December 2015 *Oleg Ustenko, Julia Segura, Valentyn Povroznyuk*
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Executive Summary

- The OSCE recently reported that the number of ceasefire violations in the last weeks of December increased in Eastern Ukraine, with pro-Russian separatist forces using heavy weapons explicitly banned by the Minsk ceasefire. Russia in turn has indicated that it will not fulfill the condition of the Minsk agreement of devolving control of the border to Ukraine until the status and autonomy of the Donbas is determined to its satisfaction. These developments suggest that the occupied areas of Donbas may continue to be in a frozen conflict, a situation that Russia may be favoring to destabilize Ukraine.
- Most reform observers report that the pace of implementing structural reforms remains slow. Nevertheless, over the past year, important reforms were carried out, as noted in the main text below. In December Ukrainian authorities concentrated efforts on further business deregulation, trade liberalization, deepening co-operation with the EU, and privatization.
- The State Statistics Service reports that the updated rate of decline of GDP decelerated to 7.2% yoy in Q3 2015, following a drop in GDP of 14.6% yoy in the second quarter of the year. The major drop took place in household consumption, which fell by 17.8% yoy in Q3 of 2015, compared to a drop of 27.6% yoy in Q2. On the other hand, gross capital formation showed a positive growth rate of 1.3% yoy in Q3 2015, compared to a decline of 0.5% yoy in Q2. Based on these results, it is now expected that GDP will decline by 10%-11% in 2015, with a small but positive growth rate of 2% to 3% in 2016.
- High-frequency monthly data shows that in November 2015, the country's output continued to be affected by low household demand and by the effects of Russian actions, both military and economic. Household demand was weakened by declining real wages, which reached -14% yoy in November 2015.
- Agricultural production was also affected by the international economic situation, with agricultural output declining by 11.1% yoy in November. Industry declined by 4.9% yoy, a rate similar to the rate in October and September. The most affected industrial subsectors were food processing (-10.4%yoy) and metallurgy (-3.4% yoy).
- Execution of the fiscal budget continues to be satisfactory. State budget revenues continued to grow at high rates. The state budget deficit for the month amounted to UAH 7.1 billion, but the consolidated budget remained in surplus of UAH 20 billion. Including government transfers to Naftogaz, the Pension Fund, and for banking re-capitalization, the overall fiscal deficit for 2015 should be close to 4% of GDP.
- On December 24th, the Verkhovna Rada adopted two highly awaited laws – the Law amending the Tax Code and the Law on the State Budget for 2016.
- Inflation in November continued to decelerate to 46.6% yoy. CPI growth has decelerated from its peak of 61% yoy in April. Inflation reached 43.3% by the end of 2015.
- The UAH/USD exchange rate remained at 23-24 UAH/USD during December, thanks in part to actions of the NBU to stabilize the market.
- In November 2015, the current account of the balance of payments showed a deficit of USD 114 million but it was more than compensated for by a surplus of USD 442 million in the financial account. As a result, international reserves increased to USD 13.1 billion.
- On January 1st of this year, the FTA between Ukraine and the EU became effective. This led Russia to cancel its FTA with Ukraine and impose a ban on food products from Ukraine. Ukraine responded accordingly.
- The IMF has endorsed the government’s fiscal budget for 2016. It is expected that the third tranche from the IMF program will be available in January/February 2016. Due to the successful public debt restructuring, Standards & Poor’s increased the ratings of sovereign foreign debt from SC to B-.

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Main Macroeconomic Indicators	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	-4.0
Public Debt, External and Domestic, % of GDP	36.3	36.7	39.9	70.3	94.0
Consumer Inflation, eop, % yoy	4.6	-0.2	0.5	24.9	43.3
Hryvnia Exchange Rate per USD, eop	8.0	8.0	8.2	15.8	24.0
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
Total Public and Private External Debt ($ billion)	126.2	134.6	142.1	125.9	138.0

Political and Reform Developments

The OSCE recently reported that the number of ceasefire violations in the last weeks of December increased in Eastern Ukraine, particularly around the city of Donetsk and towards Mariupol. Pro-Russian separatist forces have used heavy weapons explicitly banned by the Minsk ceasefire. Furthermore, the NATO commander reported that Russia is not removing any of its forces in Ukraine, with command and control, air defense, artillery support, personnel and supplies still being provided by Russia. It is also felt that there is an increase in acts of sabotage and terrorism in major Ukrainian cities. Russia in turn has indicated that it will not fulfill the condition of the Minsk agreement of devolving control of the border to Ukraine until the status and autonomy of the Donbas is secured to its satisfaction. All parties to the Minsk agreement decided to extend the deadline of the agreement until the end of 2016. In the meantime, Western sanctions on Russia have been extended through July 2016. All of these developments indicate that the occupied areas of Donbas may continue to be in a frozen conflict over the medium term, a situation that Russia may be favoring to destabilize Ukraine.

