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Olga Pogarska, Djulia Segura, Valentyn Povrozhnyuk
Edilberto Segura

- The September 5th ceasefire has not stopped hostilities in the east, but fighting intensity has notably abated since then.
- The nationwide elections, held on October 26th, are expected to produce a strong pro-European coalition that should ensure greater support for the President's peace plan and facilitate the implementation of reforms.
- At the end of October, Ukraine and Russia signed an EU-brokered interim natural gas agreement, which would allow Ukraine to avert energy shortages and to secure gas transit to Europe in the winter.
- According to early estimates of the State Statistical Service of Ukraine, real GDP shrank by 5.1% yoy in 3Q 2014. Although the decline was larger than in the previous quarter, it was better than anticipated.
- September real sector indicators revealed a continuation in the declines in output in most sectors, though at a slower pace than in the previous months. Thus, the decline in industrial production slowed to 16.6% yoy that month.
- Agricultural output surged by 16% yoy over January-September amid a high agricultural harvest and favorable base effect.
- Private consumption and investment activity remained subdued over the period.
- Thanks to revenue raising measures and tightening of expenditures (excluding military and external debt service spending), Ukraine's January-August state budget deficit in cash terms was only marginally higher than in the corresponding period last year. However, the overall public sector fiscal balance has been worsening due to higher Naftogaz imbalances.
- Consumer price inflation accelerated to 17.5% yoy in September and should increase slightly through the rest of the year.
- With the help of NBU stabilization measures, the Ukrainian banking sector seems to be weathering the crisis relatively well, although the situation remains fragile due to continuing deposit outflows, reduced access to external borrowing, lower support from foreign parent banks, and a high level of non-performing loans.
- Due to imposition of strict forex market restrictions and resumed regular NBU interventions, the weighted average Hryvnia exchange rate was virtually fixed at UAH 12.95 per US Dollar during October.
- Although the current account deficit for January-September was substantially lower than last year, the pace of its adjustment started to slow in September.
- Ukraine's exports benefited from the EU's unilateral opening of its market for Ukraine, but this did not compensate for the export shortfalls due to Russia's imposition of trade restrictions.
- Developments in the financial account of Ukraine's Balance of Payments were generally favorable in September 2014, while the disbursement of a second IMF tranche boosted NBU gross international reserves to \$16.4 billion as of the end of September.
- Despite evident improvement, Balance of Payments pressures remain high and the country remains highly dependent on foreign financial assistance to balance its external position. The likely delay in the IMF loan program (due to parliamentary elections and formation of a new government to negotiate with and Ukraine's request to adjust the program) may intensify pressures on the Hryvnia exchange rate in 4Q 2014 and 1Q 2015.

Forecast of Main Macroeconomic Indicators for 2014-2015

Political Developments

	2011	2012	2013	2014 ^f	2015 ^f
GDP, \$ billion	163.4	176.6	182.0	140.0	141.0
Real GDP Growth, % yoy	5.2	0.2	0.0	-7.0	0.0
Private Consumption, real growth, % yoy	15.0	11.7	7.8	-7.0	0.4
Fiscal Balance, incl. Naftogaz and Pension Fund, % of GDP	-4.3	-6.0	-6.5	-11.0	-7.0
Public Debt, % of GDP	36.3	36.6	40.5	68.0	76.0
Consumer Inflation, eop, % yoy	4.6	-0.2	0.5	22.5	10.0
Hryvnia Exchange Rate per USD, eop	8.0	8.0	8.0	15.0	15.0
Current Account Balance, % of GDP	-6.3	-8.1	-9.0	-4.0	-3.0
FDI (\$ billion)	7.0	6.6	3.3	0.5	2.0
International Reserves (\$ billion)	31.8	24.5	20.4	10.0	13.0
External Debt (\$ billion)	126.2	135.1	142.5	149.0	157.0

Ukraine remains in a highly challenging situation. However, advances towards resolution of the armed conflict in eastern oblasts, ensuring sufficient gas supplies during the winter season and reshaping of parliament give reason for cautious optimism about Ukraine's future outlook. Following the ceasefire agreed at trilateral peace talks between Ukraine, Russia and the EU in Minsk, Belarus, on September 5th, the intensity of fighting has notably abated, though the clashes between Ukrain-

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ian armed forces and Russian-backed rebels have not stopped. Despite numerous violations to the agreement, Ukrainian authorities seem to be determined to make the peace plan fully effective. In accordance with the deal, at the end of September two laws on prevention of persecution and punishment of participants in events in the Donetsk and Luhansk oblasts and on the special order of local self-government in certain areas of the region were approved. The self-administration law, which came into effect in mid-October, granted greater political autonomy to the rebel-controlled region, guaranteed the right to use Russian language and set local elections for December 7th. The law, however, stipulates that the elections as well as the region governance should be carried out in accordance with Ukrainian legislation. Donbas elections should produce the region's new political leaders, likely pro-Russian but more acceptable and credible for Kyiv authorities in their efforts to make a ceasefire deal fully effective. However, on November 2nd the rebels leaders carried out their own elections, which were unauthorized by official Kyiv. These elections are considered as a step towards 'freezing' a conflict in the region.

