

August 2013

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- Real GDP contracted 1.1% yoy in 2Q 2013, the same rate as in the previous quarter.
- The pace of contraction in industrial production moderated to 5.7% yoy in June.
- Agriculture surged by 15.4% yoy in 1H 2013 as Ukraine may collect a record high harvest.
- State budget fiscal deficit was almost three times wider in 1H 2013 than a year earlier.
- The government has been considering fiscal consolidation measures; however, it is seeking ways to avoid expenditure cuts. A further increase in indirect taxes, changes in transfer pricing rules, restructuring budget accounts payable via issuance of Treasury bills, etc. are among its initiatives.
- Price pressures remain subdued in Ukraine as the consumer price index was 0.1% yoy lower in June 2013.
- In June, the National Bank of Ukraine decreased its discount rate by 25 basis points to 7% pa to stimulate bank lending.
- The Hryvnia exchange rate stayed virtually unchanged in May-July amid calmed population demand for foreign exchange and extension of administrative restrictions on forex operations.
- Ukraine enjoyed improvements in its external balances over the first five months of 2013. However, in June the Balance of Payments had already turned into a deficit.
- Gross international reserves fell to \$23.2 billion at the end of June 2013, covering about 2.6 months of imports.

Executive Summary

Although select sectors of the Ukrainian economy demonstrated strong growth, overall economic activity remained weak in 2Q 2013. Slow external demand growth, a continuing slide in world commodity prices and a subdued trend in domestic demand kept weighing on Ukraine's economic growth. According to early estimates of the State Statistical Service of Ukraine, real GDP growth contracted by 1.1% yoy in 2Q, the same pace as in the previous year. Industrial production declined 5.3% yoy over January-June mainly on account of commodity exporting metallurgy and chemicals. Output reduction in Ukraine's machinery may be attributed to a more moderate pace of growth and continuing trade tensions with Russia. At the same time, thanks to domestic market protective measures and stimulus from the Ukrainian government (the imposition of a special duty on imported cars, introduction of licensing for imported drugs, extension of preferential electricity tariffs for select ferroalloy plants, etc.), the decline in industrial production started to moderate in June.

Construction dropped by 19% yoy in 1H 2013, affected by subdued bank credit activity, the adverse early spring weather conditions and lower capital expenditures from the budget. Amid weaknesses in construction and industrial sectors, the real value of cargo transportation and wholesale trade turnover edged down by 6% yoy and 10% yoy, respectively, over January-June 2013.

On the upside, consumer spending has maintained positive momentum, sustained by solid real wage growth (up by 9.6% yoy in 1H 2013), diminishing inflation expectations and a more stable exchange rate. This was reflected in an 11% yoy increase in retail sales turnover over January-June 2013. Production in the agricultural sector surged up by 15.4% yoy in 1H 2013 as Ukraine is expected to collect a record high grain harvest this year. In addition, thanks to several years of high harvests, Ukraine's animal breeding has been demonstrating solid gains. Looking ahead, the

Ukrainian economy is forecast to gradually recover over the course of 2H 2013, supported by private consumption growth, gains in agriculture and a more favorable base effect. But overall growth will remain slow at about 0.5% yoy in 2013, as there is no strong export rebound ahead due to a more protracted recession in the euro zone and growth slowdown in other key trading partners (e.g., Russia, Turkey). Moreover, the new wave of trade tensions with Russia may also exert a toll on the pace of recovery of the

budget deficit, which was almost three times higher than in 1H 2012. At the same time, there is a relatively high probability that the government will request IMF financing over the next six months. Under the IMF program, Ukraine's fiscal deficit should be sustained. So far, a weak growth outlook and increasing volatility on external financial markets amid the FED's talks on QE withdrawal may eventually cause the adjustment of fiscal expenditures in 2H 2013. Top government officials have hinted that revision may take place in September of this year. At the same time, the government has been seeking ways to avoid expenditure cuts. Further increases in indirect taxes, changes in transfer pricing rules, restructuring budget accounts payable via issuance of Treasury bills, etc. are among its initiatives. While these efforts may increase tax proceeds to the budget, they are likely to increase the tax burden as well as the cost of doing business in Ukraine. Due to current delays in consolidation measures, Ukraine's public sector deficit may stay at around 5% of GDP in 2013.

