

When bad peace is worse than a good war

Political and economic note on Ukraine

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Any solution is better than no solution

The possible “bad peace” scenario for Ukraine (or preserving the status quo in Ukrainian politics), that has rested on the December 17 deal with Russia, **doesn’t look sustainable any more:**

Last week, Russian President Vladimir Putin spectacularly demonstrated that any new portion of the offered macroeconomic support to Ukraine (up to USD 12 bln in 2014), as well as a valuable discount for natural gas (that could enable Ukraine to save up to USD 2 bln in foreign cash) will be postponed until Ukraine produces a new (pro-Russian) government.

With its estimated USD 18 bln international reserves as of end-January (about 2.1 months of future imports) and the local currency having lost 7% of its value against the U.S. dollar in just one month (more than the last four years combined), the Ukrainian government faces very limited time in its attempt to survive “autonomously”:

- the government would have to spend USD 7.5 bln (or 40% of its estimated end-January reserves) in Feb.-Dec. 2014 to repay its ForEx debt
- the January hryvnia devaluation has already inflated demand for U.S. dollars, which can easily wipe out all reserves in a matter of weeks
- Ukraine’s natural gas monopoly Naftogaz owes USD 3.3 bln to Gazprom, debt that it is clearly not willing to repay right now

Too little time for a solution. We estimate that NBU reserves can fall to an alarming level of USD 15 bln already by the end of February, which can start processes of further hryvnia devaluation beyond NBU control, further cuts to Ukraine’s sovereign ratings and eventually lead to Ukraine’s default by the end of this spring.

Ukraine’s leaders have no more than one month to form a new government and keep the macro situation under control. Any government, should it be pro-Russian (reliant on Russian money) or pro-EU (gaining some macro support from the EU and/or IMF), will be a better option than the “no-government” situation that we have right now, after the resignation of PM Mykola Azarov on January 28. No candidate has been nominated as his replacement yet.

Yanukovych and EuroMaidan are core limitations for possible solutions. The key problem on the way to appoint/elect a new government is the polarization between two unbending forces in Ukrainian politics. At the moment, the appointment of a pro-Russian Cabinet of Ministers by President Viktor Yanukovych will lead to an escalation of the EuroMaidan street protests (which can lead to consequences that no one can model right now). The alternative scenario in which a pro-EU government is elected (as a concession to EuroMaidan and the EU, which supports a return of the constitutional order to a parliamentary-presidential republic) is not acceptable to the president, who still controls all the central power branches (including the legislative and judiciary). Yet neither the EuroMaidan movement nor Yanukovych are factors that can be removed from Ukraine’s political scene. At least, that’s how it looks at this point of time.

Two most likely and sustainable directions that Ukraine can go are:

- Constitutional and economic reform in the way of “shock therapy” in 2014 and integration into EU afterwards
- Establishment of a Belarus-like dictatorship in Ukraine and full dependence on Russian sponsorship in the future

Poland, Belarus or Syria: how Ukraine will look like

Below we summarize the four possible scenarios of how Ukraine will look like in the coming year (the status quo, or “bad peace” scenario, is not sustainable, as we highlighted before. Our conclusion is that most sustainable are the Polish and Belarus scenarios. See more details on pp 7 - 11.

