

December 2014
(Advanced copy)

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- A new technocratic government was approved at the beginning of 2014. The presented government plan of action, if implemented, could overhaul the crisis-ridden Ukrainian economy and give impetus for strong sustainable growth in the future.
- Hostilities in the east were notably reduced in December and new peace talks between Ukraine and pro-Russian rebels took place on December 24th. However, little progress in these negotiations maintains our view that the confrontation is evolving into a frozen conflict.
- On December 23rd, the Ukrainian parliament abandoned the country's non-aligned status, although Ukraine is unlikely to become a NATO member in the foreseeable future.
- Real GDP fell by 5.3% yoy in 3Q 2014. The contraction in economic activity is forecast to deepen in 4Q 2014, but slow to 4% yoy in 2015.
- Industrial production decreased by 16.3% yoy in November, the same rate as in the previous month. Although other sectors' performance continued to deteriorate, the industrial data supports our expectations that the Ukrainian economy is likely to bottom out in 4Q 2014.
- At the end of December, the 2015 state budget law and a number of related austerity laws were approved by the parliament. The public sector fiscal deficit (includes Naftogaz and Pension Fund but excludes banking sector recapitalization) is targeted at about 5.5% of GDP. However, there are a number of fiscal risks that have the potential to widen the fiscal deficit beyond the targeted amount and undermine public confidence in public authorities' actions.
- Consumer inflation sped up to 21.8% yoy in November and is expected to accelerate to about 25% yoy in December. Price growth is forecast to stay elevated next year as well, with CPI increasing by about 18% yoy at the end of 2015.
- The Hryvnia depreciated by about 15% in November and by more than 5% in December. Thanks to administrative control measures and assuming sufficient foreign financing is provided next year, the Hryvnia is forecast at about UAH 18 per USD in 2015.
- Resumed Hryvnia depreciation contributed to mounting difficulties in the banking sector. Ukrainian authorities have developed a bad loan resolution and bank recapitalization program. However, some of the program initiatives appear to be controversial.
- Despite further export weaknesses, Ukraine continued to enjoy improvement in its current account balance. Due to additional import duties, although imposed temporarily, the current account gap is forecast to narrow to about 1.5% of GDP in 2015, down from 4% of GDP in 2014.
- Unlike the current account, the financial account balance developments in 2014 and its prospects for 2015 were less favorable. A sizable Balance of Payments deficit led NBU gross international reserves to decline to less than \$8 billion by mid-December, which was half of the critical minimum.
- Moreover, the country is estimated to require around \$15 billion of additional financial assistance in 2015, on top of the funds envisaged in the already approved \$27 billion financial aid package. If this financing is not secured, the country risks facing a full-scale financial crisis.

Forecast of Main Macroeconomic Indicators for 2014-2015

	2011	2012	2013	2014 ^e	2015 ^f
GDP, \$ billion	163.4	176.6	182.0	128.4	113.2
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	-7.5	-3.5
Fiscal Balance, incl. Naftogaz and Pension Fund, % of GDP	-4.3	-6.0	-6.5	-12.0	-7.0
Public Debt, % of GDP	36.3	36.6	40.5	68.0	76.0
Consumer Inflation, eop, % yoy	4.6	-0.2	0.5	25.0	18.0
Hryvnia Exchange Rate per USD, eop	8.0	8.0	8.0	15.5	18.0
Current Account Balance, % of GDP	-6.3	-8.1	-9.0	-4.0	-1.5
FDI (\$ billion)	7.0	6.6	3.3	0.5	1.0
International Reserves (\$ billion)	31.8	24.5	20.4	8.0	13.0
External Debt (\$ billion)	126.2	135.1	142.5	135.0	153.0

Political Developments

December 2014 brought a notable reduction in hostilities in the eastern oblasts of Ukraine, but the confrontation has been steadily evolving into a frozen conflict. Although a ceasefire agreement between Ukrainian forces and pro-Russian rebels was reached in September 2014, it was often violated with the rebels attempting to expand the territory under their control. The military conflict in Donbas has cost 4,700 lives, according to conservative United Nations estimates, with about 1,300 killed after the truce was agreed. Several hundred thousand people have been displaced since the conflict erupted in April 2014. In an effort to facilitate peace efforts, December 9th was declared as a 'Day of Silence', while the new round of talks between

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the sides took place on December 24th in Minsk, the Belarusian capital. The talks ended without evident progress in reaching a more stable ceasefire, an agreement to pull back heavy weapons or consent about a line of division. However, the exchange of some prisoners was agreed upon. Although Russia is likely to continue to support the rebellion in the region, despite denials by Russian authorities, the mounting difficulties of the Russian economy may encourage a compromise solution with Ukrainian authorities. However, there is a good chance that the conflict will remain frozen as the existence of such a conflict would undermine Ukraine's aspirations to join the EU and NATO, despite the Ukrainian parliament voting on December 23rd to abandon the country's non-aligned status.

