Ukraine
Macroeconomic Situation

Olga Pogarska, Djulia Segura
Edilberto Segura

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- On February 12th, a new agreement between Ukraine and Russia under the brokerage of Germany and France on conflict resolution in Donbas was reached. Although the rebels' implementation of the agreement was delayed and the risks remain high, it gives a fragile hope for de-escalation and a gradual settlement of the conflict.
- The President of Ukraine proposed a UN peacekeeping mission for the region. Although this proposal has been actively discussed, its prospects remain unclear amid a possible Russian veto and positive signs of implementation of the Minsk-II agreement.
- On February 12th, the IMF mission announced a staff level agreement with the Ukrainian government on a new four-year $17.5 billion loan. The total international financial aid package will reach $40 billion for the period.
- Real GDP declined by 15.2% yoy in 4Q 2014, while the full-year decrease is estimated at 7% yoy.
- The main causes of the economic contraction in 2014 will continue to effect real sector performance in 2015, but the negative contribution of falling domestic demand will take the lead this year.
- Fiscal data for January 2015 was rather disappointing, confirming the need for the 2015 budget law revision. Although amendments to the budget law were developed based on a revised macroeconomic forecast and were agreed with the IMF, the fulfillment of fiscal targets raises concerns.
- Consumer price inflation accelerated to 28.5% yoy in January. Given more ambitious government plans for utility tariffs and other regulated prices adjustment, we revised our year-end inflation forecast to 30% yoy in 2015.
- On February 5th, the National Bank of Ukraine abolished indicative rates and allowed the Hryvnia to free float. Due to a combination of a number of adverse developments (delays with the implementation of the Minsk-II agreement, uncertainties related to the IMF program and announced external debt restructuring), the Hryvnia lost almost half of its value in February and reached UAH 30 per USD by the end of the month.
- Another wave of Hryvnia depreciation will help further improve Ukraine's current account balance, but will aggravate difficulties in the banking sector and public finances, and will contribute to acceleration of inflation.
- Realizing that the benefits from weak domestic currency for Ukrainian producers and exporters are restricted by structural rigidities (i.e., a poor business environment), while the announced plan of reforms will take time to produce its first results, the NBU tightened forex market administrative regulations to contain Hryvnia depreciation.
- The likely approval of the IMF program and an expected sizable first tranche disbursement should help stabilize the foreign exchange market of Ukraine.

Forecast of Main Macroeconomic Indicators for 2015

	2011	2012	2013	2014[e]	2015[f]
GDP, $ billion	163.4	176.6	182.0	127.4	77.2
Real GDP Growth, % yoy	5.2	0.2	0.0	-7.0	-8.0
Private Consumption, real growth, % yoy	15.0	11.7	7.8	-7.0	-4.0
Fiscal Balance, incl. Naftogaz and Pension Fund, % of GDP	-4.3	-6.0	-6.5	-11.7	-7.5
Public Debt, % of GDP	36.3	36.6	40.5	72.0	103.0
Consumer Inflation, eop, % yoy	4.6	-0.2	0.5	24.9	30.0
Hryvnia Exchange Rate per USD, eop	8.0	8.0	8.0	15.8	28.0
Current Account Balance, % of GDP	-6.3	-8.1	-9.0	-4.1	-0.5
FDI ($ billion)	7.0	6.6	3.3	0.2	0.5
International Reserves ($ billion)	31.8	24.5	20.4	7.5	13.0
External Debt ($ billion)	126.2	135.1	142.5	135.0	153.0

Political Developments

Following the surge in fighting in Donbas in mid-January, diplomatic efforts to resolve the crisis have also intensified. On February 12th, after lengthy negotiations in Minsk, the leaders of Ukraine, Russia, Germany, and France reached an agreement, which included the ceasefire between Ukrainian forces and Russian-backed rebels starting at midnight on February 15th, the withdrawal of heavy weaponry from a compromise line (Ukrainian forces from the current front line and rebels from the demarcation line agreed according to September's Minsk agreement), a release of all prisoners and amnesty for those involved in fighting, the withdrawal of foreign troops from Ukraine and disarmament of illegal groups, and a restoration of Ukraine's control over its border with Russia after constitutional reform that grants more autonomy to the regions and local elections (both to be completed by the end of 2015).

