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- The gradual progress of Ukraine's military forces in regaining control over rebel-occupied territories was interrupted at the end of August, following an 'undeclared' invasion of Russian troops in Ukraine.
- Amid growing damages and losses, Ukraine has agreed to participate in trilateral peace talks with Russia and the EU, which ended with a ceasefire deal reached on September 5<sup>th</sup>.
- On September 16<sup>th</sup>, Ukrainian and European parliaments both ratified the EU-Ukraine association agreement. However, due to pressure from Russia, implementation of the free trade agreement was delayed until 2016.
- Ongoing hostilities in the east, Hryvnia depreciation, fiscal austerity and worsening trade relations with Russia hit the Ukrainian economy. In 2Q 2014, real GDP decreased by 4.6% yoy, bringing the cumulative decline to 3% yoy.
- High-frequency real sector indicators for July-August point to a deepening recession in 3Q 2014. In particular, the decline of industrial output production worsened from 4.7% yoy in 1H 2014 to 12% yoy in July and 21.4% yoy in August.
- Unlike other sectors, agriculture remains the bright spot of the Ukrainian economy. The sector demonstrated solid 6.3% yoy growth over the first eight months of 2014, and the country is estimated to collect a high grain harvest this year despite an unfavorable environment.
- Due to a deeper economic downturn and the intensified armed insurgency in eastern oblasts, which exerted an additional toll on budget revenues and required higher expenditures on military operations, Ukraine's fiscal accounts remained under significant strain despite a number of fiscal austerity measures. Worsening public finances demanded additional fiscal consolidation efforts. The total deficit is still forecast to widen notably to about 10% of GDP, mainly on account of larger Naftogaz imbalances.
- As anticipated, consumer inflation kept accelerating and reached 14.2% yoy in August 2014 amid the ongoing pass-through of sharp Hryvnia depreciation, an increase in excise taxes and utility tariff adjustments. End-of-year inflation is projected to reach about 20% yoy in 2014.
- Hryvnia devaluation, economic recession and political instability further weakened the fragile Ukrainian banking sector. The sector lost almost a fourth of its deposit stock over the first eight months of the year and faces asset quality problems. However, thanks to NBU measures and IFI financial assistance, the situation in the sector remains manageable, although temporary NBU administration was introduced in a number of troubled banks.
- Ukraine's current account balance notably improved from April to August 2014, mainly on account of a steeper decline in imports. Although exports suffered from Russia's trade restrictions, they benefitted from early EU trade supportive measures, Hryvnia depreciation and a high agricultural harvest.
- In turn, the capital account remained under significant strain. Despite a sizable financial aid package, access to foreign capital markets remains limited due to high country risks (geopolitical and economic), adversely affecting Ukraine's ability to successfully issue sovereign debt as well as to roll over private debt.
- Capital account pressures triggered further Hryvnia depreciation in late August and September. Thanks to NBU capital controls and foreign exchange administrative restrictions, the NBU stabilized the Hryvnia at around UAH 13 per US Dollar. From January to September, the Hryvnia lost almost 63% of its value. With the IMF program on track, the exchange rate is forecast to remain at around UAH 13.5 per USD throughout the rest of 2014 and in 2015.

### Forecast of Main Macroeconomic Indicators for 2014-2015

	2011	2012	2013	2014 <sup>f</sup>	2015 <sup>f</sup>
<b>GDP, \$ billion</b>	163.4	176.6	182.0	140.0	147.5
<b>Real GDP Growth, % yoy</b>	5.2	0.2	0.0	-7.0	1.0
<b>Private Consumption, real growth, % yoy</b>	15.0	11.7	7.8	-7.0	1.7
<b>Fiscal Balance, incl. Naftogaz and Pension Fund, % of GDP</b>	-4.3	-6.0	-6.5	-11.0	-6.0
<b>Public Debt, % of GDP</b>	36.3	36.6	40.5	66.0	72.0
<b>Consumer Inflation, eop, % yoy</b>	4.6	-0.2	0.5	20.0	10.0
<b>Hryvnia Exchange Rate per USD, eop</b>	8.0	8.0	8.0	13.5	13.5
<b>Current Account Balance, % of GDP</b>	-6.3	-8.1	-9.0	-4.0	-3.0
<b>FDI (\$ billion)</b>	7.0	6.6	3.3	1.0	3.0
<b>International Reserves (\$ billion)</b>	31.8	24.5	20.4	16.0	18.0
<b>External Debt (\$ billion)</b>	126.2	135.1	142.5	149.0	157.0

### Political Developments

Until mid-August 2014, Ukraine had been making good progress in its efforts to stabilize the political and economic situation. Following early presidential elections in May, the president of Ukraine called snap parliamentary elections on October 26<sup>th</sup>, 2014, as greater support in the parliament is necessary for smooth implementation of painful but long-awaited reforms. Ukraine has ful-

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filled all conditions to secure the second IMF tranche disbursement despite growing damage and pressure on the economy as a result of heavy fighting in the eastern oblasts of Ukraine. With the IMF program on track, Ukraine is expected to fully receive the planned amounts of financial aid this year, which will help to stabilize the macroeconomic situation of the country.

During April-August 2014, Ukrainian forces were gradually regaining control over the rebel-held Donbas region. By mid-August, the Ukrainian military had captured almost  $\frac{3}{4}$  of the occupied territories despite Russia's increasing support of rebels and mercenaries with weaponry, tanks and artillery. However, at the end of August, the conflict escalated again following an 'undeclared' invasion of Russian troops in Ukraine. This not only allowed the pro-Russian rebels to make a turnaround in the battle but has opened a new frontier in the south of Donetsk oblast. In addition, there is mounting evidence that Russia has been accumulating significant forces not only along the border with eastern oblasts of Ukraine but also in the annexed Crimea peninsula with an apparent intention to create a land corridor to Crimea. Amid growing losses and damages for Ukraine and realizing that Russia's army is almost ten times the size of Ukraine's, Ukraine agreed to participate in trilateral peace talks with Russia and EU in Minsk, Belarus, on August 26<sup>th</sup>. Although these negotiations ended with no apparent results, they continued in early September and resulted in a ceasefire deal signed on September 5<sup>th</sup>.

