Ukraine. Monthly Market Overview
February 2014

Ukraine Sovereign Ratings

LCY rating	S&P	Moody's	Fitch
Long-term	B-	Caa1	B-
Short-term	B	-	-
Outlook	Negative	Negative	Negative
FCY rating			
Long-term	CCC+	Caa2	CCC
Short-term	C	NP	C
Outlook	Negative	Negative	Negative
Latest assessment	28/01/14	31/01/14	07/02/14

Financial Markets team

CRÉDIT AGRICOLE

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Major Macroeconomic Trends

MACROECONOMIC INDICATORS - evolution

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013E*	2014F*	2015F*
Nominal GDP	(USDbn)	38.0	42.4	49.5	64.9	86.2	107.7	142.7	129.0	117.4	136.2	165	174	177	192	205
Real GDP growth	(%)	9.2	5.2	9.4	12.1	2.7	7.3	7.9	2.1	-14.8	4.2	5.2	0.2	0.0	1.8	2.9
Inflation CPI	(%)	6.1	0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	5.0	7.0
Industrial production	(%)	14.2	7.0	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	11.0	7.6	-1.8	-4.5	2.8	2.5
Producer prices index	(%) YoY			7.6	20.5	16.7	9.6	19.5	35.5	6.5	20.9	19.0	0.3	4.7	5.6	5.5
Exports	(USDbn)	20.1	23.4	28.9	41.3	44.4	50.2	64.0	78.7	39.7	51.4	68.4	68.8	72.2	77.6	83.6
Imports	(USDbn)	17.7	21.5	27.7	36.3	43.7	53.3	72.1	92.2	45.4	60.7	82.6	84.6	90.4	93.6	96.6
Public debt	(% of GDP)	37.1	33.5	29.0	24.8	18.0	14.8	12.0	13.7	32.2	39.7	35.8	37.0	38.2	39.2	39.0
Current account	(% of GDP)	3.7	7.5	5.8	10.7	2.9	-1.5	-3.6	-7.1	-1.5	-2.2	-5.5	-8.5	-9.2	-6.6	-4.7
Net FDI inflow over year NBU methodology	(USDbn)	0.8	0.7	1.4	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.6	3.8	3.7	4.6

EXCHANGE RATES - evolution

USD/UAH average	5.37	5.33	5.333	5.31	5.12	5.05	5.05	5.32	7.79	7.93	7.97	8.02	8.16	8.79	9.33
EUR/UAH average	5.1	5.02	6.02	6.61	6.38	6.26	6.92	7.78	10.88	10.52	11.09	10.31	10.81	11.63	11.84
UAH O/N average	16	3.5	6.5	5.3	3.5	4.0	3.5	11.3	8.4	1.5	5.7	11.9	2.7	2.5	1.9

- ***Ukraine's political crisis has not been resolved yet***, and January was rather volatile. The escalation occurred in the middle of the month, when the parliament approved laws significantly limiting Ukrainian citizens' freedoms and human rights. Facing pressure both domestically and externally, state officials had to make concessions, the parliament repealed the restrictive laws and the government resigned. However, the parties did not reach a full agreement, and thus the crisis was not ended. We think ***the situation may last for several more weeks, while a further protraction in negotiations would hurt both country risks and economic recovery prospects.***

- The fall of the government has raised concerns among Russian officials regarding the permanence of Ukraine's cooperation strategy with Russia. This has increased the risk of interruptions to the provision of new financial assistance from Russia. ***Having no immediate financial support from either Russia or the West, Ukraine still has around a month to stabilise its external financing flows,*** as sharper external debt repayments will fall on March.

- Continuing mass unrest and dismissal of the ***government prompted Western officials to think about providing financial help to Ukraine in place of the Russian package***. In particular, the EU and the US are discussing the possibility of providing both own financing and a new loan from the IMF, amounting to enough to allow Ukraine to refuse the Russian financing line (around USD15bn). This may be an additional factor pushing Ukrainian officials to think about changing external policy more towards the EU. We think this ***decision will depend a great deal on Ukrainian top officials' ability to find political consensus to calm the protests***.

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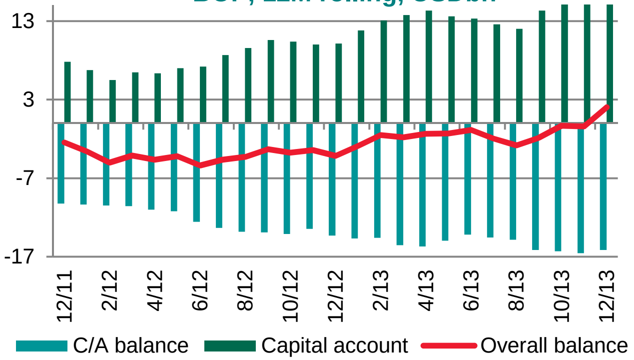
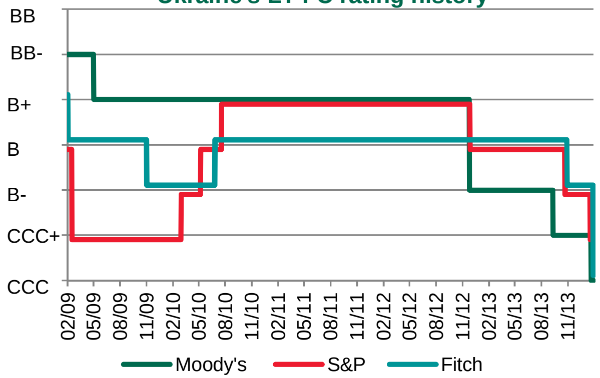
BOP, 12M rolling, USDbn



Sources: NBU, Credit Agricole

Ukraine's LT FC rating history



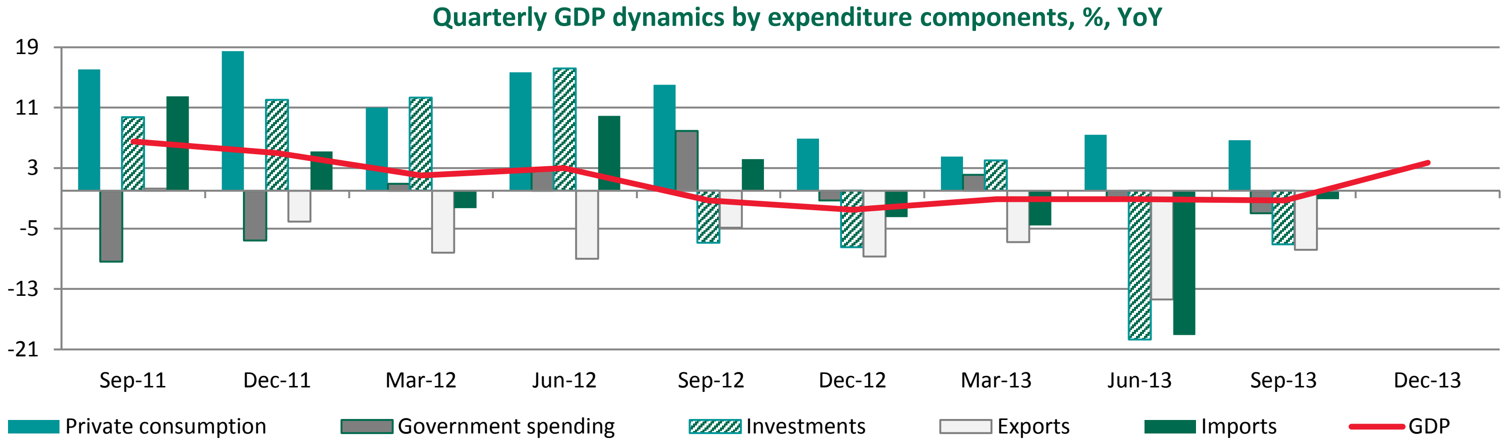
Forecasts	GDP, % YoY
Q413	**3.7%**
Q114	**1.9%**
Q214	**2.6%**
Q314	**1.9%**