Scenario	Status quo (0)	Polish scenario (1)	Russian scenario (2)	Belarus scenario (3)	Syrian scenario (4)
Key events	- No constitutional changes - No new gov't	- Constitutional changes - New pro-EU gov't	- No constitutional changes - New pro-Russian gov't	- No constitutional changes - New pro-Russian gov't	- No constitutional changes - New pro-Russian gov't
	- Some limited support from RU or EU possible	- Macro support from EU/IMF, - No gas discount	- Macro support from RU, gas discount	- Macro support from RU, - Gas discount	- Macro support from RU - Gas discount
	- Some risk of escalated street protests	- Street protests end	- High risk of escalated street protests	- Forceful dispersal of protesters, dictatorship	- Failed attempt of forceful disperse of protesters
Probability	-	Fair	Fair	Fair	Fair
Sustainability	Very low (max. 3 months.)	High	Low	High	Unclear
Possible short-term consequences	- Default - Shift to (1), (2), (3) or (4)	- Drift to EU, reforms - Coalition collapse and shift to any other scenario	- Reliance on Russian support, no reforms - Shift to (3) or (4)	- Belarus-like dictatorship - Reliance on Russian support - Shift to (1) or (4)	- Civil war - Country split - Shift to (1) or (2)
Macro outlook if sustained in 2014	UAH/USD > 10.0 Fiscal crisis GDP 2014: < -3%	UAH = 9.5-10.0/USD Budget cuts GDP 2014: -1%	UAH = 9.0/USD No budget cuts GDP 2014: around 0%	UAH = 9.0/USD No budget cuts GDP 2014: around 0%	UAH/USD > 10.0 Budget collapse GDP: unclear
	Soon default	Default risk is low	Default risk is low in 2014, high in 2015/16	Default risk is low	Soon default
		FDI +20 to +30%	FDI -10 to -30%	FDI -20 to -30%	FDI outflow
		C/A deficit: 7.0% of GDP	C/A deficit: 6.5% of GDP	C/A deficit: 6.5% of GDP	C/A balance: unclear
Possible mid-term consequences	- Shift to (1), (2), (3) or (4)	- Macro stabilization - EU integration	- Shift to (1), (3) or (4) - Default in 2015/16 or joining a Russian union and full dependence on Russian macro support	- Joining a Russian Union, full dependence on Russian macro support - Belarus-like dictatorship - Shift to (4) or (1)	- Unclear - Shift to (1) or (2)

Who is who for Ukraine now

President Viktor Yanukovych: the most powerful political figure who controls all the branches of Ukrainian power. His power rests on tight control over the prosecution, police, judges and parliamentary majority, with silent support from oligarchs, the army and hidden support from the Russian Federation. Since his persecution of the EuroMaidan protest however, he has lost some legitimacy in Ukraine's western regions and the capital, Kyiv, as well as in the U.S. and the EU. His ultimate goal is to preserve his power for as long as he can. Except terrorizing of all his allies, he is rested on strong financial support from his "family"—ultimately he could buy his opponents. The main obstacle on the way to his goal is the EuroMaidan protest movement, which not only confirmed his authoritarian, dictator-like qualities, but also undermined his story of economic stability. Yanukovych may win everything (and become a Belarus-style dictator) or lose everything, which is why he's ready maintaining his position to the very end. Time is playing against Yanukovych's popularity for economic reasons, but the time may be Yanukovych's friend in his attempt to set up a dictatorship in Ukraine.

EuroMaidan, at the moment, is the second-most powerful player in Ukraine. It derives its strength from active citizens, largely members of Ukraine's middle class that has been targeted and alienated by the Yanukovych administration. The parliamentary opposition has rode its momentum, while Western governments and citizens have supported it. Its ultimate goal is the dismissal of Yanukovych, or at minimum making him delegate most of his power to a pro-EU government. The EuroMaidan has no official leader, which makes it independent of any other political force. Its strength and unpredictability is a headache for Yanukovych. For now, he doesn't have enough police forces to liquidate its control of the Kyiv city center. Time is playing against the EuroMaidan too since nobody knows for how long it will enjoy enough public support to maintain its influential position as a powerful player. Theoretically, important activists may be physically eliminated or bought, marginalizing the mass movement. If it's violently dispersed, the EuroMaidan will likely evolve into a regional armed resistance.

