

*July 2015**Oleg Ustenko, Djulia Segura, Valentyn Povroznyuk
Edilberto L. Segura***Executive Summary**

- ❖ Despite the new rounds of talks in Minsk in mid-July and early August, military hostilities in the occupied territories in Donetsk and Lugansk have remained high.
- ❖ Despite the military conflict in the East, Ukraine continues to move its economic reform agenda forward. This progress was outlined by the IMF in its report to its Board.
- ❖ But the IMF report and local observers also state that insufficient progress has been made in many areas of reform, such as stronger anti-corruption measures (including corruption prevention, stronger conditions for the National Anticorruption Bureau and actual anticorruption enforcement results), reforming the judiciary and general prosecutor office, reforming public administration, advancing with deregulation, and privatization of state enterprises.
- ❖ Monthly production data suggests that the Ukrainian economy bottomed out in the second quarter of 2015. In fact, on a month-to-month basis industrial production increased by 1.5% mom in June, following a similar increases in many industrial subsectors in May. On a year-to-year basis, the June Industrial Production index recovered to a decline of -18% yoy from declines of -21% yoy experienced in May and -22% yoy in April.
- ❖ Output recovery is taking place in a number of industrial subsectors, including car manufacturing, machine-building, furniture, textiles, wood and paper, oil and gas extraction, rubber and plastics, and chemicals. On the other hand, some of the industrial subsectors most affected by the hostilities in the East, such as metallurgy and mining, continue to show mom output declines.
- ❖ Despite economic stabilization in the second half of 2015, GDP is likely to decline by -11.0% for the entire year 2015, due to the likely large -16.0% yoy decline in the first half of the year.
- ❖ During June 2015 state budget revenues increased at a rapid pace, thanks to the favorable effects of past inflation and currency devaluations on taxation. But both inflation and depreciation also promoted growth in budget expenditures, including defense expenditures. As a result, the state budget showed a deficit for the second consecutive month. A consolidated budget deficit of 8% is expected for 2015.
- ❖ In June inflation continued to decelerate but at a slower pace than previously expected. In fact, the CPI growth decelerated from 60.7% yoy in April to 58.4% yoy in May and to 57.5% yoy in June. It is expected to reach 45% by the end of the year.
- ❖ Thanks to a relative stability in the FX market, June was the third month in a row when deposits in domestic currency were growing, although at a low rate. Also, the banking sector has become more stable with the liquidation of 51 insolvent banks.
- ❖ The foreign exchange situation improved in Q2 2015, with the UAH/USD exchange rate gradually appreciating from slightly above 23 UAH/USD in April to about 21 UAH/USD in July. But depreciation pressures may emerge in September due to external debt repayments and the need to increase natural gas purchases. These will lead to a depreciation of the Hryvnia to around 25 UAH/USD by the end of the year.
- ❖ The current account improved in Q2 2015, with a surplus of USD 361 million in June. Along with significant capital inflows, the overall Balance of Payments surplus reached USD 489 million in June. This surplus allowed the National Bank of Ukraine to accumulate gross international reserves, which reached USD 10.4 billion at the end of June, and which was sufficient to cover 2.2 months of future imports.
- ❖ On July 31 the IMF Board approved the disbursements of USD 1.7 billion under its EFF Program.

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Forecast of Main Macroeconomic Indicators for 2014-2015	2011	2012	2013	2014	2015f
GDP, \$ billion	163.4	176.6	182.0	127.4	98.0
Real GDP Growth, % yoy	5.5	0.2	0.0	-6.8	-11.0
Private Consumption, real growth, % yoy	15.7	8.4	6.9	-9.6	-17.0
Fiscal Balance, incl. Naftogaz and Pension Fund, % of GDP	-4.3	-6.0	-6.5	-11.7	-8.0
Public Debt, % of GDP	36.3	36.7	39.9	70.3	94.0
Consumer Inflation, eop, % yoy	4.6	-0.2	0.5	24.9	45.0
Hryvnia Exchange Rate per USD, eop	8.0	8.0	8.2	15.8	25.0
Current Account Balance, % of GDP	-6.3	-8.2	-9.2	-4.1	0.0
FDI (\$ billion)	7.0	6.6	3.3	0.2	0.5
International Reserves (\$ billion)	31.8	24.5	20.4	7.5	13.0
External Debt (\$ billion)	126.2	134.6	142.1	125.9	138.0