Despite the ceasefire agreement, the outlook for Ukraine still remains highly uncertain for many reasons. First, the deal did not envisage the withdrawal of Russian troops (only rebels and mercenaries) from Ukrainian territory as Russia continues to deny the presence of its troops. Moreover, Putin's further intentions remain unclear, particularly taking into account that the deal does not envisage any shift in Kyiv foreign policy. Indeed, it was a drastic turnaround in Ukraine's political landscape with the ouster of a Ukrainian president sympathetic to Moscow and a clear shift in Kyiv foreign policy towards the EU that triggered the annexation of Crimea and fighting in eastern oblasts. Despite Russia's objections and pressures to delay the ratification of the EU-Ukraine Association Agreement by suggesting numerous changes to the text of the agreement, Ukrainian and European parliaments both ratified the agreement on September 16<sup>th</sup>. However, due to Russia's pressure, the implementation of the free trade agreement will be delayed until 2016. This time will be used to reduce Russia's concerns over the likely impact of establishing a free trade regime between EU and Ukraine on the Russian economy. Furthermore, the armed conflict restored the NATO membership aspirations of Ukraine as part of Ukrainian policy, which irritates Russia and, hence, poses an additional risk for the ceasefire to break down.

Second, according to the deal, the territories under the rebels' control will receive greater autonomy, and additional guarantees for the usage of Russian language and amnesty. On September 16<sup>th</sup>, the Ukrainian parliament approved two laws, imposing a special order of local self governance in certain districts in Donetsk and Luhansk oblasts for a three-year period and giving amnesty to rebels acting in the region since February 2014. In addition, local elections were set for December 7<sup>th</sup>. President Poroshenko pledged to have a dialog with anybody that the people of this region vote for. The rebels' response on the Minsk agreement and the approved laws was mixed, however. Shortly after the agreement, which contains no explicit mention of independence, was signed, one of the rebels' leaders stated that they will continue to seek secession from Ukraine. And although fighting has notably diminished since September 5<sup>th</sup>, the truce has barely been holding with numerous reports of violations.

Under the baseline scenario, sporadic fighting may occur through the rest of the year. It will not, however, lead to a full-scale military operation and will not expand beyond the current occupied territories. Negotiations will continue and, eventually (presumably by the end of 2014), will result in a more durable peace settlement. Granted with greater autonomy, the region will remain heavily pro-Russian and will continue to be a major source of political uncertainty and instability, impeding Kyiv central power authority and weakening the economic unity of the country. For that reason, Ukraine will have to maintain its military forces at a high state of readiness, which would continue pressuring its strained public finances, while the reconstruction of the region will proceed at a moderate pace.

### **Economic Growth**

Hostilities in the east exert a significant toll on the Ukrainian economy. Strict fiscal austerity measures, deteriorating trade relations with Russia and Hryvnia depreciation also contribute to the deepening of the economic downturn. At the same time, assuming that the conflict in eastern oblasts is resolved by the end of the year in either a diplomatic way or through relatively limited military action, real GDP is forecast to decline by about 7% yoy in 2014 and to start to recover at about 1% yoy in 2015.

In the meantime, real GDP fell by 4.6% yoy in 2Q 2014, bringing the cumulative decline to 3% yoy for the first half of the year. Moreover, a range of real sector indicators for July and August signaled about a worsening economic slump in 3Q 2014. An uncertain political and economic environment weighed on the population's confidence and business activity across all sectors of the Ukrainian economy. For the first time since crisis-hit 2009, private consumption negatively contributed to economic growth in 2Q 2014. Household expenditures fell by 2.7% yoy over the period as consumers began to feel pain from government fiscal austerity measures, rising inflation and net worth decline due to sharp Hryvnia depreciation. As wages continued to slide down (they were almost 9% yoy lower in real terms in July 2014), retail sales turnover dropped 13.8% yoy over January-August 2014. In addition, a reduction in retail sales may also be attributed to a shift in consumer preferences towards essentials and savings. Indeed, according to the Auto-Consulting Group, new car sales in Ukraine dropped almost 75% yoy in August, while a cumulative eight-month decline amounted to about 50% yoy. For similar reasons, passenger turnover dropped 11.8% yoy over the first eight months of the year.

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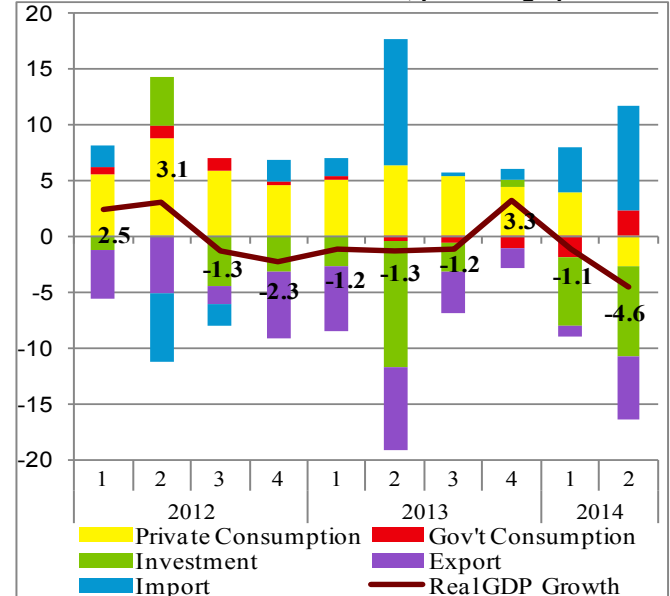
A challenging environment was the principal reason for a sharp drop in the business investment. Thus, fixed investment was down by about 19% yoy in real terms in 1H 2014, while large inventory destocking reinforced a drag on real GDP growth. Moreover, greater weakness in the construction sector, evident from a 15.6% yoy decline in real value of construction works over January-August (further down from about 9% drop for 1H 2014) points to a further plunge in business investment in 3Q 2014. Affected by a sharp contraction in industrial production and foreign trade (both exports and imports), coupled with infrastructure and supply network disruptions, wholesale trade and transportation turnover fell by 13.8% yoy and 3.8% yoy respectively over January-August 2014.

