

# Ukraine Business Forecast Report Q4 2013

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## Abstracts

### Core Views

In line with our view for Ukraine to enter a recession, real GDP contracted for a second consecutive quarter in year-on-year terms, shrinking by 1.1% on the back of weak exports and minimal fixed capital investment. We maintain our expectations for growing external account imbalances to drive a devaluation of the hryvnia by end-2013. We see political risks as likely to growth over the next 12 months, as the government is forced to decide over closer relations with the EU or Russia.

### Major Forecast Changes

We have downgraded our outlook for real GDP growth for 2013 and 2014, and now expect GDP to contract by 1.4% in 2013 and grow by just 1.0% in 2014. This change reflects our bearish outlook for global metallurgical markets next year, our expectations for hryvnia devaluation, and expectations of a retrenchment in government spending.

### Key Risk To Outlook

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 20% magnitude or greater. We see significant downside risks to our fiscal deficit forecasts, as government energy spending looks set from already elevated levels in the winter months.

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Ukraine's government seems to be slowly shifting its policy focus towards the EU after the president and parliament approved new laws, enabling the country to sign an Association Agreement in November. This will not only end Ukraine's chances of joining the Eurasian customs union, but could spark a trade war with Russia, with significant consequences for the domestic economy.

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Ukraine's long-term political trajectory is far from certain, with the coming years likely to prove crucial to the country's convergence prospects over the next decade. Weak institutions remain the greatest challenge to long-term stability, though we also highlight systemic tensions in bilateral relations with Russia and growing demographic issues as additional threats likely to confront future governments. Going forward, the most likely scenario is a future where Ukraine remains torn between closer relations with West while remaining under Russia's sphere of influence.

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The recent narrowing of Ukraine's current account deficit does not signal a notable improvement in balance of payments pressures. Even if the authorities are able to substantially diversify their energy dependence from Russia in the short term, which we doubt, there are major risks to Ukraine's ability to finance what remains a structural current account shortfall without devaluing the currency.

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The National Bank of Ukraine's surprise rate cut in August is a clear sign that the authorities are becoming seriously concerned about the lacklustre pace of economic activity. We do not expect the rate cut to have a material impact in the wider economy, though, as concerns over the stability of the currency will continue to disrupt the monetary policy transmission system and push up the cost of borrowing.

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