Source: Credit Agricole

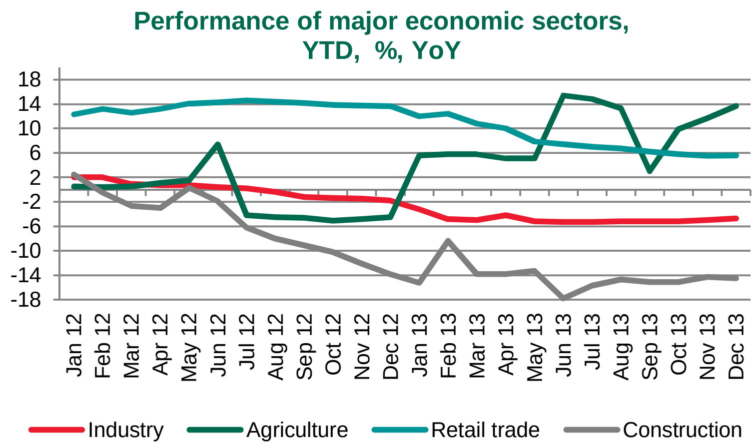
- The first signs of potential external risks had already occasioned the rating agencies to review their Ukrainian sovereign ratings. In particular, ***the resignation of the government and the potential (but as yet unproved) risk of no additional financing from Russia induced S&P and Moody's to downgrade the sovereign rating by one notch to CCC+ and Caa2, respectively***, with a negative outlook. However, Fitch downgraded the rating by two notches at once on same factors. It has already became practice that ***rating agencies downgrade Ukraine's sovereign rating ahead of risks anticipated by them***, even though the probability of these risks is less than 50%. We think the recent rating downgrade reflects the same tactics by the rating agencies. However, risks mentioned by all agencies may be rather short-lived, as ***the situation should return to normal once political consensus is found and a new government appointed***.
- By basing their views mostly on negative potential factors, the ***rating agencies did not consider fully any positive potential factors***, such as the intentions of both the EU and US to provide joint financial assistance to Ukraine as soon as a new government is appointed.
- Statistics ***on economic performance over December*** do not show the public unrest having a major impact on most sectors. The only worsening performance was recorded in the construction sector, while other sectors showed improvement, mostly off last year's low comparison base. Agriculture still leads the race, with solid YoY growth of 45.4% in December due to an abundant grain harvest and a shift in the harvesting season. We think the ***same effect will guide economic dynamics in January, weakened by continuing public unrest in the country***.
- ***Preliminary estimates of State Statistics office shows 3.7% YoY GDP growth over Q413***, considerably below of both our (0.7%) and consensus (1.1%) forecasts. Such a high figure affected preliminary estimate of GDP dynamics at 0% over the whole 2013. ***We think the figure will be adjusted downwards soon***.
- ***Overly optimistic government macroeconomic projections in 2013 played a part in budget targets being missed last year*** in both revenues (underfunding by 6%) and expenditures (2% lower than planned). ***This widened the budget deficit to 4.5% of GDP***, while the loan from Russia at the end of December and heavy domestic borrowing (with the bulk of bonds purchased by the NBU) provided the necessary financing for the budget deficit last year.
- ***The budget for 2014 is again based on optimistic macroeconomic projections*** (3.0% and 8.0% for GDP and CPI against our forecasts of 1.8% and 5.0%, respectively). Hence, the core scenario for government finances this year may be the underfunding of budget revenues as well as ***the budget deficit widening to around 6% of GDP in a pre-election year*** (versus 5% projected in the budget).
- Financial assistance of USD3.0bn from Russia in the few weeks before the year-end ***stabilised the BOP and moved it into positive territory for the whole of 2013 (USD2.0bn)***. The accumulation of arrears for gas delivered from Russia over last two months of the year also contributed to the improvement in the BOP. However, ***the CA remained negative*** at USD16.1bn or 9.1% of GDP, reflecting the inability of exports to recover on global markets as well as interruptions to exports to Russia in mid-year.
- A moderate UAH devaluation should improve the CA by enhancing exports and limiting imports in 2014. Therefore, ***we expect the CA deficit to improve to 6.2% of GDP this year***.

Ukraine. Monthly Market Overview. February 2014

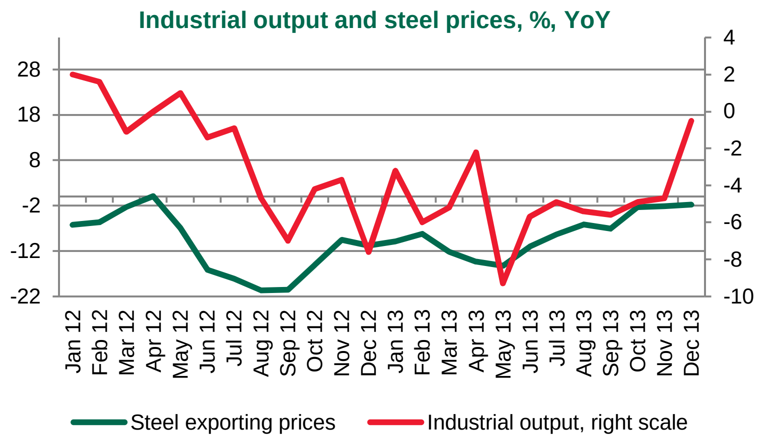
Major Macroeconomic Trends



Sources: State Statistics Committee



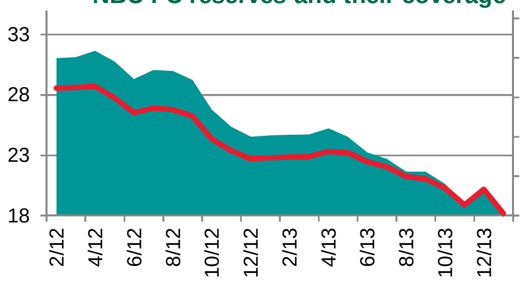
Source: State Statistics Committee



Sources: State Statistics Committee, Bloomberg, Credit Agricole

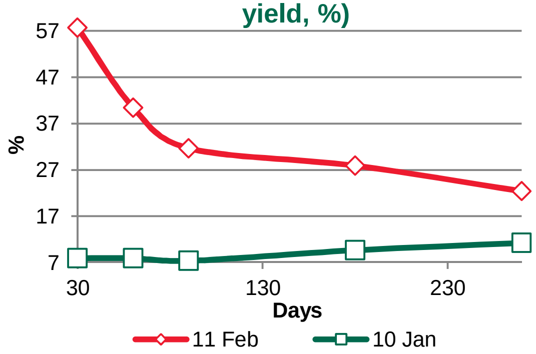
Ukraine. Monthly Market Overview. February 2014
FX Market

NBU FC reserves and their coverage



Sources: NBU, Credit Agricole

USD/UAH NDF curve (implied yield, %)



Source: Bloomberg

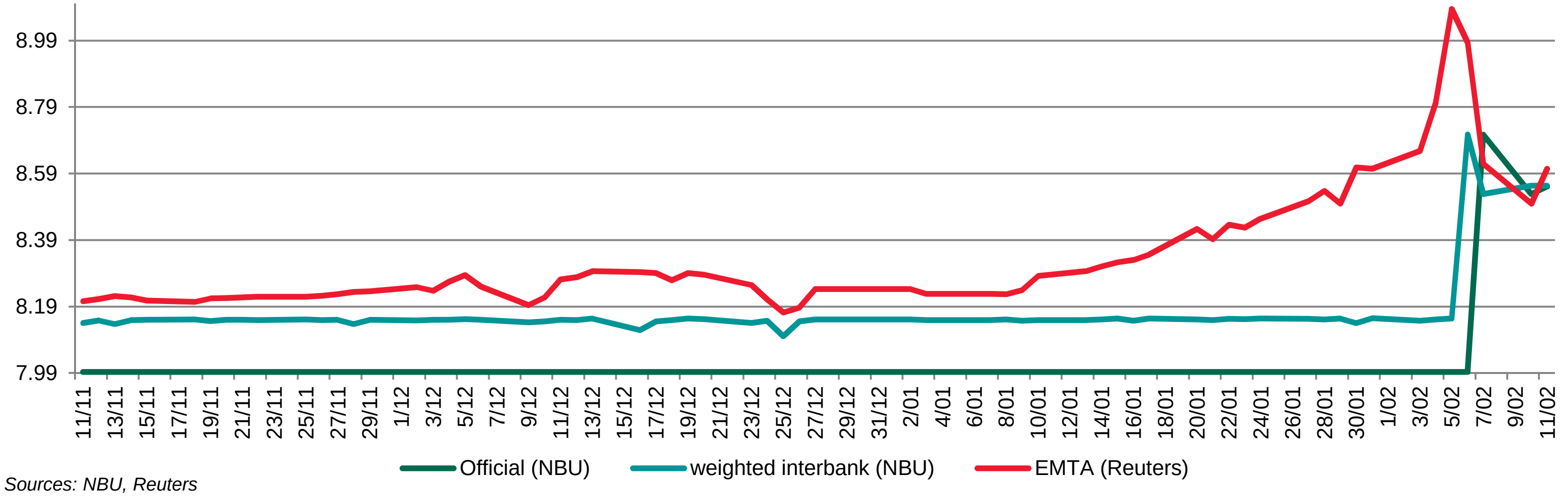
Forecast, eop	USD/UAH	EUR/UAH
Q1'14	8.82	11.82
Q2'14	8.61	11.28
Q3'14	8.85	11.51
Q4'14	8.90	11.39