Political and Reform Developments

Despite the new rounds of talks in Minsk in mid-July and early August, military hostilities in the temporarily occupied territories in Donetsk and Lugansk regions have remained high. Moreover, the OSCE monitoring mission has reported that after more than a year of fighting, both sides are fortifying their positions. As a result of the on-going military actions, the number of Ukrainian death has increased to more than 6,700 people. The daily number of casualties among civilians is still high. To avoid possible future deterioration, the leaders of the Normandy Four Group conducted a conference call on July 17th, in which they re-confirmed all earlier agreements reached in Minsk-2. The subsequent early August discussions were also unsuccessful. Military actions in the field have continued.

Despite the military conflict in the Eastern part of the country, Ukraine continues to make progress in moving its economic reform agenda forward. The IMF Staff Report of July 29th highlights progress in the following areas: implementation of appropriate fiscal and monetary policies to secure economic stabilization and disinflation; measures to improve the institutional capacity and independence of the NBU; initial measures to restore the health of the banking sector; including liquidation of insolvent banks; improvements in public procurement of medicines; improvement in energy sector pricing policies; initial steps in anticorruption with the establishment of the National Anticorruption Bureau; progress in investors' protection; and start of deregulation process.

Nevertheless, the IMF report and local observers have also stated that essential structural and institutional reforms are still pending, particularly in the fight against corruption (including corruption prevention, stronger conditions for the National Anticorruption Bureau and actual anticorruption enforcement results), improving the business climate, reforming public administration, advancing with deregulation, further improving the banking sector, reforming state-owned enterprises and advancing their privatization, financial rehabilitation of Naftogaz, and reforming the judiciary and general prosecutor office.

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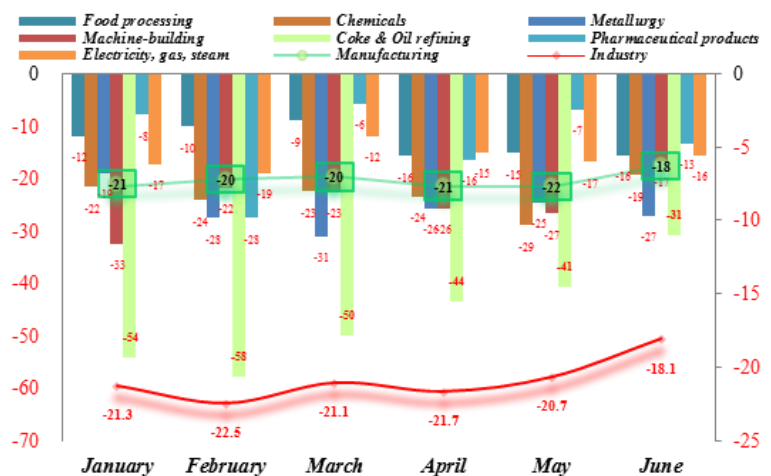
More recently, the following developments in structural reforms have taken place:

- In connection with the implementation of the government's decentralization program, proposed changes in the Constitution have been endorsed by the Constitutional Court and will be voted by Rada in September. In this connection, the government has already started the strengthening of local budgets. In particular, local budget revenues have been increased by 38% and reached UAH 44.6 billion during the first half of 2015. Central budget decentralization became the first step towards increasing the financial resources of local communities and providing them with greater independence.
- To move forward the process of fighting corruption, following the establishment of the National Anticorruption Bureau, it has been now partly staffed. Furthermore, the Cabinet of Ministers of Ukraine established a working group to transfer some of the most corrupted customs agencies (i.e., Zakarpattia, Lviv, Volyn and Chernivtsi) to an outside international management agency. In particular, it is likely that management will be provided by a British company that has considerable experience in managing customs' units in Eastern European countries. In addition to fighting against corruption, these steps should increase customs' revenues and improve the quality of customs' services.
- To ensure a high quality of police services, Ukraine has opened a new patrol police in Kiev, which was trained by Western instructors. It is considered the first step towards a broad reform of administrative services. The same initiatives are under implementation in several other big Ukrainian cities.
- To provide greater exposure for Ukrainian companies to international markets and to diversify its exports potential, Ukraine and Canada signed a document on the completion of negotiations regarding the establishment of a free trade area (FTA) between the two countries. When the FTA comes into effect, it should open around 98% of the Canadian market for Ukrainian exports. Over the long run, it should partly compensate for the collapse of Ukrainian exports to the Russian market. The agreement should also catalyze the modernization of Ukrainian production facilities to be more competitive on Western markets.

Economic Growth

Monthly production data suggest that the Ukrainian economy bottomed out in the second quarter of 2015. In fact, in June on a month-to-month basis industrial production increased by 1.5% mom, following a similar increases in many industrial subsectors in May. These positive monthly growth rates held even after seasonal adjustment. On a year-over-year basis, the June Industrial Production index recovered to a decline of -18% yoy in June from declines of -21% yoy experienced in May and -22% yoy in April. The bulk of the -18% yoy decline in June occurred during the last quarter of 2014, due to the intensification at that time of military hostilities in the east of the country and the trade sanctions imposed by Russia on

Industrial Production by Sectors, % yoy



Source: The Bleyzer Foundation

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Ukrainian exports.

Although the June yoy improvement over May may also be due in part to a lower statistical base (reflecting the deterioration that took place in June 2014), monthly data shows that recovery is taking place in a number of industrial subsectors. In fact, some of the industrial subsectors showing the stronger recovery in June 2015 included (with data for June mom, June yoy and May yoy): car manufacturing (+10.8% mom, -17.9% yoy in June improved over -30.4% yoy in May), machine-building (+8.8%, -16.7%, -26.7%), furniture (+21.9%, -13.9%, -30.3), textiles (+5.9%, -1.0%, -9.2%), wood and paper (+8.6%, -14.6%, -18.5%), oil and gas extraction (+30.0%, -1.1%, -7.1%), rubber and plastics (+5.7%, -11.6%, -15.5%), and chemicals (+0.9%, -19.4%, -29.0%). On the other hand, some of the industrial subsectors most affected by the hostilities in the East continue to show mom output declines. They included metallurgy, which reported a -27.1% yoy decline in output in June compared to -24.6% yoy in May (a -5.7% mom decline in June). The decline in metallurgy was due to disruptions to Mariupol infrastructure and metallurgical plants as well as to a decline in world steel prices. Similarly, mining fell by -5.7% mom (with a decline of -53.2% yoy in June, compared to -52.3% yoy in May).

Agricultural production also showed a large decline of -17% yoy in June (compared to -7.3% in May). This decline was caused both by a late start to the grain harvesting season this year, and by a decline in the poultry and livestock populations. Although only about 1.0 million tons of crops had been collected by July 1, 2015 (compared to 3.2 million tons the year before), the average crop yield was higher than last year. According to the Ministry of Agrarian Policy and Food of Ukraine, the country is expected to harvest 60 million of grains in this 2016/2016 marketing year. Given large ending stocks from the previous year, Ukraine's grain supply may be around 72 million tons, which may enable about 37-40 million tons of grain exports (compared to 35 million last year).