The parliamentary opposition is relying on tenuous support from the EuroMaidan and strong support from western Ukrainian oblasts and the West. Its ultimate goal is to gain power from Yanukovych, or at minimum not lose what it has now. The latter goal doesn't satisfy the EuroMaidan but is supported by the West. Thus far, Yanukovych has been effective enough to block any steps by the opposition to change the political situation to their advantage. A decision to form a government under Yanukovych's presidency will be received warmly by the West but is likely to be rejected by the EuroMaidan. Yet time is playing against the opposition, as both the West and the EuroMaidan may eventually grow tired with their lack of progress, resulting in a withdrawal of support.

The West (the EU and the U.S) openly supports structural changes in Ukraine but remains wearing extremely cautious in trying to solve the crisis. The EU is clearly not interested in a "hot spot" on its borders. Sanctions against Ukraine's top officials and oligarchs remain "an option" for the West, while all the other peacemaking efforts have brought no results, expect public irritation from Russia. Possible sanctions, the West's core instrument of influence on the crisis, are likely to have a diminishing effect the later they are introduced given that those targeted are already preparing for them.

Ukraine's oligarchs are now between a rock (pressure from Yanukovych) and a hard place (the threat of sanctions from the West). The "rock" looks like the more powerful factor to them since they are still supporting Yanukovych, largely out of fear. Publicly, they are calling for a peaceful resolution, but in fact their parliamentary MPs have voted in favor of all of Yanukovych's initiatives, however counterproductive they may be.

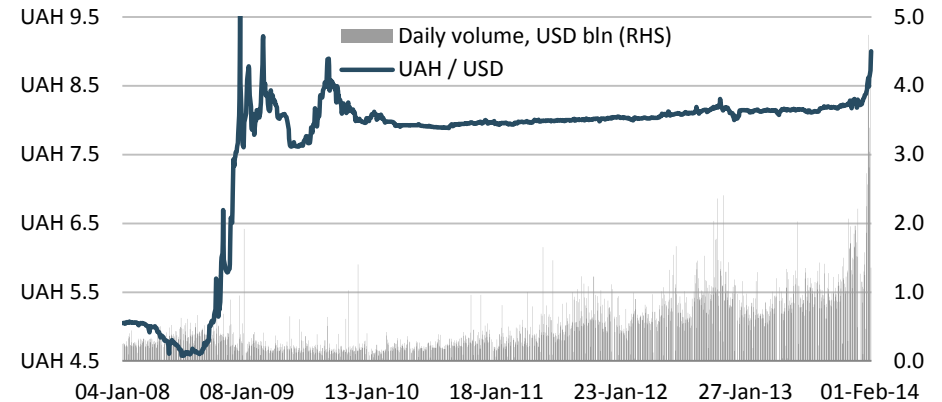
Russian Federation (Vladimir Putin) is clearly interested in a "no-EU" scenario in Ukraine, in any form. Russia has some support from the residents of the southeastern regions of Ukraine, as well as those close to Yanukovych. Russia sponsored Ukraine's exit from the EU Association Agreement with the Dec. 17 agreement for loans and cheaper gas. A EuroMaidan victory may create a dangerous precedent for Russia's opposition activists, which is why Putin will not tolerate Ukraine's move towards the EU. He has already frozen macro support and the reincarnation of a customs war look unavoidable. It's possible that Russia will lend military support to aid Yanukovych in a crackdown following the Olympics in Sochi. Putin's key adviser Sergei Glaziev has already called for a federalization of Ukraine that would allow the southeastern regions to join the Customs Union. Russia is the only player clearly benefitting as time passes.