Price pressures in Ukraine remain subdued as the consumer price index grew by 0.1% mom in May and stayed unchanged in June. As a result, in annual terms the index was 0.1% lower in June compared to a year earlier. As in previous periods, low inflation was a reflection of weak economic activity, good agricultural harvests for several years in a row, subdued imported inflation amid a downward trend in world commodity

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prices and calmed Hryvnia depreciation expectations, and virtually unchanged utility prices. We expect price pressures to moderately increase over the coming months. The acceleration will likely be the result of an increase in indirect taxes and higher world energy prices. In addition, the Ukrainian government may eventually increase natural gas tariffs to the population in its efforts to resume borrowing from the IMF. But overall inflation will remain subdued with the annual rate of growth at about 4% yoy at the end of the year.

The annual growth of monetary aggregates kept strengthening amid the National Bank of Ukraine's efforts to stimulate credit activity, continuing deposit inflow to the banking sector, moderate monetization of public debt and positive NBU interventions on the interbank forex market. At the beginning of June, the National Bank of Ukraine decreased its discount rate by 25 basis points to 7%.

Despite a challenging external environment, Ukraine's external balance developments were rather favorable over the first six months of 2013. Although export performance was weak, declining by almost 6% yoy in US Dollar terms, imports fell even sharper by 13.5% yoy, affected by government efforts to reduce energy imports. As a

result, the current account deficit was almost 36% yoy lower over the period. Over the first five months of the year, Ukraine generated a solid capital account surplus in spite of large external debt repayments and an absence of IMF financing. Loose international liquidity and calmed population demand for foreign exchange may be the principal reasons for capital account improvements over the period. However, already in June, the capital account turned into a small deficit due to high external public debt repayments, which was reflected in a decline in NBU gross international reserves.

The situation on the foreign exchange market remained stable as administrative restrictions on foreign currency operations and a favorable external balance over the first five months of the year calmed population demand for foreign currency. Turbulent international financial markets, low international reserves and higher population demand for foreign exchange following the end of vacation period may increase Hryvnia exchange rate pressures in the fall of this year. Assuming Ukraine secures IMF financing at the end of the year, Ukraine will be able to maintain its external stability, although higher short-term Hryvnia exchange rate fluctuations are likely in 2H 2013.

	2009	2010	2011	2012	2013f	2014f
DP growth, % yoy	-14.8	4.1	5.2	0.2	0.5	3.0
GDP per capita, \$	2545	2974	3575	3864	4106	4432
Industrial production, % yoy	-21.9	11.2	7.6	-1.8	-3.0	3.0
Retail sales, % yoy	-17.4	9.8	14.8	15.9	--	--
Budget de cit, % GDP*	-8.5	-6.7	-4.3	-5.6	-5.3	-4.0
Government external debt, % GDP	20.5	23.8	20.4	18.3	17.0	17.3
Inflation, eop	12.3	9.1	4.6	-0.2	4.0	6.0
Gross international reserves, \$ billion	26.5	34.5	31.8	24.5	23.0	25.0
Current account balance, % GDP	-1.5	-1.9	-5.5	-8.4	-7.7	-7.5
Gross external debt, % GDP	88.2	86.0	77.2	76.6	74.7	72.6

* Including Naftogaz and Pension fund deficits (not including bank recapitalization expenditures and VAT refund bonds in 2009 and 2010 respectively).

Source: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2013 Budget Law, The Bleyzer Foundation

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Economic Growth

Following encouraging signs in April, Ukraine's real sector data for May was disappointing. While select sectors of the Ukrainian economy continued to demonstrate strong growth, overall economic activity was weak, affected by slow external demand, the ongoing slide in world commodity prices and subdued credit growth. In addition, a high base for comparison and variable holidays¹ also contributed to weaker economic data over the period. At the same time, thanks to domestic market protection measures and stimulus from the Ukrainian government, the decline in industrial production started to moderate in June.

The contraction in industrial production deepened to 9.3% yoy in May mainly on account of commodity exporting metallurgy and chemicals. As international steel and fertilizer commodity prices kept declining, Ukraine's production of metals and chemical products went down by 11.2% yoy and 16.2% yoy, respectively, in May. Ukraine's manufacturing of transport vehicles fell by 24.4% yoy in May, which may be attributed to a more moderate pace of growth and continuing trade tensions with Russia, the main destination market for Ukraine's exports of heavy machinery and transport vehicles. At the same time, thanks to the imposition of a special duty on imported cars, the pace of decline in the industry slowed to 10.3% yoy in June. Weak industrial activity and excess supply of coal weighed on production of electricity, which was down by 3.8% yoy and 1.5% yoy in May and June, respectively.

