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- After lengthy talks, a strong pro-European and pro-reform coalition was formed in the Ukrainian parliament.
- The macroeconomic outlook for 2015 has deteriorated amid signs the crisis in eastern oblasts is evolving into a 'frozen conflict'. The economy is forecast to continue contracting in 2015 with real GDP down by about 4% yoy.
- Industrial production seems to have stabilized at low levels in October as less intense fighting in the east and a high agricultural harvest compensated for the adverse effect of Russia's new trade restrictions and domestic supply shortages of fossil fuels.
- In 2014, Ukraine may hit a new grain harvest record of about 64 million tons. Due to adverse weather conditions and funding restrictions, grain production may decline next year.
- Due to the lasting military conflict in eastern Ukraine, the severe economic downturn and Hryvnia depreciation, Ukraine's public sector fiscal budget deficit (including Naftogaz) is forecast to widen to 12% of GDP in 2014. Without prompt fiscal correction measures to restore the country's fiscal sustainability and significant financial support from abroad, the country may face a financial crisis.
- Consumer price inflation accelerated to almost 20% yoy in October.
- Ukraine continued to enjoy a current account balance improvement in October, despite Russia's new trade restrictions and higher energy imports.
- In contrast, the financial account of the Balance of Payments sharply deteriorated amid Naftogaz external debt redemption and NBU support of the Hryvnia exchange rate prior to parliamentary elections.
- As a result, NBU net international reserves fell to $12.6 billion, a ten-year minimum.
- The rapid depletion of reserves amid still large foreign debt liabilities due in the last two months of 2014 and the likely delay in IMF financial aid disbursement caused Hryvnia depreciation pressures to resume in November 2014. The pressures are likely to persist in 2015 amid high external financing needs, but anticipated provision of sizable foreign financial aid should contain Hryvnia depreciation beyond UAH 17 per USD.

Forecast of Main Macroeconomic Indicators for 2014-2015

	2011	2012	2013	2014f	2015f
GDP, $ billion	163.4	176.6	182.0	135.3	120.4
Real GDP Growth, % yoy	5.2	0.2	0.0	-7.0	-4.0
Private Consumption, real growth, % yoy	15.0	11.7	7.8	-7.0	-2.0
Fiscal Balance, incl. Naftogaz and Pension Fund, % of GDP	-4.3	-6.0	-6.5	-12.0	-6.0
Public Debt, % of GDP	36.3	36.6	40.5	68.0	76.0
Consumer Inflation, eop, % yoy	4.6	-0.2	0.5	24.0	12.0
Hryvnia Exchange Rate per USD, eop	8.0	8.0	8.0	15.0	17.0
Current Account Balance, % of GDP	-6.3	-8.1	-9.0	-4.3	-4.3
FDI ($ billion)	7.0	6.6	3.3	0.5	2.0
International Reserves ($ billion)	31.8	24.5	20.4	8.0	15.0
External Debt ($ billion)	126.2	135.1	142.5	145.0	157.0

Political Developments

Shortly after parliamentary elections, five out of six parties represented in the new Verkhovna Rada of Ukraine started coalition negotiations. Given the pro-EU reform platform of these parties, the parlous state of the Ukrainian economy and facing increasing risk of conflict escalation in eastern oblasts, it was surprising that negotiations dragged on for almost a month. According to final election results, the President's bloc has the largest faction in the new parliament, holding 146 seats. Yatseniuk's People's Front faction accounts for only 83 seats, despite the fact that it won the popular vote (though with a very thin advantage over the President's party). In its view, this success gave the People's Front the right to demand the prime minister position and control over key ministries. Despite longer than expected talks, the coalition was formed on November 27th, which demonstrated that the two leading forces in the parliament are prepared to accept a good degree of compromise.

The coalition, called "European Ukraine", was formed by the five pro-Europe parties: the Bloc of Petro Poroshenko, the People's Front, the Samopomich (Self-Help) party, the Radical Party and former Prime Minister Tymoshenko's Batkivshchyna (Fatherland) party. In total, the coalition is supported by 302 members of parliament, a constitutional majority. The same day, Yatseniuk was re-elected to the prime minister post, receiving 341 votes in a de-facto 423-seat parliament,[1] while Volodymyr Groisman, a close ally of President Poroshenko, became the new Verkhovna Rada chairman. The whole cabinet

[1] Nominally, the Verkhovna Rada of Ukraine has 450 members. However, due to Russia's annexation of Crimea and conflict in Donbas region, the effective number of deputies fell to 423.