Hryvnia instability is the core challenge. UAH also needs prompt stability

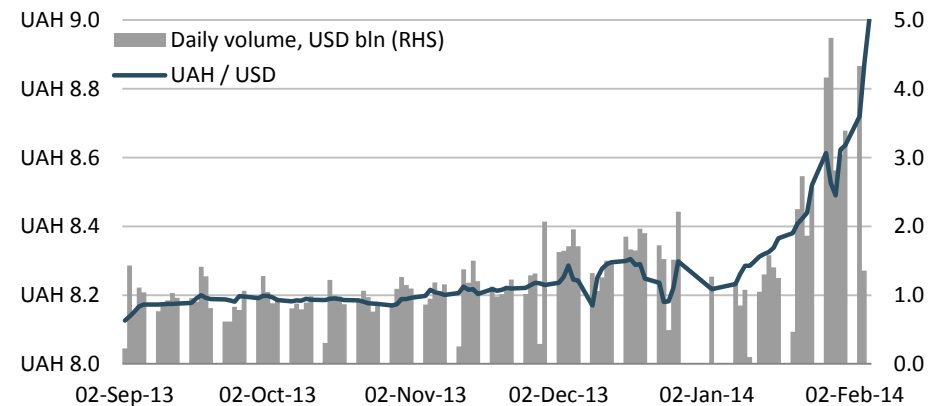
After remaining remarkably calm over the last four years, Ukraine's ForEx market became nervous with the escalation of political conflict:

- The hryvnia started losing ground on Jan. 16 when parliament adopted strict "dictatorship" laws and its stability was shaken even further since Jan. 22, when the first protest-related casualties were reported.
- The fundamental stability of the hryvnia rested on Russia's agreement to provide macro financing of up to USD 12 bln in 2014, which was withdrawn on Jan. 29 after Ukraine's pro-Russian PM Azarov resigned the prior day and Putin stated clearly that all support is frozen.
- Last week, the NBU tried to intervene but increased trading volume on the ForEx market (NBU reserves are just 4x current daily volumes) prevented the bank from regaining control over the hryvnia exchange rate.

Ukraine's securing of some macro aid from either Russia or the West looks like the only way to calm panic on the ForEx market. The sooner the better.



Source: Minfin.com.ua



Source: Minfin.com.ua

Consequences of weaker hryvnia

Hryvnia devaluation, although having been broadly expected over the last 2-3 years, comes as a negative surprise to Ukrainian business in January 2014. Ironically, devaluation expectations were as low as never before on Dec. 17, when Russia offered an unprecedented macro support package to Ukraine.

Devaluation will trigger inflation and will revive Ukrainian exports to some extent. On the other hand, we expect a decline in private consumption (which used to be one of the core drivers of Ukraine's economy over the last three years), hardships in the banking sector and problems with external debt servicing.

At what level will hryvnia stabilize?

The level at which the UAH/USD rate might stabilize will mainly depend on the future government's geopolitical orientation.

- **In case the new government chooses the EU as its core partner** (resulting in EU/IMF help that will require reforms, loss of the Dec. 17 deal with Russia and a reignited trade war): the hryvnia will have a chance to stabilize at 9.5/USD (providing this scenario will start quickly) with some potential to weaken to 10/USD over the rest of the year. The 2014 C/A deficit will amount to 7.0% of GDP in this case.
- **In case of a pro-Russian government** (resulting in renewed Dec. 17 aid in the form of loans and cheaper gas): the hryvnia may stabilize at 9.0/USD. The C/A deficit will amount to 6.5% of GDP in 2014 in this case.

Consumption to slow down significantly

The hryvnia decline will shave off nearly 5% of the 2013 private consumption level this year, damaging businesses and undermining budget revenue (see below), especially in light of the budget's considerable dependence on import taxes.

Budget deficit may expand

Budget revenue to some extent will benefit from inflation but sliding private consumption and falling demand for imports (which generates 2/3 of tax revenue) will definitely weigh on collections. Against this backdrop, non-tax revenue (wires from the NBU and additional administrative pressure) will be mobilized to offset the tax revenue decline. However, we expect that won't be enough to avoid a 3-5% budget revenue drop this year. The fiscal gap in this case will approach 9.0% of GDP, excluding Naftogaz and potential banking sector refinancing.