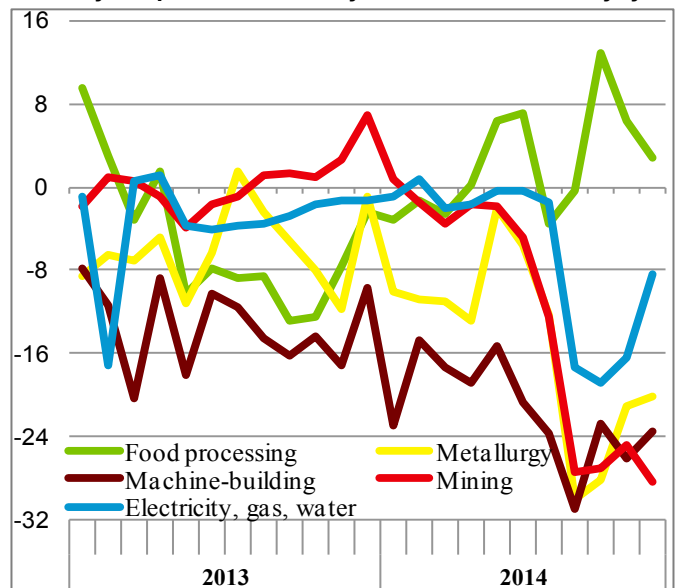
On December 2nd, the Ukrainian parliament approved a new government headed by Mr. Yatseniuk. The appointment of private sector professionals, including two foreign-born investment fund managers and several Georgian reformers, for key ministerial posts, signaled a strong commitment to pursuing painful but long-awaited reforms. The presence of civil activists and reform-minded people in the parliament also increases the chances that the tough but needed reforms will be implemented. A week later, the government announced its action plan for the next two years, which was promptly supported by the Ukrainian parliament. The program contains a broad range of reform efforts encompassing macroeconomic stabilization measures, liberalization and deregulation of business activities, an anti-corruption program, and reforms of the tax system, the judiciary, law enforcement, public governance and the social sectors. The proposed measures will help overhaul the crisis-ridden economy and give impetus to strong sustainable growth in the future.

Economic Growth

As anticipated, hostilities in the East, the ongoing currency crisis, fiscal austerity measures, and worsening trade relations with Russia took their toll on the real sector performance of Ukraine over the course of 2014. According to the latest real GDP growth breakdown, the decline in economic growth deepened to 5.3% yoy in 3Q 2014, and was broad-based among components. Indeed, private consumption showed a 13.2% yoy decrease, reflecting lower real incomes, a consumer credit squeeze and rising economic and political uncertainties. Investment declined by about 30% yoy, although its negative contribution to real GDP growth was partially offset by stronger inventory build-up. The latter should be mainly attributed to a record high agricultural harvest this year and a favorable base for comparison. With imports falling by a markedly higher rate than exports (32.2% yoy vs. 19.2% yoy, respectively) in 3Q 2014, the contribution of net external demand to GDP was effectively positive.

Although real sector indicators are likely to show marked deterioration in 4Q 2014, a stabilization of the rate of contraction in the industrial sector over October-November may signal that real GDP may bottom out this quarter. Thus, industrial production decreased by 16.3% yoy in November, the same rate as a month earlier. With many coal mines located in rebel-held territory and damaged during fighting, output production in the mining industry was down by 28.5% yoy in November. This, coupled with transportation infrastructure damages, weighed on metallurgy and production of electricity, which are heavily dependent on coal supplies. At the same time, the reduction in fighting intensity helped improve fossil fuel deliveries and, thus, slowed output decline in the respective industries to 20% yoy and 8.5%. A high agricultural harvest and improved access to the EU market supported Ukraine's food processing industry despite numerous Russian trade barriers. In contrast, Ukraine's machine building kept suffering from Russian trade restrictions, exacerbated by a notable slowdown of the Russian economy. Economic indicators for other sectors, however, continued to deteriorate. Growth in the agricultural sector