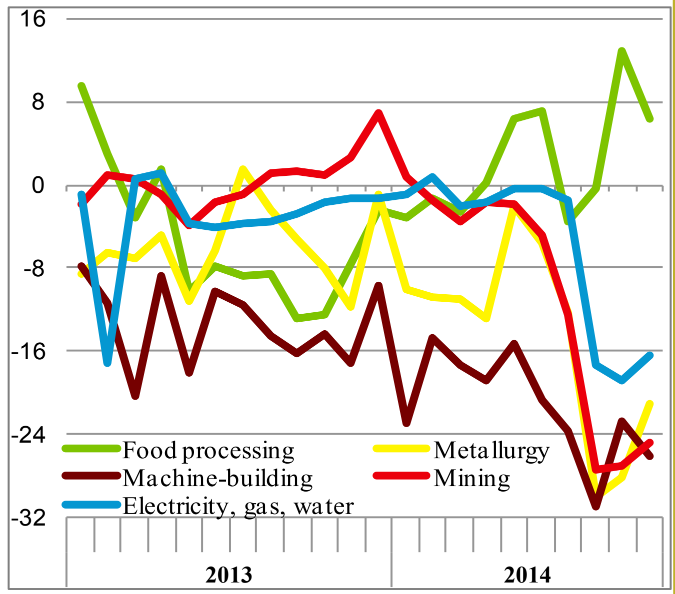
of ministers was approved on December 2. The quick formation of a new government is important to resuming negotiations with the International Monetary Fund, whose financing (coupled with other aid) kept the Ukrainian economy from a free fall. At the same time, the new government will have to demonstrate a very strong commitment to economic reforms. A coalition agreement signed by the five parties contains many useful provisions to transform the economy, including elimination of corruption, tax reform, decentralization, and de-regulation. However, expedient approval of a realistic 2015 fiscal budget with effective fiscal consolidation measures will be a real test for both the new government and the parliament coalition's readiness to finally implement painful but necessary measures.

Local elections in rebel-occupied territories on November 2nd (unauthorized by Kyiv) and numerous continuing violations of the ceasefire agreement clearly signaled that the conflict in eastern oblasts of Ukraine has entered a frozen phase. Moreover, there are signs of further build-up of heavy weapons and armor, which increase the risk of fighting escalation. The presence of a frozen conflict will weigh on any economic recovery (due to disrupted economic ties and damage to infrastructure) and the fiscal budget deficit (due to the need to maintain high defense expenditures). These issues will limit Ukraine's foreign policy choices, undermine investments, and slow progress in select reform efforts (e.g. decentralization). With now low chances of quick conflict resolution and de-facto nominal ceasefire agreement, the economic outlook for 2015 has notably worsened, causing us to revise our macroeconomic forecast for next year downwards.

Economic Growth

The Ukrainian economy was hit hard by hostilities in the East, sharp Hryvnia depreciation and deteriorated investor and consumer confidence. The pressures continued in October, but select sectors reported signs of improvement, which allowed us to keep the forecast of real GDP contraction at 7% yoy in 2014. At the same time, as the likelihood of conflict resolution in the Donbas region in the short run looks negligible, we now project real GDP to decline by 4% yoy in 2015.

Monthly Output Production by Select Industries, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Looking into recent trends in the real sector, industrial production in October declined at a slower pace than in September as less intense fighting allowed select large enterprises and mines to resume work as well as to partially rebuild heavily damaged infrastructure in the conflict-hit region. As a result, the contraction in metallurgy and mining slowed to 22.4% yoy and 24.9% yoy in October, respectively. A high agricultural harvest and improved access to the EU market underpinned an increase in Ukraine's food processing. However, output growth in the food processing industry moderated to 7% yoy in October due to Russia's imposition of new restrictions on trade in crop products with Ukraine. In the machine building subsector, higher government defense-related expenditures supported this industry, but increasing weakness in private consumption due to accelerating inflation, the adverse income effect of Hryvnia depreciation, lower social spending from the budget and subdued bank lending exerted a toll on industrial performance with output contraction deepening to 26% yoy in October. Fossil fuel (coal and natural gas) supply shortages were a serious drag on production of electricity and chemicals, which fell by 16.5% yoy and 10.6% yoy in October respectively.