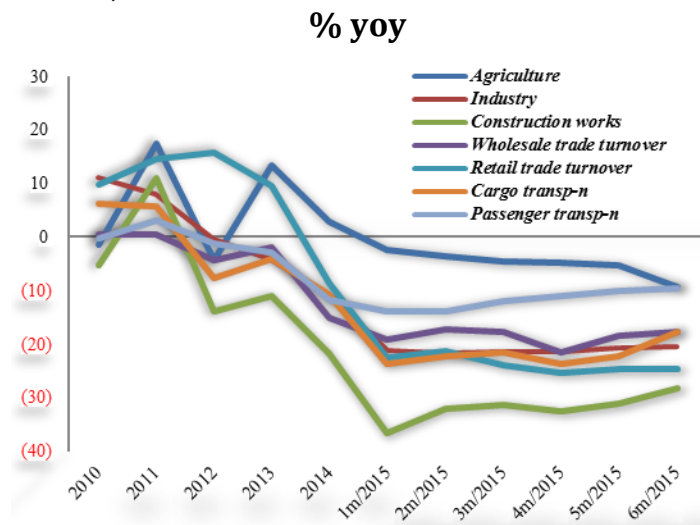
Output Indicators of Ukraine, % yoy

	2015 6m*	2014	2013	2012	2011	2010
Agriculture	-9.3	2.8	13.3	-4.5	17.5	-1.5
Industry	-20.5	-10.7	-4.3	-1.8	7.6	11.2
Construction works	-28.3	-21.7	-11.1	-14	11.1	-5.4
Domestic trade, turnover:						
Wholesale trade	-17.6	-15	-2	-4.4	0.6	0.4
Retail trade	-24.6	-8.6	9.5	15.9	14.7	9.8
Transportation, turnover:						
Cargo	-17.7	-10.8	-3.9	-7.6	5.7	6.4
Passenger	-9.5	-11.7	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service of Ukraine, the Bleyzer Foundation

* Excluding Crimea and occupied territories

Economic Performance of Ukraine, by Sector,



Source: The Bleyzer Foundation

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In June, positive results were also experienced in other sectors. In particular, the construction sector showed signs of improvements in June, with an increase in output of 3.6% mom, thus reducing the year-over-year sector decline from -32.0% yoy in May to -23.9% yoy in June. This improvement was due to a revival of non-residential construction and civil engineering works. Other sectors that performed better in June included retail turnover which recovered from 26% yoy in May to 24% yoy in June, wholesale trade turnover and passenger transportation which showed lower yoy declines in June than in May.

From a geographical standpoint, nine oblasts showed positive rates of industrial production growth yoy in June 2015, compared to only three oblasts with positive rates yoy in May 2015. In June, industrial production indexes increased yoy in the following oblasts: Zhytomyr (25.2%), Chernivtsi (19.6%), Odesa (13.4%), Sumy (12.7%), Rivne (10.3%), Volyn (4.8%), Lviv (3.6%), Kherson (3.2%) and Kyiv (2.1%). On the other hand, the largest output declines took place in the war-afflicted east, which used to be the industrial center of the country, with large declines in Lugansk (-78% yoy in June, compared to 88% yoy in May) and Donetsk (-46.6% yoy in June, compared to 45.9% in May). These two oblasts accounted for a large share of the drop in GDP experienced by Ukraine in the last 12 months.

Supporting the view of a likely economic stabilization, a Consumer Confidence survey carried out by GfK Ukraine shows that its consumer confidence index improved to 48.8, which is 3.3 points higher than in May, with an increase in the index of propensity to consume to 57.2, 8 points higher than in May. But the pace of economic recovery during the rest of the year will depend on the evolution of the military situation in the East of the country. Assuming that there is no major increase in hostilities, economic output will stabilize on a mom to month basis, but with a low rate of growth after seasonal adjustment of around 1% to 2% mom. A higher rate of growth would require more clarity on the permanence of the cease of hostilities and stronger measures to improve the country's investment climate to revive investments. In terms of real GDP, given the sharp declines that have already taken place (-17.2% yoy in Q1 and possible 15.0% yoy in Q2), it is now estimated that GDP will decline by about -9.0% yoy in Q3 2015 and by -3.0% yoy on Q4 2015. Despite these improved trends, for the entire year 2015, GDP is likely to decline by -11.0%. This large decline in 2015 GDP should take place, even though we expect that output would stabilize (at low levels) in the second half of the year. In 2016, GDP growth may become positive, with a growth rate of about 2%.