Monthly Output Production by Select Industries, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Select Real Sector Indicators for Ukraine

	2014				2013	2012	2011	2010
	11m	10m	9m	8m				
Agriculture	5.0	7.5	16.0	6.3	13.3	-4.5	17.5	-1.5
Industry	-10.1	-9.4	-8.6	-7.8	-4.3	-1.8	7.6	11.2
Construction works	-19.3	-18.6	-17.2	-15.6	-11.1	-14	11.1	-5.4
Domestic trade, turnover								
Wholesale trade	-14.5	-14.2	-14.0	-13.8	-2	-4.4	0.6	0.4
Retail trade	-8.7	-7.9	-6.5	-4.0	9.5	15.9	14.7	9.8
Transportation, turnover								
Cargo	-9.1	-7.9	-6.5	-3.8	-3.9	-7.6	5.7	6.4
Passenger	-11.7	-11.4	-11.8	-11.8	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service of Ukraine, The Bleyzer Foundation

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moderated to 5% yoy over January-November amid a less favorable base effect. The decline in real value of retail sales and cargo transportation turnover accelerated slightly to 8.7% yoy and 9.1% yoy, respectively. Overall, real GDP is forecast to decline by about 7% in 2014.

Looking to 2015, economic activity is expected to remain subdued despite a number of government reform initiatives that should improve the business environment of Ukraine. However, the outlook for personal consumption is clouded by expected adverse employment development and a decline in real income due to tight fiscal austerity measures and elevated consumer price growth. Public expenditures are also forecast to decline thanks to fiscal consolidation. Profound banking sector difficulties and uncertainty surrounding the military conflict in Donbas and government policies (e.g., changes in taxation, business deregulation) will weigh on investment growth. Exports may remain weak, reflecting forecast subdued world commodity price growth and challenging relations with Russia. At the same time, a sharper contraction in imports due to the imposition of additional duties on all non-critical imported goods will have a favorable impact on real GDP growth. As a result, the Ukrainian economy is forecast to contract but at a slower pace of about 4% yoy in 2015.

Fiscal Policy

In 2014, Ukraine's public sector fiscal deficit, which includes state and local budgets, Naftogaz and Pension Fund imbalances, is forecast to widen to about 12% of GDP. While a number of both revenue and expenditure consolidation measures prevented the state budget deficit from significant deterioration, the Naftogaz fiscal position has worsened notably. In particular, the sharp Hryvnia depreciation virtually eroded the fiscal benefits from natural gas tariff increases to the population and heating companies carried out in mid-2014 and increased the burden of the imported natural gas bill and external liabilities. As a result, the Naftogaz deficit alone grew to about 7% of GDP in 2014.

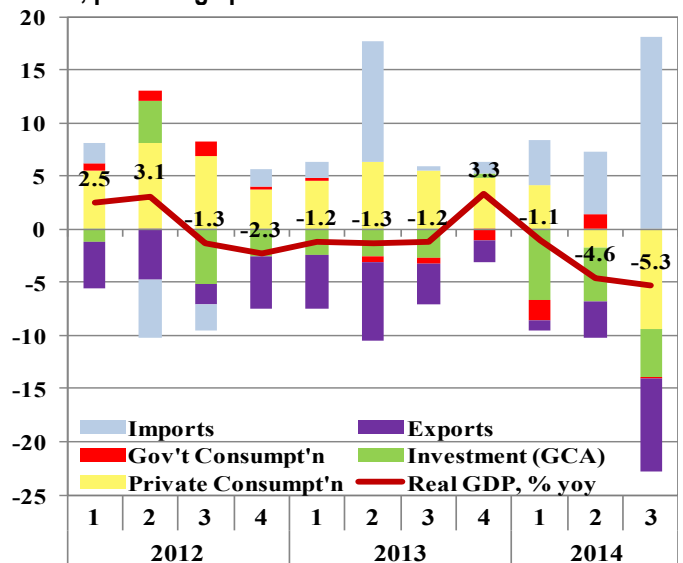
Given potential inflationary effects (due to high monetization of the public sector fiscal deficit in 2014) and public debt sustainability risks, the new government has developed broad fiscal corrective measures and reform initiatives. At the end of December, the parliament approved these fiscal consolidation measures embedded into the 2015 state budget law and related austerity laws. While the targeted state budget and public sector deficits (including Naftogaz and Pension Fund but excluding banking sector recapitalization) of 3.7% of GDP and 1.85% of GDP, respectively, are a notable improvement from the 2014 levels, the 2015 budget has significant risks, which may cause further deterioration in public finances and reduce population tolerance of painful government measures.