In the meantime, Ukrainian authorities have been strengthening border control with Russia, a move that should help prevent the inflow of Russian weaponry and fighters in Ukraine. The mandate of the OSCE special monitoring mission at two crossing points on the Russian-Ukrainian border was extended in late-October for another month but the expansion to other border crossing was blocked by Russia. In addition, in late September the government of Ukraine launched the 'Wall' project, which envisages an actual construction of defense facilities and other infrastructure along the most poorly controlled part of Ukraine's eastern border at the boundaries of Kharkiv, Luhansk and Donetsk oblasts. Indeed, in some of these areas the border between the two countries was not properly demarcated, being a mostly imaginary line going through open farmland or forests, which made the border crossing relatively easy even before the eruption of the conflict. Currently, rebels control around 200 kilometers in the Donbas region, which make it unclear how the Wall project will be realized in these territories. Furthermore, even if Kyiv manages to construct the necessary facilities, it would mean unilateral demarcation of the border with Russia, which may further complicate tense relations between the countries. Finally, international experience shows that similar border fences have had relatively limited defense effectiveness, but they may become a powerful instrument in government anti-smuggling and anti-illegal migration efforts.

The October's parliamentary elections are expected to produce a strong pro-European majority that should ensure greater support for the President's peace plan and facilitate implementation of painful but long-awaited reforms. According to preliminary results, six parties passed the 5% election threshold. President Poroshenko's party and Prime Minister Yatsenyuk's People's Front received almost an equal percentage of the votes - 21.8% and 22.2% respectively. The two parties are expected to be the basis of a future coalition, likely with the help of the third-run (11% of votes) Samopomich (Self-Help) party headed by Lviv mayor Andriy Sadovyi and former Prime Minister Tymoshenko's *Batkvishchyna* (Fatherland) party, which received 5.7% of votes. However, the formation of a ruling coalition may take longer time than anticipated as the People's Front finished in first place, although with a very thin advantage. Winning first place, Ukrainian Prime Minister Yatsenyuk believes he should lead in coalition talks, keeping the Prime Minister post and demanding equal appointments to the government. At the same time, thanks to the mixed electoral system when only half of members are elected from party lists, while the others are chosen in the single-mandate districts, the president's party will obtain almost 1/3 of the Rada seats. Although coalition negotiations are likely to be difficult, a clear population mandate for Yatsenyuk and Poroshenko to work together and lessons learnt from the not so distant past gives reason to think that they will avoid political squabbles and fruitfully cooperate. Out of pro-Russian parties and representatives of the former regime, only the Opposition Bloc passed the threshold, receiving 9.4% of the votes.

Given the composition of the newly elected assembly one may expect a good degree of cooperation on issues related to foreign policy, reforms and the democratization process. At the same time, the parliament will have to follow a balanced approach, safeguarding the interests of the eastern regions. Moreover, addressing domestic security issues may remain challenging with a significant number of parliamentarians critical of the President's peace plan. We believe, however, that the peace process will proceed although with likely substantive debates and political battles in the parliament.

At the end of October, Ukraine and Russia signed an EU-brokered temporary gas agreement, which should resolve a five-month long impasse over Russia's natural gas supplies to Ukraine. In particular, the three parties agreed on a price of \$378 per 1000 m³ and \$365 per 1000 m³ effective in 4q 2014 and 1q 2015 respectively. The price is higher than the \$268.5 Ukraine was paying in 1Q 2014 and the roughly \$350 average price for European consumers of Russian gas, but more than \$100 less than Russia's initial demand. Ukraine needs about 5 billion m³ of natural gas in addition to reverse-flow gas supplies from the EU, domestic production and gas stocks in underground storage facilities to avert energy shortages and secure gas transit to Europe in the winter. Gas deliveries from Russia, however, are conditioned on Ukraine's repayment of \$3.1 billion of debts for previously consumed gas (in two tranches: \$1.45 billion by the end of October and \$1.65 billion by the end of the year) and advance payments for November and December gas. Facing funding difficulties, Ukraine requested a €2 billion credit from the EU on top of the financial aid package agreed by the IMF, the EU and other IFIs at the beginning of the year. While the size of the gas purchase loan for Ukraine is likely to be further discussed, there are good chances Ukraine will receive the necessary financial support.

Economic Growth

Although the ceasefire agreement, reached on September 5th, was often violated, it brought a notable reduction in the intensity of fighting. This, in turn, allowed the Ukrainian real sector to show tentative signs of improvement in September. In par-

Headquarters

123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111
Fax: +1 (713) 621-4666
Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine

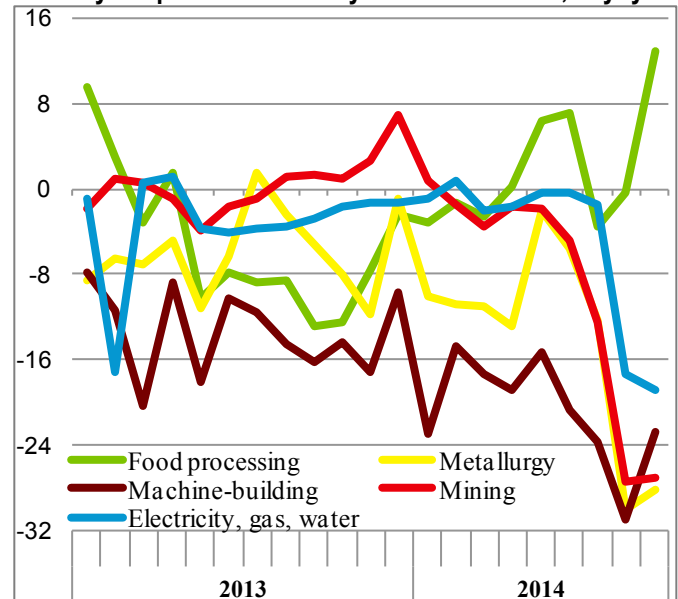
4A, Baseyna Street, «Mandarin Plaza», 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289
Fax: +38 (044) 284-1283
Email: kyiv.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine

Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180
Fax: +38 (057) 714-1188
Email: kharkov.office@sigmableyzer.com.ua

ticular, agricultural output soared by 16% yoy over the first nine months of the year amid an anticipated record high grain harvest. Thanks to these developments and a favorable base effect, the early State Statistical Committee estimate of real GDP shrinking by 5.1% in 3Q 2014 was better than expected. However, despite some progress in conflict resolution, large territories of the Donbas region, which generated almost 16% of GDP and 25% of export revenues in the past, remain under rebel control. Moreover, pro-Russian insurgents continue to target key assets and infrastructure in eastern Ukraine, severely damaging plants, roads and other facilities. Furthermore, available information points to continuing sluggish performance in consumer spending, fixed investment and exports, while the likely positive impact from higher government expenditures and likely inventory build-up (to a notable extent due to a high agricultural harvest) will be overshadowed by an anticipated acceleration in imports and less favorable statistical base effect. As a result, we are keeping our real GDP growth forecast at -7% yoy for 2014.

Looking deeper into real sector data, the slowdown in the decline of industrial production in September was mainly achieved due to stabilization in the mining sector, moderation in the rates of contraction in metallurgy and machine building, as well as a strong rebound in the food processing industry. In particular, manufacturing of food products surged by 13% yoy in September as their production is closely linked to agricultural sector performance. In September, agricultural production was up by almost 47% yoy. While such impressive growth should be mainly attributed to a high agricultural harvest, a favorable statistical base effect was also an important contributor (last year, due to adverse weather conditions the harvesting campaign was delayed in August-September, causing a sharp deterioration in the sector indicators). The Ministry of Agrarian Policy and Food of Ukraine forecasts the grain harvest to reach a record of 64 million tons this year. The country is also expected to collect a high harvest of vegetables and sugar beets, which will also spur food manufacturing. Moreover, although the food processing industry was hit by and will continue suffering from Russia's restrictions on imports of select food products from Ukraine, it also turned out to be among the main beneficiaries from the EU unilateral trade opening for Ukraine.

Monthly Output Production by Select Industries, % yoy


Source: State Statistical Service of Ukraine, The Bleyzer Foundation

September's hard data for other sectors painted a less favorable picture. Indeed, a deeper decline in retail sales turnover (-6.5% yoy for the first nine months of 2014) point to further weakening of private consumption. Although a decrease in real wages started to lose momentum in September, Hryvnia depreciation, acceleration of inflation and higher unemployment (according to ILO methodology, the unemployment rate rose to 8.6% in 1H 2014, up from 7.2% in 2013) hit consumer purchasing power. High economic and political uncertainties and an ongoing credit squeeze were also a major drag on consumer spending and investment activity. Indeed, although the decline in the construction industry started to moderate in September, the cumulative output decline stood at 17.2% over January-September. Due to transportation infrastructure disruptions, weaker foreign and domestic trade, transportation sector performance continued to deteriorate. Indeed, freight and passenger transportation turnover was down by 6.5% yoy and 11.8% yoy over January-September.

Select Real Sector Indicators for Ukraine

	2014			2013	2012	2011	2010
	9m	8m	6m				
Agriculture	16.0	6.3	-3.9	13.3	-4.5	17.5	-1.5
Industry	-8.6	-7.8	-4.7	-4.3	-1.8	7.6	11.2
Construction works	-17.2	-15.6	-8.9	-11.1	-14	11.1	-5.4
Domestic trade, turnover							
Wholesale trade	-14.0	-13.8	-10.5	-2	-4.4	0.6	0.4
Retail trade	-6.5	-4.0	0.8	9.5	15.9	14.7	9.8
Transportation, turnover							
Cargo	-6.5	-3.8	0.4	-3.9	-7.6	5.7	6.4
Passenger	-11.8	-11.8	-10.3	-2.9	-1.2	3.3	-0.2

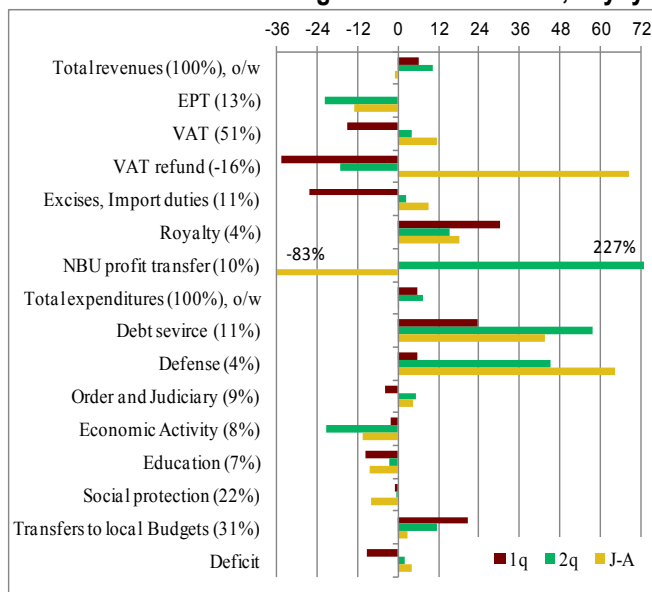
Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Economic growth prospects for 2015 remain subdued as profound challenges in the areas of domestic security, public finances and Balance-of-Payments will persist next year too. However, assuming that hostilities in the east are brought under control through the rest of the year, international support is provided and the country progresses in implementing structural reforms, Ukraine should be able to grow by about 1% yoy in 2015. An extension of the conflict into next year would mean a delay in economic recovery to 2016.