Select Real Sector Indicators for Ukraine

	2014				2013	2012	2011	2010
	10m	9m	8m	6m				
Agriculture	7.5	16.0	6.3	-3.9	13.3	-4.5	17.5	-1.5
Industry	-9.4	-8.6	-7.8	-4.7	-4.3	-1.8	7.6	11.2
Construction works	-18.6	-17.2	-15.6	-8.9	-11.1	-14	11.1	-5.4
Domestic trade, turnover								
Wholesale trade	-14.2	-14.0	-13.8	-10.5	-2	-4.4	0.6	0.4
Retail trade	-7.9	-6.5	-4.0	0.8	9.5	15.9	14.7	9.8
Transportation, turnover								
Cargo	-7.9	-6.5	-3.8	0.4	-3.9	-7.6	5.7	6.4
Passenger	-11.4	-11.8	-11.8	-10.3	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Agriculture reported solid growth of 7.5% yoy over January-October amid high grain and vegetables harvests. In particular, as of the beginning of November, Ukraine's harvest of grains, vegetables (including potato) and sugar beets was 13.6%, 7% and 41% higher than in the corresponding period last year, respectively. Given the higher yields, the 2014 grain harvest may reach a new record of about 64 million tons. The slowdown in the pace of agricultural sector growth in October was fully anticipated as it was attributed to a faded favorable base effect. Other sectors demonstrated less favorable developments, with the real value of construction works showing a deeper contraction of 18.6% yoy, while cargo transportation turnover and retail sales fell by almost 8% yoy over the first ten months of the year.

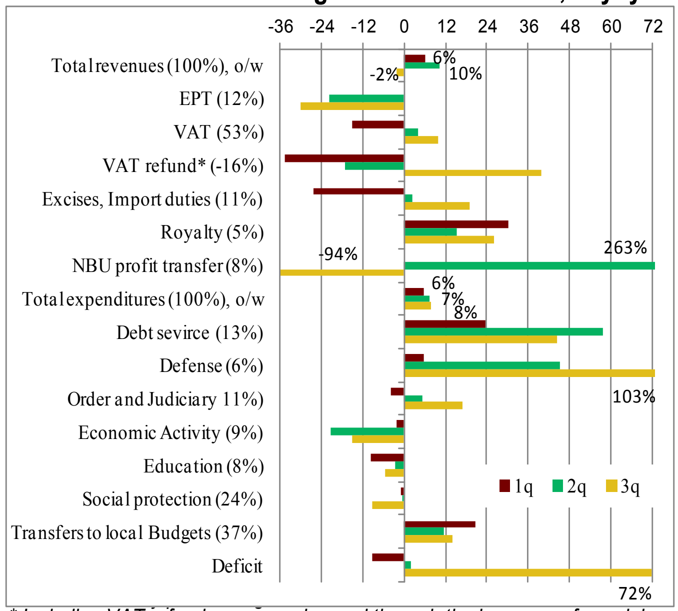
Turning to the 2015 macroeconomic forecast, economic growth will continue to be hindered by domestic demand weaknesses due to tough fiscal austerity measures and the ongoing credit squeeze, subdued exports and likely higher volumes of energy imports. On the production side, agriculture is likely to decline in 2015, as droughty autumn weather and funding constraints will worsen next year's harvest prospects. The Ukrainian economy may start to recover in 2016 following the acceleration of structural reforms in the country.

Fiscal Policy

Ukraine's rapidly deteriorating public finances, caused by the lasting military conflict in the east and the severe economic downturn, is currently among the main causes of concern and a major threat to public debt sustainability and future recovery. Moreover, without prompt corrective actions and acceleration of reforms, the country may face a severe financial crisis as it may fail to secure the necessary foreign aid.

Thanks to a number of revenue-raising measures, which principally rested on increases in indirect taxes (excises, abolishment of VAT privileges for select goods, etc.) and higher taxation of passive incomes (a 0.5% fee on foreign currency purchases, a 1.5% military duty on the wage fund, taxation of deposit income, etc.) the government was able to collect almost 4% yoy higher proceeds to the state coffers over January-October 2014. Excluding UAH 6.8 billion of VAT refund arrears redeemed through the issuance of special domestic VAT bonds, state budget revenues were up by 6.3% yoy over the period. At the same time, a sharp increase in military and public debt expenses, by more than 60% yoy and 43% yoy over January-October respectively, limited the scope of fiscal consolidation despite expenditure cuts on public administration, economic activity, education, healthcare and social protection. As a result, the state budget deficit widened to UAH 53.8 billion over the period, or about 3.4% of forecasted full-year GDP. The annual fiscal deficit is targeted to widen to about 5.5% of GDP, including redemption of VAT refund arrears accumulated prior to January 1st, 2014, and energy subsidies to local budgets, which were funded through special domestic bond issuances.