The 2015 state budget was developed based on a conservative economic scenario with real GDP contracting by 4.3% yoy and consumer inflation slightly exceeding 13.1% yoy at the end of the year. Revenues of the national budget for 2015 were approved at UAH 475 billion, up by a nominal 25.8%. Despite earlier promises that government revenues to GDP would be reduced by 10%, the planned proceeds would account for 27% of GDP, an increase of about 3.5 percentage points. This suggests an increase in fiscal pressure on the Ukrainian economy despite some government measures to reduce the tax burden on business. In particular, the government decreased the number of taxes from 22 to 9 (although a number of them were just consolidated), reduced the unified social tax rate and relaxed taxation of small business. At the same time, the increase in state budget revenues will be achieved through imposition of additional duties on imports, higher taxes on passive income, increased royalties on hydrocarbon extraction, taxes on luxury goods, new excise taxes, etc.

As part of fiscal consolidation measures on the expenditure side, the government will allow a minimum wage adjustment for the forecast end-of-period inflation to be effective only at the end of the year 2015 (as a result, the average real wage is forecast to decline by about 4.5% yoy in 2015). It has also either narrowed or eliminated some social privileges and benefits (e.g., the wage ceiling for government agencies and budget-financed institutions was set at 7 minimum wages, retirement benefits for select public sector employees were narrowed, etc.) and will carry out employment cuts in the public sector (in particular, the number of employees in the public prosecution services and the Ministry of Internal Affairs will be reduced by 25% and 11.6%, respectively). In addition, Naftogaz support will be reduced by more than 70% in 2015. Nevertheless, expenditures are projected to increase by a nominal 21% yoy, mainly on account of higher pension fund subsidies, military spending and external public debt service.

There are a number of fiscal risks that have the potential to widen the 2015 fiscal deficit beyond the targeted amount. First, a sizable reduction in energy subsidies to Naftogaz should imply that household natural gas tariffs will be adjusted to market level in 2015, which would be an almost fourfold increase from the current level. So far, the government has not officially

Contributions to Real GDP Growth by Demand Components, percentage points



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

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announced such a move, which is likely to be extremely unpopular. Even if approved, the tariff adjustment should be accompanied by a cash support program for poor households. According to early estimates, almost half of all families may need to receive government assistance to pay their utility bills, which may reduce the scope of fiscal consolidation next year. Moreover, further exchange rate depreciation may reduce the benefits of tariff adjustment for the Naftogaz operational balance and adversely affect the company's ability to meet its financial liabilities. Finally, tariff adjustment should not be considered as the only remedy to improve Naftogaz financial soundness. Deep energy market reorganization is required to improve sector efficiency and secure its sustainable development in the future.

Second, the Ukrainian parliament backed a reduction in the unified social tax (UST) from around 41% to 16.4% at the beginning of 2015. To balance this tax reduction, the government counts heavily on legalization of wages and raising efficiency of Social Funds administration. However, these are unlikely to be achieved in the short term, therefore requiring more comprehensive reform efforts. At the same time, the Pension Fund revenue shortfall may be quite substantial, increasing the burden on state budget performance (according to Ukrainian legislation, the Fund's deficit should be covered from the state budget). In particular, in 2012 (the latest available), proceeds from UST accounted for 70% of total Pension Fund receipts and represented almost 11% of GDP. Hence, a 60% reduction in tax rate may be detrimental for both the Pension Fund and state budgets.

Finally, the approved amendments to the Budget Code and budget decentralization envisage some redesign of tax revenue distribution between the state and local budgets. In particular, the residential property tax was transferred from the state to the local level.¹ Excises on tobacco, alcohol and fuel will now be collected by local authorities. In addition, 10% of corporate profit tax will be transferred to local budgets. At the same time, the amendments envisage higher shares of personal income tax, a major source of local budget revenues currently, and royalties transferred to the state budget. For the time being, it is hard to evaluate whether these changes increase the fiscal autonomy of local authorities, which is a pre-requisite for greater independence in decision-making at the local level, and how they will affect state budget revenues. Moreover, the approved decentralization measures may fail to bring more efficiency in budget relations as the redefinition of the roles and a clear distribution of functions between the central and local authorities were not undertaken. Given that decentralization was among the key reform priorities of both the Prime Minister and the President of Ukraine, the failure of this reform may undermine public confidence in public authorities' actions.