In the meantime, Ukraine is improving its defenses. According to the Fiscal Budget for 2016 approved in December, Ukraine will devote around 5% of next year's GDP to improve its defense. Moreover, Ukraine continues its close cooperation with NATO and a new cooperation plan for 2016 was already approved. According to this plan, the Ukrainian army will continue to be trained by NATO instructors and non-lethal weapons will be supplied to the country. Ukraine's goal is to become a "de-facto" member of NATO.

In terms of economic reforms, most analysts report that the pace of implementing structural reforms in Ukraine remains slow. According to the investment attractiveness index survey conducted by the European Business Association, tax burdens, corruption and the absence of quick reforms are the key barriers to business development. Nevertheless, over the last year, there were significant developments and a number of important reforms were carried out, including the following: (a) a comprehensive free trade agreement with the EU has been arranged, which should bring FDIs and improve market efficiency; (b) in November the Rada approved legislation that may permit Ukrainians to travel to Europe without visa; (c) Ukraine's international competitiveness has improved thanks in part to large recent currency devaluations; (d) partly as a result of currency devaluations, the current account of the balance of payments is in equilibrium; (e) the financial account of the balance of payments is also favorable, thanks to the restructuring of public and private foreign debt, with reductions in principal amounts and postponement of repayments; (f) a large IMF program was approved which includes agreed upon reform measures and provide financing to cover any necessary future requirements; (g) thanks to equilibrium in the current account, restructuring of foreign debt and IMF financing, international reserves have increased to USD 13 billion which brought stability to the Hryvnia foreign exchange rate, which may remain stable in 2016; (h) the energy sector has improved with increases in energy prices, reduction of Naftogaz deficits, and enactment of the Gas Market (de-monopolization) Law in April 2105 ; (i) business deregulation was advanced with the cancellation of a number of license requirements; (j) the payroll tax have been halved and brought to more reasonable levels; (k) reform of public administration has been advanced, resulting in reductions in personnel and government expenditures; (l) the large government fiscal budget deficit was brought under control in 2015 and would not exceed 3.7% of GDP in 2016; (m) the online procurement system and the law on public procurement approved in September 2015 should reduce costs and curb corruption in government purchases; (n) the solvency of the banking sector has been improved with better banking supervision and with the closure of 43 insolvent banks in 2015, which brought the number of operating banks down to 120; (o) the legal institutions required to combat corruption have been put in place and staffed, though real action is still pending; (p) the inflation rate has been declining since April 2015 and should go down to 12% by end of 2016; (q) the economy has been stabilized on a month-to-month basis since mid-2015 (though it still remain below one year ago) and will have positive growth yoy in 2016; (r) thanks to a stronger defense, with the number of soldiers increasing to 250,000 during 2015, the conflict in the East may be frozen at current levels with the high probability that Russia has abandoned plans to take further Ukrainian lands; and (s) local elections held in October 2015 have given more resources and responsibilities to local officials will set the stage for future deeper administrative decentralization.

In December Ukrainian authorities concentrated efforts on business deregulation, further trade liberalization, deepening co-operation with EU, and privatization, as follows:

Business deregulation. In December, the Verkhovna Rada of Ukraine adopted a package of government laws that will reduce the tax burden in the economy. It envisages cutting the single social contribution (SSC) rate of 41% of wages to a single rate of 22%, abolishing imposition of SSC on income of individuals. Starting January 1st 2016, special import duties are abolished. The approved 2016 fiscal budget introduces other amendments to tax legislation aimed at balancing the state budget.

Trade liberalization. Due to the introduction of Russian imports bans on raw materials and food from Ukraine, the government has accelerated its efforts to diversify the country's exports. In particular, during the December visit of President Poroshenko to Israel, there was an agreement that in 2016 both countries would finalize a free trade agreement. Initiation of the FTA with the EU should also help compensate Ukrainian producers for the falling Russian market.

Cooperation with the EU. In December, the European Commission adopted the last progress report on the implementation of the Visa Liberalization Action Plan. The progress report highlights the significant headway made by Ukraine to meet the liberalization criteria. Ukrainian authorities welcomed the decision of the European Commission. It expects that the new visa system will be in place around mid-2016.

Privatization agenda. Ukraine's government announced that it would continue consultations with the Verkhovna Rada on the adoption of laws aiming to ensure large-scale privatization. The main efforts will be concentrated on ensuring transparent, fair and competitive privatization in 2016. However, further development will depend on future decisions by the ruling coalition on the speed of privatization.