Source: Credit Agricole

- ***The continuing political crisis as well as clumsy support for the hryvnia by the NBU triggered volatility on the market in late January and early February, with strengthening fears of UAH devaluation***. As a result, the USD/UAH exchange rate rather quickly reached its five-year peak, slightly exceeding the benchmark level of 9.0000. Growing devaluation fears forced the NBU to take the situation under its full control while trying to avoid further foreign currency interventions. In fact, the NBU spent around USD1.7bn via its foreign currency interventions in January. However, those interventions had only a minor effect on exchange rate volatility.
- ***Not wishing to spend foreign currency reserves in the way it did in January, the NBU decided to calm down the market by introducing tougher administrative requirements regarding FX market trades***. In particular, the NBU introduced a six-day postponement of orders for foreign currency purchase, thus increasing its control over FX market operations and exchange rate dynamics. In addition, the NBU limited the scope of purposes for foreign currency purchases by both corporate clients and individuals. Although they had a strong positive effect on UAH dynamics in the short run, ***these measures may reduce the volume of operations on the official FX market in a few months***, thus moving part of the business into grey or black markets.
- During its recent actions, ***the NBU decided to adjust its official USD/UAH exchange rate closer to the market level*** (having been stable at 7.993 for more than 1.5 years) and to make it more flexible, depending on the market exchange rate. The movement is quite positive for the market, as it will allow a reduction in currency differences in accounting and ***meet the IMF requirement for more flexibility in the official exchange rate***.
- The NBU's intention to stabilise the FX market through interventions as well as repayment of USD0.60bn to the IMF moved ***NBU foreign currency reserves to a seven-year low of USD17.8bn at end-January***. As a result, the coverage ratio of NBU reserves was lowered to 2.1 months of imports. This ratio signals that ***the NBU's ability to maintain FX market stability is rather limited currently***. That is why the NBU decided to defend the UAH and to calm down the FX market entirely by administrative methods. Together with a deficit of hryvnia resources on the money market and the absence of gas payments in February, this factor ***should reduce the necessity of the NBU intervening with foreign currency sales, while a six-day gap between foreign currency supply and demand may even replenish reserves in the first half of February***. From the other side, the repayment of debt to IMF of USD0.38bn and the redemption of foreign currency government bonds of USD0.20bn will still require foreign currency spending from NBU reserves.
- Even though devaluation fears grew on the cash FX market on the back on political uncertainty, the situation is still far from dramatic. In particular, ***net foreign currency sales to households on the most volatile segment of the FX market, the cash market, remained rather moderate at USD0.66bn***. NBU's administrative limitations should keep this figure from expanding further, while continuing political uncertainty and correspondingly solid devaluation expectations ***could still keep excessive foreign currency demand moderately high***.
- In our base-case scenario we expect stabilisation of political situation, creation of the government soon and presidential elections in early 2015. In this view we think the NBU will try to keep relative stability on FX market . At the same time, ***we adjusted slightly upwards our year-end USD/UAH forecasts to 8.90*** to account for recent UAH weakening

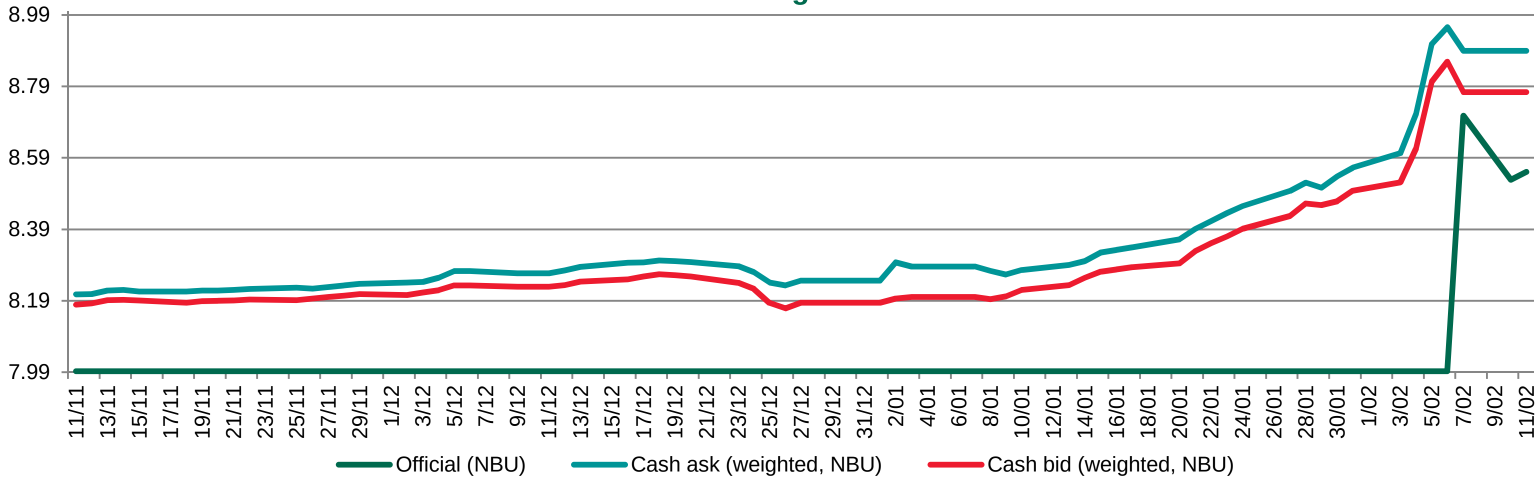
FX Market

USD/UAH interbank exchange rate over last 3 months



Sources: NBU, Reuters

USD/UAH cash exchange rate over last 3 months



Source: NBU

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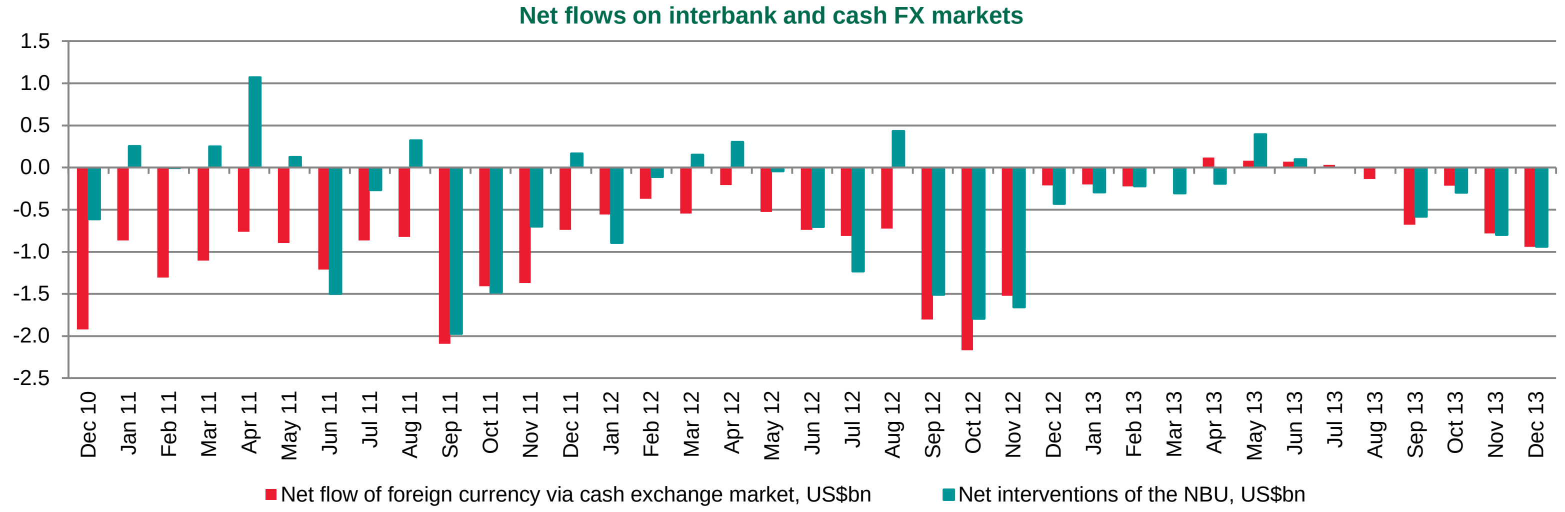
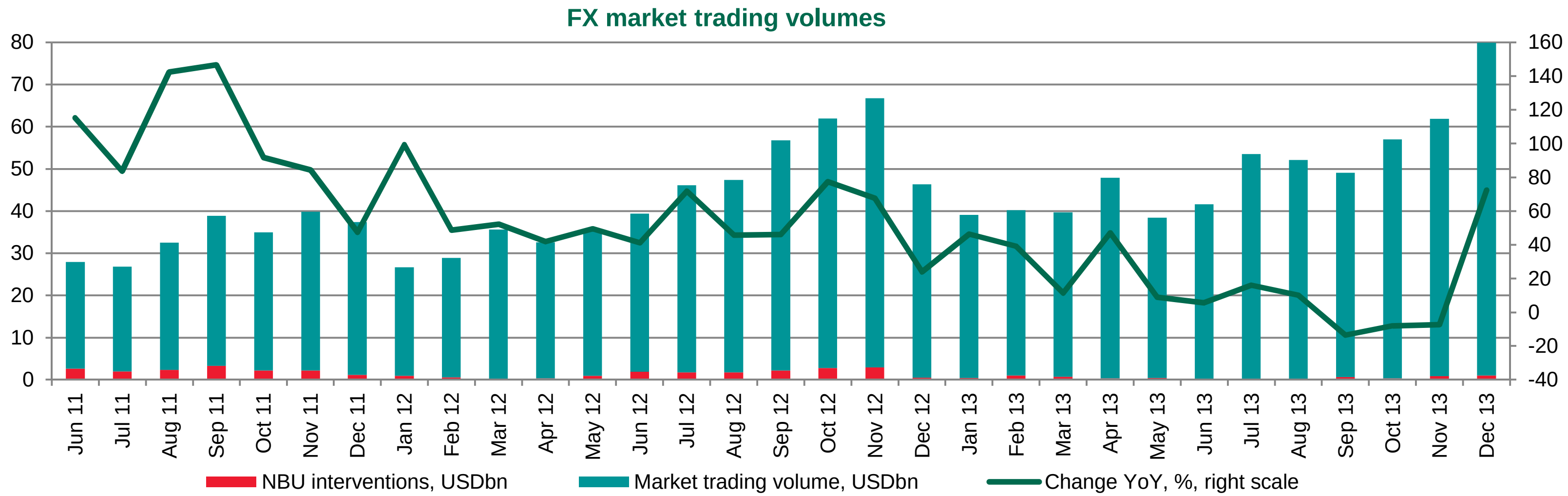
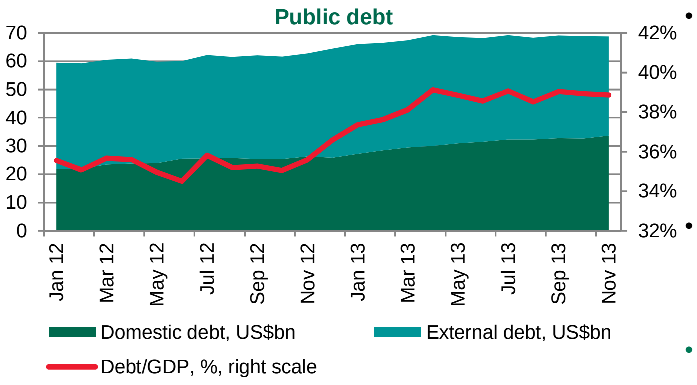
FX Market