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



** Including VAT refund arrears redeemed through the issuance of special domestic VAT bonds*
Source: The Ministry of Finance of Ukraine, The Bleyzer Foundation

At the same time, sharp Hryvnia depreciation exacerbated financial difficulties of Naftogaz, the state energy monopoly. Despite a 50% increase in household gas and heating company tariffs in May, the population tariff coverage of natural gas prices only grew from about 23.5% in 2013 to about 31% for gas imported over May-September 2014.[2] Nevertheless, the tariff coverage ratio is estimated to decline back to less than 24% already in 4Q 2014. In addition, the company accumulated significant arrears for natural gas deliveries in the previous year and faced maturing external debt obligations in autumn 2014. An almost 48% Hryvnia depreciation to date made the repayment of Naftogaz external debt liabilities even more challenging. As a result, the Naftogaz deficit is forecast to widen to about 6.5% of GDP in 2014, bringing the total public sector fiscal budget gap to 12% of GDP.

Ukraine has been running fiscal deficits in excess of 3% of GDP, a level considered to be sustainable, since 2008. As a result, its public debt to GDP ratio is forecast to exceed 60% and 70% at the end of 2014 and 2015, respectively (from less than 13% at the end of 2007), raising concerns over the country's fiscal sustainability. Moreover, the crossing of the 60% of public-debt-to-GDP level may add to the financial difficulties of the country in the short-term as the option of early repayment of Russia's $3 billion bonds, granted to Ukraine at the end of 2013, is conditional on Ukraine's public debt exceeding the 60% of GDP threshold.

All of this points to the need for urgent government actions to restore the soundness of Ukraine's public finances and secure necessary IMF and other international support. In particular, addressing the Naftogaz deficit will require increasing gas tariffs to the population to its import costs, while simultaneously providing cash compensation to the very poor. A second important fiscal budget measure should be to reform the pension system to increase the pension age and reduce generous special privileges and benefits. Despite previous pension reform efforts, pension expenditures accounted for over 17% of GDP in 2013. Despite sizable pension expenditures, many pensioners live in poverty – the average pension benefit amounted to

[2] There is a dispute between Russia and Ukraine over the price of Russian natural gas deliveries to Ukraine in 2Q 2014. After Crimea annexation, Russia increased the price for its natural gas shipped to Ukraine from $268.5 per 1000 m3 in 1Q 2014 to $485 per 1000 m3. Ukraine strongly objected to the increase. As the dispute was not resolved, Russia stopped natural gas supplies to Ukraine since mid-June 2014. Before the dispute is resolved by the Stockholm Arbitration Tribunal, Ukraine reports natural gas imports from Russia in 2Q 2014 based on a price of $268.5 per 1000 m3 in its foreign trade statistics. This price was used for calculating population natural gas tariff coverage ratio.

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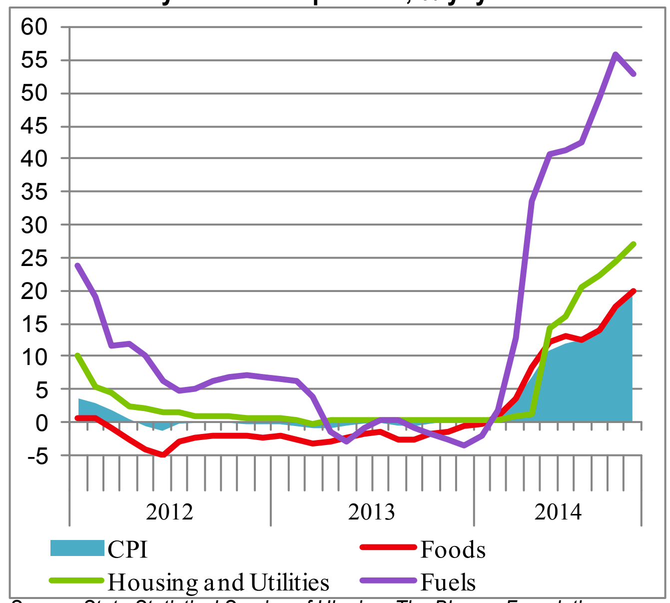
UAH 1670 (around $110) at the beginning of October 2014. At the same time, maximum old-age pension benefits were almost 18 times higher than the minimum in 2013. Thirdly, the size of the government at all levels should also be reduced drastically by merging agencies and reducing staff. Reform of government procurement rules should also help control government expenditures. All government subsidies to productive activities should be eliminated or phased out. Finally, for these measures to be most effective and sustainable in the future, broad-based public administration reform is required.