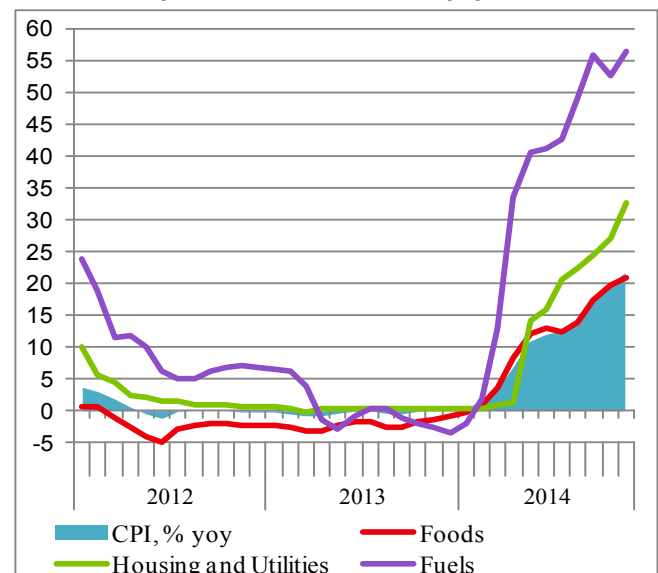
Given significant fiscal risks, the budget will be revised after discussions with the IMF and budget execution results in 1Q 2015.

Monetary Policy

Inflation. According to Ukraine's State Statistical Service, the slowdown in consumer price inflation on a monthly basis continued in November as CPI growth eased to 1.9% mom from 2.4% mom in October. The trend was due to downward pressures of a high agricultural harvest, Russia's import restrictions on select Ukrainian food products and a sharp drop in world energy prices. These factors partially offset the impact of the ongoing upward adjustment of utility tariffs and resumed Hryvnia depreciation on domestic price growth. Indeed, the weakening of the Ukrainian currency was among the key drivers of inflation this year. In addition to the direct impact of the depreciation on the price of imported goods, including fuels, medicine, and home appliances (due to their high import dependency), there were also prevalent second-round effects. First, a fuel local price increase leaked into higher transportation costs. More expensive imported inputs also contributed to the growth of domestic prices. Finally, marked depreciation compounded with higher indirect taxes (excises, removal of select VAT privileges, etc.) and utility tariff adjustment fed inflationary expectations.

Over the coming months, inflation is likely to accelerate again given further Hryvnia depreciation in December (although at a slower pace than in November), planned increases in import duties and excises since the beginning of 2015. Furthermore, inflation would be affected by the need to speed up the adjustment of utility tariffs as Hryvnia depreciation has eroded the fiscal gains achieved by hikes in household natural gas and heating tariffs in mid-2014. As a result, in annual terms CPI growth is forecast to reach 25% yoy at the end of 2014 and may speed up to 28% yoy in 1Q 2015. At the same time, thanks to a growing statistical base effect and subdued domestic demand, year-end inflation is forecast to decelerate to about 18% yoy in 2015, but will remain considerably above a level consistent

CPI Growth by Select Components, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

¹ Apartments up to 60 m² and houses up to 120 m², and commercial property used in agriculture and manufacturing, same as small architectural forms, kiosks and market places are exempted from this tax.

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with price stability. Moreover, given the sizable monetization of fiscal deficits in 2014 and 2015, inflationary pressures are likely to remain elevated over the medium term.