Naftogaz's financial gap exacerbates

In the event that gas rates for households and heating companies remain unchanged, Naftogaz's fiscal gap will increase by UAH 2.0 bln for each 10pp of hryvnia weakening against the U.S. dollar. In particular, assuming a hryvnia devaluation from UAH 8.2/USD to UAH 9.0/USD and the Russian discounts remaining in place, Naftogaz's deficit would rise to UAH 13.5 bln in 2014 (vs. UAH 11.5 bln if no devaluation happens, still smaller than the our 2013 estimate: UAH 22.0 bln). Ironically, in case Russia does not help with cheaper gas (as we model below, that would assume Ukraine's turn to the EU and appropriate gas rate adjustments), Naftogaz's deficit may be much smaller.

What's next: Poland, Belarus or Syria

Ukraine's current autonomous drift with no apparent solution to the political and upcoming economic crises is not sustainable. In the next 1-2 weeks, we expect changes in the government that will either draw the nation into the Russian orbit or lead to the signing of the EU Association Agreement. Each of these geopolitical scenarios looks possible right now, but the way in which they will be reached looks neither clear nor straightforward. Therefore below, we offer analysis that starts from the ultimate solution and examines what barriers Ukraine stands to face on the way. The proposed set of scenarios is not exhaustive, through we believe they are the most likely.

1) "Polish" scenario. Constitutional reform (president loses some of his current power) and election of a pro-EU government in parliament. Ukraine receives some macro support from the EU and/or IMF in exchange for some macro reforms ("shock therapy," as in Poland in the 1990s). EuroMaidan street protests calm down or conclude.

This looks like among the more sustainable and transparent scenario (in terms of predictability of macro indicators). And it fully corresponds to the "maximum concessions from the president" scenario described in our strategy note of Dec. 4, 2013. The key impediment for this scenario is the clear unwillingness of Yanukovich and his entourage in government (known as "The Family") to offer any concessions and apparent desire to retain power at any cost.

2) "Russian" scenario. No radical change in the current political situation and Yanukovich appoints a new, pro-Russian government. Ukraine receives its promised macro support from Russia (USD 12 bln loan, gas discounts) in exchange for silent loyalty.

This scenario also looks sustainable from the point of view of macroeconomics, as it addresses current challenges. And it corresponds to "painless drift to Russia" scenario as described in our Dec. 4 note. The core problem for this scenario is it fully rejects the demands of the EuroMaidan protest movement, thus will likely lead to an escalation in protest activity and possible violence. From a political standpoint, it does not look sustainable at the moment.

3) "Belarus" scenario. This assumes not only a pro-Russian government, but also a violent dispersal of the EuroMaidan (possibly with the help of Russian forces). If successful, it will lead to Belarus-like dictatorship in Ukraine. Full Russian support looks indispensable in this case, in exchange for the full loyalty of Yanukovich.

This scenario seems to be sustainable from the point of view of macroeconomics and politics. The core problem on the way to achieve such sustainability will be the likely fierce reaction from the West, including personal sanctions against top state officials and their sponsoring oligarchs, as well as economic sanctions against the government. For Ukrainian oligarchs, the full dictatorship implies new risks for their property (the Belarus case is indicative: there are no tycoons there). In the most extreme case, it may lead to a military invasion by Western countries (especially if there is some reported use of weapons of mass destruction). On top of that, a possible fierce reaction of street protesters should not be ignored.

4) "Syrian" scenario. This assumes a pro-Russian government emerging and failed attempt to forcefully disperse the EuroMaidan, or the shifting of mass protests from Kyiv to western Ukraine. It will result in a civil war in Ukraine, with neither the pro-presidential forces nor pro-EU forces being able to win the war (similar to what's happening in Syria).

For sure, this is the worst scenario for Ukraine, its investors and most of its incumbents (including the oligarchs) and most of its international partners. But unfortunately, we cannot rule out such an outcome currently.