Construction dropped to 19% yoy in 1H 2013, affected by subdued bank credit activity, adverse early spring weather conditions and lower capital expenditures from the budget. Amid continuing weaknesses in construction and industrial sectors, the real value of cargo transportation and wholesale trade turnover edged down by 6% yoy and 10% yoy, respectively, over January-June 2013.

On the upside, despite ongoing weakness in metallurgy and sliding world iron ore prices, extraction of iron ores went up by a solid 2.7% yoy in May and 2.4% yoy in June. Ukrainian producers may have increased iron ore production in anticipation of higher demand from China amid evidence of low inventories there. Moreover, after a temporary slump in May, the pharmaceutical industry resumed growth in June, expanding by 28% yoy. The introduction of licensing of imported medicines supported the industry's performance while May's drop in production can be attributed to the impact of variable holidays, as the industry is very labor intensive. Consumer spending has also maintained positive momentum, sustained by solid real wage growth (up by 9.6% yoy in 1H 2013), diminishing inflation expectations and a more stable exchange rate. This was reflected in an 11.2% yoy increase in retail sales turnover over the period.

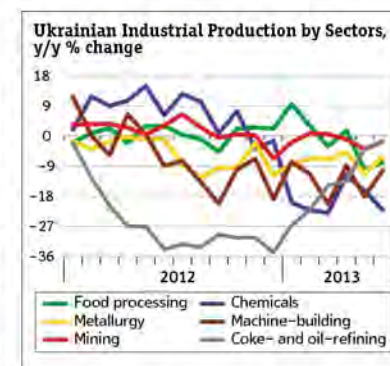
Production in the agricultural sector surged by 15.4% yoy in 1H 2013 as Ukraine may collect a record high grain harvest this year. As of the end of July, Ukraine had harvested almost 27 million tons of grains, up by 21% yoy. Although the drought during the summer months may adversely affect production of summer grains, it favored corn growing. Given the larger sown area under this crop, Ukraine's harvest of corn is expected to jump 20% from the previous year to at least 25 million tons. As a result, the Ministry of Agrarian Policy and Food of Ukraine

Real Sector Performance of Ukraine,
% yoy

	2013			2012	2011	2010
	6m	5m	4m			
Agriculture	15,4	5,1	5,1	-4,5	17,5	-1,5
Industry	-5,3	-5,2	-4,2	-1,8	7,6	11,2
Construction works	-19,2	-17,3*	-13,8*	-14,0	11,1	-5,4
Domestic trade, turnover						
Wholesale trade	-6,0	-5,8	-4,2	-4,4	0,6	0,4
Retail trade	11,2	11,6	12,7	15,9	14,7	9,8
Transportation, turnover						
Cargo	-10,1	-11,4	-10,7	-7,6	5,7	6,4
Passenger	-4,2	-3,5	-3,4	-1,2	3,3	-0,2
Communication services	-0,5	0,5	2,0	1,1	3,1	
Other Services, non-financial	-2,2	-1,6	-0,9	0,8	18,6	2,9

* Revised data
Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

World Steel and Fertilizer Price Indices,
% yoy



¹Due to the Easter holiday and transfer of working days due to celebration of Labor Day, there were fewer working days in May 2013 than last year.

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upgraded its grain harvest forecast to about 57 million tons. In addition, thanks to several years of high harvests, Ukraine's animal breeding has been demonstrating solid gains.

Looking ahead, the Ukrainian economy is forecast to gradually recover over the course of 2H 2013. But overall growth will remain slow at about 0.5% yoy in 2013 as there is no strong export rebound coming due to a more protracted recession in the euro zone and growth slowdown in Ukraine's other key trade partners (e.g., Russia and Turkey). Moreover, the new wave of trade tensions with Russia may exert a toll on the pace of recovery of the Ukrainian economy. In July, Russia announced it will not extend the tax free quota for the supply of Ukrainian pipes for 2H 2012, introduced a ban on Ukraine's confectionary and began monitoring select dairy products. On the upside, growth will be supported by steady increases in household consumption and good prospects for agricultural exports. Ukraine is projected to increase grain shipments abroad amid a high harvest this year. In addition, Ukrainian producers of poultry secured the right to supply their products to the European Union, which came into effect at the end of July. Finally, Ukraine is expected to sign an Associated Agreement with the EU in November of this year, which includes a deep and comprehensive free trade area. This will further support Ukraine's growth as the agreement will 'put Ukraine into the supply chain' of Europe. Although the impact of the Agreement is unlikely to be felt in the short run, it will give strong impetus for the development of foreign trade and will encourage investments in Ukraine. Also thanks to gradual strengthening of foreign trade, this should underpin Ukraine's real GDP growth at about 3% yoy in 2014.