The industrial sector was particularly hit by the ongoing conflict in the eastern regions of Ukraine. Following a 4.7% yoy drop in 1H 2014, industrial output plunged by 12% yoy in July and 21.4% yoy in August, bringing the cumulative contraction to 7.8% yoy. Sharp declines in July-August were attributed to the escalation of military turbulence in the Donbas region. Due to severe fighting, industrial output in Donetsk and Luhansk oblasts, the industrial heartland of Ukraine (particularly for mining and metallurgy), dipped 28.5% yoy and 56% yoy in July and 59% yoy and 85% yoy in August respectively. The mining industry and metallurgy reported a sharp drop in output production over these months.

Given halted production at almost half of all coal mines, delivery difficulties due to damaged infrastructure (railway lines, roads, bridges, etc.) and the absence of natural gas supplies from Russia, the Ukrainian energy market felt the shortages of fossil fuels, which led to a 17% yoy dip in electricity production in August. Although the Ukrainian government has been seeking supplies from abroad (South Africa, Poland, and other countries), the country may still face a deficit of thermal coal this year. As a result, low coal reserves may add to energy shortages this winter (in addition to natural gas supply difficulties), increasing Ukraine's economic woes. These difficulties, however, may be softened considerably if Ukraine and Russia (with the help of EU mediation) reach an interim gas agreement. During the talks, scheduled for the end of September, Ukraine wants to negotiate a new compromise price for Russian gas as a maximum and to secure sufficient gas transit to Europe in amounts that will allow stable reverse flow supplies of natural gas from Europe to Ukraine as a minimum. Under the baseline scenario, we assume that an interim price for a specified amount of gas shipments to Ukraine will be negotiated, which will help avert the energy crisis and gas transit disruptions to Europe in case of a very cold winter.

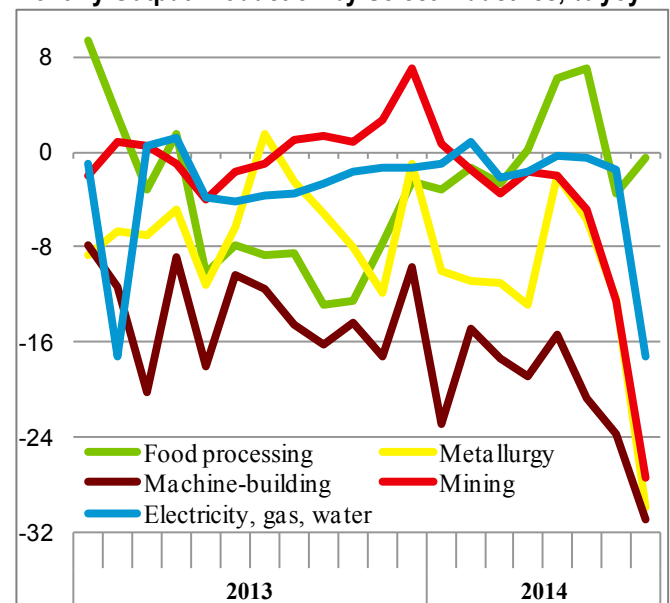
Agriculture remains the bright spot of the Ukrainian economy, as the sector demonstrated solid 6.3% yoy growth over the first eight months of 2014. According to the Minister of Agrarian Policy, Ukraine harvested 39.6 million tons of grain as of September 22<sup>nd</sup>, which was almost 15% higher than in the corresponding period last year. Despite insurgencies in the east, Ukraine's total grain harvest is pro-

**Contributions to Real GDP Growth, percentage points**



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

**Monthly Output Production by Select Industries, % yoy\***



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

**Select Real Sector Indicators for Ukraine**

	2014			2013	2012	2011	2010
	8m	6m	4m				
<b>Agriculture</b>	6.3	-3.9	5.0	13.3	-4.5	17.5	-1.5
<b>Industry</b>	-7.8	-4.7	-5.3	-4.3	-1.8	7.6	11.2
<b>Construction works</b>	-15.6	-8.9	-5.8	-11.1	-14	11.1	-5.4
<b>Domestic trade, turnover</b>							
Wholesale trade	-13.8	-10.5	-4.1	-2	-4.4	0.6	0.4
Retail trade	-4.0	0.8	5.6	9.5	15.9	14.7	9.8
<b>Transportation, turnover</b>							
Cargo	-3.8	0.4	-2.8	-3.9	-7.6	5.7	6.4
Passenger	-11.8	-10.3	-6.3	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service of Ukraine, The Bleyzer Foundation

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jected at about 60 million tons in 2014, on par with last year's record. High crops are expected to support Ukraine's agricultural exports. Although they will not compensate for sharp declines in revenues from heavy industry and other sectors, coupled with a steep reduction in imports they will help soften Ukraine's Balance-of-Payments pressures.