(1) Polish scenario

A pro-EU government is established after constitutional reforms reduce the president's powers. It implements IMF reforms, including ForEx market liberalization, higher household gas prices, and fiscal consolidation. Ukraine receives macro support from the EU and/or IMF to fund the reforms and avoid sovereign default. Street protests finish. Russia cancels the Dec. 17 agreement (no discount for gas since 2Q14, no loans from Russia).

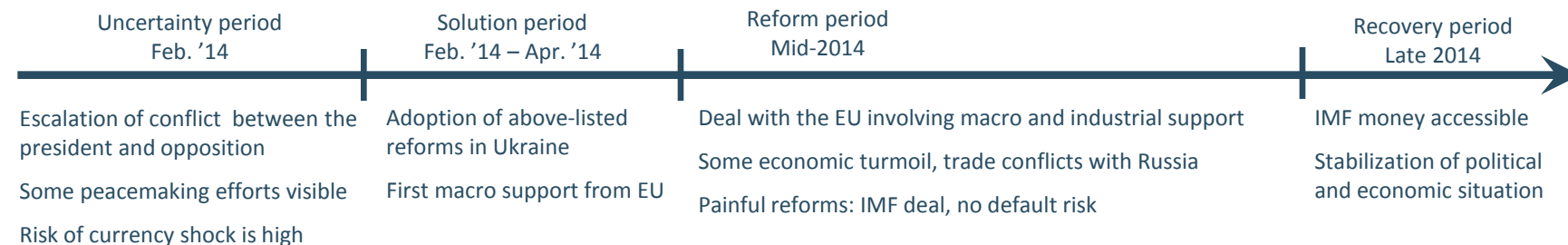
When it's possible:

- Such a scenario presumes that Yanukovich will make considerable concessions due to pressure from oligarchs (who, in turn, are being pressured by the U.S. and EU). Some Party of Regions MPs (especially those aligned with top oligarchs Akhmetov and Firtash) look ready to support the reforms right now, though they have been dissuaded by Yanukovich from offering their votes so far.
- Here's why the fulfillment of such a scenario is possible in the very limited time frame (1-3 weeks):
 - So far reports of police brutality are making global headlines, giving U.S and EU officials an additional impetus to pressure oligarchs
 - So far oligarchs have not yet "gotten used to" their role of being unwilling sponsors of bloodshed, and/or they have not yet restructured their assets in a way to minimize the effect of possible sanctions
 - So far Putin is bound from acting drastically in Ukraine as he is concerned about Russia's image during the Olympics (which finish on Feb. 22)
 - So far "not everything" is lost in the Ukrainian economy

Limitations to this scenario:

- The key limit is the inability (at least, as of now) of the pro-EU parliamentary opposition to gain a majority in the Rada and change the political situation in its favor. The president has maintained efficient control over all the branches of state power, including the legislature and judiciary. Change depends on his good will, which is entirely lacking. Key hopes for change are rooted in the ongoing EuroMaidan protest, which puts psychological pressure on the government and on the EU/U.S., which are still trying to pressure oligarchs.
- Again, all these possible pressure mechanisms will be effective only if they're introduced as soon as possible.
- The pro-Western opposition has a history on infighting and corruption. It's possible its leaders will fail to implement the necessary reforms, which would give Ukraine's pro-Russian forces the ideal pretext to retake power and swiftly implement Russian integration in the resulting vacuum.
- Russia may lead a secession attempt by Crimea and some eastern regions of Ukraine, triggering a constitutional crisis.

Base case timeframe for the scenario



(2) Russian scenario (drift to Russia)

Yanukovich is able to appoint his own pro-Russian government. Ukraine receives the promised macro support from Russia (USD 12 bln loan, gas discounts) in exchange for Ukraine's silent loyalty. Yanukovich has all the chances to be re-elected (reappointed) as president in 2015. As the agreed Russian loans will be provided for two years only, in late 2015 Yanukovich will have to choose between default or joining the Eurasian Economic Union.