Fiscal Policy

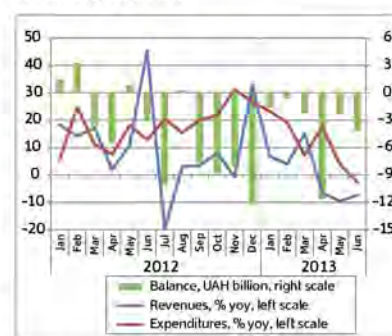
The overall fiscal budget situation was manageable over the first half of 2013, mainly thanks to solid domestic and external borrowings. Nevertheless, Ukraine's public finances remain under severe strain and the execution of the fiscal budget in 2H 2013 raises concerns. At the same time, there is a relatively high probability that over the next six months the government will request IMF financing. Under the IMF program, Ukraine's fiscal deficit should be sustained.

In the meantime, due to weak economic growth and low inflation, total state budget revenues fell by 0.2% yoy in nominal terms in 1H 2013. This was mainly the result of under-performance of value added tax collections. Accounting for more than half of total state budget revenues, VAT proceeds were down by a nominal 1.9% yoy over the period. In contrast to gross VAT receipts, VAT refunds kept growing at a robust 19.4% yoy in 1H 2013, which is surprising given declining industrial activity and exports. Repayments of outstanding VAT refunds accumulated in the previous years may explain the increase, although tax refund fraud may also be the cause.

Collections from corporate income tax and excises demonstrated growth of 6.4% yoy and 8% yoy respectively over 1H 2013. At the same time, these increases should be principally attributed to the new mechanism of advance tax payments and higher rates applied since the beginning of the year, respectively. Although the government imposed a special duty on imported cars in mid-April, proceeds from import duties declined in May and June due to a sharp decline in imports. As a result, accumulated revenues from import taxes were just 1% higher than in the corresponding period last year. Partially, weak tax proceeds were offset by higher NBU profit transfers to the state budget. In particular, NBU transferred UAH 10 billion, or 6.2% of total state budget revenues for the period, which is 27.4% higher than last year. Thus, revenue execution data over the period suggests that the full year revenue target, projected based on overly optimistic macroeconomic data, will not be achieved.

In contrast to revenues, expenditures continued to increase at a robust 10.3% yoy in 1H 2013, despite under-execution of a number of budget programs, principally in the areas of national defense, public investments and public administration. As expenditures rose much faster than revenues, the state budget deficit amounted to UAH 22.7 billion (\$2.8 billion) over the period, almost three times higher compared to a year before. Solid domestic and external borrowings, however, helped keeping fiscal situation manageable and allowed delaying painful consolidation measures. Weak growth outlook and increasing volatility on external financial markets amid the FED's talks on QE withdrawal may cause the government to revise fiscal revenue and expenditure targets downwards in the coming months. At the same time, the government has been seeking ways to avoid expenditure cuts.

Monthly State Budget Execution, not seasonally adjusted



Source: Ministry of Finance, The Bleyzer Foundation

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First, the government announced plans to further increase excise taxes on alcohol, tobacco, fuel, etc. Second, at the beginning of July, the Ukrainian parliament approved amendments to the Tax Code of Ukraine regarding transfer pricing (intra-group transactions). The new rules, effective September 1st, provide for better definition of related parties, controlled transactions, clarify procedures and transfer pricing methods, etc. In particular, the law eliminated the previous rule that contract prices can deviate by up to 20% from a market price and introduced a new penalty regime for violation of general transfer pricing requirements and failure to comply with reporting requirements to the tax authorities. The new transfer rules are generally based on OECD guidelines and were necessary to reduce tax evasion by large companies. However, the new rules may pose significant challenges for both tax authorities and business. In particular, due to the lack of transition period, there may be insufficient numbers of trained tax officers and judges to manage and rule on transfer pricing matters. In addition, there is a risk of excessive tax interference in the price setting mechanism. And while Ukraine is already considered one of the most difficult countries in terms of paying taxes², the new amendments to the tax legislation may increase tax pressure and the costs of doing business in Ukraine.