Monetary Policy

Inflation. According to the State Statistical Service of Ukraine, monthly CPI inflation eased in October to 2.4% compared with 2.9% in the previous month. This mainly reflected lower transport fuel prices, which were down by 2% mom in October affected by an ongoing reduction in world crude oil prices. In annual terms, however, inflationary pressures remained high. CPI growth reached 19.8% yoy in October, driven by the lagged effects of Hryvnia depreciation and increases in indirect taxes, and continuing adjustment of utility tariffs. At the same time, a record high agricultural harvest and uneven impact of food export developments[3] exerted downward pressure on prices of select food products. Thus, prices for fresh vegetables fell by 18% yoy in October, while prices for milk, cheese and edible oil grew at the slowest paces across the group. In addition, an increase in services price inflation was subdued due to weakening consumer demand and a moderation of wage growth.[4] However, resumed Hryvnia depreciation is likely to counterbalance the favorable impact of these developments, maintaining an upward trajectory of domestic prices going forward. Hence, consumer inflation is forecast at 24% yoy in 2014 and 12% yoy next year.

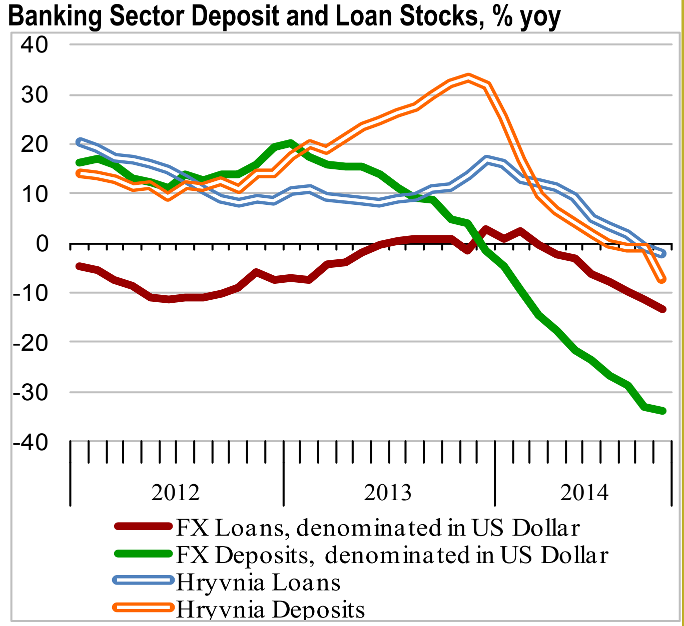
CPI Growth by Select Components, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Banking Sector. The resumed Hryvnia depreciation will exacerbate the existing weaknesses of the Ukrainian banking system, which include a poor credit portfolio, reduced access to foreign financing amid still large foreign debt repayment needs, and deposit outflow. Although the number of insolvent banks has increased this year, overall the situation in the sector remained under the NBU's control. At the same time, due to further Hryvnia depreciation, the sector may require significantly higher recapitalization than was anticipated based on the results of the stress tests carried out for the 35 largest banks in 1H 2014. As non-performing loans will increase, eroding banking capital, there are concerns that some banks' bailouts will require state involvement, which may put additional stress on the already strained public finances.

Banking Sector Deposit and Loan Stocks, % yoy



Source: NBU, The Bleyzer Foundation

Hryvnia Exchange Rate. Following a month of relative stability, the Ukrainian currency resumed depreciation at the beginning of November, falling to a historical low of UAH 16.05 per USD by the middle of the month. At the beginning of November, the National Bank of Ukraine had to abandon an unofficial peg of UAH 12.95 per USD, a compromise solution reached between government officials and monetary authorities, banking sector representatives and large exporters on the eve of parliamentary elections. Exchange rate stability during October was achieved at the cost of rapid depletion of international reserves and the development of a 'black' foreign exchange market. Indeed, the NBU spent $1.4 billion to defend the Hryvnia peg in October. Coupled with sizable quasi-sovereign external debt repayments that month, this cut net NBU international reserves by almost ¼ in one month to $12.6 billion at the end of October. In addition, the official cash foreign exchange market was virtually frozen as it was almost impossible to buy even small amounts of foreign currency at the specified rates despite regular NBU forex interventions held twice a week to

[3] Ukraine's exports of agricultural and food products suffered from Russia's trade restrictions on a number of commodities. In turn, Ukrainian food producers benefited from the EU unilateral trade opening for Ukraine. However, as the commodity structure of Ukraine's export to Russia and the EU differ substantially, reduced access to Russia's market led to oversupply of select products on domestic market.

[4] The nominal wage growth slowed to less than 5% yoy over January-August 2014. While the growth rebounded to 6.3% yoy in September, wage arrears almost doubled from January to October 2014. In real terms, wages have been declining for six months in a row and were 11.4% yoy lower in September 2014.

satisfy the needs of banks' cashier departments and client requests for eligible foreign currency purchases. Instead, the black market flourished with Hryvnia trading at rates in excess of 15 UAH per USD.