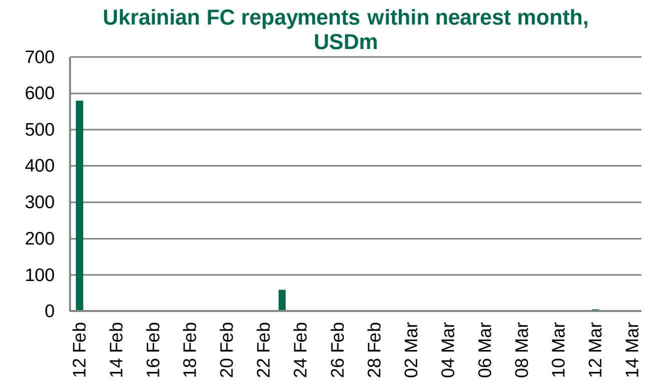


CRÉDIT AGRICOLE

Debt indicators



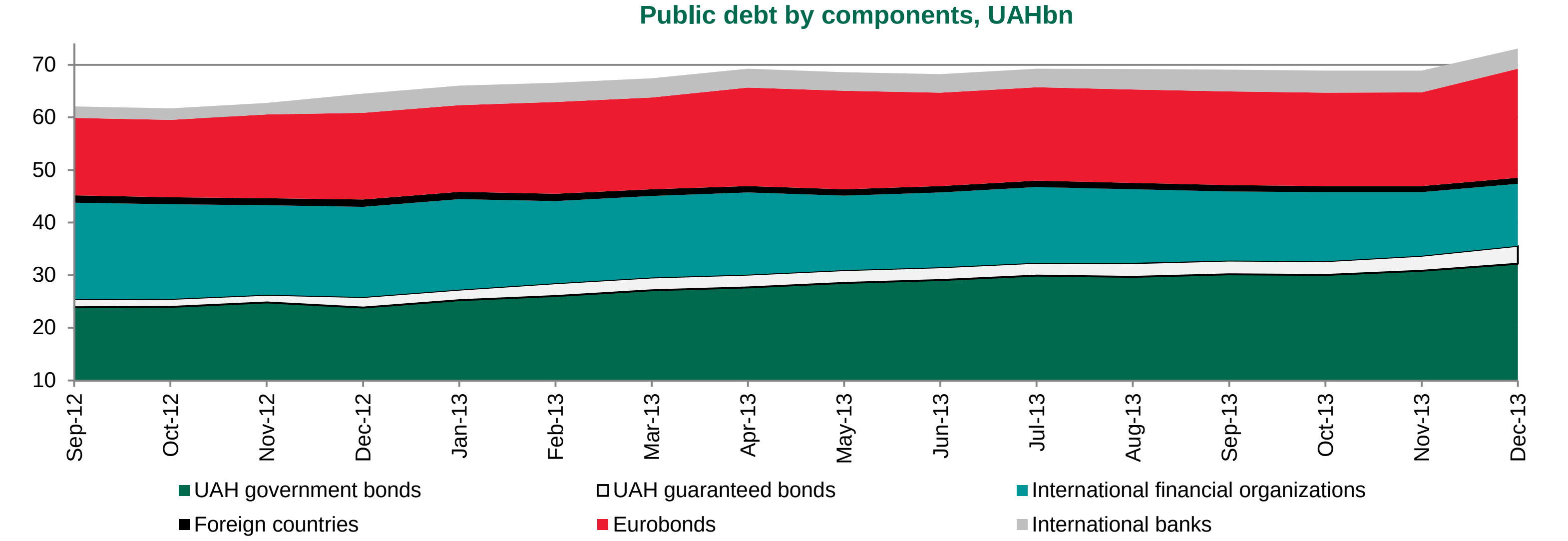
Sources: Finance Ministry, Credit Agricole



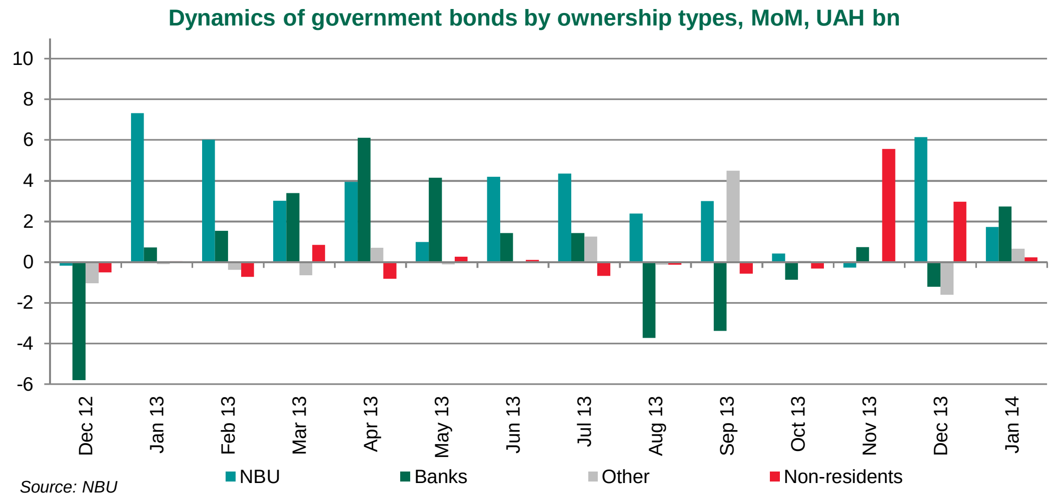
Sources: Finance Ministry, Credit Agricole

- The receipt of USD3.0bn in financial assistance from Russia was the core factor behind ***a solid increase in public debt over December. It grew by 6.3% MoM and reached a historical peak of USD73.1bn***. However, in YoY terms external debt is still showing a decline (-2.9% YoY), which we can attribute to active redemptions of external obligations by the government last year (mostly, to the IMF and on Eurobonds). The government continues to finance its current needs mostly through domestic borrowings (via hryvnia- and FC-denominated government bonds), which kept domestic debt on a high growth track in 2013 (37.6% YoY).
- The increase in public debt in December raised the debt-to-GDP ratio to a 10-year high of 41.1%. ***We expect a slight decline in public debt in January*** on USD0.65bn repayment of debt to the IMF and USD0.38bn payments on Eurobonds and FC government bonds, coupled with a rather small inflow of new debt via local government bonds. The ***debt-to-GDP ratio should follow***.
- ***The expected inflow of a new tranche of the loan from Russia (USD2.0bn) did not happen in January***, due largely to political instability in Ukraine. In particular, the dismissal of the government was a formal reason for Russian authorities to postpone the provision of a new tranche of the loan to Ukraine. The news on the resumption of loan provision by Russia is still controversial. In fact, ***the degree of Russian involvement in financial assistance to Ukraine may be tied to the external orientation of new government***. If the prime minister comes from an opposition party with a strong pro-Western orientation, this may increase the risk of postponement in loan provision by Russia. However, we think in this case the probability of receiving financial assistance from the EU, US and/or IMF will be higher. Hence, ***the risks associated with external obligations by the Ukrainian government should not increase in the medium term***, if a new government is formed quickly.
- ***Ukraine has rather moderate external obligations in February (USD0.66bn).*** The figure looks manageable, even though no additional external inflows are expected soon. Taking into consideration that new rules of FX market operation will not require heavy NBU interventions and will even allow it to replenish FC reserves slightly***, we think external obligations will not burden the NBU's foreign currency reserves this month***. In March, however, Ukraine will have more of an external burden: together with USD0.38bn repayments on its ordinary obligations, the government has to repay arrears of around USD3.2bn for gas delivered in late 2013 and early 2014. Hence, ***an external loan from either party within the coming three to four weeks would be crucial for maintaining the government's ability to service its external obligations.***
- Although the government's local currency obligations look moderate in February (UAH6.73bn), a rapid hike in the cost of the hryvnia would reduce the government's ability to refinance this repayment through the local capital market. However, ***the government is highly likely to continue its local obligations***, as the necessary repayment will be refinanced by purchasing new bond issues by state-owned banks. The latter will, as usual, refinance government bonds with the NBU.