Fiscal Policy

Mirroring real sector developments and the growing cost of the military, energy and external debt spending, Ukraine's fiscal situation has been worsening. Due to deeper economic contraction and inability to collect taxes in the rebel-held Donbas region, state budget revenues declined by about 1% yoy in July-August 2014 compared with 8% yoy growth in 1H 2014. But thanks to fiscal consolidation measures, Ukraine's eight-month state budget deficit in cash terms was only marginally higher than in the corresponding period last year (up by 1.3% yoy). With respect to GDP, however, the state budget balance will continue to deteriorate. Coupled with a higher Naftogaz deficit, Ukraine's public sector fiscal deficit is forecast to worsen to about 11% of GDP in 2014. The deterioration of the Naftogaz fiscal position stems from large differences between natural gas tariffs for the population and heating companies, and imported natural gas prices. The sharp Hryvnia depreciation this year exacerbated this discrepancy despite 50% and 40% increases in household gas and heating company tariffs since May and July respectively. Although the Ukrainian government has initiated energy sector reform, its results will take time to materialize. Given that Naftogaz will remain the principal contributor to public sector fiscal imbalances, the government will need to adjust other public expenditures to ensure sustainable public finances in the medium-term. However, as further fiscal consolidation may hinder the pace of future economic recovery, the speed of fiscal adjustment is likely to be relatively moderate. For that reason, we forecast the public sector deficit to narrow only to about 7% of GDP in 2015.

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



Source: The Ministry of Finance of Ukraine, The Bleyzer Foundation

Looking deeper into state budget revenue data, corporate income tax receipts declined by about 17% yoy over the first eight months of 2014 as profits were hit by falling domestic demand, Hryvnia depreciation and disruption of economic ties with Russia and between different regions of Ukraine due to armed conflict in eastern oblasts. Proceeds from import duties have decreased by about 15% yoy in nominal terms for the period. At the same time, a number of revenue raising measures approved in April and July (including increases in excises and royalties, removal of select VAT exemptions, etc.) helped soften the budget revenue shortfall. Thus, receipts from excises and royalties rose by 16% yoy and 21% yoy, respectively, over January-August 2014, while the decline in VAT collections slowed to only 1% yoy for the period despite higher VAT refunds. Furthermore, to a notable extent, the decline in budget revenues over July-August should be attributed to different timing of some payments to and from the state budget. In particular, this year the NBU transferred the almost entire annual targeted amount of profit payments to the budget in April-May, while the respective payments were more equally distributed last year. Furthermore, over July-August 2014, Ukraine issued UAH 6.7 billion of domestic securities to resolve the problem of large VAT arrears accumulated by the end of 2013.

On the expenditure side, as July's budget amendments envisaged additional spending cuts, the nominal growth of state budget expenditures continued to slow and increased by only 4.8% yoy over January-August 2014. Government cuts of capital spending, freezes of pensions and wages, savings in the cost of the state apparatus as well as delays in launching public procurement tenders (particularly in the healthcare system) were the main reasons for this deceleration. Across the main budget programs, budget outlays on economic activity, education, healthcare and social protection fell by 12% yoy, 6.4% yoy, about 29% yoy and 2.4% yoy respectively, while expenditures on public administration decelerated to 1.4% yoy. In contrast, due to high external debt repayments, Hryvnia depreciation and the need for re-armament of the Ukrainian army, expenditures on public debt service and defense sped up to 42.5% yoy and 37% yoy, respectively.

Due to high fiscal deficits over the last five years, sizable foreign financial aid inflows, Hryvnia depreciation and real GDP decline, Ukraine's public debt-to-GDP ratio is expected to rise to 66% in 2014 and exceed 70% next year. With the IMF program in place, the debt ratio is projected to return to a downward trend in the medium-term, but its high level may add to fiscal and BoP pressures in the short-term. In particular, Russia may demand an early repayment of \$3 billion in bonds granted to Ukraine at the end of 2013 given that they contain a Ukrainian debt-to-GDP trigger. Given Russia's multidimensional pressures on Ukraine, it is very likely the repayment will be accelerated in 2015. We believe, however, that the possibility of early repayment of these bonds will be included in negotiations over the new IMF loan. So far, the government seems determined to meet all of its external obligations in a timely manner, although some debt restructuring could have softened Ukraine's fiscal stains in the near term. This strategy may help to reopen the international foreign debt market faster for Ukraine in 2015 following de-escalation of military conflict in eastern region.

Monetary Policy

Inflation. Consumer inflation continued to accelerate in September 2014 with annual CPI growth picking up to 17.5% in

Headquarters

123 N. Post Oak Ln., Suite 410
 Houston, TX 77024 USA
 Tel: +1 (713) 621-3111
 Fax: +1 (713) 621-4666
 Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine

4A, Baseyna Street, «Mandarin Plaza», 8th floor
 Kyiv 01004, Ukraine
 Tel: +38 (044) 284-1289
 Fax: +38 (044) 284-1283
 Email: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine

Meytin House, 49 Sumska Street, Office 4
 Kharkiv 61022, Ukraine
 Tel: +38 (057) 714-1180
 Fax: +38 (057) 714-1188
 Email: kharkov.office@sigmableyzer.com.ua

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September 2014. As in the previous months, the prices were pressured by further Hryvnia depreciation, utility cost adjustments and government tax raising measures (e.g., an increase in excise taxes, abolishment of some VAT privileges). These pressures are forecast to remain strong through the rest of the year. However, a record high agricultural harvest and drop in world energy prices should help contain the growth of domestic prices in the coming months. As a result, we forecast consumer inflation at 22.5% yoy at the end of 2014.