### Fiscal Policy

Ukraine's public finances continue to be under significant strain. The economic downturn, ongoing hostilities in east, the industrial heartland of Ukraine, and ineffective tax collection in the past (when a substantial portion of last year tax revenues were collected in advance) weighed on budget revenues. At the same time, intensified military operation in eastern oblasts and high external debt payments restrain the scope of fiscal consolidation. As the economic recession is forecast to be deeper than initially expected and the Hryvnia exchange rate to US Dollar is weakening more than anticipated, Ukrainian authorities called for additional fiscal tightening efforts. The approved measures will help contain the state budget deficit from further deterioration. However, due to higher Naftogaz imbalances, Ukraine's public sector fiscal deficit (including Naftogaz and Pension Fund) is now forecast to widen to around 10% of GDP in 2014, up from about 6.5% of GDP in 2013. Following the reassessment of the overall economic situation, the IMF has agreed to a temporary widening of Ukraine's fiscal deficit beyond the initial targets in 2014-15, assuming that continuous government fiscal consolidation measures and announced fiscal and energy reforms will help restore Ukraine's fiscal sustainability over the medium-term.

Developments on the revenue side of the state budget were mixed in 1H 2014. Although a weak economy and further escalation of the conflict in eastern Ukraine exerted a significant toll on tax proceeds, total state budget revenues were up by about 8% yoy in nominal terms over January-June 2014. As anticipated, receipts from value added tax, excises and import duties, and corporate profit tax continued to decline in a contracting economy. At the same time, the rate of decrease of major tax proceeds slowed in 1H 2014 compared to 1Q 2014 as amendments to the Ukrainian Tax Code, aimed at raising budget revenues (as well as reducing expenses), have been taking effect since April 1<sup>st</sup> 2014.<sup>1</sup> In addition, higher royalty payments, sizable NBU profit transfers and lower VAT refunds offset the decrease in the contribution of major revenue-raising taxes. In particular, an almost 22% yoy increase in royalty payments over the period may be attributed to both broadening the tax base as well as increasing the rent rates.<sup>2</sup> In April-May 2014, the National Bank of Ukraine transferred UAH 22 billion (about \$1.9 billion) of its profit to the state budget, an annually targeted amount. Finally, VAT refunds were almost 27% yoy lower in nominal terms.

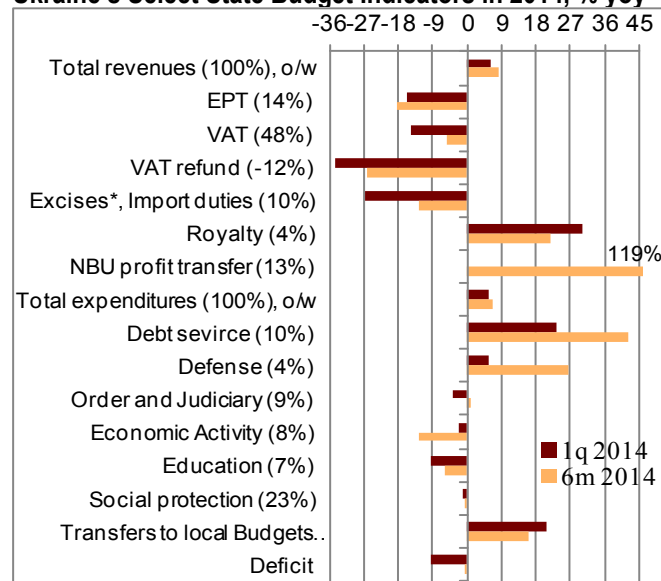
Looking deeper, although the decrease in VAT refunds should be primarily attributed to lower industrial activity and a slow-down in consumption, Ukrainian authorities' efforts to deter corruption may also be an explanation. VAT refunds in Ukraine have been a long-standing problem for both legitimate business and tax authorities as it is a complex and nontransparent mechanism that allows for numerous fraudulent refund schemes and rampant corruption. Following a drastic change in Ukraine's political landscape at the beginning of 2014 and the intention of the new authorities to reduce corruption, including strengthening of tax administration and reforming tax institutions, the amount of fraudulent VAT claims may have declined. This could also explain the sizable downward revision of the limit volume for the issue of government VAT bonds. VAT bonds are domestic government bonds issued to restructure the VAT refund arrears. To address the problem of large VAT refund arrears accumulated by the end of 2013, the government agreed with the IMF to securitize UAH 16.7 billion of arrears (about \$1.4 billion). However, following verification by a tax audit, in July the Ukrainian government issued VAT bonds worth only UAH 7 billion.

As previous experience showed (Ukraine issued VAT bonds for the third time in ten years), conversion of VAT claims into government bonds can be only a temporary solution for the VAT problem. To solve it on a permanent basis (as well as to increase effectiveness of the tax system as a whole) would require comprehensive tax reform. Realizing that an effective tax system will not only allow generate necessary funds for the provision of public services and public goods but also lay the

<sup>1</sup> On March 27<sup>th</sup>, 2014, Ukrainian Parliament approved the Law of Ukraine #1166 "On Prevention of Financial Disaster and Creation of Grounds for Economic Growth in Ukraine", which froze the rates of corporate profit tax (18%) and VAT (20%), reduced or changed the procedure of VAT exemptions (e.g., a 7% VAT on the supply of pharmaceuticals and select medical products was introduced, a 0% VAT will be applied only for grain producers upon grain exports), re-introduced a 0.5% mandatory contribution to the Pension Fund of Ukraine from transactions for foreign currency purchases, broadened the progressive PIT (personal income tax) scale and included passive income (interest on bank deposits, dividends, royalties, investment income), increased rates of some other taxes and charges (excises on beer, alcohol, tobacco, new vehicles, water usage, land tax, etc.). The majority of the Law provisions came into force at the beginning of April, although some of them were to take effect gradually (e.g., an increase in excises for alcohol will be enforced on September 1<sup>st</sup>, 2014, excises on tobacco took effect on July 1<sup>st</sup>, etc.).