As the truce was to come into effect only on the third day of the agreement, fighting escalated around the strategically impor-

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

tant town of Debaltseve (a strategic railroad junction and a critical highway linking the two separatist-held areas of eastern Ukraine). Hostilities continued after the ceasefire as rebels announced the agreement did not apply to the town as it was almost surrounded, although the Ukrainian military denied this. After heavy battles, the Ukrainian forces retreated from the town on February 18th. In addition, although Ukraine and rebels have exchanged dozens of prisoners, Russia refused to release Ukrainian pilot Nadia Savchenko, claiming she was under ongoing investigation and only a Russian court could decide on her guilt or innocence. Ms. Savchenko was captured by the rebels in June 2014 and illegally taken to Russia, where she was detained and is being prosecuted for charges in her involvement in an attack that killed two Russian journalists.

The Russian-backed rebels' disregard of the Minsk II agreement cast doubts on the future of the agreement and raised calls from both Ukraine and abroad for the West to provide military aid to Ukraine. As an alternative, Ukrainian President Poroshenko has proposed a UN peacekeeping mission for the region. Russia and the rebels strongly opposed the proposal, asserting that this would violate the Minsk II agreement. Given a possible Russian veto on any UN Security Council mandate as well as Western leaders' concerns that providing weapons to Ukraine may aggravate the violence in the region, the prospects of both initiatives (sending military aid and an international peacekeepers mission) remain unclear. In the meantime, during the last week of February, the intensity of fighting receded and both sides started to pull back heavy weapons from the front line at the end of the month. The OSCE special mission has been monitoring the process, but notes the rebels' unwillingness to cooperate and provide safe access to OSCE monitors. Moreover, there is still a risk that rebels are just regrouping their troops to other areas (e.g., Mariupol, a strategic sea port and industrial center in the southeast of Ukraine.)

On February 12th, the IMF mission announced a staff level agreement with the Ukrainian government on a new four-year $17.5 billion loan. The new program will be part of a $40 billion international bailout package for Ukraine, which will also include bilateral loans (from the EU, US and others) as well as savings from Ukraine's external debt (bonds) restructuring, targeted to reach $15 billion. The new IMF Extended Fund Facility Arrangement will replace the previous Stand-By program, stalled in mid-2014 amid escalation of hostilities in the East of Ukraine, deeper economic downturn and parliamentary elections, which entailed a government reshuffle and delayed implementation of reforms. The deal, which is still subject to approval from the IMF board, is strongly conditioned on the implementation of economic reforms, including the energy sector, deregulation, tax system and customs, strong anti-corruption measures, a flexible exchange rate regime, and fiscal adjustment measures, such as freezing nominal wages and pensions, raising utility tariffs and cutting expenditures. While the announced foreign assistance will substantially help address Ukraine's high foreign financing needs, uncertainties regarding the timing and the size of the first aid disbursements and the details of the announced debt restructuring process failed to boost confidence among both domestic and foreign investors. This led to a further plunge in the national currency, which may deepen economic distress in the country. Given the strong commitment of the Ukrainian authorities to meet the IMF's prior actions, we expect the necessary measures to be approved at the beginning of March and a positive IMF board decision on a new loan to Ukraine with an expedient and sizable disbursement of the first tranche. With the international donors' financial support and improved clarity on bond restructuring process, Ukraine should be able to stabilize the macroeconomic situation over the next few months, while a broad-based reform program may help resume growth in 2016.

Economic Growth

According to preliminary data of the State Statistics Service of Ukraine, the decline in real GDP deepened to 15.2% yoy in 4Q 2014. As a result, according to our estimates, the Ukrainian economy fell by a real 7% yoy in 2014. A marked deterioration in real sector performance in the last quarter of 2014 (compared to a 5.3% yoy decline in 3Q) was fully anticipated amid growing damages caused by the military conflict in industrial Donbas (directly due to the rebels' seizure of large territories in the region, where many enterprises of metallurgy, machine-building, chemical and mining industries are located and destruction as a result of fighting, and indirectly due to disruptions in production and transportation links between the regions), increasing pain of fiscal consolidation, sharp Hryvnia depreciation, accelerating inflation and credit squeeze for households and businesses. Exports reported deeper declines in the second half of 2014, responding to Russia's expansion of trade restrictions on select Ukrainian goods imports and overall deterioration of relations with Russia. All of these forces will continue to shape economic performance in 2015. At the same time, as imports will continue to decline and the announced structural reforms may start to bear early fruit at the end of this year, we forecast real GDP to decrease by about 5% yoy in 2015.