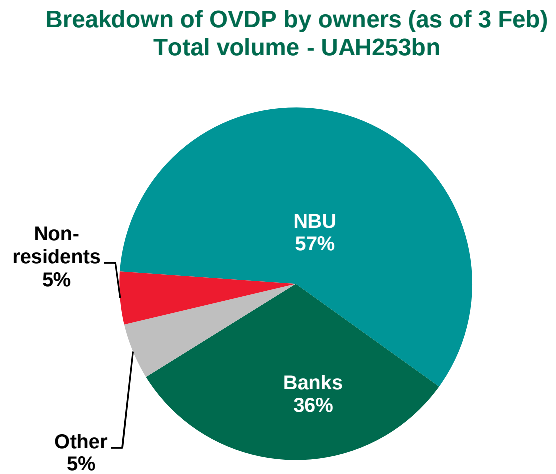
Ukraine. Monthly Market Overview. February 2014
Debt indicators



Source: Finance Ministry



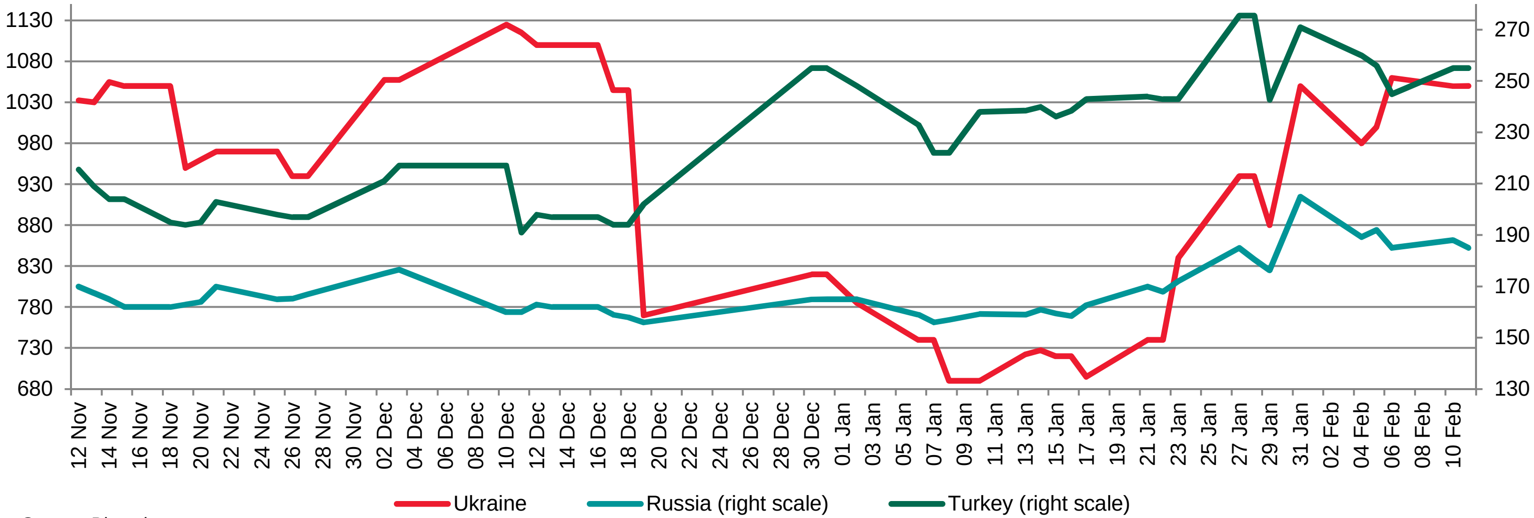
Source: NBU



Source: NBU

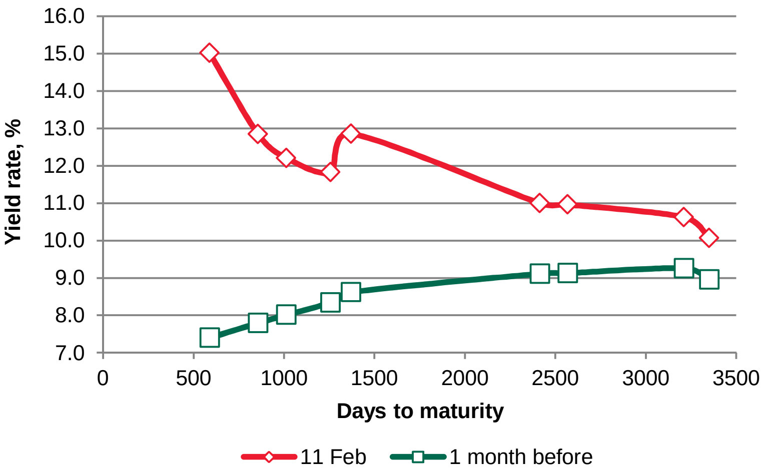
Debt indicators

Ukrainian CDS versus other countries



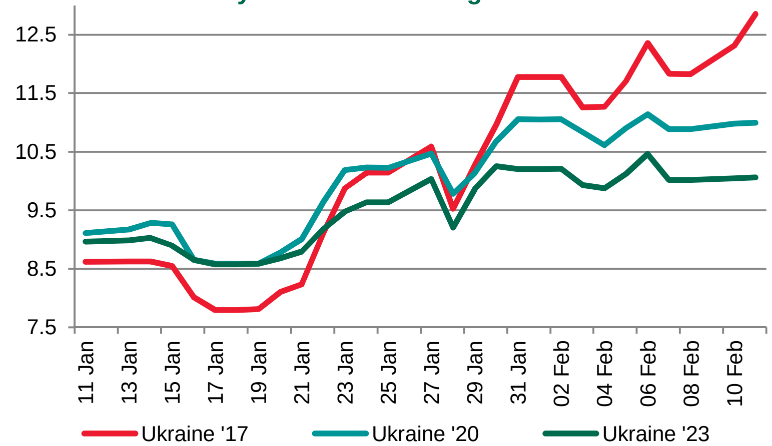
Source: Bloomberg

Ukraine's sovereign Eurobonds yield curve



Source: Bloomberg

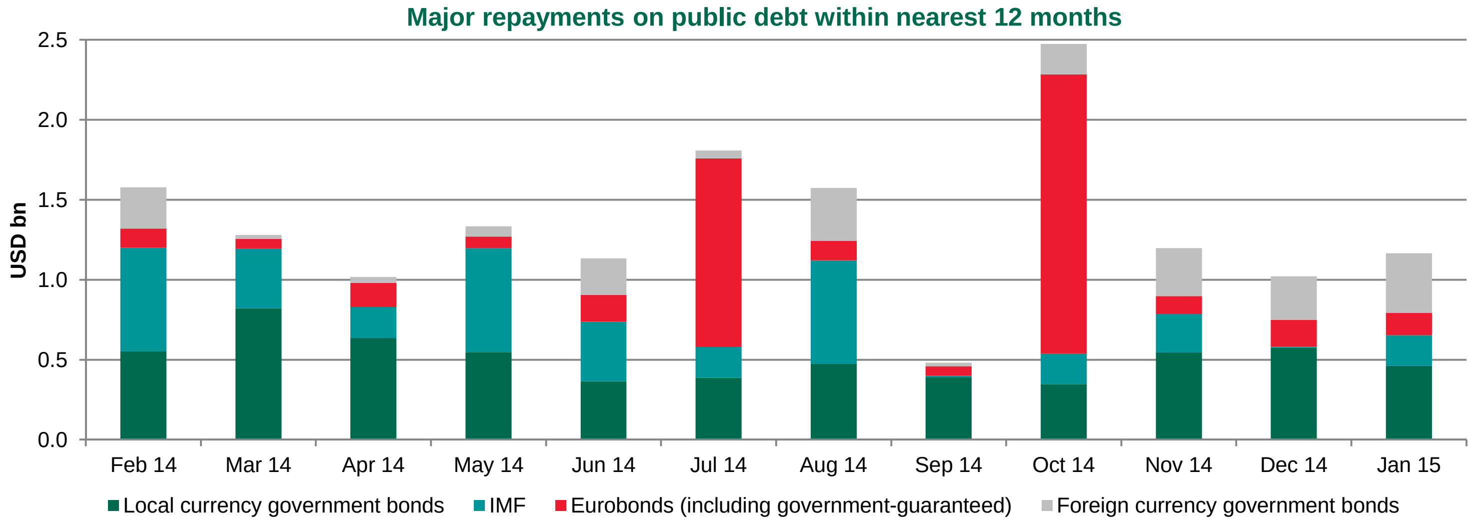
Yield dynamics of sovereign Eurobonds



Source: Bloomberg

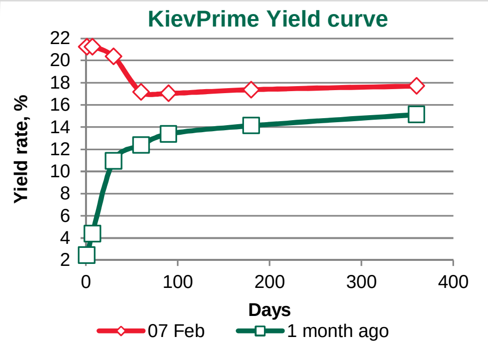
Ukraine. Monthly Market Overview. February 2014
Debt indicators