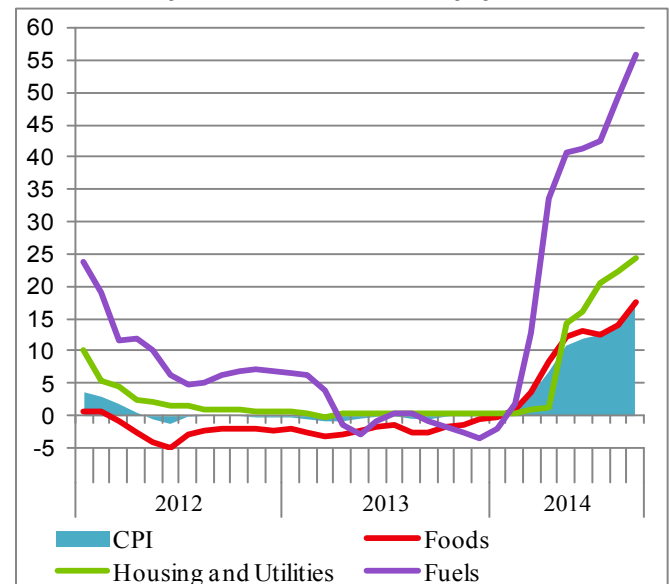
Looking in more detail, Hryvnia depreciation affected price developments through a number of channels. Due to the high share of imports, it had a pronounced impact on prices of select food products (e.g., fruit prices rose by almost 54% yoy in September), fuel (up by 56% yoy), clothing and footwear (prices in this commodity group picked up by 4.5% yoy compared to a 3.3% yoy decline a month ago), household appliances (up by 16% yoy), and pharmaceuticals (up by 32 yoy). In addition to the direct impact, Hryvnia depreciation is transmitted into other domestic prices through higher costs of imported materials, including fuels, and higher demand for domestically produced substitutes. Higher excises and the removal of VAT privileges contributed to the pick-up in prices for alcoholic drinks and tobacco (up by 22% yoy) and medicine. Due to continuing tariff adjustment (although not as significant as in May and July of this year), inflation in this category remained on an upward but somewhat flatter trend. At the same time, anticipated market saturation with fresh-harvest vegetables and some other foods due to Russia's import ban (such as meat and dairy products, cereals and vegetables) should ease food inflation pressures. In addition, declining world energy prices since July of this year should help mitigate the growth of fuel prices.

Banking Sector. With the help of NBU stabilization measures, the Ukrainian banking sector seem to be weathering the current crisis relatively well, although the situation remains fragile. Indeed, a modest inflow of Hryvnia denominated deposits continued in September, supported by high deposit rates and government plans to provide financial support to Individuals' Deposit Insurance Fund.¹ At the same time, the inflow was mainly registered for demand deposits, reflecting particularly high liquidity preferences of money holders in an uncertain environment. The stock of foreign currency deposits (denominated in US Dollars) continued to decline, adversely affected by a number of NBU measures to stabilize the Hryvnia exchange rate. In particular, in mid-September the NBU reduced the daily limit for cash foreign exchange purchases as well as foreign currency deposit withdrawals from the previous UAH 15,000 (about \$1150) to UAH 3,000 (about \$230) equivalent. The limit was applied regardless of whether the deposit period came to an end or was terminated early.

Although the National Bank of Ukraine continued to support commercial banks by providing liquidity, the deterioration of the deposit base, reduced access to external borrowing and lower support from foreign parent banks, and high domestic credit risks undermined commercial banks' lending activity. Thus, the stock of national currency loans fell by 1.1% yoy, a development not observed for the last 15 years. Although the stock of foreign currency loans (denominated in US Dollars) continued to decline (down by 11.4% yoy in September), its pace remains subdued due to the difficulties for foreign currency purchases (e.g., the NBU banned foreign currency purchases on the interbank market for early foreign currency loan repayment purposes).

The fragility of the Ukrainian banking system was also confirmed by the results of the stress tests carried out by the National

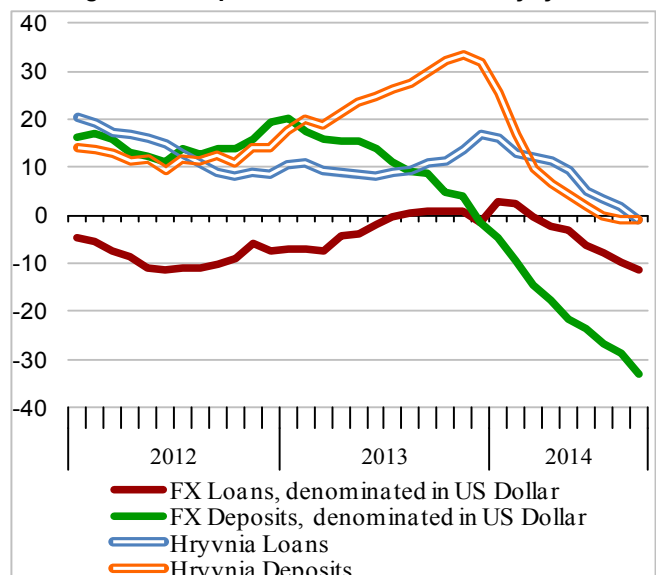
CPI Growth by Select Components, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

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Banking Sector Deposit and Loan Stocks, % yoy



Source: NBU, The Bleyzer Foundation

¹ In mid-October, the Ukrainian parliament approved amendments to the law 'On amendments to Article 231 of the law on 2014 state budget of Ukraine', according to which UAH 10.1 billion (\$0.8 billion) of domestic securities will be issued to enhance population confidence that the Fund has sufficient funds to fulfill liabilities to repay the guaranteed amount for each depositor (up to UAH 200,000 or about \$15400).