Select Real Sector Indicators for Ukraine

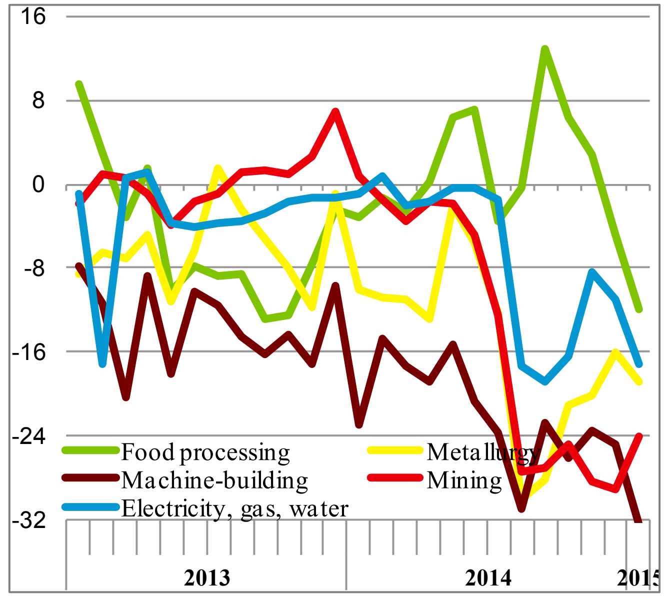
	2015 1m	2014	2013	2012	2011	2010
Agriculture	-2.4	2.8	13.3	-4.5	17.5	-1.5
Industry	-21.3	-10.7	-4.3	-1.8	7.6	11.2
Construction works	-36.6	-21.7	-11.1	-14	11.1	-5.4
Domestic trade, turnover						
Wholesale trade	-19.2	-15	-2	-4.4	0.6	0.4
Retail trade	-22.6	-9.6	9.5	15.9	14.7	9.8
Transportation, turnover						
Cargo	-23.5	-10.8	-3.9	-7.6	5.7	6.4
Passenger	-13.4	-11.7	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Real sector data for January 2015 was in line with our expectations. The decline in the industrial sector deepened to 21.3% yoy amid escalation of fighting in the second half of the month and a worsening external environment (falling world commodity prices). As in previous months, mining, coke, chemical and metallurgy industries were the hardest hit, reporting 24% yoy, 51.5% yoy, 21.6% yoy and 19% yoy drops in output, respectively. Limited export opportunities and falling domestic demand underpinned a 32.5% yoy decrease in machine building.

In contrast to the previous year, agriculture also reported a 2.4% yoy decline in output, which may be attributed to rising production costs (e.g., domestic grain prices, one of the main production costs for animal breeding, rose by 91% yoy in January 2015) and falling domestic consumption. The latter, underpinned by a continuing decline in real wages (by 13.6% yoy and 17.3% yoy in December 2014 and January 2015, respectively) and the adverse income effect of Hryvnia depreciation, also weighed on domestic demand-dependent sectors. Thus, retail sales turnover fell by 22.6% yoy, the food processing industry reported an almost 12% yoy decline in output production, while manufacturing of cars plummeted by about 80% yoy. Amid a severe credit squeeze and deteriorating financial positions of both households and legal entities, the construction sector kept declining, posting a 36.7% yoy decline in the real value of construction works.