<sup>2</sup> For instance, according to the Law #1166, the rates for extraction of ore minerals as well as some hydrocarbons were raised on April 1<sup>st</sup>, 2014. Moreover, those who use the subsurface for purposes not related to the production of minerals and land owners or tenants extracting underground water were also defined as objects for application of the fee.

**Ukraine's Select State Budget Indicators in 2014, % yoy**



\* On domestically produced goods  
 Source: The Ministry of Finance of Ukraine, The Bleyzer Foundation

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foundation for future sustainable economic growth, the new Ukrainian government committed to develop a plan of changes in the tax system of Ukraine, pledging ambitious tax cuts, improving administration of taxes and increasing accountability of tax authorities. In particular, the number of taxes is proposed to be cut from the current 22 to just 9. In addition, the load on the payroll was announced to be decreased three times. At the same time, so far the plan does not specify compensatory measures for the budget, except for government counting on de-shadowization of wages and other income. The full draft of tax reform is forecast to be presented at the beginning of September. For the time being, although effective tax reform is a long-awaited endeavor, it is too early to assess the likely budget outcome of tax reform as well as its overall impact on the economic performance of the country. Moreover, full-scale public expenditure reform may be an important complementary measure to tax reform in order to sustain government finances, and it may be a precondition for effective public governance.

Thus far, thanks to some spending cut measures approved at the end of March, the growth of state budget expenditures was contained in 1H 2014 despite much higher debt service and defense spending. Indeed, state budget expenditures were up by a nominal 6.5% yoy in nominal terms over the period, which was only marginally higher than 5.6% yoy in 1Q 2014. At the same time, the growth of budget outlays on public debt service and defense, together accounting for about 15% of total budget expenditures, sped up to 42% yoy and 26.5% yoy respectively. As the government canceled planned increases in pensions and public sector wages for this year, froze public sector hiring and reduced capital expenditures, the state budget deficit for 1H 2014 changed marginally compared to the same period last year (-0.2% yoy in nominal terms).

Due to an unfavorable revenue outlook for the coming months as well as the need to further increase military and security spending, the government developed a mix of additional revenue raising and expenditure cutting measures in July.<sup>3</sup> In particular, select corporate profit tax and VAT privileges<sup>4</sup> were abolished, a 1.5% military duty levied on payroll was temporary introduced until January 1<sup>st</sup>, 2015, and specific excises and royalty rates were temporary increased. On the expenditure side, the government proposed 70% savings in the cost of the state apparatus and further cuts in labor costs (for members of Ukrainian parliament). As a result, state budget revenues and expenditure targets for 2014 were increased by 1.3% and 1.1% respectively, while the planned deficit remained unchanged at UAH 68.5 billion (about \$5.5 billion or around 4.5% of forecast full-year GDP). Although the new set of budget numbers was developed based on the revised official macroeconomic forecast (6% yoy decline in GDP and 19.5% Dec/Dec inflation in 2014), the risks for budget execution remain tilted to the downside amid likely deeper economic recession and growing damage in eastern regions of Ukraine.

The 2014 Naftogaz deficit is now projected to be much larger than initially expected. Although the volume of natural gas imports is likely to be considerably lower than last year (as Russia halted natural gas supplies to Ukraine in June 2014 on price disagreements between the countries and Ukraine's debt for earlier gas deliveries, while reverse gas supplies from Europe will only be a partial substitute) and Ukraine raised natural gas tariffs for the population and heating companies, years of mismanagement in the past, deeper Hryvnia depreciation and lower GDP growth will drive the Naftogaz deficit to about 6% of GDP in 2014,<sup>5</sup> up from about 2% of GDP a year ago. To reduce the toll of Naftogaz imbalances on the budget, the government has initiated energy sector reform, which includes partial privatization of Ukraine's gas transportation system and lease of underground gas storage facilities. These measures, coupled with planned further increases in natural gas tariffs next year and energy savings, will help stabilize Naftogaz finances in the medium term.

## Monetary Policy

**Inflation.** As anticipated, Ukraine's consumer prices continued to edge up in the summer months due to continuing spillover of Hryvnia depreciation into domestic prices, increases in utility costs and excises on select products. In particular, consumer price inflation picked up to 14.2% yoy in August 2014 and is expected to accelerate to about 20% yoy by the end of the year. While monetary expansion has a relatively moderate impact on price developments in 2014 due to subdued demand, it may trigger sustained inflation in the future. Ukraine's monetary policy will eventually be adjusted to achieve the medium-term inflation target as monetary authorities seem determined to switch to an inflation targeting regime in 2015. However, rapid growth of monetary aggregates this year as well as further adjustments of utility tariffs will keep consumer inflation at close to 10% in 2015.

Overall price growth in Ukraine is strongly influenced by food, alcoholic drinks and tobacco price developments, as these commodities together account for almost 58% in the CPI basket. While prices of most food products were favorably affected by the expectations of a good agricultural harvest, they rose by 14% yoy in August, reflecting transmission of Hryvnia depreciation into prices of imported goods (particularly, fish and fruit, which were about 23% and 42% more expensive than last August, respectively) and upward pressures from fuel prices. As Ukraine is heavily dependent on imported petroleum products (their share is estimated at around 80%), domestic fuel prices are primarily driven by external factors, such as global energy price and exchange rate developments. After remaining broadly stable over January-April 2014, global crude oil prices temporarily spiked in June but have been declining since the beginning of July. However, due to sharp Hryvnia depreciation in the spring, ongoing sharp fluctuations on the foreign exchange market and higher excises, domestic fuel

<sup>3</sup> The Law of Ukraine #1621-VII "On Amendments to the Tax Code of Ukraine and Certain Other Legislative Acts of Ukraine" and the Law of Ukraine #1622-VII "On Amending the Law of Ukraine 'On State Budget of Ukraine for 2014'" as of July 31st, 2014.