When it's possible:

- It's possible right now, as Yanukovich has enough state resources to appoint a loyal government. But the key question becomes, "What then?"
- The key impediment to fulfilling this scenario is the current EuroMaidan protest. Theoretically, there is some chance to de-escalate the street protests and "marginalize" the protesters if the Party of Regions' plan to "buy some time" and avoid the constitutional reforms works out. In particular, Party of Regions MPs are insisting on the appointment of a "constitutional commission" that produce a new draft of the constitution during the next two months (read "twelve months"). If the parliamentary opposition swallows this idea, it can offer an exit for the "political wings" of the EuroMaidan protest, which will weaken, radicalize and marginalize it. Meanwhile, the president will work on regaining full control over the political situation and even may succeed in his efforts.
- The president might simply "buy" some opposition leaders or powerful protesters to bleed dry the protest movement.

Limitations to this scenario:

- It does not look probable that opposition leaders will agree on preserving the current constitutional order (with unlimited power for the president) and accept the idea of working on a new constitution. We assume they understand the consequences, which is a big loss of popular support. Moreover, any success to buy time by the Party of Regions may lead to a new escalation of protests. That will lead to a shift to any other scenario.
- The key precondition that makes this scenario sustainable is the gradual de-escalation of street protests. As we can observe from the events of the last two months, the people in power (particularly Yanukovich) have no patience for allowing protests to extinguish themselves. Instead, they always find an occasion to add fuel to the fire and we have no reason to expect this won't repeat itself.

Base case timeframe for the scenario



(3) Belarus scenario

Yanukovych appoints a new pro-Russian government, violently disperses the EuroMaidan and establishes a Belarus-style dictatorship in Ukraine. Ukraine becomes fully dependent on Russian macro support and it will join any supranational unions sponsored by Russia. Yanukovych – forever.

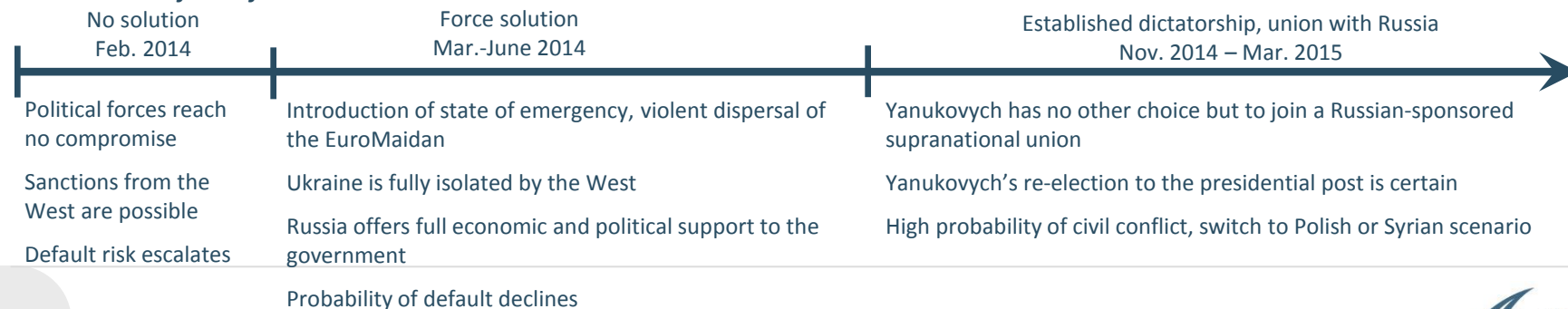
When it's possible:

- Such a scenario looks possible if Russia provide its help to disperse the EuroMaidan from central Kyiv and change Ukraine's legislation to legalize the dictatorship and political repressions (actually, both trends have already been assumed/observed in Ukraine).
- Assuming that Russia is indeed bound by the Olympic games in Sochi from offering "law enforcement" support for the Yanukovych regime, we see this scenario as possible only after Feb. 23.
- This scenario will most likely follow an introduction of a state of emergency in Ukraine.
- As such a scenario practically ensures economic sanctions against Ukraine's oligarchs, they will need some time to adjust their businesses accordingly to minimize the effect. So, the most probable time of launching such a scenario is mid-2014.
- The fulfillment of the Belarus scenario is also possible in any time after the start of scenario (2), which assumes a peaceful drift to Russia. As scenario (2) does not look sustainable, there is a high probability that it will transform into this one.