Fiscal Policy

During June 2015, state budget revenues continued to increase at a rapid pace, thanks principally to the favorable effects of past inflation and currency devaluations on taxation. But both inflation and depreciation also promoted growth in budget expenditures, including defense expenditures. As a result, the state budget showed a deficit for the second consecutive month, which reached UAH 7.7 billion in June.

Including local governments and agencies, during January-June 2015, the overall consolidated budget revenues posted a 33.0% yoy increase to UAH 298.7 billion, while consolidated budget expenditures grew by 16.8% yoy to UAH 285.2 billion. As a result, the consolidated budget was executed with a surplus of UAH 12.3 billion for the period January-June 2015, compared to UAH 19.4 billion surplus during January-May 2015. At the same time, the cash balances at the single treasury account (STA) also continued to increase. After a record high UAH 27.7 billion at the end of May, the STA balances reached a new record of UAH 33.2 billion at the end of July. This amount is sufficient to ensure the smoothness of finance allocation within the state budget programs until the end of the year.

However, despite fiscal surpluses and high balances at the STA, the government has continued to borrow on both domestic and external markets mostly to satisfy its quasi-fiscal needs. In fact, domestic government bonds were issued to support Naftogaz, commercial banks, and the Deposit Insurance Fund.

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Overall, the government borrowed UAH 89.1 billion equivalent on external markets (supported in part by US Government guarantees) and UAH 47.3 billion in the domestic market. Public and publicly guaranteed debt grew by 0.5% mom in May, reaching UAH 1,424 billion as of the end-May, due to the issuance of U.S.-government-guaranteed Eurobonds.

Despite some expected easing of austerity measures and expected high expenditures on subsidies to the population because of growth in tariffs, we have maintained our forecast for the public sector fiscal deficit at 8% of GDP for the entire year 2015.

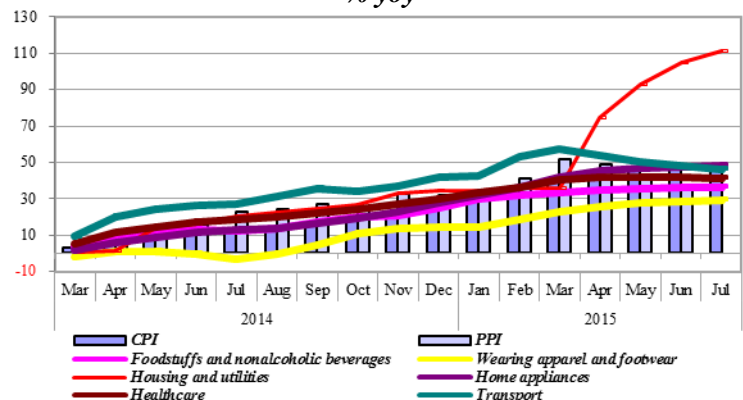
Monetary Policy

Inflation. In June, inflation continued to decelerate but at a slower pace than previously expected. In fact, the CPI growth decelerated from 60.7% yoy in April to 58.4% yoy in May and to 57.5% yoy in June. These improvements were due in part to the stabilization of the foreign exchange market, which led to a drop in the prices of imported goods. But the most significant deceleration took place in healthcare prices (0.1% mom decline). Footwear and apparel saw some seasonal monthly declines in prices; but they were not enough to slow-down inflation on a year-over-year basis. Prices of foodstuffs and non-alcoholic beverages saw mixed developments in June. Whereas most food products saw monthly declines in prices or deceleration in price growth, dairy products and eggs saw growth in prices on both monthly and year-over-year terms. This may be related to product scarcity and fears concerning the proposed lifting of preferences to agricultural producers (as discussions of this matter were once again initiated in the parliament recently). As a result, overall prices of foodstuffs and non-alcoholic beverages were flat on June in monthly terms but their over-year inflation decelerated by 1.1 percentage points to 51.9%. Deceleration in 12-month inflation was observed also for housing, utilities, home appliances, and other goods and services. Tobacco and alcohol prices saw a 2.5% mom increase due to legal changes in the status of beer. According to the latest legal amendments, beer is now considered a strong alcoholic beverage along with vodka and wine. This led to increase in the excise duty for beer.