<sup>4</sup> E.g., preferential taxation of profits of joint investment institutes, transactions with securities and derivatives, exemptions for hotel business and renewable energy generation, VAT exemptions on supplies of timber, fuel wood, zero VAT rate on passenger transportation by Intercity+ high-speed trains, etc.

<sup>5</sup> E.g., preferential taxation of profits of joint investment institutes, transactions with securities and derivatives, exemptions for hotel business and renewable energy generation, VAT exemptions on supplies of timber, fuel wood, zero VAT rate on passenger transportation by Intercity+ high-speed trains, etc.

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prices were on a steady upward trend. In August, fuel prices were almost 50% yoy higher, pressuring prices of other goods and services through increases in transportation costs. Thus, the cost of public transportation services, although subject to administrative regulations, advanced by 18% yoy in August 2014. Due to increases in excises and administratively set minimum prices, prices of alcoholic drinks and tobacco rose by 18% yoy in August 2014, contributing to the general price level growth.

The costs of utility services, which account for about 11% of the consumer basket, surged by 22.5% yoy in August 2014, in response to government policies to reduce the burden of generous energy subsidies on a strained fiscal budget and enhance energy efficiency. The contribution of this commodity group will continue to increase as Ukrainian authorities signaled a further adjustment of natural gas tariffs for the population and heating companies.<sup>6</sup>

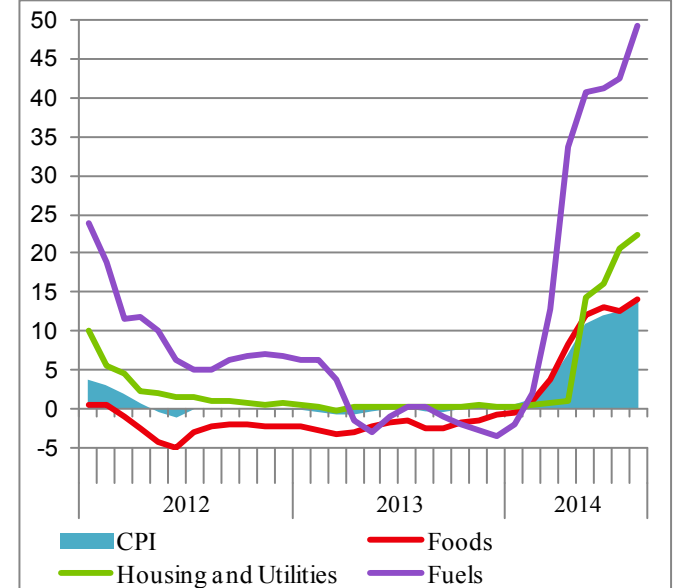
**Banking Sector.** Hryvnia devaluation, economic recession and political instability hit the fragile Ukrainian banking sector, which did not fully recover after the 2008-09 financial crisis. At the same time, thanks to NBU measures, the situation in the sector remains manageable.

Political unrest, hostilities in the eastern regions, almost 65% Hryvnia depreciation, and continuing volatility on the foreign exchange market undermined population and business confidence in the banking system of Ukraine. Coupled with contracting economic activities and incomes, this has triggered notable deposit outflow. Administrative measures, which limited foreign currency denominated deposit withdrawals to an equivalent of UAH 15000 (around \$1300) per day, did not prevent further deposit outflow. The banking sector lost almost a quarter of its stock of foreign currency deposits, denominated in US Dollars, from January to August 2014. Furthermore, as Hryvnia deposit rates, running at a high 20-25% pa, did not cover for depreciation and rising inflation, the stock of deposits in national currency declined by 10% since the beginning of the year. In addition, due to high country risk and a worsened medium-term outlook, commercial banks face not only reduced access to external borrowing but also experience either retrenchment or reversal of fund flows from parent foreign banks due to foreign banks' downscaling of operations in Ukraine or exit from the country.

In addition to funding challenges, Hryvnia depreciation and the economic downturn likely magnified the asset quality problems in the banking system of Ukraine. According to NBU data, the share of non-performing loans (doubtful and loss) in the total banking sector credit portfolio stood at about 13% at the end of 2013 and rose to 14.6% by the end of June 2014. At the same time, in international practice, the notion of non-performing loans also includes sub-standard loans, loans on which payments of interest or principal are overdue for more than three months, restructured, with factors adversely affecting the value or quality of collateral, etc. According to expert estimates, the share of sub-standard loans stood at around 30% at the end of 2013. Although credit activity remained subdued (the stock of bank loans in local currency and in foreign currency, denominated in US Dollars, rose by an average of 15% pa and declined by an average of 7% pa for 2009-2013, respectively), commercial banks asset quality likely worsened further through the course of 2014.

