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Ukraine Business Forecast Report Q2 2014

https://marketpublishers.com/r/UB60B8B6866EN.html
Date: March 2014
Pages: 46
Price: US$ 1,195.00 (Single User License)
ID: UB60B8B6866EN

Abstracts

Core Views

The new government of Ukraine to be composed of pro-Western officials. EU/IMF financing package will require reforms, including: FX liberalisation (although this is likely to be implemented in stages), partial removal of gas subsidies and potentially pension reform. An emergency financing package without conditions may be provided in order to prevent default in 2014.

Russia will not relinquish Crimea, although whether part of a semiindependent state (eg Transnistria, Abkhazia etc.), or more formally part of Russian Federation is hard to call. To limit fallout with the West we think the former, but the recent vote by Crimean parliament to join Russia may push their hand. We see political risks as likely to threaten growth over the next 12 months, as the government is forced to decide over closer relations with the EU or Russia. Russia’s Vladimir Putin will be happy with Crimea for now, and will not push military intervention into north east of Ukraine. Ethnic divisions in north-east Ukraine not nearly as clear cut as Crimea, and it would benefit Putin to retain a large ethnic Russian influence in mainland Ukraine (enabling him to maintain a direct political stake in Ukrainian affairs).

Major Forecast Changes

We have downgraded our outlook for real GDP growth for 2014, and now expect GDP to contract by 1.9% in 2014. This change reflects our expectations for hryvnia devaluation and concomitant impact on household purchasing power, the Crimean conflict dampening fixed investment and expectations of a retrenchment in government spending.

Key Risks To Outlook

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A sharper than expected devaluation could trigger major shockwaves through the domestic economy, particularly within the financial sector which has barely recovered from the 2008 devaluation. Existing capital buffers may prove insufficient to deal with a devaluation of 30% magnitude or greater.

We see huge challenges surrounding the ability of the interim government to pass the unpopular reforms required to gain access to a full IMF/EU funding package. Removing gas subsidies, for example, could inflame tensions within the eastern regions. Further unrest in the eastern regions of Ukraine could spur military intervention by Russia on the pretext of protecting the Russian population present there. The threat of a protracted military conflict would likely accelerate capital flight, placing the unit under intense pressure.

Even excluding the prospect of a protracted military intervention from Russia for the moment, the country is at severe risk of an uncontrolled devaluation of the hryvnia and consequent economic collapse. A devaluation to UAH11.0-12.0/US$ for any extended period would place severe pressure on households who would see their savings and purchasing power sharply reduced overnight, thus dampening already slowing retail sales and pushing up inflation. The government itself would also suffer due to additional debt servicing costs on its US$27bn external debt burden, while the banking sector would likely experience a sharp deterioration in asset quality on its FX loan books.

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escalation of tensions with Russia has increased the pressure on Ukraine's external accounts, with gas discounts likely to end in Q214 Despite new capital controls, domestic dollar accumulation and capital flight continues to erode the country's limited international reserves, and Ukraine will default on its external obligations in 2014 without a financing package.

Table: CURRENT ACCOUNT

Fiscal Policy

In Urgent Need Of External Financial Aid

Ukraine is on the brink of a major credit event and urgently requires external assistance in order for the government to meet its financial commitments. While we expect the West may provide a small interim loan to allow the country to avoid defaulting on its repayments in April and June, larger financing packages will be on a conditional basis, and we see risks that the government will be unable to implement the associated reforms. The recent devaluation of the hryvnia has also substantially worsened the sovereign credit profile.

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