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Bank for the largest 35 banks. The results showed that only 6 out of 15 largest banks successfully passed the tests, while the total capitalization need for all 35 banks stand at around UAH 66 billion (\$5 billion, or around 4% of forecast full-year GDP). Out of this amount, about UAH 56 billion (\$4.3 billion) in additional capital is needed for the country's top 15 banks. The state-owned banks need UAH 12.5 billion (about \$1 billion), while the capital needs of subsidiaries of foreign banks were estimated at UAH 20.5 billion (\$1.6 billion). Large recapitalization needs may be explained by a poor credit portfolio in the banking industry with non-performing loans (substandard, doubtful and loss) estimated at around 45-50% of total loans. Given the high presence of subsidiaries of foreign banks and state-owned banks among tested banks, we believe the necessary capital is likely to be raised. Given that these banks account for about 86% of total bank assets, this will enhance sustainability of the whole banking system of Ukraine.

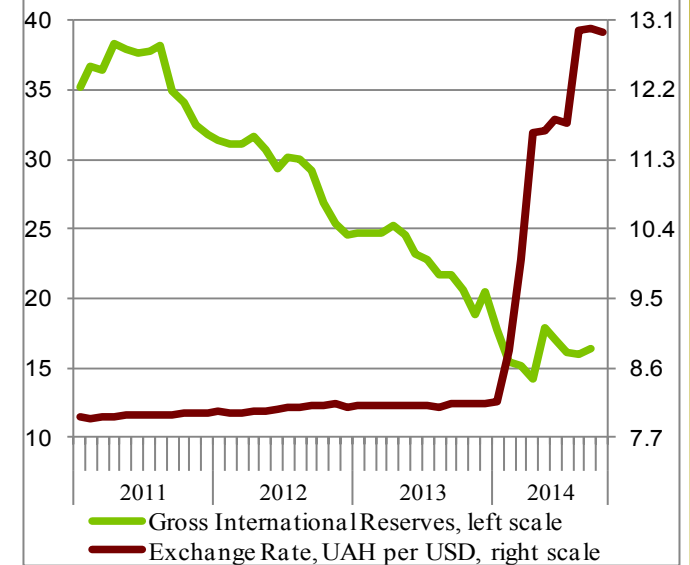
Hryvnia Exchange Rate. During October, the National Bank of Ukraine kept tightening administrative controls over foreign exchange transactions aimed at suppressing Hryvnia depreciation pressures, intensified since mid-August 2014. In addition to a reduction of the foreign currency purchase limit for one person to UAH 3,000 (about \$230) per day within one bank institution, broadening the list of banned foreign exchange transactions, the NBU obliged commercial banks to compose a full list of clients' forex purchase requests and made their fulfillment subject to the NBU approval. During the month, the NBU regularly met with representatives of the 40 largest banks to agree on the corridor of Hryvnia exchange rate fluctuations. In October, the corridor was set at UAH 12.90/13.15 per USD.

On the foreign exchange supply side, although the NBU relaxed the mandatory sale of exporters revenues to 75% (down from previous 100%), the supply of foreign exchange fell sharply, which may be attributed to weaker export performance, lower transfers from abroad and lower private external debt rollovers. To support the national currency, the National Bank of Ukraine carried out regular (once or twice a week) forex interventions to satisfy the needs of banks' cashier departments and client requests for eligible foreign currency purchases. Given these developments, it is not surprising that the weighted average Hryvnia exchange rate stayed virtually fixed at UAH 12.95 per USD during the month. Strict forex regulations, however, spurred the development of a 'black market' (with Hryvnia trading at about 14.30/14.90 per USD) and formed deferred demand for foreign exchange, estimated at around \$1 billion at the end of the month. After parliamentary elections, the NBU is likely to start relaxing forex restrictions. Coupled with the anticipated worsening of the current account balance of the Balance of Payments in the last quarter of 2014 and likely delay in the IMF program, this will increase Hryvnia exchange rate volatility through the rest of the year.

International Trade and Capital

Despite evident improvement in 2014, Ukraine's Balance of Payments position remains fragile amid high external financing requirements and heavy reliance on foreign financial assistance in addressing its external imbalances. In particular, Ukraine's nine-month current account deficit was almost 70% lower than in the corresponding period last year. Although both exports and imports of goods and services reported sharp declines over the period (almost 16% yoy and 24% yoy for January-September 2014 respectively), import compression was more pronounced, which made it the major source of the current account balance correction. At the same time, the pace of current account adjustment started to slow in September and is expected to worsen further through the rest of the year. Such development will be mostly driven by anticipated higher volumes of energy imports and new restrictions imposed by Russia on import of Ukrainian goods. For 2014, the current account deficit is forecast to reach 4% of GDP, a notable improvement from about 9% of GDP in 2013 but insufficiently strong to reduce its large stock of net foreign liabilities.