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Economic Growth

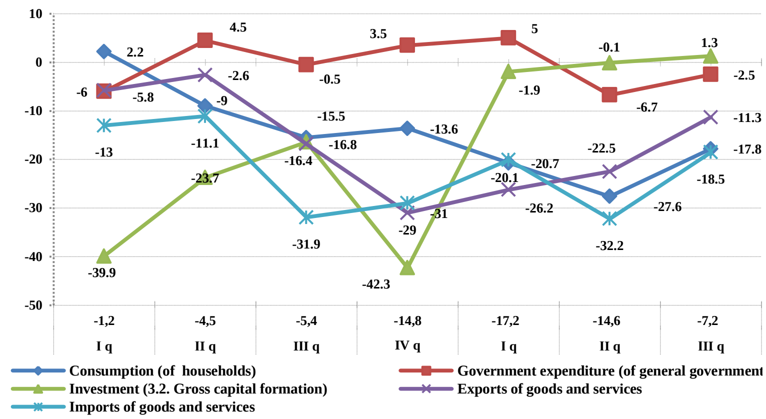
According to the latest information from the State Statistics Committee, the rate of decline of Ukraine's GDP in Q3 2015 continued to improve. GDP declined by 7.2% yoy in Q3 2015, compared to declines of 14.6%yoy in Q2 and 17.2%yoy in Q1. Furthermore, on a quarter-to-quarter basis, seasonally adjusted real GDP in Q3 had a positive rate of growth of 0.5% compared to Q2 2015. Based on these results, it is now expected that GDP will decline by 10%-11% in 2015, with a small but positive growth rate of 2% to 3% in 2016.

On the expenditure side, GDP's household consumption fell by 17.8% yoy in Q3 of 2015, compared to a drop of 27.6% yoy in Q2. Government consumption had a smaller decline of 2.5% yoy in Q3. Similarly, exports declined by 11.3% yoy in Q3, compared to a decline of 22.5% in Q2. Imports also declined by 18.5% yoy in Q3. Regarding investments, gross capital formation showed a positive growth rate of 1.3% yoy in Q3 2015, compared to a decline of 0.5% yoy in Q2.

On the production side of GDP, major declines in Q3 took place in the financial and insurance sector (-29.3% yoy), the construction sector (-12.1% yoy) and manufacturing (-10.0% yoy). With a smaller decline of 3.8% yoy, agriculture represents 21% of GDP.

High-frequency monthly data shows that in November 2015, the country's output continued to be affected by low household demand and by the effects of Russian actions, both military and economic. Household demand has been weaken by declining real wages, which accelerated to -14% yoy in November 2015. Agricultural production was also affected by the international economic situation, with

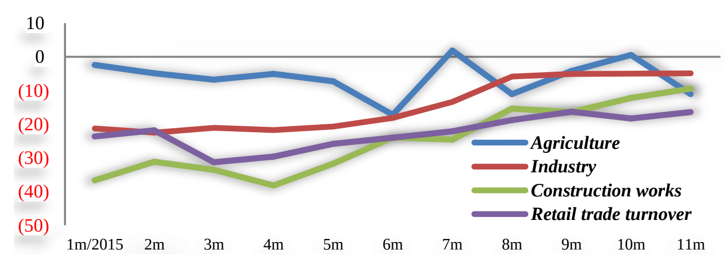
Composition of Gross Domestic Expenditure Side, growth % yoy



Source: NBU, The Bleyzer Foundation

Economic Performance of Ukraine by Sector, %YOY

(To corresponding month of previous year)



Source: The Bleyzer Foundation

Real Sector Indicators of Ukraine, % yoy

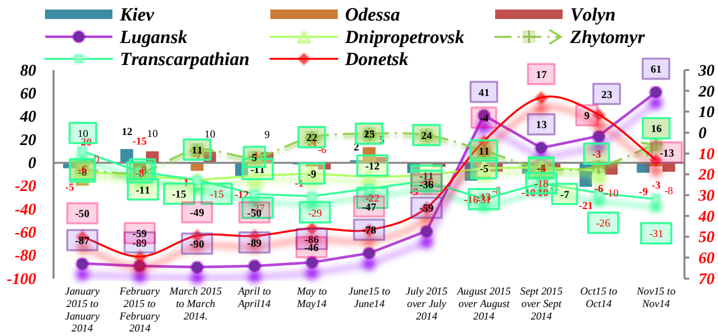
	2015 11 m*	2014	2013	2012	2011	2010
Agriculture	-4.7	2.8	13.3	-4.5	17.5	-1.5
Industry	-14.4	-10.7	-4.3	-1.8	7.6	11.2
Construction works	-18.8	-21.7	-11.1	-14	11.1	-5.4
Domestic trade, turnover:						
Wholesale trade	-13.3	-15	-2	-4.4	0.6	0.4
Retail trade	-21.4	-8.6	9.5	15.9	14.7	9.8
Transportation, turnover						
Cargo	-6.5	-10.8	-3.9	-7.6	5.7	6.4
Passenger	-8.9	-11.7	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service of Ukraine, the Bleyzer Foundation
** Excluding Crimea*

output declining by 11.1% yoy in November. This represents a deterioration, since agricultural output had improved by 0.5% yoy in October. Other sectors, however, showed slight moderation in their contractions. In November, industry, retail trade turnover and construction works showed yoy declines of 4.9% yoy, 16.4% yoy and 9.5% yoy, respectively. These declines were slightly lower than in October 2015 (5.0% yoy, 18.3% yoy, and 12.2% yoy, respectively).