Limitations to this scenario:

- While Yanukovych proved to be effective in controlling the Rada and neutralizing the political opposition, the EuroMaidan is still untamed and its possible fierce resistance to any violence should not be ignored. In this case, a shift to the Syrian scenario will look much more probable. Considering this outcome, the president (yes, we are assuming he will think rationally) may chose to avoid violence.
- The oligarchs are unlikely to accept Yanukovych magnifying his power and that of his insatiable entourage. Oligarchs will clearly face a risk of losing their assets in Ukraine (in Belarus, the only business tycoon is the president). They also want to avoid sanctions from the West and the development of a Syrian scenario. Very likely, they will oppose any plans for a violent crackdown.
- As Ukraine will become fully dependent on Russia, Putin will have to sponsor Ukraine's regime actively. It does not look likely that such a sponsorship will be supported by the Russian electorate.

Base case timeframe for the scenario



(4) Syrian (civil war) scenario

A failed attempt to forcefully disperse the EuroMaidan escalates the conflict, either in Kyiv or western Ukraine. It may result in a civil war in Ukraine, with neither pro-presidential forces nor pro-EU protesters being able to win decisively. A relatively even split of the country is possible.

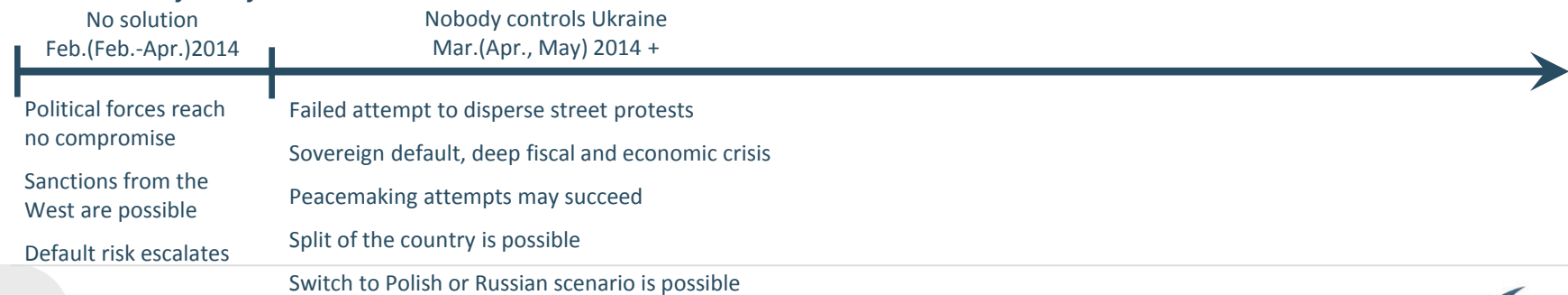
When it's possible:

- We hate to think about the probability of such a scenario, but it cannot be ruled out. In particular, it is possible should the president and his opponents (parliamentary opposition and/or EuroMaidan) fail to reach a compromise.
- It looks possible if Yanukovich doesn't offer significant concessions to his opponents and decides to deal with the EuroMaidan using force. That will likely lead to opposition forces organizing an armed resistance with the western oblasts, led by Lviv, refusing to join any union with Russia. Unfortunately, these listed conditions are valid at the moment.

Limitations to this scenario:

- The general limitations are that the West, Ukraine's oligarchs and other mindful domestic forces aren't interested in such a development. Some peacemaking attempts by the West and the oligarchs may be successful.

Base case timeframe for the scenario



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