USDbn	Q114	Q214	Q314	Q414	2014
Repayment of FC-denominated public debt	**1.6**	**2.2**	**3.7**	**3.7**	**11.0**
Foreign currency local government bonds	0.3	0.3	0.5	1.0	2.2
IMF debt	1.2	1.2	0.9	0.4	3.7
Eurobonds (including state-guaranteed)	0.3	1.4	1.9	0.4	4.1
Other	0.4	0.2	0.3	0.1	1.0

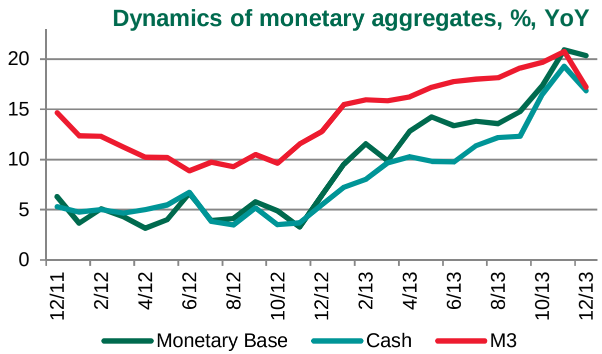


Source: Credit Agricole

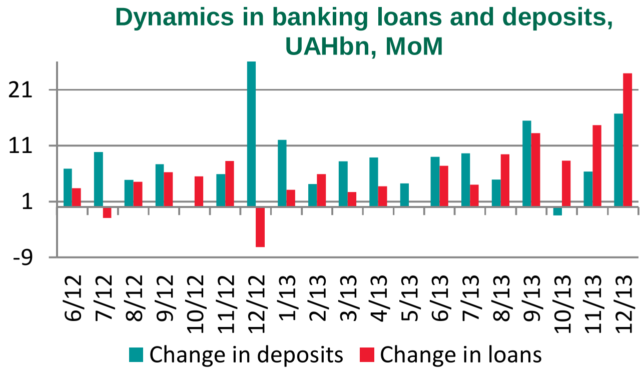
Money Market



Source: Bloomberg



Source: NBU

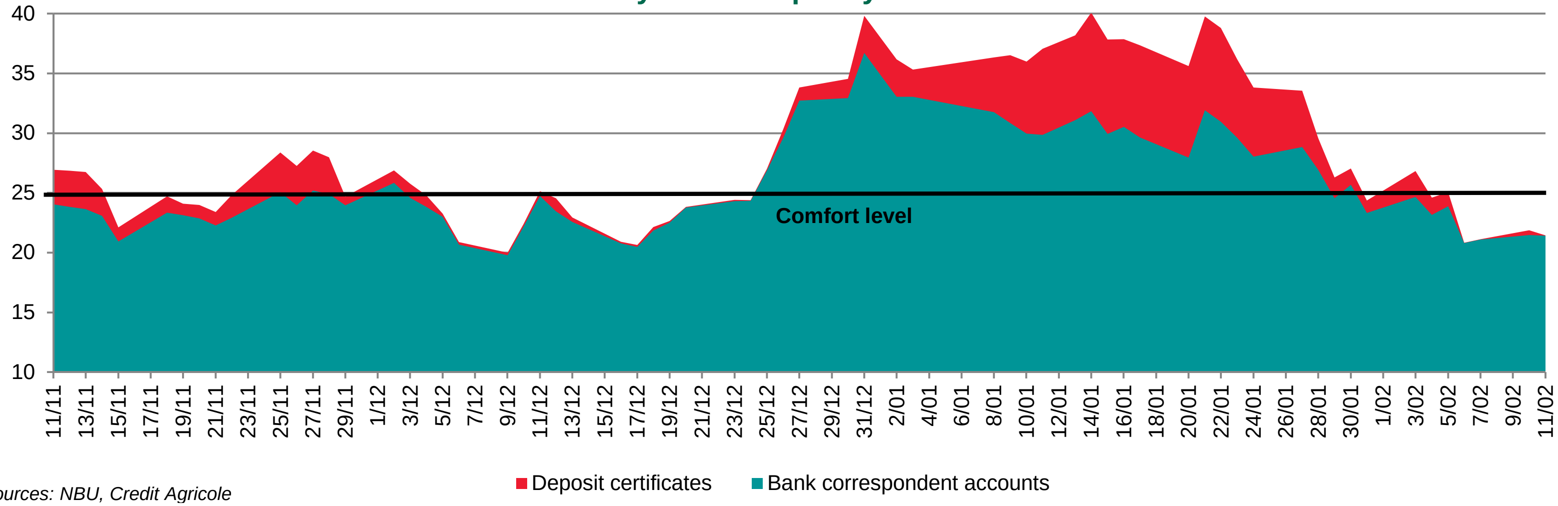


Source: NBU

- Recent statements of NBU officials support our view that ***the NBU's policy is likely to remain unchanged in the medium term in terms of keeping its monetary policy easy*** in order to stimulate the economy and switch it into growth mode. According to the bank's representatives, besides traditional refinancing of the banks, ***the NBU is planning to continue the cut its discount rate as well as to reduce gradually the volume of banking funds held on special account in the NBU***.
- ***We should not be too optimistic regarding the positive effect on money market liquidity of a prospective increase in access to NBU refinancing and the cut in the key rate***. In particular, the access to NBU refinancing is still quite limited, while the level of the key rate has no direct influence on money market interest rates. However, the intention to reduce the volume of funds on the special NBU account may be a good factor for increasing liquidity and reducing the cost of funds in the medium term. In particular, at the start of 2014 the volume of banking funds in the special account in the NBU was at UAH10.8bn, or around a third of banking system quick liquidity. Hence, ***if the NBU follows its strategy, our base-case scenario of reducing interest rates and the changing structure of banking resources towards more medium- and long-term resources in 2014 remains unchanged***.
- ***In contrast to NBU's medium-term strategy of continuing and even increasing monetary easing, the actual figure is completely different at present.*** In particular, the NBU's intention to reduce devaluation and speculative factors on the FX market squeezed short-term liquidity sharply, sending interest rates to new one-year highs of more than 30% for both O/N and 1W rates in the first third of February. However, we believe these measures are temporary. And liquidity should return to its normal mode as soon as speculative factors on the FX market are reduced. ***We think two or three weeks would be necessary to reduce the imbalance on money market and to correct short-term interest rates***. ***We still see no valid reasons for keeping interest rates high for months in 2014***.
- Official data on banking deposits' dynamics over January is not available yet, while preliminary information shows a ***visible outflow of deposits from the banking system by around UAH13.1bn***. However, in relative terms the outflow was rather moderate (by 1.95% MoM) and is comparable to average monthly growth of 1.30% MoM in 2013. And we cannot even compare this figure to the deposits outflow of 5% MoM after UAH devaluation in 2008. We think high hryvnia deposit rates can allow banking clients to afford even a slight hryvnia devaluation of 10% and prevent a mass outflow of deposits from the banking system. ***And an increase in the cost of the hryvnia on the money market may correct short-term deposit rates upwards temporarily, if the hryvnia deficit lasts for several weeks***. ***We also do not expect any mass outflow of deposits from banks in the near future***, as in extreme cases the NBU may implement a temporary ban on pre-term withdrawal of deposits, as it did during the previous political crisis in late 2004.
- ***None of the inflation indicators over January showed any worrying signs*** regarding growing inflationary pressure on the economy. YoY headline CPI was just 0.5% in January, while core CPI turned negative at -0.1%. Although CPI may be corrected upwards slightly in February on UAH devaluation, ***the figure is still a weak argument for the NBU tightening its monetary policy this year***.