Industrial Production by Region, % YOY

(To corresponding month of previous year)



Source: The Bleyzer Foundation

Within the industrial sector, the most affected subsectors in November 2015 were food processing (-10.4%yoy) and metallurgy (-3.4% yoy). On the other hand, there were improvements in machine building, in coke & oil refining, and in electricity production with positive growth rates of 4.1% yoy, 7.6% yoy and 4.4% yoy, respectively.

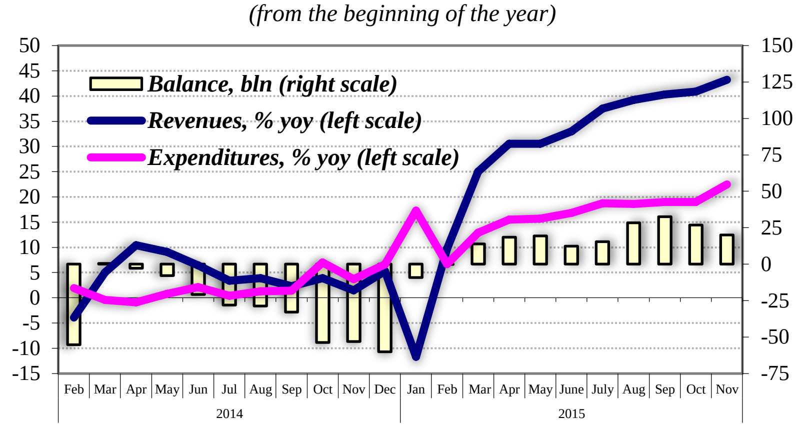
Regarding the regional composition of Ukraine's industrial production, in November 2015, Lugansk, Zhytomyr and Rivne were the only regions with positive growth rates of 61% yoy, 16.2% yoy and 0.5% yoy, respectively. At the same time, others regions continued to show declines in industrial output, particularly in Donetsk (-13.0% yoy), Transcarpathian (-31.1% yoy), Kirovograd (-16.3% yoy), Khmelnytsky (-3.4% yoy), Vinnitsa (-10.3% yoy), Chernivtsi (-10.9% yoy), Nikolayev (-9% yoy), and Sums (-0.8% yoy).

Fiscal Policy

Despite increased fiscal expenditures in energy subsidies because of the heating period, Ukraine's fiscal situation remained satisfactory in November. The state budget deficit for the month amounted to UAH 7.1 billion but the consolidated budget remained in surplus of UAH 20 billion. Including government transfers to Naftogaz, the Pension Fund, and for banking re-capitalization, the overall fiscal deficit for 2015 should be close to 4% of GDP.

Dynamics of Consolidated Budget Components

(from the beginning of the year)



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

Budget revenues continued to grow at high rates at the central level and to a lesser extent at local levels. Both were fueled by inflation and the prolonged impact of the Hryvnia depreciation observed at the beginning of the year. In particular, state budget revenues grew by 50.4% yoy in January-November, while total local budget revenues increased by 17.6% yoy over the period. As a result, the consolidated budget revenues posted a 43.2% yoy increase during the period.

As for budget expenditures, they also grew during the period, but at rates around two times lower than those of revenues. Similarly to revenues, expenditures grew faster at the central level, with a growth rate of 27.1% over the period January-November. As a result, consolidated budget expenditures expanded by 22.5% yoy in January-November.

Tax revenues continued to be the main revenue source, reaching 76% of total state budget revenues. They increased by 47.2% yoy in eleven months. The largest tax inflows were provided by VAT receipts at UAH 162.7 billion, UAH 125 billion of which were received from taxation of imported goods. The VAT receipts from domestic and from imported goods posted quite similar growth of 31% yoy over the reporting period. The corporate profit tax remained the only major tax with decreasing receipts, but the pace of receipts' decline slightly decelerated to 14.2% yoy. The non-tax revenues of the state budget expanded by 75.1% yoy in January-November mainly thanks to a 2.5 times increase in transfers from the NBU to UAH 59.1 billion.

Fiscal expenditures on general government functions and on social protection and social security remained the largest state budget expenditures in January-November, amounting to UAH 92.6 billion and UAH 82.2 billion respectively. But in terms of growth rates, they remained behind expenditures on defense (59.3% yoy and 11.8% yoy respectively, against 101.3% yoy for defense). Due to fast growth, defense expenditures almost reached the level of expenditures made on public order, security, and judiciary. Expenditures on education and healthcare observed the lowest growth at 2.8% yoy and 4.7% yoy respectively, while expenditures on utilities and on economic activities continued to decline at high rates, especially the latter (88.5% yoy).