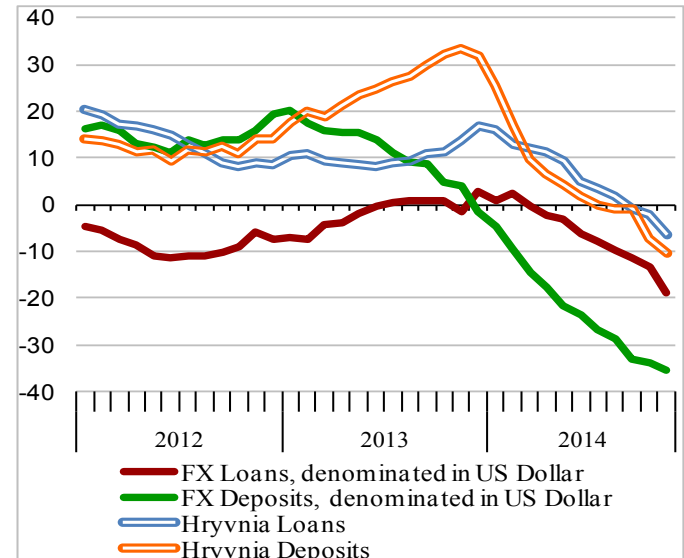
Banking Sector. As anticipated, the resumed Hryvnia depreciation since the beginning of November exerted a toll on the already fragile banking sector of Ukraine. Indeed, deposit outflows, both in Hryvnia and foreign currency, intensified with the stock of these deposits declining by 10.2% and 35.5% yoy respectively in November. Also, Hryvnia depreciation and a deepening economic downturn caused a deterioration in loan quality. According to NBU data, the share of non-performing loans (classified under the 4th and 5th quality categories) grew from about 13% in 3Q 2013 to 17% of the total credit portfolio in 3Q 2014 and is forecast to increase further. All these factors led to liquidity and capital shortfalls. Although the NBU provides necessary liquidity support, which is evident from the high cash balances on the commercial banks' correspondent accounts with the NBU, high interbank interest rates may signal an uneven distribution of liquidity injections. At the same time, due to the economic crisis and restricted access to foreign financial markets, private shareholders' response to bank recapitalization needs was rather weak. As a result, about 35 banks were recognized as insolvent in 2014, out of which 17 have already been liquidated. The number of insolvent banks is likely to continue to rise next year, but as many of these banks are rather small and were supposedly created to serve vested interests of related business companies, the ongoing 'cleanup' should improve the soundness of the banking system of Ukraine.

The Ukrainian authorities, with the assistance of the IMF and other IFIs, developed a bad loan resolution and bank recapitalization program. In particular, given private owners' difficulties in injecting fresh capital, the NBU may allow temporary relaxation of capital adequacy requirements and simplified recapitalization procedures to facilitate the process. Despite strained public finances, the government has recapitalized the state-run banks by about UAH 16 billion in 2014 and enhanced the financial position of the Deposit Guarantee Fund (DGF). In 2015, the government allocated an additional UAH 56 billion for banking sector (including DGF) recapitalization purposes.

At the same time, Ukrainian authorities approved a number of controversial initiatives in late December 2014. Thus, converting household forex-denominated mortgages into Hryvnia will be allowed at the pre-crisis rate (UAH 7.99 per USD). This may help reduce the burden of forex loan servicing for borrowers and thus facilitate the resolution of non-performing loans in the short-term. But it may increase banking sector exposure to credit risk in the future as it undermines borrowers discipline and incentives to repay loans. Moreover, it remains unclear how foreign exchange valuation losses of commercial banks from the conversion will be compensated for. Finally, the approved law that imposes a moratorium on repossession of residential property provided as collateral for forex-denominated loans may suppress commercial banks' lending activity in the future. As a result, commercial banks may continue reducing credit to the Ukrainian economy, while lending activities are likely to be restored very slowly.

Hryvnia Exchange Rate. Following an almost 15% depreciation in November alone, the Hryvnia continued to weaken in December although at a slower pace. Demand for foreign currency remained strong amid high external debt repayments (including the second Naftogaz tranche of \$1.65 billion as payment for Gazprom natural gas consumed at the end of 2013 and 2Q 2014), larger energy imports and relaxation of some NBU restrictions on forex purchases after parliamentary elections. In addition, due to falling exports and lower external debt rollovers, the supply of foreign exchange on the market was rather scarce. Moreover, NBU gross international