Monthly Output Production by Select Industries, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

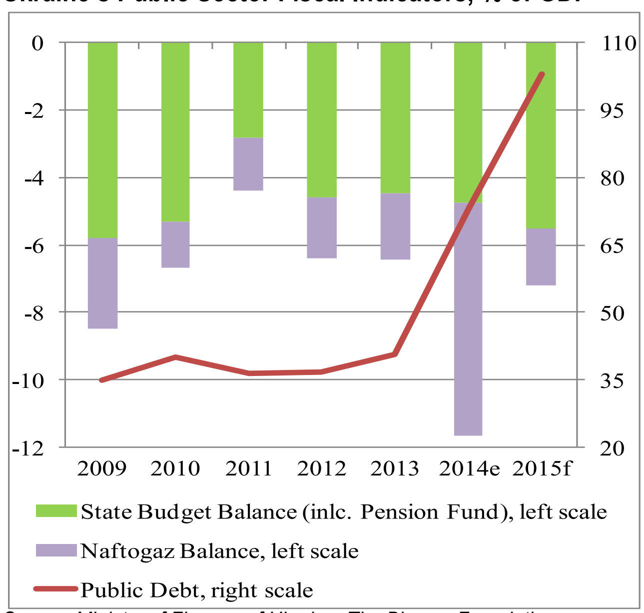
Fiscal Policy

Fiscal data for the first month of 2015 confirmed our concerns that the proposed government measures reflected in the approved budget law for this year and its related legislation may not be sufficient to correct growing public sector imbalances. Although some of the approved reforms (business deregulation, simplification of tax administration, anti-corruption measures, etc.) are expected to produce favorable results over the longer term, the government needs convincing fiscal adjustment measures to prevent Ukraine's public debt from running out of control.

Thus, despite a number of tax increases (excises, royalties, etc.) and accelerating inflation, total state budget revenues declined by a nominal 11.7% yoy in January. In contrast, state budget expenditures rose by 17.3% yoy amid almost twice as high public debt service and defense expenditures (95% yoy and 83% yoy, respectively) and an almost 50% yoy increase in transfers to local budgets. Although the reported state budget deficit for January 2015 may not be fully comparable with the respective number last year due to the absence of NBU profit transfers this year, poor budget revenue performance clearly signaled for the need of additional fiscal corrective measures.

As anticipated, following negotiations with the IMF and the first fiscal data for this year, the government developed amendments to the budget law. Although the new budget parameters were agreed with the IMF, the revised budget still raises a number of concerns and is likely to be corrected again during the year taking into account budget performance indicators for 1Q and/or 1H of 2015. As a result, we keep our public sector fiscal deficit forecast at around 8% of GDP in 2015.

Ukraine's Public Sector Fiscal Indicators, % of GDP



Source: Ministry of Finance of Ukraine, The Bleyzer Foundation

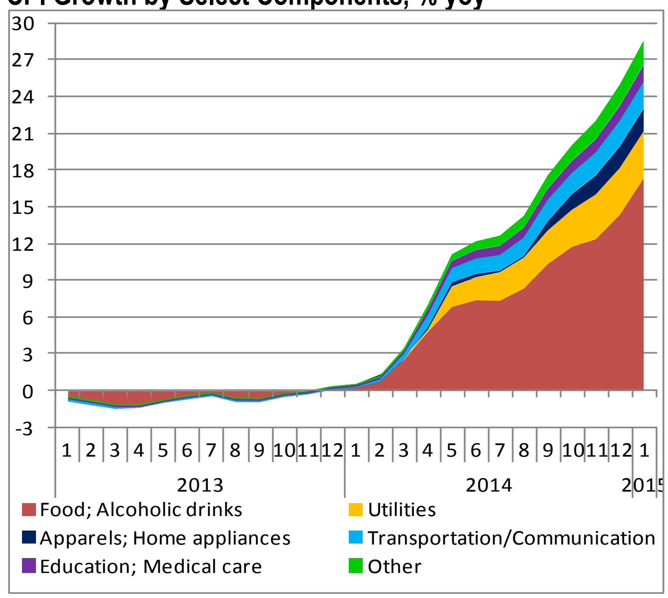
The amended state budget parameters were developed based on a revised macroeconomic forecast. Indeed, the forecast of real GDP decline was worsened from the previous 4.3% yoy to 5.5% yoy, while the nominal GDP estimate was improved from UAH 1720.8 billion to UAH 1850.2 billion, which is principally related to a higher inflation forecast (26.7% yoy in December 2015 compared to previous projections of 13.1% yoy). In addition, the new budget indicators were calculated taking into account the average Hryvnia exchange rate at UAH 21.7 per US Dollar (up from about UAH 17 per USD before). Based on a revised macroeconomic forecast and a number of legislative initiatives effecting both the revenue and expenditure side of the budget (e.g., the government proposed to increase rental duties for extracted natural gas, to cap pension benefits for working pensioners, etc.), state budget revenues and expenditures are going to be raised by 4.7% and 6.7% compared to the previous plan and 37% and 34.7% compared to the previous year, respectively. As a result, the state budget deficit will amount to UAH 74 billion, or about 4.1% of GDP (up from the previous 3.7% of GDP). At the same time, expenditures on energy subsidies to Naftogaz will be reduced to UAH 29.7 billion or (1.63% of GDP), on account of faster adjustment of natural gas tariffs to population.