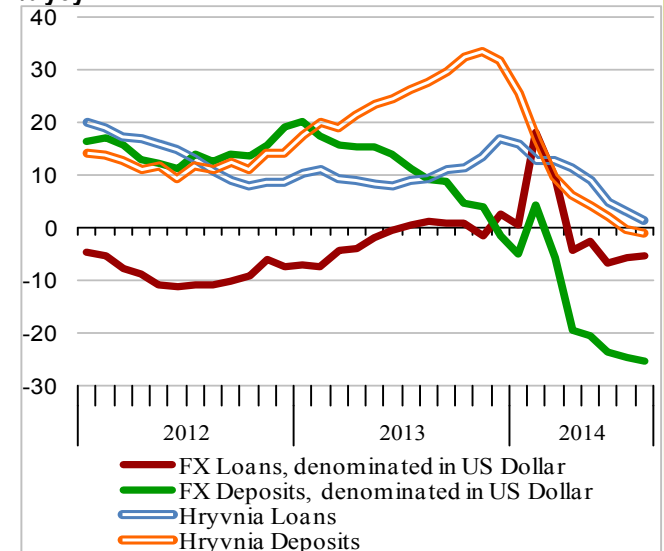
In accordance with the IMF program, stress tests were carried out in 15 systemic banks and are currently being exercised in the next 20 banks. The test results for the largest 15 banks showed that almost a half of them will require significant recapitalization. At the same time, according to NBU officials, these results do not imply the banks' insolvency, and the capital can be raised gradually. Smaller banks, however, may face more severe deterioration of asset quality (a substantial portion of such banks were created to service related companies). At the same time, in the current economic and political environment,

CPI Growth by Select Components, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Evolution of Banking Sector Deposit and Loan Stocks, % yoy



Source: NBU, The Bleyzer Foundation

<sup>6</sup> In late September 2014, one of top Naftogaz officials said the company together with the Ministry of Energy and Coal Industry of Ukraine has been considering setting a unified gas price for all consumers, which would mean an almost four-fold increase in natural gas tariffs for the population. Although we attach a rather low probability for such an outcome due to its high political cost, we believe that the staged tariff hikes will be implemented at a steeper rate than previously anticipated.



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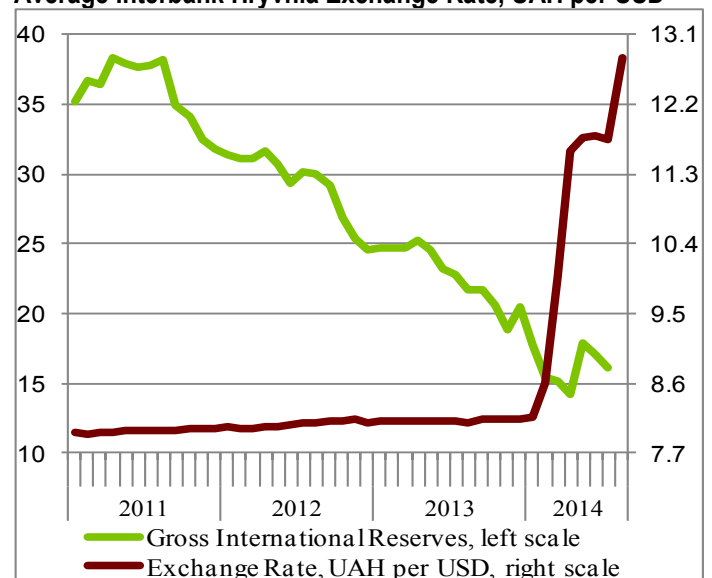
their owners' capacity to provide additional capital may be substantially impaired. An increasing number of commercial banks under NBU temporary administration is a clear indication of the difficulties the banking sector of Ukraine is currently facing. Thus, from January to September 2014, temporary NBU administration was introduced in 22 banks, out of which 10 have been decided to liquidate, and the number of problem banks may further increase through the end of the year.

At the same time, the National Bank of Ukraine has been tightly monitoring the banking sector situation, providing necessary liquidity support, demonstrating a good degree of forbearance in terms of capital and asset quality requirements but simultaneously strengthening bank supervision. Thus, in mid-September 2014, the NBU appointed curators to oversee all systemic banks and take early preemptive measures to address bank weaknesses. In addition to administrative NBU measures, Ukrainian authorities approved the issuance of about UAH 14 billion (\$1.1 billion) in domestic bonds to ensure that the Deposit Insurance Fund has sufficient funds to cope with a growing amount of insured deposit compensations amid a rising number of bank failures and, thus, enhance public confidence in the banking system. Thanks to these measures as well as technical and financial assistance from IFIs, the situation in the Ukrainian banking sector is forecast to remain under control.

**Hryvnia Exchange Rate.** Following sharp Hryvnia depreciation over the first four months of the year, the Ukrainian foreign exchange market revealed signs of stabilization during May-July 2014. However, conflict escalation in eastern Ukraine and deeper economic contraction, which caused a delay in the second IMF tranche disbursement, led to further Hryvnia depreciation. During August-September, the Hryvnia fell to a weighted average of about UAH 13.0 per US Dollar, sometimes hitting almost UAH 15 per US Dollar as a low level of international reserves and NBU commitment to maintain flexible exchange rate and to gradually reduce administrative controls on the FX market reduced the NBU's ability to influence foreign exchange market.

Following relaxation of some IMF requirements at the beginning of September, the National Bank of Ukraine resumed national currency support via limited forex interventions (through foreign currency auctions) as well as administrative measures. In particular, the sale of cash foreign exchange was restricted to an equivalent of UAH 3000 (about \$230) per day and some foreign currency transactions<sup>7</sup> were temporary banned. In addition, at the end of August, the NBU increased the mandatory sale of export earnings from 50% to 100%, although later relaxed this requirement to 75%. These measures, coupled with unofficial agreement between the NBU and commercial banks to maintain the Hryvnia exchange rate within a narrow band around UAH 12.95 per US Dollar, helped stabilize both retail and interbank foreign exchange markets at the end of September but may inspire the development of a black foreign exchange market. Assuming Ukraine receives the planned amounts of foreign financial assistance and additional funds if requested, the exchange rate is forecast to remain at around UAH 13.5 per USD in both the rest of 2014 and 2015.