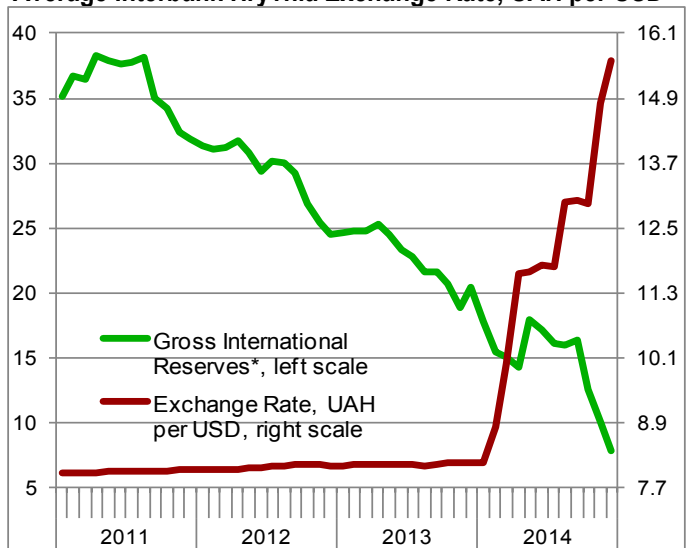
Banking Sector Deposit and Loan Stocks, % yoy



Source: NBU, The Bleyzer Foundation

relaxation of capital adequacy requirements and simplified relaxation of capital adequacy requirements and simplified public finances, the government has recapitalized the state-run banks by about UAH 16 billion in 2014 and enhanced the financial position of the Deposit Guarantee Fund (DGF). In 2015, the government allocated an additional UAH 56 billion for banking sector (including DGF) recapitalization purposes.

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



* Estimate for December 2014

Source: NBU, The Bleyzer Foundation

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reserves fell to a decade low of about \$8 billion by mid-December, limiting the NBU's capacity to smooth exchange rate fluctuations. The current level of reserves is barely enough to cover 1.3 months of imports, less than half of the internationally accepted critical minimum. But thanks to strict administrative measures and banking sector liquidity control, the NBU attenuated Hryvnia depreciation pressures with the Hryvnia losing about 5% of its value in December.

The National Bank of Ukraine, however, cannot control the shadow foreign currency trade, which re-emerged as a by-product of strict administrative measures on the official market. Hryvnia offers on the black market, sometimes exceeding UAH 20 per USD in mid-December, signal about the severity of the Balance of Payments challenges and allow for estimation of the magnitude of Hryvnia depreciation pressures. A number of commercial banks introduced informal commissions in addition to their interbank exchange rate quotations. As a result, the Hryvnia exchange rate of actual deals at the interbank market almost converged with the black market rate, fluctuating in the range of UAH 18.5-19.2 per USD. Although the current Hryvnia exchange rate has notably exceeded the level suggested by PPP estimates, the existing external imbalances will continue to pressure the domestic currency in the near future. At the same time, the expected provision of sufficient foreign financial assistance should calm these pressures. Foreign financing will not only help cover Ukraine's foreign financing needs but will reduce uncertainty over the country's future economic prospects as the financial assistance program is likely to be strictly conditional on economic reform measures that should restore macroeconomic stability and lay the foundation for future economic growth. Under this scenario, the Hryvnia exchange rate is forecast at about UAH 18 per USD in 2015.

International Trade and Capital

Despite adverse developments in Ukraine's external trade, the current account balance continued to improve in November. However, the net external position of Ukraine kept deteriorating that month amid sizable outflows on the financial account. As a result, the Balance of Payments deficit amounted to \$2.5 billion that month, which was reflected in a reduction of NBU gross international reserves to less than \$10 billion as of the end of November 2014.