The rate of core inflation also moderated to 0.4% in June compared to 4.6% in April and to 1.9% in May. Despite recent positive developments, the high level of consumer price inflation remains one of the main challenges facing the National Bank of Ukraine.

Deceleration in the inflation rate was supported by tight monetary policies of the NBU and the general economic recession. We expect inflation to decrease in the coming months, despite a CPI hike in October, when households will be required to pay new communal tariffs. Taking into account the current dynamics of consumer prices, we expect consumer inflation to slow to around 45% yoy by the end of the year. For the next 12 months, June to June, a business survey carried out by the NBU shows that inflation expectations have improved, with businesses expecting inflation to go down to 27% by June 2016.

CPI, PPI and Growth of Prices for Select Goods & Services % yoy



Source: State Statistical Service of Ukraine, the Bleyzer Foundation

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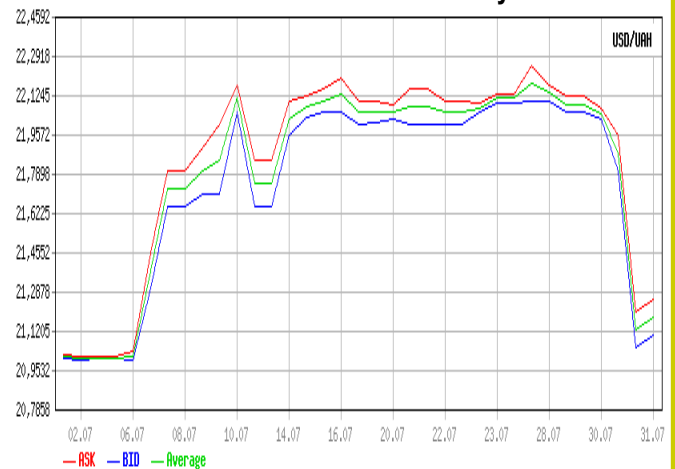
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Banking Sector. Thanks to relative stability in the FX market, June was the third month in a row when deposits in domestic currency grew, although at a low rate. Similarly, the pace of decline in foreign currency deposits decelerated. In fact, as of the end of June, bank deposits of non-financial corporations increased bringing the cumulative annualized growth to 1.5% compared with a 5.4% decline in May. On other hand, households' deposits with commercial banks remained flat at the previous monthly level, posting an annualized decrease of 28.5%.

During June, commercial banks' demand for NBU certificates of deposit remained buoyant. To strengthen the monetary market fundamentals and to widen the banks' options to diversify their asset operations, the National Bank of Ukraine offered a new short-term liquidity management instrument - weekly auctions on placement of certificates of deposit with maturity of 1 and 3 months, with the interest rate thereon determined through limited-amount interest-rate tenders.

The NBU has continued the process of cleaning the banking system from insolvent banks. Of 180 banks active in 2014, only 129 remained active in July 2015. During the first half of 2015, the financial results of operating banks were negative and amounted to UAH 30.6 billion in losses, while already liquidated banks or banks under administration generated UAH 51.4 billion of losses over the period. Many banks still face liquidity difficulties, including some large banks. In particular, Finance and Credit Bank (FCB), which is a systemic bank, applied for and received a financial rehabilitation loan from the NBU in the amount of UAH 750 million for two years. At the same time, in June the needs for liquidity support in the banking system continued to decline. Total liquidity support provided by the NBU amounted to UAH 1.4 billion during the reporting month. Apart from the loan provided to the FCB, this included UAH 527 million in overnight loans and UAH 77.5 million in loans with maturity up to 90/360 days provided in specialized auctions. The poor financial state of the banking sector, together with the NBU's policy of limiting the growth in the money supply have almost stopped banking credits in the country, hurting business operations.