**NBU Gross International Reserves, \$ billion, and Weighted Average Interbank Hryvnia Exchange Rate, UAH per USD**



Source: NBU, The Bleyzer Foundation

### International Trade and Capital

In 2014, Ukraine faces a notable improvement in its current account balance despite weak exports. For the whole 2014, it is now expected to decline to about 4% of GDP, down from 9.2% of GDP a year before. Indeed, current account deficit amounted to \$2.4 billion in 1H 2014, shrinking by 56% yoy for the period. Moreover, the deficit continued to narrow in the ensuing months and was almost zero in August.

Sharp import reduction was the principle reason for a narrowed foreign trade deficit. Thus, imports of goods and services contracted by 16% yoy in US Dollar terms over 1H 2014 and dropped by 36% yoy on average over July-August. While to a notable extent, the drop in imports was related to a sharp contraction in gas imports, weak domestic demand and Hryvnia depreciation were the principal drivers of a large decline in non-energy imports. Thus, imports of agricultural and food products, metals, machinery and transport vehicles fell by 20% yoy, 34% yoy and 38% yoy respectively over January-August 2014. Following Russia's natural gas supplies cutoff to Ukraine in mid-June, Ukraine's imports of fossil fuels decreased by an average of 46% yoy over July-August. At the same time, as Ukraine has started reverse flow natural gas deliveries from Slovakia and may reach a temporary natural gas agreement with Russia, the pace of the import decline may

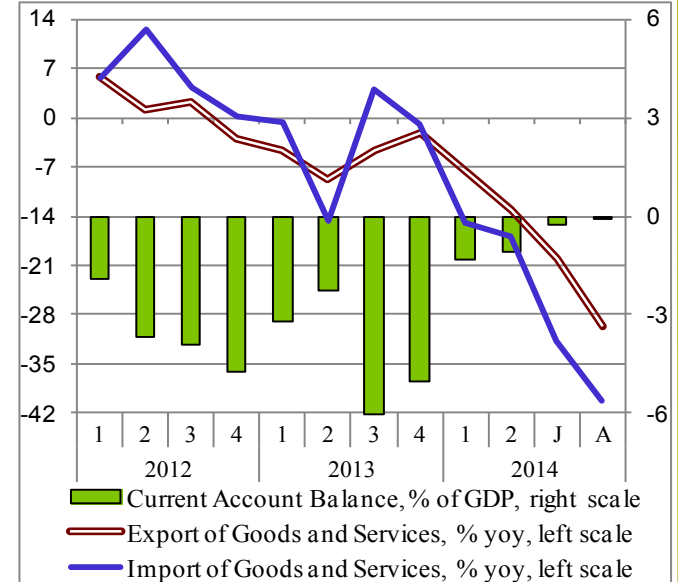
<sup>7</sup> Payments for imports without their transportation into the territory of Ukraine, repatriation of funds received by foreign investors as a result of the sale of securities of Ukrainian issuers outside stock exchanges, apart from the government bonds of Ukraine and payment of dividends to foreign investors abroad, apart from cases of returning dividends on securities circulating on Ukrainian stock exchanges, etc.

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substantially slow throughout the rest of 2014. Due to likely acceleration of energy imports at the end of 2014 and weak exports, we are keeping the full-year current account deficit forecast at a rather conservative 4% of GDP.

Indeed, Ukraine's exports of goods and services posted an 8.2% yoy decline over the first eight months of the year. Moreover, the export slump deepened to 17.7% yoy in August amid escalation of hostilities in the east, growing transportation infrastructure damages, a series of new Russian trade restrictions with Ukraine as well as Ukraine's ban on export of military and dual-use goods to Russia. Correspondingly, chemicals, machine-building and metallurgy suffered the biggest export drop (28% yoy, 24% yoy and 6% yoy over January-August respectively). On a positive note, high agricultural harvest, early EU trade measures and Hryvnia depreciation supported Ukraine's exports. In particular, despite Russia's ban on Ukraine's exports of dairy, meat, some vegetables and other goods, export of agricultural and food products expanded by almost 7% yoy in US Dollar terms over January-August 2014.

Unlike the current account, the capital account of Ukraine's Balance-of-Payments remained under stress despite sizable foreign financial assistance. Due to higher country risks (both geopolitical and economic), Ukraine faced notable capital outflows and restricted access to international debt markets. Indeed, net outflow of FDI amounted to \$1.1 billion over the first five months of 2014. Although the inflow of FDI resumed in June, its monthly amounts remain much below the five-year average and the crisis-hit 2009. Private sector debt rollover ratios fell from 101% and 111% in 2013 to 95% and 78% in January-August 2014 for commercial banks and corporate enterprises of Ukraine respectively. Expectations of Ukraine's issuance of sovereign Eurobonds (excluding those with US guarantee) are unlikely to materialize in 2014. The imposition of capital controls reduced the pace of capital outflows, while the first tranches of foreign financial assistance helped to virtually balance Ukraine's foreign financing needs, the near-term outlook remains challenging. Indeed, resumed volatility of the Hryvnia exchange rate market triggered higher population demand for foreign currency, while private sector foreign debt repayments are typically tilted to the end of the year. Furthermore, the likely settlement of natural gas arrears to Gazprom will also contribute to BoPs pressures throughout the rest of the year. Thanks to sizable financial assistance from the IMF and other IFIs, these pressures will be mitigated. However, due to a deeper economic downturn and Hryvnia depreciation, Ukraine may require additional foreign financing, which will be provided, according to our baseline scenario.

**Select External Balance Indicators of Ukraine**


Source: NBU, The Bleyzer Foundation