Given the low level of international reserves, after the elections the National Bank of Ukraine reduced the size of its interventions and relaxed some of its forex trade restrictions. This coincided with factors that put depreciation pressures on the Hryvnia, including the heightened fears of conflict escalation in the Donbas region, fed by growing evidence that Russia-supported rebels had been reinforced with new military troops and heavy armaments, and the expectations of deterioration of Ukraine's current and capital account through the rest of the year amid uncertainty over the timing of IMF financing. The IMF mission, which visited Ukraine during November 11-25 to review the Stand-By Agreement and assess the current economic situation, did not shed light on the potential timing and terms of further disbursements as IMF officials have repeatedly stated the loan program will be discussed with the new government. As the latter was formed only at the beginning of December, there is a high probability that no IMF funds will be available until early 2015.

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

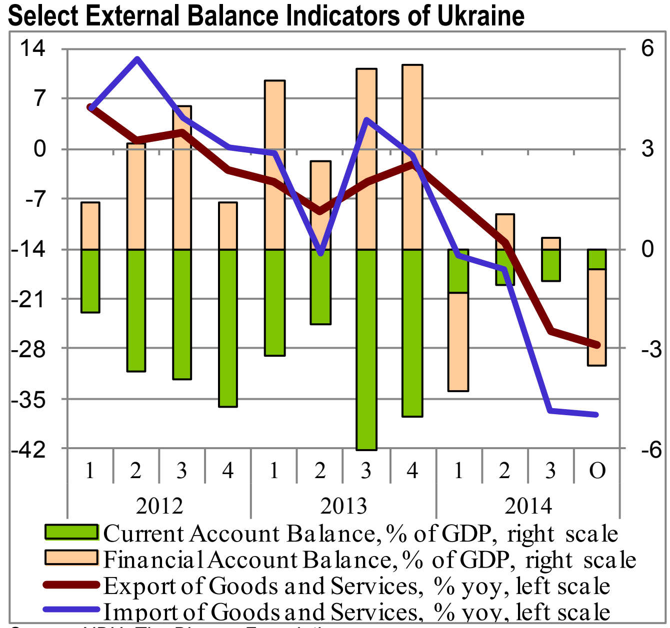
Source: NBU, The Bleyzer Foundation

With the absence of IMF funds amid anticipated Balance-of-Payments worsening, Hryvnia exchange rate is expected to remain volatile. At the same time, thanks to continuing administrative controls over forex trading and small but regular interventions, the Hryvnia is expected to fluctuate at about UAH 15-16 per USD during December 2014 and the beginning of 2015. Indeed, the NBU has changed the procedures and timing of its forex auctions. The latter are now held daily with the regulator selling small volumes of foreign currency ($3-5 million). Weighted average exchange rate, defined during the auction excluding speculative bids (defined by the NBU), serves as indicative NBU rate for the day. The National Bank also recommended commercial banks set their cash rates at levels that do not deviate by more than 5% from the indicative NBU rate. In addition, on November 13th, the NBU raised its discount rate by 1.5 percentage points to 14%, the highest rate since 2001. Thanks to these measures, the Hryvnia slightly appreciated to UAH 15 per USD by the end of November. However, in the absence of IMF financing, Ukraine's international reserves are likely to decline below $10 billion at the end of 2014 but are forecast to rebound to about $15 billion in 2015 if international financing becomes available.

International Trade and Capital

In October 2014, Ukraine's current account deficit decreased slightly compared to the previous month as deterioration in the goods balance due to further export weakness was partly compensated for by an improvement in the services balance. Overall in October and the first ten months of 2014 the current account deficit of Ukraine narrowed considerably compared to the corresponding periods last year. For the whole 2014, the current account gap is forecast to shrink more than twice from about 9% of GDP in 2013. In contrast to the improving current account balance, the financial account deficit rose sharply in October, contributing to further deterioration of Ukraine's external position and being among the main reasons of resumed Hryvnia depreciation pressures since the beginning of November. As the levels of net external liabilities remain elevated through the last two months of 2014 and 2015, Ukraine will require both further current account improvement and sizable foreign financial assistance to soften the adjustment of the country's external imbalances through exchange rate changes.

Select External Balance Indicators of Ukraine



Source: NBU, The Bleyzer Foundation

Data on trade values showed that following some signs of stabilization in September, the decline in exports of goods deepened in October when exports dropped by almost 25% yoy. The deterioration reflected Russia's trade restrictions as well as adverse developments on select goods markets of Ukraine.