Third, in July the government approved a law allowing the government to restructure budget accounts payable accrued as of January 1, 2013, including VAT refund debt. The new T-bills will yield up to 5% and will mature in 5 years. While their issuance will help resolve the issue of VAT refunds and will reduce budget pressures in the short-run, this innovation raises concerns for the following reasons. First, despite the fact that the law stipulates a 'voluntary' principle for choosing between cash or T-bills reimbursement, in practice there may be informal pressure to choose the latter. As in the case of VAT bonds, these securities are likely to be traded on the secondary market with a large discount, which would mean lower working capital for business. Second, in fact, the law allows for creation and functioning of a quasi-money instrument, whose issuance will be controlled by the Ministry of Finance of Ukraine. This may increase the cost of transactions and uncertainty in the economy. Third, it may cause an increase in Ukraine's public debt to unsustainable levels.

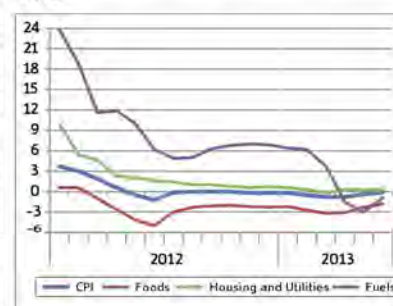
Finally, the Ministry of Finance has developed amendments to the tax system of Ukraine. In particular, it has proposed to reduce the VAT rate from the current 19% (17% since the beginning of 2014) to 9% and introduce a 1-2% sales tax. While this reform may increase tax proceeds to the budget, it will increase the tax burden as well as the cost of doing business in Ukraine.

All of these initiatives indicate that the government realizes the growing fiscal challenges and has been seeking ways to reduce budget pressures, principally relying on raising tax revenues. At the same time, international experience shows that fiscal consolidation is more effective if it is based on expenditure cuts. Moreover, some of the above initiatives are unlikely to comply with IMF requirements. Hence, we believe a combination of revenue-raising and expenditure-cutting measures will be used to sustain Ukraine's public finances. However, due to current delays in consolidation measures, Ukraine's public sector deficit may stay around 5% of GDP in 2013.

Monetary Policy

Price pressures in Ukraine remain subdued as the consumer price index grew by 0.1% mom in May and remained unchanged in June. As a result, in annual terms the index was 0.1% lower in June compared to the previous year. As in the previous periods, low inflation was a reflection of weak economic activity, good agricultural harvests for several years in a row, subdued imported inflation amid a downward trend in world commodity prices and calmed Hryvnia depreciation expectations, and virtually unchanged utility prices. In particular, food prices stood almost 2% below their June 2012 level with fruit, vegetables, and milk and dairy products contributing the most to the decline. The rates of price change for clothing and footwear and household equipment remained unchanged at -2.8% yoy and -2.1% yoy in May and June, respectively. The prices for these commodity groups are dependent on Hryvnia exchange rate developments due to the high share of imports. In addition, a deflation in these groups may be attributed to stronger summer sales than a year ago. Thanks to falling world crude oil prices, domestic fuel prices declined by almost 1% yoy in June. Due to the government reluctance to raise natural gas prices to the population, utility prices remained stable at 0.3% yoy over May-June.

Consumer Price Index by Select Components, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

²Although Ukraine's ranking of paying taxes in the World Bank Doing Business 2013 report improved by 18 points, it still held 165th position out of 185 countries.

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Looking ahead, we expect price pressures to moderately increase over the coming months but overall inflation will remain subdued with the annual rate of growth standing at about 4% yoy at the end of the year. The acceleration will be the result of a likely increase in indirect taxes (excises on fuel, alcohol and tobacco) and higher world energy prices (already in June, crude oil prices started to rise, responding to intensifying tensions in the Middle East). In addition, the Ukrainian government may eventually increase natural gas tariffs to the population in its efforts to resume borrowing from the IMF. Forecast inflation, however, will be the second lowest over the decade.