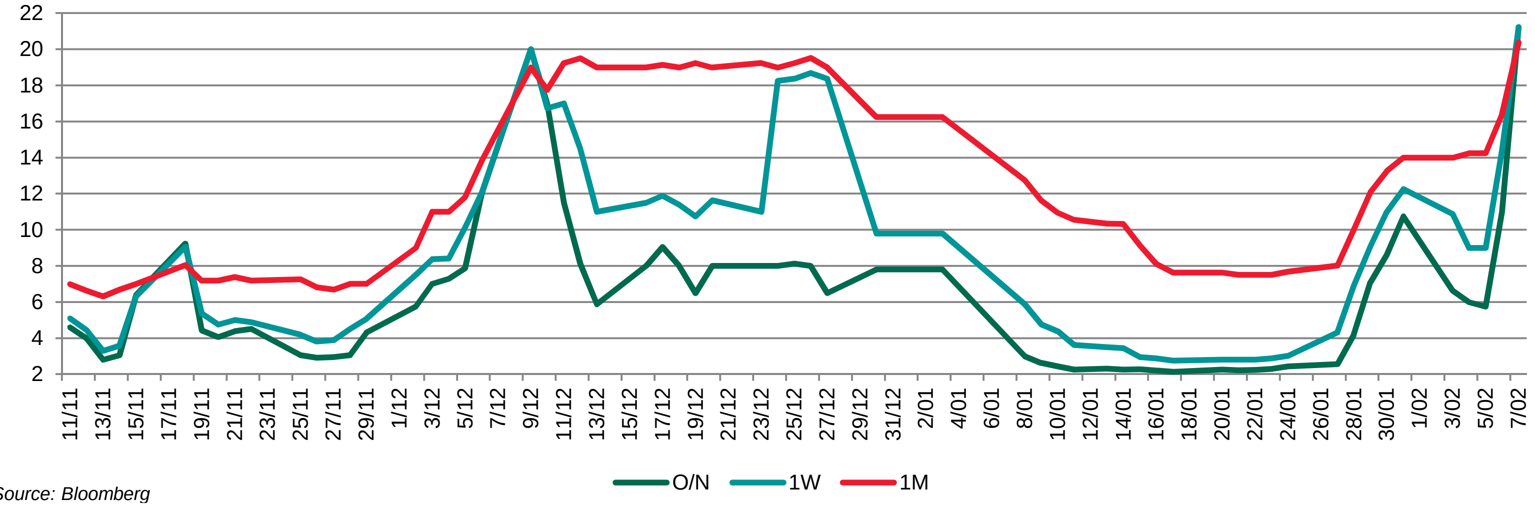
Money Market

Money market liquidity over last 3 months



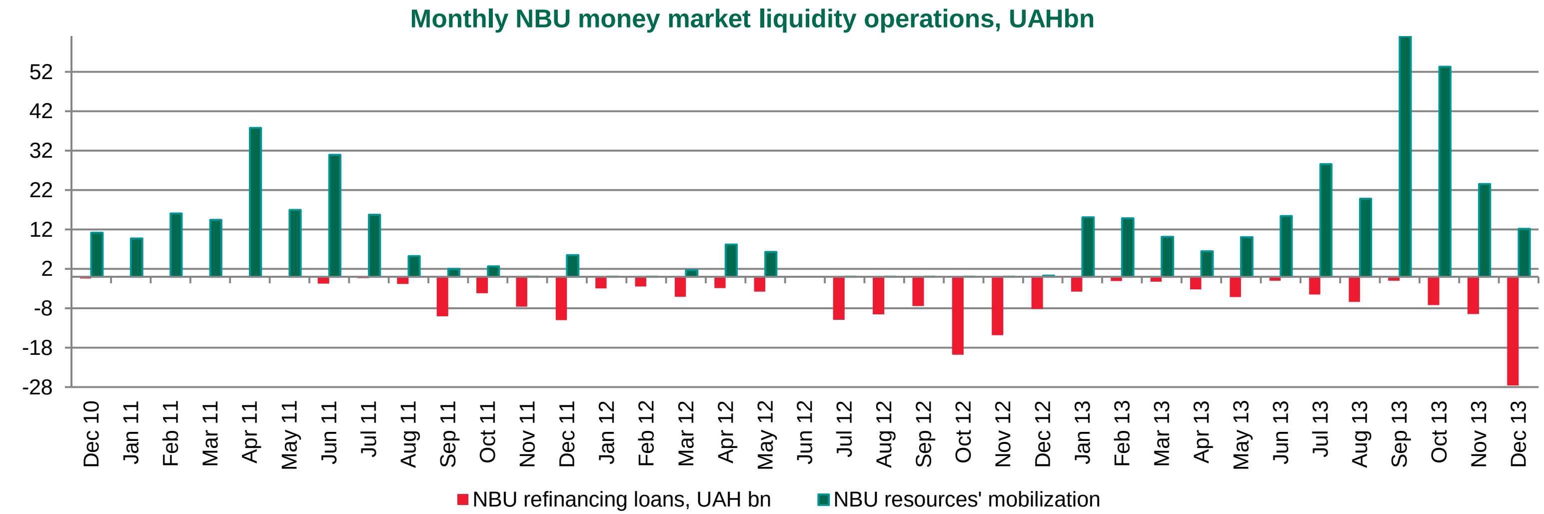
Sources: NBU, Credit Agricole

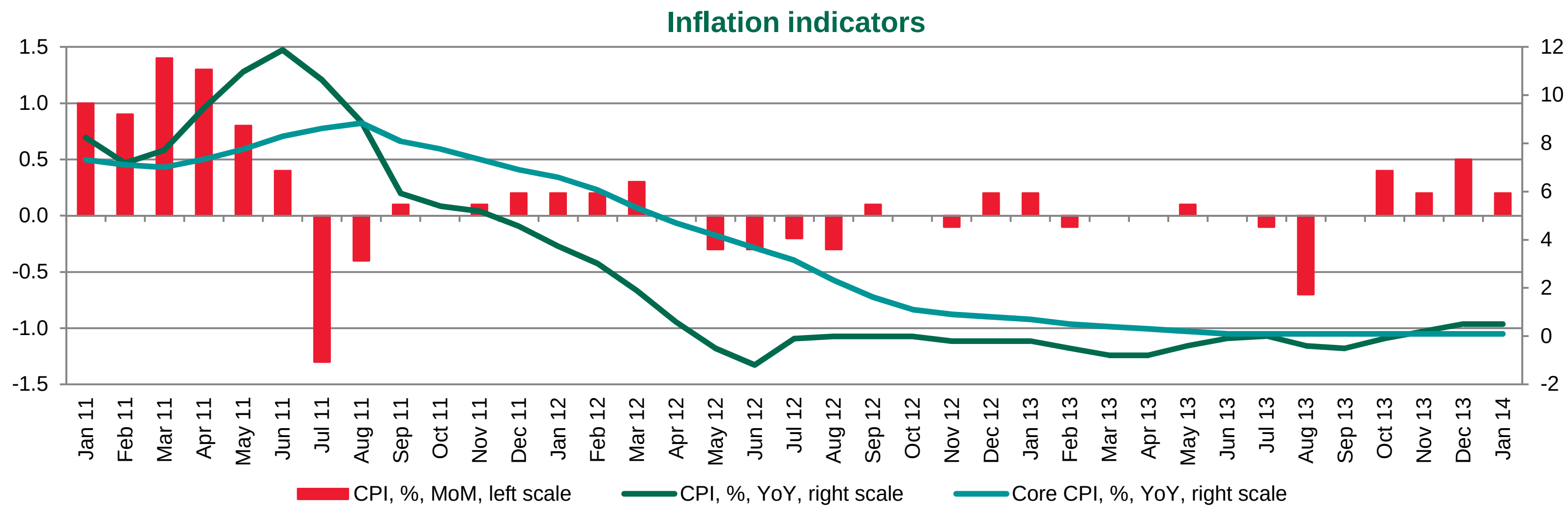
KievPrime rates over last 3 months



Source: Bloomberg

Money Market





Source: State Statistics Committee

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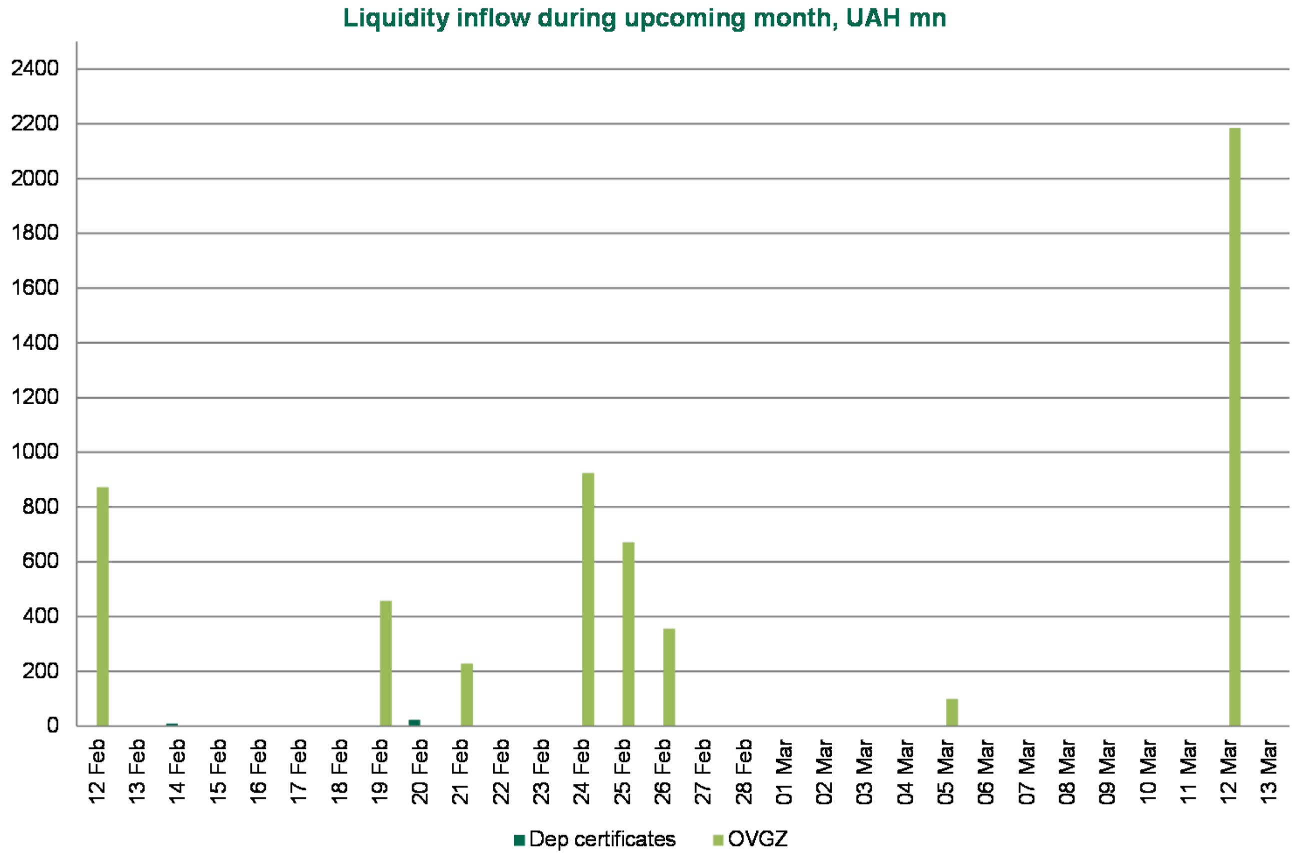
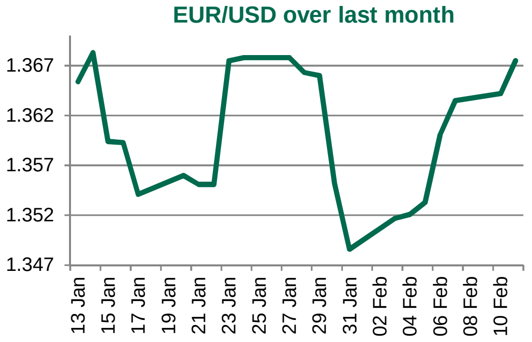
Money Market

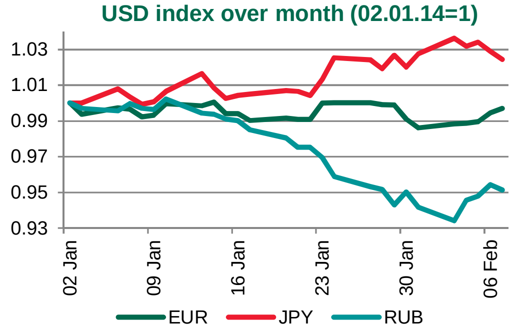


Sources: NBU, Finance Ministry, Credit Agricole

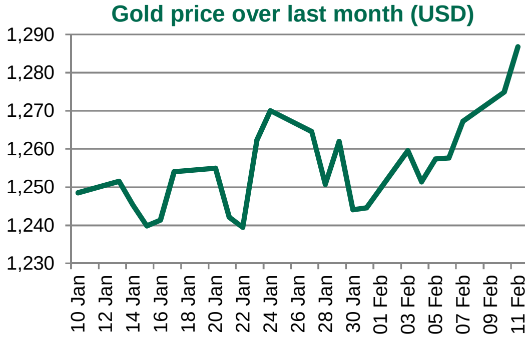
Ukraine. Monthly Market Overview. February 2014



Source: Bloomberg



Sources: Bloomberg, Credit Agricole



Source: Bloomberg

- The EUR/USD took a major tumble in the last week of the month to trade at 1.3497, well off the high of 1.33775 for the month. The EUR traded comfortably between 1.35 and 1.38 in January, supported by ongoing capital flows. Technically there are no major EUR patterns, but January did mark a more bearish turn in sentiment. For the EUR the combination of low inflation and subdued credit dynamics is likely to see the ECB turn to more accommodative policy, perhaps through President Draghi's suggestion of the purchase of private-sector loans.