In particular, in October Russia completely banned imports of crop products from Ukraine, including fruit and vegetables, as well as cheese and cheese-like products. The ban came after a series of other Russia's restrictions on imports of select agricultural goods from Ukraine, such as dairy products and juices (since end-July 2014), meat and meat products.[5] Although exports of these commodity group to Russia account for a relatively moderate share (about 11% in 2013) of the total Ukrainian external trade in agricultural and food products, Russia was an important destination market for Ukraine's exports of tomatoes, cucumbers, apples, etc. These restrictions, coupled with infrastructure damages due to hostilities in the east and Russia's annexation of Crimea, explain a 15% yoy contraction in Ukraine's exports of agricultural and food products in October compared with a solid growth in the previous periods. On a positive note, the decline of exports to Russia was mitigated by the growing agro-food exports to the EU thanks to unilateral trade preferences for Ukraine, extended by the EU until the end of 2015.[6] However, due to the asymmetry in the structure of agro and food exports of Ukraine to Russia and the EU (exports to the latter are dominated by grains and edible oil and by increasing supplies of meat and dairy products) and the quality standards mismatches, improvements in Ukraine's external trade with the EU did not compensate for deteriorating trade with Russia.

Ukraine's Agro-Food Exports to Its Main Partners

	9m 2014									% of Commodity Total				
	% yoy			% of Country's Total						to Russia		to EU-28		Ukraine, total
	to Russia	to EU-28	Ukraine, total	to Russia		to EU-28		Ukraine, total		9m 2014	9m 2013	9m 2014	9m 2013	
Total Ukraine's exports of goods	**-27.3**	**12.3**	**-7.7**	**100.0**		**100.0**		**100.0**		**19.4**	**24.6**	**31.8**	**26.2**	**100.0**
Agro-food exports	***-38.3***	***21.2***	***7.3***	***12.0***	***100.0***	***25.0***	***100.0***	***24.8***	***100.0***	***6.9***	***11.9***	***29.8***	***26.4***	***100.0***
Meat, fish products and prep. thereof	**-44.8**	594.9	11.3		*10.7*		*0.2*		*2.6*	**24.2**	**48.8**	*12.5*	*2.0*	100.0
Dairy products, eggs	**-54.6**	65.1	-7.1		*20.0*		*0.9*		*4.3*	**26.8**	**54.8**	*9.3*	*5.2*	100.0
Vegetables, fruit and prep. thereof	**-31.1**	**16.1**	-2.8		*13.2*		*7.5*		*4.5*	**24.7**	**34.9**	***52.1***	***43.6***	100.0
Beverages and spirits	**-39.9**	56.2	-2.6		*10.4*		*0.7*		*2.3*	**32.6**	**52.9**	*13.0*	*8.1*	100.0
Cereals, prep. and products thereof	8.3	**35.1**	19.8		*9.6*		*37.5*		*36.9*	2.8	3.1	***30.3***	***26.8***	100.0
Oil seed and edible oil	-37.0	**3.6**	1.9		*5.6*		*39.7*		*33.8*	1.2	2.0	***31.5***	***31.0***	100.0
Mis. edible prep. and residues	16.5	28.3	21.8		*5.6*		*11.9*		*7.3*	8.7	9.1	*45.2*	*43.0*	100.0

Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Furthermore, adverse developments on domestic markets exerted a toll on exports of select commodities. Indeed, due to a growing domestic deficit of coal, exports of coal declined notably in October. Moreover, for the same reason, the Ukrainian government restricted electricity supplies abroad by 50% in mid-September and limited exports of thermal coal since mid-November. As a result, Ukraine's exports of mineral products contracted by about 43% yoy in October following a decline of 34.5% yoy in the previous month. In line with lower output production of metals and chemicals, due to the shortages of fossil fuels , destruction of transportation infrastructure, military actions and/or plants' location in rebel-held territories, exports of the respective commodity groups were down by 25% yoy and 28% yoy in October correspondingly.

Despite growing import supplies of fossil fuels (in October, Ukraine started to import natural gas from Norway and coal from South Africa), total imports of goods continued to decline at a robust pace. An almost 39% yoy drop in imports in October may be attributed to lower domestic demand due to the economic downturn and a reduction in real wages, and to a sharp Hryvnia depreciation, which made foreign goods more expansive. Thus, purchases of foreign agro-food products, machinery, chemicals and metals (account for more than 50% of total merchandise imports) contracted by about 41% yoy, 40.5% yoy, 23.5% yoy and 32% yoy in October, respectively.