Despite a relatively realistic macroeconomic forecast and further increases in taxes, the amended fiscal revenue plan may be quite difficult to achieve as a number of individual tax targets look overly optimistic. For instance, receipts from corporate profit tax are planned to increase further by 6.9% compared to the previous target despite their poor execution in January, growing financial losses in the corporate sector and vague prospects for improving corporate financial results in the short-term. Indeed, in January, proceeds from the corporate profit tax were down by almost 40% yoy. Moreover, government plans on higher proceeds from rent payments of natural gas extraction may also not fully realize due to the presence of vested interests in the areas related to fossil fuel extraction. Furthermore, receipts from import duties may fall short of the targeted amount due to likely sharper decline in imports amid further significant Hryvnia weakening in February 2015. For the latter reason as well as higher utility subsidies for the population following an ambitious program of utility tariff and regulated price adjustments, fiscal budget expenditures may exceed the year-end target.

Monetary Policy

Inflation. As anticipated, consumer price inflation remained on an upward trend at the beginning of 2015. According to the State Statistical Service of Ukraine, the consumer price index rose to 28.5% yoy in January driven by changes to indirect taxes, the continuing pass-through of Hryvnia depreciation through import prices and secondary effects of Hryvnia depreciation (e.g., through growing transportation costs), and high inflation and depreciation expectations. In particular, the hike in excise duties and broadening of their tax base[1] contributed to the acceleration in price growth of tobacco products and alcoholic drinks (to 30% yoy) and transport vehicles (to 84% yoy). In contrast, fuel prices decelerated slightly to 59.5% yoy, as the continuing fall in world crude oil prices offset the impact of excise tax increases and Hryvnia depreciation (according to the official exchange rate, the Hryvnia depreciated by about 2.5% in January compared to the previous month). At the same time, sharp Hryvnia depreciation in previous months and expectations of further national currency weakening continued to contribute strongly to the price growth of imported goods. Thus, prices on fruits, fish products, home appliances and drugs and medical equipment sped up to 73%, 47%, 34% and 49% in annual terms, respectively. In addition, rising transportation and utility costs have been affecting the broad range of consumer retail goods prices. On the downside, early discounts and stock sales contained the price growth on clothes and footwear, which slowed to 14.3% yoy in January 2015. Falling domestic demand suppressed service price inflation. Thus, the costs of education, culture and recreation, restaurant and hotels advanced by relatively moderate rates of 7% yoy, 12.5% yoy, and about 16% yoy, respectively.

CPI Growth by Select Components, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Looking ahead, consumer price growth in 2015 will be underpinned by two major forces – continuing Hryvnia depreciation and adjustment of utility tariffs and other regulated prices. Just in February, the Hryvnia lost about half of its value with respect to the US Dollar. As anticipated, the strained fiscal budget situation and the need to return public finances to a sustainable path prompted Ukrainian authorities to adjust utility tariffs faster. In particular, the government already announced that natural gas and heating tariffs to the population will be raised by 280% and 66% starting April 1st, respectively. Electricity prices for households will be increased to a cost-covering level (from about 21% of its production costs as of the beginning of 2015, according to the National Commission for State Energy and Public Utilities Regulation of Ukraine) in two years. In 2015, electricity tariffs will be raised by a weighted average of 36%[2] starting April 1st and by another 25% starting September 1st. Given the rapid increase in fuel prices and transportation costs, Ukrainian authorities started to adjust public transportation tariffs. Indeed, at the beginning of February, public transportation tariffs were doubled in Kyiv, the capital of Ukraine, and many other local authorities have been considering an increase in public transportation tariffs by about 40%-100% in the near term. Many prices will also be pressured upwards due to increases in railroad transportation fares (passenger fares will

[1] According to amendments to the Tax Code of Ukraine and select legislative acts approved at the end of December 2014 and linked to the approval of 2015 State Budget Law, a 5% levy on retail sales of excisable products was introduced starting January 1, 2015. In addition, the list of excisable goods was broadened to include electricity, products used as components for motor fuels, select vehicles (such as trucks and buses, electric cars, etc.)