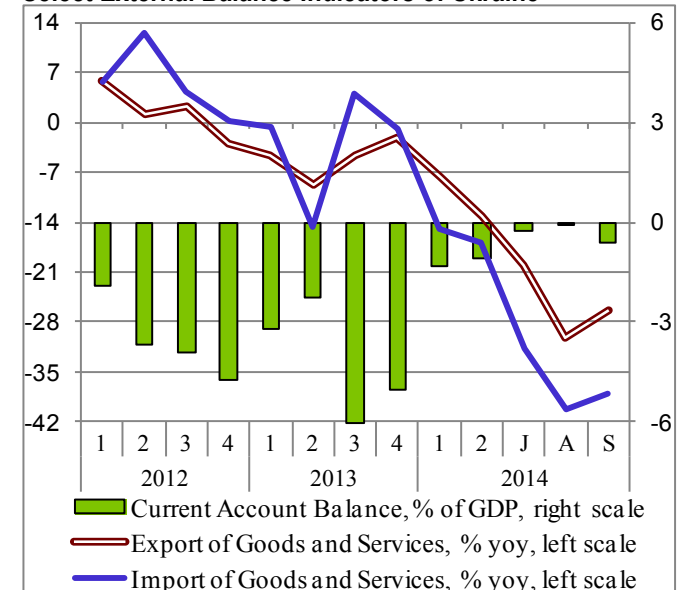
NBU Gross International Reserves, \$ billion, and Weighted Average Interbank Hryvnia Exchange Rate, UAH per USD



Source: NBU, The Bleyzer Foundation

formed deferred demand for foreign exchange, estimated at around \$1 billion at the end of the month. After parliamentary elections, the NBU is likely to start relaxing forex restrictions. Coupled with the anticipated worsening of the current account balance of the Balance of Payments in the last quarter of 2014 and likely delay in the IMF program, this will increase Hryvnia exchange rate volatility through the rest of the year.

Select External Balance Indicators of Ukraine



Source: NBU, The Bleyzer Foundation

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Imports continued to decline in September, reflecting domestic demand weaknesses and lower energy supplies. However, import contraction decelerated to 40% yoy that month amid signs of strengthening import demand for ferrous metals, machinery and transport vehicles, and other industrial goods that largely mirrored the pattern of industrial production. A continuation of the modest upward import trend may be expected in the coming months, underpinned by higher natural gas and coal shipments as well as the presence of statistical base effects. In particular, due to high monthly natural gas deliveries in September-October 2013, import of mineral products reported deeper decline in September 2014 than in the previous months (56% yoy vs about 46% yoy on average over July-August) despite growing volumes of natural gas imports from Europe.² In late October, Ukraine and Russia signed an EU-brokered interim natural gas agreement, according to which Ukraine will import about 4-5 billion m³ of gas in November-December. If implemented, it will avert a potential energy crisis and natural gas supply disruptions to Europe, but will lead to notable deterioration in Ukraine's foreign trade and, hence, current account balances over these months.

Following a sharp decline in August, merchandise exports showed a slower pace of decline in September, with the pace of decline slowing to 16.5% yoy. The improvement was driven by a high agricultural harvest and continuing benefits for Ukrainian producers from the EU unilateral trade preferences for Ukraine. In particular, as a result of these measures, about 95% and 80% of EU tariffs on industrial and agricultural goods from Ukraine respectively were removed since April of this year. These tariff removals supported Ukraine's exports to EU countries, which rose by about 14% yoy over the first eight months of the year but could not compensate for a 25.5% yoy decline in exports to Russia for the period. Ukraine's exports to EU countries lag behind their potential as structural reforms (particularly in the technical regulation area) take time to materialize. Furthermore, in mid-October 2014, Russia introduced new trade restrictions, banning imports of fruits, vegetables, grains and cereal products from Ukraine. As a result, the outlook for prospective export recovery of Ukraine remains subdued in the short term.

In September, the Ukraine's financial account recorded net inflows of about \$250 million mainly thanks to foreign financial assistance from the World Bank and IMF as well as individual countries, such as Canada and Japan. In addition, the direct foreign investment balance has been improving for the fourth month in a row. Following substantial net outflows in January-May 2014, net FDI balance shifted into surplus, totaling \$0.8 billion for the June-September. Although monthly FDI flows remained substantially lower than in previous years, Ukrainian authorities' strong commitment to restoring peace and implementing structural reforms should gradually renew foreign investors' confidence in Ukraine. So far, however, unfavorable sentiment adversely affects private foreign creditors' preparedness to rollover Ukraine's foreign currency obligations. Indeed, the rollover rate for non-financial private sector debt decreased to 43% in September, the lowest level on record. At the same time, although net foreign capital outflows continued from the banking system in September, the rollover rates in 3Q 2014 notably improved compared to the previous quarter (95% vs 80% in 3q and 2q 2014 respectively, according to NBU data).