Dynamics of UAH/USD Exchange Rate Quotations in the Interbank Forex Market in July



Source: Ukrdealing, The Bleyzer Foundation

Hryvnia Exchange Rate. The foreign exchange situation improved in Q2 2015 but remained stressed. On the one hand, the UAH/USD exchange rate gradually appreciated from slightly above 23 UAH/USD at the beginning of April to about 21 UAH/USD at the end of June. This appreciation was due principally to the administrative measures taken by the NBU. A temporary depreciation of the exchange rate during July was related to negative expectations concerning the second tranche from the IMF under the EFF Program. Those negative expectations were linked to very difficult negotiations between the Ukrainian government and holders of Ukrainian Eurobonds. However, the positive decision of the Board of Directors of the IMF concerning the provision of USD 1.7 billion equivalent to Ukraine led to the appreciation of the exchange rate back to the levels observed at the beginning of July. Over the next few months, some depreciation pressures may emerge around September/October due to large external debt repayments and the need to increase natural gas purchases. In particular, Ukraine still needs to buy around 6 billion cubic meters of gas in the course of the next few months. This will require the state gas company NAK Naftogas to buy in the forex market around

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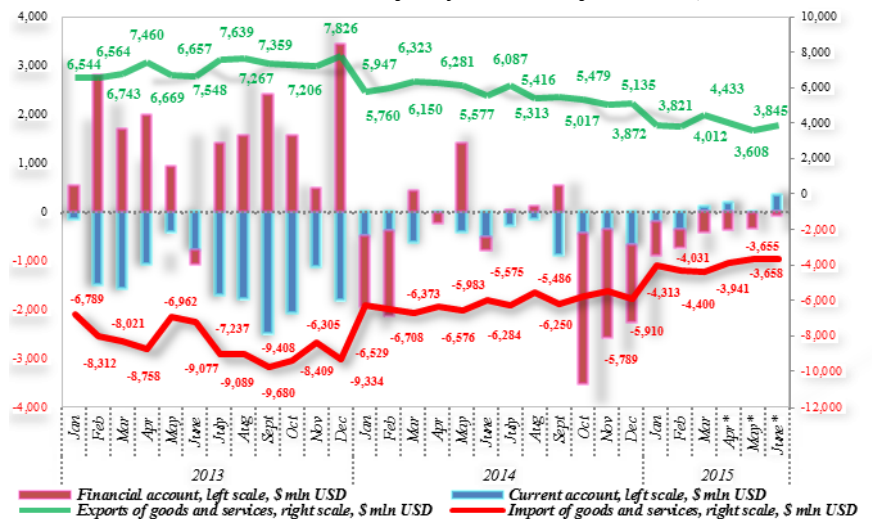
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USD 1.5 billion. These will lead to a depreciation of the Hryvnia to around 25 UAH/USD by the end of the year.

International Trade and Capital

The current account of the balance of payments continued to improve during Q2 2015. In fact, in June 2015, the current account showed a surplus of USD 361 million, compared to a deficit of USD 521 million in June 2014. Improvements took place in all categories of the current account, including goods, services and foreign income. In particular, the foreign trade balance of goods recorded a small surplus of USD 49 million in June, the first surplus in years, despite poor international commodity conditions. Exports of goods increased from USD 2,708 million in May 2015 to USD 2,918 million in June 2015, whereas merchandise imports in June stayed at the same level as in May (USD 2, 869 million). Most of the recent improvement in merchandise exports took place in agriculture, chemicals, timber, wood products, and minerals, whereas exports of metals and machinery continued to suffer from the negative impact of the hostilities in Donbas, where many metallurgical plants are located. Similarly, in June foreign trade in services showed a surplus of USD 141 million, which originated from increases in computer services exports. Imports of goods decelerated in May-June 2015 mostly because of lower prices for imported natural gas.

Ukraine's External Balance of Payments Performance, \$ mln USD



Source: NBU, The Bleyzer Foundation

From a geographical stance, in January-June 2015 exports of goods to the Russian Federation declined by -45.9% yoy; and represented only 13% of total Ukrainian exports (compared to 19% in the same period of 2014 and 30% in 2012). As a share of the total, exports to Europe declined from 29.6% in H1 2014 to 28.6% in H1 2015, while exports to the US remained at a negligible 1.3% of the total. Only exports to Asia showed a large increase of total exports from 27.9% of the total in H1 2014 to 35.7% in H1 2015.