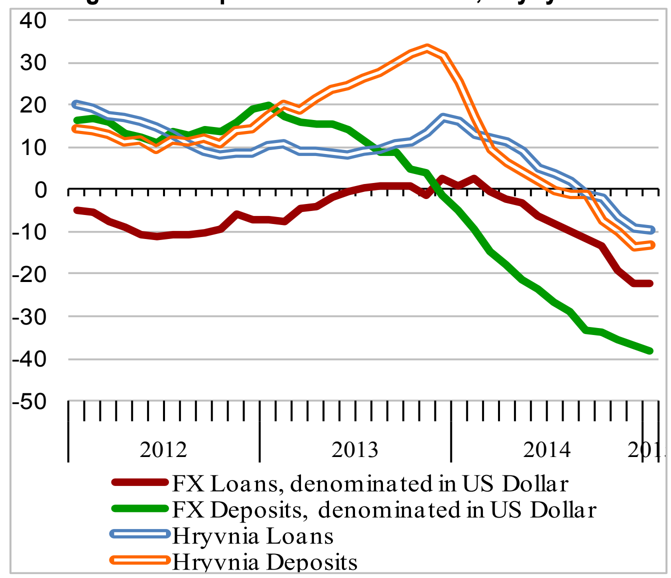
[2] Electricity tariffs for the population are volume-differentiated. According to the National Commission on Electricity and Public Utilities Regulation of Ukraine, tariffs will be increased by 19% and 25% for households consuming less than 100 kWh of electricity (about 42% of total households), by 50% and 25% for those consuming less than 600 kWh (56% of total) and by 5% for those who consume more than 600 kWh (about 2% of total) since April 1st and September 1st 2015, respectively.

be raised by about 20% in three steps during March-May 2015, cargo fares[3] were increased by 30% at the end of January 2015 and are planned to be raised by another 25% later this year).

The continuing contraction in economic activity and the notable reduction in real wages (nominal wages and pensions will be mostly frozen in 2015 with a planned increase of about 13% only in December 2015) will have a dampening effect on price growth during 2015. Moreover, the National Bank of Ukraine raised its discount rate by 5.5 percentage points to 19.5% in February 2015 to anchor inflation. However, the effectiveness of this move is likely to be undermined by a continuing, though less sizable than in 2014, monetization of public sector deficit. Given also the much more aggressive adjustment in administratively regulated prices than previously anticipated and sharper Hryvnia depreciation, we have revised our year-end inflation forecast upwards to 30% yoy in 2015.

Banking Sector. The banking sector of Ukraine continued to be under significant stress. Rising inflation, Hryvnia depreciation, administrative restrictions on deposit withdrawals and foreign currency transactions, and an increasing number of insolvent banks kept driving depositors' run on Ukrainian banks. Indeed, following a 13% yoy and 37% yoy decline in Hryvnia and foreign currency (denominated in US Dollar) deposits in 2014, respectively, the stock of deposits continued to decline in January 2015 (by 13% yoy and 38% yoy, respectively). Continued deposit outflows aggravate other financial difficulties in the banking system, stemming from rapid deterioration in the quality of commercial banks' credit portfolios and relatively high external debt financing needs.

