress-test and asset quality review. Moreover, even with such dramatic deterioration recently, the true extent of banking system troubles is still probably yet to be fully reflected in the financial statements. At the same time, banks' operational financial indicators remain rather resilient for now. Net interest income of the banking system increased by 16.3% in yoy terms as of end-September and net interest margin increased from 4.1% to 4.2% since the beginning of the year. Net income from fees and commissions went up by 8% yoy, while net non-interest margin slightly decreased – from 1.8% to 1.7%.

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