- The lingering threat of deflation combined with the ongoing contraction in bank lending has fuelled increasing pressure on the ECB to provide additional monetary stimulus. Headline inflation dipped to 0.8% YoY at the end of 2013. While unconventional measures are the more likely policy choice in the current environment, there is scope for rate cuts should inflation and/or survey data disappoint in the coming months. Speaking at the World Economic Forum in Davos, ECB President Draghi dismissed speculation of traditional quantitative easing, saying that a more reasonable option would be for the ECB to buy packages of bank loans to the private sector. Since such a market does not yet exist, this prospect remains some way off. For now, sentiment indicators continue to trend gradually upwards, while industrial production data have begun to show a material improvement. The first member state to report fourth-quarter GDP results was Spain, where a 0.3% QoQ expansion marked the second quarter of positive growth following nine quarters of recession.

The following are adjusted market forecasts:

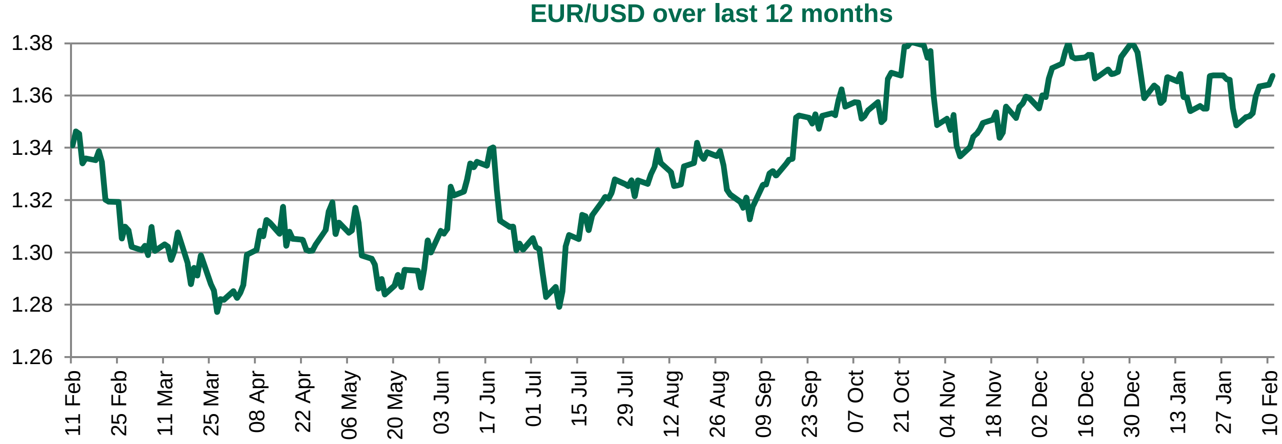
Crédit Agricole CIB EUR/USD forecast:

Q114	Q214	Q314	Q414
1.3300	**1.3000**	**1.2900**	**1.2800**

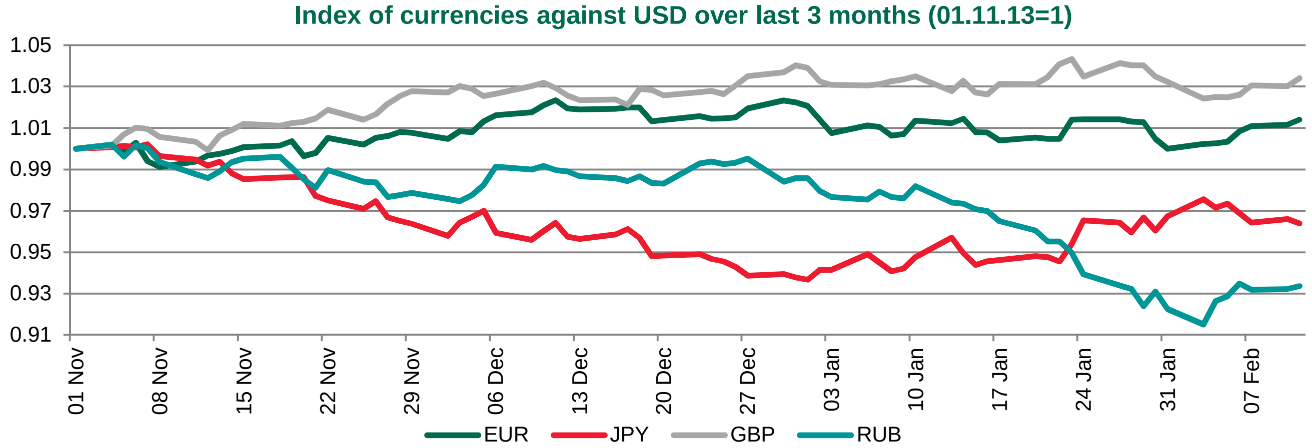
Consensus forecast (Bloomberg FC Poll by 86 strategists average)

Q114	Q214	Q314	Q414
1.3400	**1.3100**	**1.3000**	**1.2800**

Ukraine. Monthly Market Overview. February 2014



Source: Bloomberg



Sources: Bloomberg, Credit Agricole

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