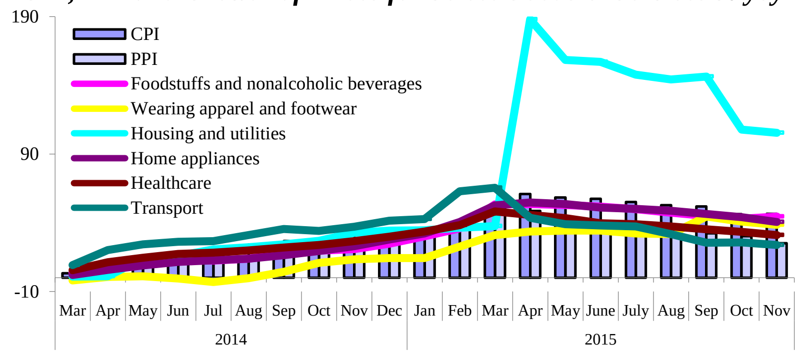
On December 24th, the Verkhovna Rada adopted two highly awaited laws. The first one was the law amending the Tax Code and the second one was the Law on the State Budget for 2016. The amended Tax Code does not change the rates for VAT and corporate profit tax. At the same time, it foresees the unified income tax rate at 18% (previously there were two rates of 15% and 20% depending on the size of income). But the most significant change was a drastic reduction of the unified social contribution tax from 41% of wages to 22%. This change is supposed to help promote wage de-shadowing. The simplified taxation system was preserved for agricultural producers, same as the unified tax for small business. At the same time, the number of entrepreneur groups eligible for the unified taxation was reduced (the maximum annual turnover threshold was reduced 4 times to UAH 5 million), while the tax rate was increased from 2% to 3% of turnover. Initially, the special regimen of the VAT payment for agricultural producers was cancelled. However, after public unrest initiated by farmers, the initial draft was revised. It was decided that proceeds from the VAT would be distributed in different proportions depending on type of goods agricultural producers are selling. Pensioners will pay 15% tax on pensions exceeding 3 minimum wages UAH 3,990 (previously only working pensioners paid taxes). Introduction of new energy efficient technologies is stimulated through waivers from taxes of funds provided to a taxpayer by an international financial organization on energy efficiency and energy saving. The rate of excise tax on spirit, alcohol distillates, and alcoholic beverages was raised by 50%, while the rate of excise on low-alcohol beverages was tripled. Excises on fuel were increased by 13%. All the changes related to tax rates would come into force on January 1st, 2016, while other changes will come into force in the second quarter of 2016. Other changes in tax administration included the demilitarization of the tax police, the establishment of the electronic office of the taxpayer, and the creation of an automatic system of VAT refunds.

The draft budget developed by the government was highly criticized by the Ukrainian Parliament. Nevertheless, the draft law was adopted with the help of the opposition, as two of the government's coalition factions, Batkivshchyna and Samopomich, refused to vote. The major discussions were about the payments for social expenses, which were considered to be low. At the same time, Batkivshchyna was not satisfied with the proposed distribution of funds among different oblasts, while Samopomich disagreed with excessive state budget financing of the State Fiscal Service and the Prosecution Service. Total state budget revenues are foreseen at UAH 595.1 billion and total state budget expenditures at UAH 684.5 billion. The state budget deficit is set at 3.7% of GDP or UAH 83.6 billion, which is approximately the same as in the draft. The energy stabilization fund was approved at USD 700 million. Immediately after adoption, it was announced that the budget would be amended taking into account remarks from the IMF and proposals of the government.

Monetary Policy

Inflation. After two months of monthly deflation, prices increased again in November, with the CPI increasing by 46.6% yoy. A 2.0% mom increase in prices was mainly the result of a 2.5% mom growth of foodstuffs prices and of a 3.3% mom growth in prices of housing and utilities. But all the major price indexes except for alcohol and tobacco posted increases. The highest growth rates in prices among foodstuffs were reported for vegetables (18.6% mom), eggs (13.1% mom), and sugar (10.9% mom). Fruits posted a 3.0% mom decline in prices. Growth in prices of housing and utilities was mainly the result of a 19.7% mom increase in heating tariffs, which was accompanied by a 4.8% mom increase in prices of liquefied gas and a 3.3% mom growth in housing rent. A 0.6% mom increase in transportation prices was the result of a 4.3% mom growth in prices of cars and of a 0.7% mom increase in road transportation tariffs, which together overwhelmed the declines in aviation and railway tariffs (by 3.2% mom and 0.4% mom respectively).