Despite favorable financial account developments, the overall external balance of Ukraine worsened in September due to a higher current account deficit. However, the second IMF tranche disbursement early that month not only covered the Balance of Payments deficit but also allowed Ukraine to augment its gross international reserves to \$16.4 billion as of the end of September. Ukraine is projected to continue to receive sizable financial support in 2014 and 2015. But uncertainties regarding its size and timing overshadow the near-term BoP outlook for Ukraine. In particular, according to an interim gas agreement with Russia, Ukraine will have to pay off \$3.1 billion for natural gas consumed in the previous periods and to prepay about \$1.5-\$2 billion (depending on the agreed volumes) for future natural gas deliveries from Russia. In addition, given the large economic damage from insurgencies in the Donbas region and high military expenditures, Ukraine requested an adjustment in the terms of the IMF bailout (i.e. an increase in the size of the loan). However, due to parliamentary elections, negotiations over the new IMF loan and its conditionality (with 2015 budget deficit target being among key conditions) loan negotiations will be delayed until after the new government is formed. All of this increases the risk that the next IMF loan tranche will be postponed until the beginning of 2015. While Ukraine and the EU have been discussing a bridge loan for Ukraine to buy natural gas from Russia, the potential IMF program delay may increase BoP pressures in the coming months, leading to higher Hryvnia exchange rate volatility in the last quarter of 2014 and the first quarter of 2015. As soon as the IMF loan is in place, the gas deal with Russia is implemented and political uncertainties abate, the Hryvnia exchange rate is likely to stabilize and stay at around UAH 15.0 per USD.

² In addition to natural gas supplies from Poland and Hungary, in September 2014 Ukraine started to import natural gas in reverse order from Slovakia, which has the largest natural gas transport capacity to Ukraine (not taking into account Russia). As a result, Ukraine received almost 1 billion m³ of gas from Europe that month, almost the same amount as for the first eight months of the year (\$1.2 billion m³).

Headquarters

123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111
Fax: +1 (713) 621-4666
Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine

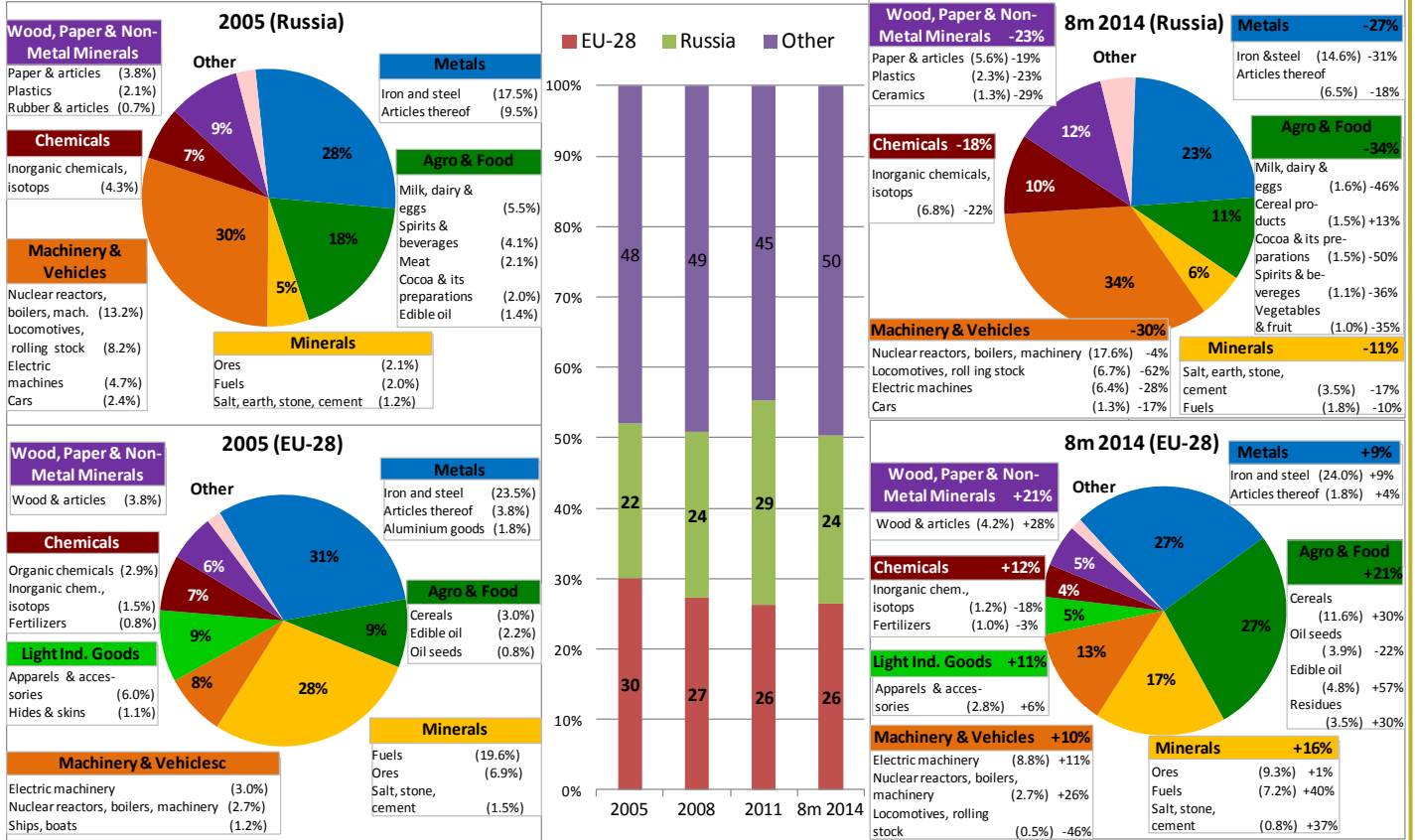
4A, Baseyna Street, «Mandarin Plaza», 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289
Fax: +38 (044) 284-1283
Email: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine

Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180
Fax: +38 (057) 714-1188
Email: kharkov.office@sigmableyzer.com.ua

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Ukraine's Merchandise Exports to Its Main Partners, % of total, % yoy for 8m 2014



Source: UN Comtrade database, State Statistical Service of Ukraine, The Bleyzer Foundation