A wider deficit in the trade of goods in October was partially compensated for by an improved foreign trade balance in the services account, which occurred mainly due to lower imports of tourism-related services and higher exports of telecommunication services. Despite this improvement, the balance of foreign trade in services remained negative for the sixth month in a row. The switch from relatively high surpluses to deficit occurred in May 2014, following the start of armed conflict in eastern Ukraine amid contraction of transportation and travel services exports. In addition, the crash of a Malaysia Airline plane in mid-July, when it flew over the territory controlled by pro-Russian rebels, and conflict escalation in August caused a sharp deterioration in Ukraine's service exports. Despite October's narrower deficit, the whole year foreign trade balance in services may be the worst since the Balance of Payments statistics was released at the beginning of 1998. However, the adverse impact of its worsening on current account developments in 2014 will be outweighed by the adjustments in foreign trade in goods balance.

[5] Officially, Russia did not ban imports of meat and meat products from Ukraine. However, it imposed numerous restrictions on their trade, such as certification and pre-approval of the list of producers allowed for their products deliveries to Russia. As the list is frequently changing and its amendments are hard to predict, Ukraine's exports of meat and meat products to Russia significantly declined and were down by more than 60% yoy over the first nine months of 2014.

[6] Initially, the EU trade preferences for Ukraine, which removed almost 95% and 80% of EU tariffs on imports of industrial and agro-food goods from Ukraine respectively, were introduced until November 2014, when the EU-Ukraine association agreement was expected to take effect. However, in September 2014, it was decided to delay the implementation of a free trade zone part of the agreement until the end of 2015.

Turning to the financial account of Ukraine's Balance of Payments, the balance recorded a significant deficit of about $2.9 billion in October, bringing the ten-month cumulative deficit to $4.4 billion. Naftogaz redemption of $1.6 billion worth of Eurobonds and low private sector foreign debt rollovers were the principal reasons for poor financial account performance that month. In particular, due to country-specific risks (military conflict, economic downturn, sharp Hryvnia depreciation and slow reform progress), the provision of and access to foreign borrowing resources narrowed substantially for Ukrainian banks and corporate enterprises. Indeed, foreign debt rollover for the banking sector fell to 91% in October, while the ratio for the corporate sector remained below 50% for the third consecutive month. The current low level of international reserves, uncertainties over the timing and size of the next IMF tranche disbursement, and large foreign debt repayments through the rest of 2014 and in 2015 raise market concerns over the near-term developments in Ukraine's Balance of Payments, which in turn generate Hryvnia depreciation pressures.

Ukraine's Merchandise Exports to Its Main Partners

External Financing Needs	63.2	Potential Sources	70.2
CA Deficit	**5.0**	**Net FDI**	**2.0**
Sovereign and Quasi-Sovereign Debt, o/w	**10.4**	**International Financial Aid, o/w**	**22.0**
Eurobonds	4.3	IMF	15.0
IMF	1.4	WB	2.0
FX-Denominated Domestic Bonds	2.0	EU	1.5
Syndicated Loan to Sberbank CIB	1.0	Other	2.5
Other (EBRD, EIB, IBRD, Russia)	0.6		
Quasi-Sovereign (Kyiv city, Ukreximbank)	1.1	**Sovereign Debt Issuance**	**1.0**
Banking Sector	**11.8**	**Rollover (95%)**	**11.2**
Corporate Sector	**34.0**	**Rollover (100%)**	**34.0**
Private Sector Demand for FX	**2.0**		
Net Change in the NBU International Reserves	**7.0**		

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

In particular, further declines in international reserves will take place due to natural gas arrears repayment to Russian Gazprom of $3.1 billion in total during November-December 2014. This is likely to drive Ukraine's international reserves to below $10 billion at the end of the year. At the same time, only government and quasi-government foreign financing needs are estimated at about $10 billion in 2015. These high foreign financing requirements make the country highly dependent on the substantial inflow of foreign capital. Due to marked worsening of foreign investors' confidence about the economic prospects of Ukraine, the resumption of the IMF program looks critical to reduce Ukraine's Balance of Payments challenges and restore macroeconomic stability. The IMF's importance stems from the fact that it not only provides substantial bailout financing and unlocks resources from other IFIs, but also serves as an anchor of necessary structural reforms, which helps to improve foreign investors' confidence and, hence, maintain, private sector external debt rollover at decent levels. The continuation of cooperation with the IMF is highly conditional on the effective implementation of government policies and reforms, particularly in the area of fiscal policy. We expect negotiations on the expansion of the IMF program and the next tranche disbursement to resume shortly after the formation of a new government, which should take prompt and credible fiscal deficit correction measures to reduce Ukraine's fiscal deficit to a more sustainable level. Since the coalition and a new government talks dragged on longer than expected, the IMF disbursement is likely to be delayed until the beginning of 2015.