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



Source: State Statistical Service of Ukraine, the Bleyzer Foundation

The above-mentioned monthly price developments led to minor changes in the year-over-year consumer price dynamics in November. In particular, the all items price index edged up by 0.2 percentage points to 46.6% yoy. On the other hand, data on December inflation shows that prices did not follow the trend common for the end of the year. As a result, the all items inflation index went down to 43.3% for 2015.

The monetary base and money supply saw almost identical monthly increases in November (by 0.9% and 1.0% respectively.) As a result, the decrease in the monetary base from the beginning of the year decelerated by 0.8 percentage points to 3.6%, while growth in money supply accelerated to 1.3% compared to 0.2% observed in October. We expect mixed developments in prices in December. On the one hand, foodstuffs and beverages get more expensive prior to the New Year holidays. On the other hand, retailers usually also provide discounts for apparel, footwear, electronic appliances, toys, and some other groups of goods. As foodstuffs and utilities still have the largest portion of consumer basket, we expect further acceleration of consumer inflation in year-over-year terms to around 48% by the end of the year.

Banking Sector.

The amount of Hryvnia bank deposits continued to recover slowly in November, while foreign currency denominated deposits further decreased. Total Hryvnia deposits inched up by 0.6% mom thanks to small increases in both corporate and household deposits. Total foreign currency deposits denominated in USD dropped 1.4% mom in November due to a further decline in household deposits. The latter posted a 2.3% mom decline. This decline more than offset the 0.5% mom increase in foreign currency deposits of the corporate

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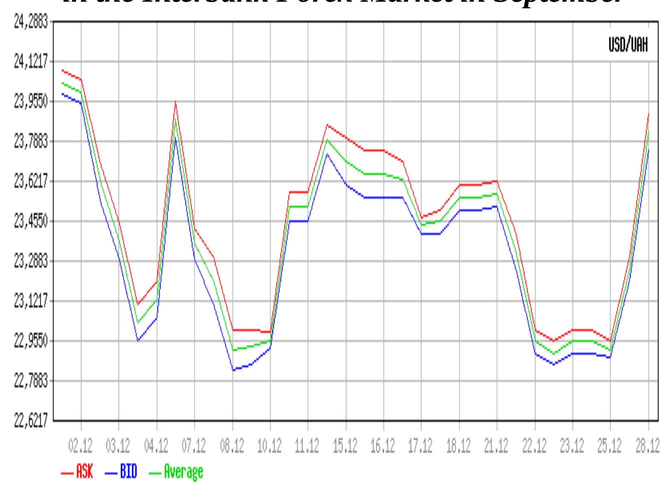
sector. Thanks to these dynamics, the decline of total Hryvnia deposits decelerated to 0.5% from the beginning of the year as a 10.7% increase in deposits of legal entities almost fully compensated for a 10.3% decline in household deposits. As for foreign currency deposits denominated in USD, their decline from the beginning of the year was sharper in November compared with that observed in October (28.6% compared to 27.8%).

A number of measures of the NBU to stimulate lending had very little effect in November. Both national currency and foreign currency loans remained almost flat. National currency loans saw minor increases at both the corporate and household levels (0.1% mom and 0.3% mom, respectively), while a 0.8% mom increase in household foreign currency loans denominated in USD fully compensated for a 0.1% mom decline in corporate loans. As a result, the dynamics of both national and foreign currency loans from the beginning of the year did not change in November. The national currency loans dropped 14.9%, while the foreign currency loans denominated in USD decreased by 19.8%.

The Board of the National Bank of Ukraine decided to leave the policy interest rate unchanged at 22% in December. The decision was made to create further conditions for restraining inflation. A tight monetary policy stance is needed to lower inflation from the current 46.6% yoy to a planned 12% at the end of 2016, especially in light of observed external and internal risks. In particular, the regulator mentioned the following external risks of upward pressure on prices: still low demand for Ukrainian exports, an increase in the policy rate by the US Federal Reserve for the first time since 2006, and devaluation of currencies in several trading partner countries. Increases in excise taxes on alcohol and tobacco foreseen by the Law on the State Budget for 2016 are the internal risks of increases in prices in 2016.

The NBU continued its work on optimization of the banking system. In particular, the regulator made a decision to withdraw one banking license and liquidate seven banks in December. Two more banks were declared insolvent. The NBU finished stress testing the 20 largest banks and provided them with recommendations concerning development of additional capitalization programs or restructuring plans. Most of the banks already started to attract additional capital but the terms for adoption of additional capitalization plans set by the NBU were still too optimistic. Therefore, the regulator moved the deadline for the 10 largest banks forward by one month to February 1st, 2016 and for the other 10 banks by two months to April 1st, 2016. The terms for ensuring the positive value of capital and regulatory capital adequacy ratio at a level of not less than 5% were also moved forward accordingly. As a part of the program for combating money laundering and financing of terrorism & proliferation, the NBU adopted Regulation No. 920 of December 23rd, 2015, which introduces quarterly reports on financial monitoring risk management and on estimation of financial monitoring risks. The Regulation was prepared within joint activities of the NBU and the IMF of provision of the NBU with risk-oriented instruments of supervision in the field of financial monitoring.