In seeking new export markets, Ukraine has completed talks with Canada on a Free Trade Agreement. The provisions of the draft agreement on free trade between Ukraine and Canada are aimed, among other things, at deepening trade and economic cooperation, including in trade in industrial and agricultural goods, intellectual property protection, and the regulation of public procurement. After the agreement comes into effect, Canada will provide Ukrainian exporters free access to 98% of its market. Ukraine will be given a transition period prior to the liberalization of the market by lifting all import duties.

Regarding the financial account of the balance of payments, in June 2015 it showed a surplus of USD 80 million, following a surplus of USD 330 million in May. These surpluses were the result of large foreign direct investments, which reached USD 437 million during June 2015, and the conversion into a reserve

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currency of a non-convertible currency under a foreign exchange swap with the People's Bank of China. About 80% of all foreign direct investments in June went to the banking sector (USD 346 million), to strengthen the capital of subsidiaries of foreign banks.

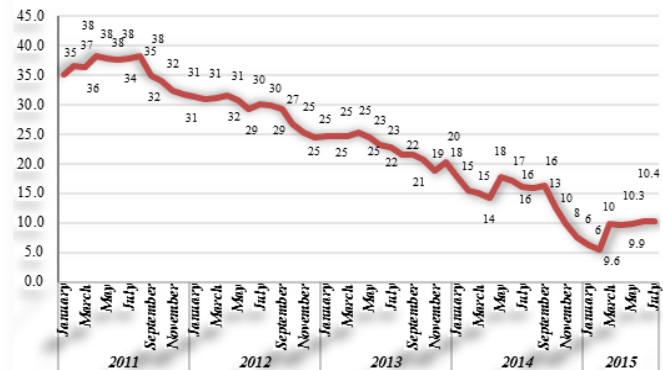
Improved current and financial account balances allowed the NBU to accumulate gross international reserves to USD 10.4 billion as of the end of June. These reserves are equivalent to about 2.2 months of imports.

Ukraine and its Eurobond creditors are still in negotiations regarding Ukraine's external debt restructuring. Despite some statements about "progress" in mid-July, Ukraine has not managed to reach agreement on the terms of this external debt restructuring. The main issue in the negotiations is the strong opposition of creditors to the 40% haircut proposed by Ukraine. Creditors have offered a 5% haircut, and claim that it is possible to reach the goal

of reducing Ukraine's debt repayment and servicing obligations by USD 15.4 billion over the next four years without writing down 40% of the face value of its sovereign bonds. Meanwhile, on July 24th, Ukraine paid a coupon of USD 120 million on Eurobonds issued in 2012. Many experts believe that the payment of the coupon strengthened investors' optimism about the possibility of reaching agreement between Ukraine and its external creditors. This is reflected in the dynamics of prices of Ukrainian Eurobonds. In particular, the price of the Eurobonds with maturity in July 2017 increased from 48 cents to the dollar at the beginning of July 2015 to 55.3 cents to the dollar on July 22nd.

On July 31, the IMF Board approved the disbursement of the USD 1.7 billion tranche under the EFF program. This tranche will be used to increase the forex reserves of the NBU, which should support the country's financial stability. But the provisions of the next tranches under the IMF program will depend on progress in reforms, in particular, in reforms of the energy and financial sectors and in fighting corruption. The IMF revised the EFF program for Ukraine and included new benchmarks that Ukraine must reach in order to obtain further financing from the Fund. These benchmarks include adoption of the plan for privatization of state companies (the list of 10 companies must be adopted by the end of August), the creation of a specialized anti-corruption unit within the public prosecution service, and the creation of necessary conditions for the effective operation and staffing of the National Anticorruption Bureau. Ukraine also needs to continue restoring financial sector stability and confidence, ensure the financial rehabilitation of Naftogaz, and adopt bylaws necessary for the implementation of the law on the energy market.

Ukraine International Reserves in July 2015, bln \$



Source: the NBU, the Bleyzer Foundation

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