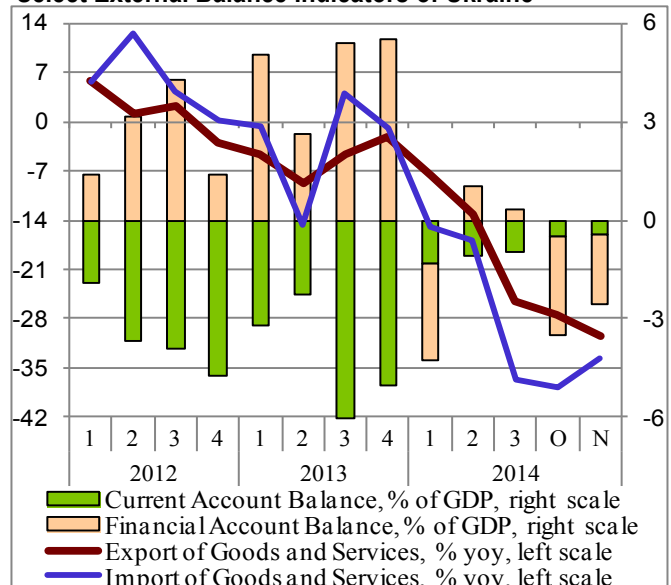
As anticipated, Ukraine's merchandise exports weakened further in November 2014, declining by 27.7% yoy, which resulted from a combination of trade restrictions imposed by Russia on select Ukrainian goods (e.g., in mid-November Russia banned imports of cheese products from Ukraine), transport infrastructure damages due to hostilities in the east and Russia's annexation of Crimea as well as downward movements of world commodity prices. Indeed, according to FAO estimates, world food prices were down by 6.4% yoy in November. In addition to the fact that a large number of export-oriented industrial enterprises (including metallurgical plants) are situated on rebel-held territory, world carbon steel prices have been declining since mid-2014 and were 7% yoy lower in November 2014, an almost 5 year low according to MEPS, an independent supplier of steel market information. At the same time, the EU extension of a preferential trade regime with Ukraine for 2015, a high agricultural harvest, and Russia's imposition of grain export restrictions (Ukrainian exporters may benefit from both lower competition on the market and a likely increase in world grain prices) provide reason to expect some improvement in Ukraine's export performance over the coming months.

The Hryvnia depreciation, declining household consumption and sluggish business activity coupled with lower volumes of natural gas imports led to a decline in total merchandise imports of about 37% yoy on average over July-November 2014. A slightly slower decline of 34% yoy in November may be attributed to higher demand for imported fossil fuels due to domestic supply shortages (e.g., coal) as well as a less favorable statistical base effect. Given weak domestic currency, the government initiative to impose additional import duties and substantial downward revision of world crude oil price forecasts for 2015, Ukrainian imports are likely to continue declining in 2015. Despite subdued exports, this should help narrow the current account deficit to about 1.5% of GDP in 2015, down from an estimated 4% of GDP in 2014.

Unlike the current account, the prospects for the financial account balance in 2015 are less favorable. Indeed, foreign investors' confidence has been undermined by the sharper-than-anticipated Hryvnia depreciation, the military conflict, a receding economy, significant challenges faced by the Ukrainian banking sector, and delays in IMF disbursements and in the implementation of structural reforms. Widespread uncertainties and a deteriorating outlook fueled capital flight in 2014 and virtually closed foreign financial market access for Ukraine's sovereign borrowings. Although the net inflows in direct investment resumed in May, their monthly flows remained relatively small, amounting to only \$80 million in November 2014. Rollover rates for banks and corporate entities fell sharper than anticipated to 85% and 55% in November 2014, respectively.

Ukraine's private sector access to foreign financial markets is likely to remain restricted in 2015. In addition, the country will

Select External Balance Indicators of Ukraine



Source: NBU, The Bleyzer Foundation

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need to repay about \$10 billion of its maturing sovereign and quasi-sovereign external debt liabilities next year. At the same time, large energy import bills will prevent the current account balance from shifting into surplus, despite the fall of the Hryvnia by about 48% against the US Dollar in 2014. As a result, the country will require additional financial assistance in 2015, on top of the funds envisaged in the already approved \$27 billion international assistance package. According to various estimates, Ukraine will need around \$15 billion of additional funds to meet its high external financing needs and replenish its gross international reserves to a level covering 2 months of imports. An IMF mission visited Ukraine in the middle of December and the next round of discussions are scheduled for the beginning of January 2015. The approval of the fiscal budget law for 2015 is seen as an important step towards unlocking international financial aid. But given that the budget has significant risks, negotiations may not be easy. According to our baseline scenario, Ukrainian authorities will expediently approve the necessary conditionality requirements, while the financial aid program will be expanded for the required amounts. Moreover, the first tranche disbursement will be sizable enough (around \$5 billion) to improve market sentiment and ease financing concerns in case of Russia's request for early repayment of the \$3 billion bailout loan granted to Ukraine in late 2013. If these assumptions do not materialize, Ukraine may face a severe financial crisis in 2015.

Ukraine's Private Sector External Debt Rollover Ratios*

	2013	2014				
		1	2	3	Oct	Nov
Banks	87%	111%	82%	95%	91%	85%
Corporate	106%	0.7	85%	57%	49%	55%

* Excluding Eurobonds and overnight credit

Source: NBU