The annual growth of monetary aggregates kept strengthening amid the National Bank of Ukraine's efforts to stimulate credit activity, continuing deposit inflow to the banking sector, moderate monetization of public debt and positive NBU interventions on the interbank forex market. In particular, banking sector liquidity remained loose in May-June, despite increased NBU sterilization operations. Indeed, daily cash balances on commercial bank correspondent accounts stood at about UAH 25.5 billion on average in May and June, almost 10% higher than in the previous two months. Excluding the short period at the beginning of May, overnight credit for Hryvnia resources on the interbank money market stood at 2-4% pa, also indicating the market had ample liquidity.

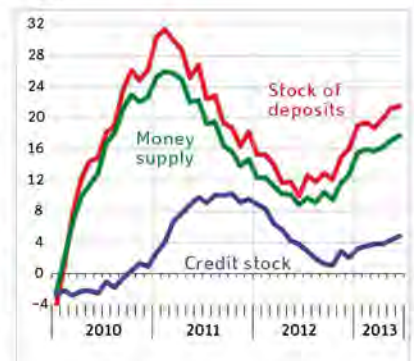
In addition, at the beginning of June, the National Bank of Ukraine decreased its discount rate by 25 basis points to 7%. By this move, the monetary authority aimed to stimulate bank lending to the private sector, which has remained weak so far. The stock of bank credit had grown by a moderate 4.8% yoy as of the end of June 2013. To a notable extent, weak credit activity is attributed to commercial banks' unwillingness to lend amid high credit risks in Ukraine, on the one hand, and low demand for loans from the private sector due to high credit rates and strict lending standards, on the other hand. Abundant liquidity may inspire commercial banks to soften their lending requirements and reduce lending rates, which will make bank credit affordable for corporate enterprises and households.

The growth of deposits increased to 21.5% in May and slightly moderated to 20.9% yoy in June. The deceleration occurred mainly on account of deposits held by non-financial corporations and may be attributed to higher liquidity preferences amid declining deposit rates. At the same time, the growth of household deposits showed further improvement, expanding by 21% yoy in June. Continuing NBU purchases of government securities, in the amount of UAH 5.3 billion (\$0.7 billion) over May-June, also contributed to money creation over the period.

Finally, during May and June the National Bank of Ukraine seized the opportunity of a calmed foreign exchange market and carried out purchase interventions. The Bank bought about \$0.5 billion over these two months to soften the decline in gross international reserves caused by large external public debt repayments in June. Indeed, gross international reserves decreased to \$23.2 billion as of the end of June, covering 2.6 months of imports. Partially, the decline in reserves may be attributed to revaluation adjustments (due to June's drop in gold prices, fluctuation of Euro/US Dollar exchange rate), which may be temporary. However, given recently increased volatility on foreign capital markets amid Ukraine's high external financing needs, the decline in reserves may continue in the coming months. In addition, international reserves below the three months' import cover are adversely affecting investor sentiment, which may further complicate the roll-over of Ukraine's external debt, and narrow the room to absorb adverse domestic and/or external shocks.

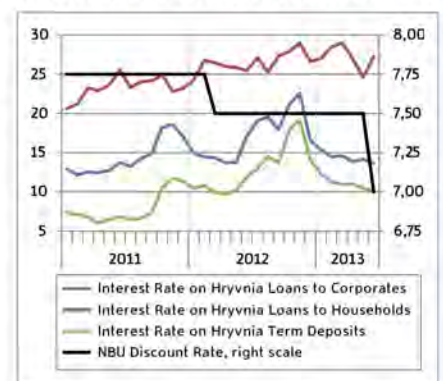
So far, the situation on the foreign exchange market has remained stable as administrative restrictions on foreign currency operations and favorable external balance over the first five months of the year calmed population demand for foreign currency. Thus, in mid-May the NBU extended the mandatory requirement to sell 50% of export earnings on the interbank forex market. In addition, document requirements to purchase/sell foreign currency and seasonally weak demand during the summer months may have contributed to lower population transactions with foreign exchange. As a result, net population forex purchases stayed positive for three months in a row in May-July. An anticipated worsening of Ukraine's Balance of Payments in the fall amid turbulent international financial markets, low international reserves and higher population demand for foreign exchange following the end of the vacation period may increase Hryvnia exchange

Select Monetary Indicators, % yoy



Source: NBU, The Bleyzer Foundation

Select Interest Rate Trends in Ukraine in 2012-2013



Source: NBU, The Bleyzer Foundation

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rate pressures. Assuming IMF financing can be secured at the end of the year, Ukraine will be able to maintain its external stability, although higher short-term Hryvnia exchange rate fluctuations are likely in 2H 2013.