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



Source: Ukrdealing, The Bleyzer Foundation

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Hryvnia Exchange Rate. During December the FX market continued to show high volatility, due to uncertainties related to increased military hostilities in the East, increases in energy imports, depreciation of local currencies in other countries, and uncertainties about the IMF program and the 2016 budget approval. From the beginning of the month, the fluctuations in the interbank forex market led the NBU to intervene in the markets. The exchange rate moved up or down depending on the extent to which the NBU decreased the demand for USD though cuts of requests for dollar purchases submitted by banks. Therefore, the exchange rate appreciated when the regulator extensively cut the requests for dollar purchases and depreciated when the NBU was not very strict with those requests. These exchange rate developments in the interbank forex market widened the gap between the interbank and cash forex market quotations from around 1 UAH/USD to 1.5-2 UAH/USD.

The exchange rate was more stable from December 15th to December 20th. But then, starting on December 21st, the exchange rate started to appreciate due to calendar reasons. Approaching the end of the taxation period (month, quarter, and year) and New Year holidays raised the demand for Hryvnias forcing banks to sell US dollar. In order not to allow the exchange rate to appreciate too much, the NBU renewed its practice of dollar purchases through so-called forex auctions. As a result, the exchange rate fluctuated around 22.9-23.0 UAH/USD until December 25th. As dollar markets were closed on Christmas and the NBU did not cut the requests for dollar purchases much, the UAH/USD exchange rate returned to around 24 UAH/USD. Actions of the NBU in relation to the exchange rate showed that the regulator is going to meet the foreign market parameters specified in the EFF agreement with the IMF. The Program sets the exchange rate to be around 23.5 UAH/USD at the end of the year. The exchange rate was around 24.0 UAH/USD at the end of the year.

The NBU has now introduced some changes to foreign exchange regulations. Those changes are meant to liberalize foreign exchange operations in line with the plan agreed with the IMF. The regulator prolonged the term for the obligatory sale of 75% of foreign exchange revenues by exporters but excluded from the list several types of revenues. Settlements of private persons abroad using electronic payment means were also somewhat liberalized in response to numerous requests on the side of banks and the Ukrainian Interbank Payment Systems Members Association. Foreign investors may transfer abroad amounts received from any sale of sovereign bonds, while previously they could do this only with amounts received from sale of sovereign bonds only on stock exchanges. On the other hand, the regulator also closed some loopholes allowing banks to circumvent foreign currency restrictions. In particular, starting on December 5th, 2015, banks cannot purchase foreign currency for clients having USD 25,000 and more on current, deposit, and balance accounts (previously only on current and deposit accounts). Also the NBU was given the right not to approve purchase or transfer of foreign exchange in case it finds any evidence of risk activities on the side of a bank or of activities related to money laundering and the financing of terrorism & proliferation.

International Trade and Capital

In November 2015, the overall balance of payment showed a surplus of USD 339 million, compared to a surplus of USD 229 million achieved in October. This BOP surplus led to an increase in international reserves, which reached USD 13.1 at the end of November (about three months of imports). The BOP surplus in November was the result of a surplus of USD 442 million in the financial account and despite a deficit of USD 114 million in the current account. The main factors yielding a surplus in the financial account were Central Bank swaps of USD 713 million and sales of foreign exchange by the population of USD 201 million. These inflows more than compensated for the repayments of debt. Foreign direct investment (FDI) continues to be negligible, reaching only USD 19 million in November, principally for the banking sector. In January-November 2015, net inflow of FDI was USD 2.3 billion also mainly for bank recapitalization.

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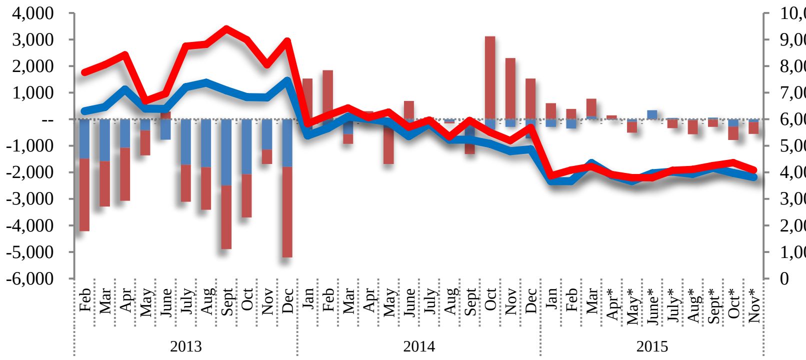
The current account deficit of USD 114 million in November was USD 163 million lower than the CA deficit of USD 277 million showed in October. The reduction in the deficit was due to the fact that exports of goods declined by 3.1% mom, a lower rate than the decline in good imports, which fell by 8.1% mom. Workers remittances also increased by 10.6% % mom, reaching UAD 199 million in November. On a year-over-year basis, in November exports of good decreased by 22.3% yoy, whereas goods imports decreased by 22.7% yoy.