International Trade and Capital

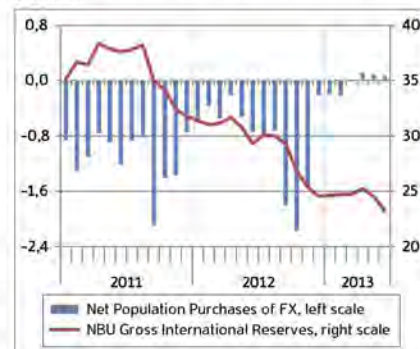
Despite a challenging external environment, Ukraine's external balance developments were rather favorable over the first six months of 2013. Although export performance was weak, imports fell even sharper. As a result, the current account deficit stood at \$3.7 billion over January-June 2013, almost 36% lower than in the corresponding period last year.

On the export side, shipments of Ukrainian goods abroad fell by almost 6% yoy in 1H 2013, mainly due to lower supplies of metals, chemicals and transport vehicles. Although a high agricultural harvest supported exports of agricultural and food products, in value terms exports of these commodities were 6% yoy lower over the period due to softening commodity prices and a high base for comparison. Looking ahead, near term export prospects remain mixed. On the one hand, Ukraine's exports will benefit from a gradual recovery in global demand, high agricultural harvest (grain export is forecast by the Ministry of Agrarian Policy and Food to reach a record high 28 million tons in 2013-14) and improved access to select product markets (e.g., poultry shipments to the EU). On the other hand, intensifying trade tensions with Russia will weigh on export growth.

On the import side, imports declined 13.5% in 1H 2013, affected by government efforts to reduce energy imports. In particular, the volume of natural gas purchases was 35% yoy lower over the period. In addition, imports of machinery and transport vehicles were down by 13.3% yoy in value terms, due to low investment demand as well as imposition of a special duty on imported cars. Thanks to lower imports, Ukraine is forecast to narrow its current account deficit in 2013. However, due to weak exports and real GDP growth the decline will be relatively moderate to around 7.5% of GDP.

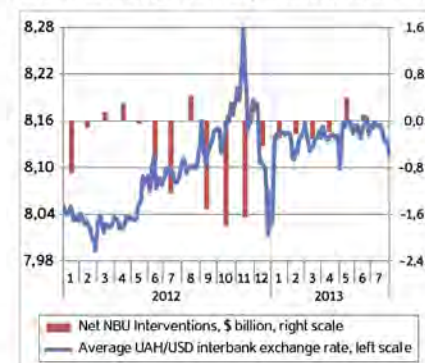
Over the first five months of the year, Ukraine generated solid capital account surplus in spite of large external debt repayments and absence of IMF financing. Loose international liquidity and calmed population demand for foreign exchange may be the principal reasons for capital account improvements over the period. However, already in June, the capital account turned into a small deficit due to high external public debt repayments, which were reflected in a decline in NBU gross international reserves. Given increased volatility on foreign financial markets and evidence of investors turning risk averse again, Ukraine may find it increasingly difficult to meet its still high external financing needs. We believe that falling reserves and likely intensified Hryvnia depreciation pressures in autumn will prompt the government to meet IMF conditions to secure its financing, as unpopular natural gas tariff increases will bear lower political costs than another sharp depreciation of the national currency. With IMF financing, the Hryvnia exchange rate is projected to remain either stable or depreciate moderately.

Population Demand for Foreign Currency, net purchases*, and NBU Gross International Reserves, \$ billion



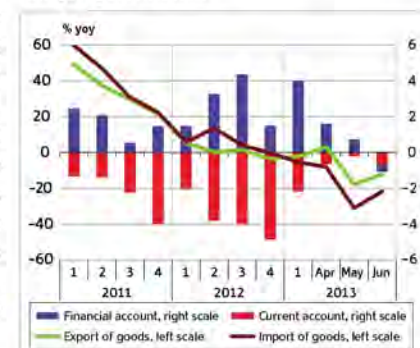
* Negative number means that purchases of foreign currency exceeded sales of foreign exchange
Source: NBU, The Bleyzer Foundation

Inter-bank Foreign Currency Market in 2012-2013



Source: Finance.ua, NBU, The Bleyzer Foundation

Ukraine's Balance of Payments Performance, analytic presentation



Source: NBU, The Bleyzer Foundation