Ukraine's External Balance of Payments, mln USD



Source: NBU, The Bleyzer Foundation

The reduction in goods exports was affected not only by the military hostilities in the East, but also by decreases in the prices of Ukrainian exports. In November, the most affected export goods were mineral products, which fell by 41.8% yoy, ferrous metals, which declined by 40.5% yoy, and chemical products, which dropped by 38.3% yoy. On the other hand, exports of agricultural produces declined by 4.8% yoy in November, compared to a decline of 12.0% yoy in October. The pace of the decline in exports of machinery and equipment also slowed down slightly to 24.5%, compared to 26.5% yoy in October. The better performance of exports of agricultural goods has led to an increase in their share in total exports. In fact, in January-November 2015, agricultural exports represented 41% of total exports, compared to 32% a year earlier. This increase of 9 percentage points was achieved principally at the expense of reductions in the export share of metallurgy (-3.4% points), minerals (-3.0% points) and machinery and equipment (-2.1%).

On the import side, the major reductions in goods imports in November were in natural gas and other minerals (-32% yoy), agriculture (-30% yoy), and metallurgy (-28% yoy).

On a regional basis, exports to Russia experienced the largest decline (-54% yoy) during January-November 2015. During this period, Russia took only 11.9% of Ukrainian exports, compared to 17.8% a year ago. Exports to Asia had the lowest decline (-20%), and during the period absorbed 35% of total Ukrainian exports. The share of Ukrainian exports to Europe increased from 28% a year ago to 30% during January-November 2015.

The share of imports from Russia has also continued to decline from 22% of total imports on January-November 2014 to 19.5% in the same period of 2015. Imports from Russia declined by 40.9% yoy during January-November 2015 and now consist mainly of energy goods. The share of imports from Asia has remained at 17% of the total, whereas imports from Europe increased their share from 33% of the total last year to 37% at present.

In terms of prospects for the BOP, a major development is that the Free Trade Agreement (FTA) between Ukraine and the EU has become effective on January 1st, 2016, after a one-year delay requested by Russia. According to the government, the FTA will eliminate 97% of EU tariffs on Ukrainian exports and will reduce the average tariff on Ukrainian exports from 7.6% to 0.5%. On the other side, imports into Ukraine are expected to be subdued due to the recent large Hryvnia devaluation and low economic growth. Therefore, imports should not cause difficulties to local producers. Zero Ukrainian duties will be introduced for 70% of all goods imported from the EU and transition periods of three to ten years will be in effect for the rest of the imports.

In retaliation for the Ukraine-EU FTA, Russia decided to cancel its free trade agreement with Ukraine ad subject Ukrainian exports to Most Favored Nation (MFN) treatment starting January 1st. This means that Ukrainian exporters will now need to pay Russia regular Russian import duties on their exports. In addition, Russia has imposed trade embargo on Ukrainian food and some raw materials. The Russian government stated that such measures are necessary to protect Russia from a flood of European products that could be caused the FTA between Ukraine and the EU. Both the EU and Ukraine believe that these Russian fears are unfounded as the FTA contains strict Rules of Origin that would avoid re-exports of European goods to Russia.

In response, Ukraine announced that from January 2nd, the country will also impose Ukrainian import duties on all Russian products. In addition, from Jan. 10, Ukraine will restrict imports to the country of 43 Russian products, including vodka, beer, cigarettes, meat, chocolates, dairy products, animal food and locomotives.

The Ukrainian government believes that the Russian measures may cost Ukraine about USD 600 million, with other analysts believing that the cost could reach USD 1.0 billion (about 1% of GDP). The Ministry of Agriculture has estimated that the value of Ukrainian food exports that Russia would ban could amount to USD 116 million, while the value of Russian imports that Ukraine plans to ban is about USD 119 million. The overall BOP effect of the ban therefore would not be significant. The negative effect of all Russian measures will not be substantial, as exports to Russia have already declined by three times over the three last years, from 35 percent of overall exports in 2012 to the current 12 percent.

The November IMF mission concluded that Ukraine should receive the third tranche from the IMF program only when it had satisfied a number of conditions, including anti-corruption measures, reform of the banking sector, tax reform. It has also requested some changes in the fiscal budget for 2016 recently approved by the Parliament. IMF disbursements are now expected in January/February 2016.