Banking Sector Deposit and Loan Stocks, % yoy



Source: NBU, The Bleyzer Foundation

Deep economic crisis, hostilities in the East and sharp Hryvnia depreciation (foreign currency loans still accounted for more than 1/3 of total commercial bank loans to the private sector as of the end of 2013) led to a notable increase in commercial banks' non-performing loans (defined as the IV and V credit quality category), the share of which in total loans grew from less than 13% in 4Q 2013 to 19% in 4Q 2014. At the same time, given that the most widely used definition of non-performing loans also includes substandard loans (not timely-services), the share of NPLs likely stood much higher (it exceeded 27% already in 2Q 2014, according to IMF estimates). The existing gaps and loopholes in Ukrainian legislation (particularly in the areas of corporate insolvency, mortgages, enforcement proceedings, etc.) contributed to the build-up of non-performing loans and complicate their resolution. Parliamentary hearings 'On the ways to stabilize the banking system of Ukraine', held in mid-February 2015, revealed monetary and legislative authorities' awareness of the causes of banking sector weaknesses and broad consensus on the required legislation amendments to address the sector's difficulties and enhance the banking crisis resolution. Among other proposed measures, the previous initiative of converting household forex-denominated mortgages into Hryvnia at the pre-crisis rate was rejected. Instead, commercial banks have been developing individual programs of forex loan restructuring, which may foresee a write off of up to 50% of a loan and a conversion into Hryvnia of the remaining part at a current rate.

The credit boom of 2005-2008 was mainly financed by borrowed funds on foreign financial markets. Indeed, the stock of Ukraine's banking sector external debt grew almost 16 times during these years. In part, such an increase was attributed to a strong influx of foreign banks into the Ukrainian banking sector, attracted by great potential of the industry amid low market penetration and impressive economic growth since 2000. However, the economic and financial crisis of 2008-09 and delays in implementation of structural reforms prompted many foreign banks and investors to revise their strategies and even exit from the Ukrainian market. Although a number of foreign parent banks continued to support their subsidiaries in Ukraine, the Ukrainian banking sector recorded net external debt outflows since 2009 (except for 2013). Although the stock of external debt liabilities fell to about $20 billion as of the end of September 2014 (down from more than $42 billion in September 2008), the sector's external debt financing needs remain high as about 63% of these liabilities need to be repaid within a year. Given sharp Hryvnia depreciation and virtually closed foreign capital markets, high short-term external debt liabilities contributed strongly to Ukrainian banking sector difficulties.

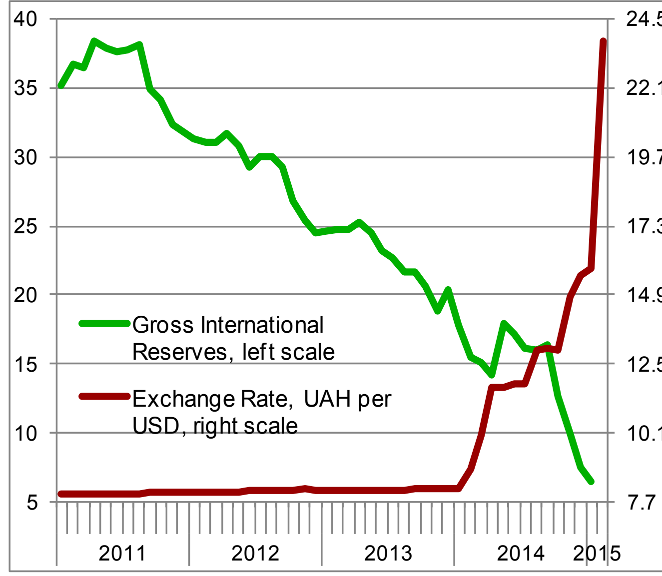
The National Bank of Ukraine continued to support the banking sector by providing refinancing funds. Moreover, announced legislative initiatives should help address a number of banks' difficulties and resolve the banking crisis. However, implementation of banking sector reform measures may take some time, leading to a growing number of insolvent banks and continuing the credit squeeze.

Hryvnia Exchange Rate. As anticipated, the somewhat faster depreciation of the official Hryvnia exchange rate with respect to the US Dollar at the end of January and the beginning of February was part of the NBU's preparatory steps for a fully free

[3] Given that railways accounted for almost 63% of total freight turnover (in 2014), a rise in cargo fares has a profound impact on many retail prices.

floating Hryvnia exchange rate regime, which was actually implemented on February 5th. By abolishing foreign currency auctions and indicative rates, the NBU aimed at converging the official, grey (interbank market rate with unofficial commission) and black market rates, which should have contributed to activity reduction on grey and black markets. Although the NBU decision was principally rational, the timing of its implementation seemed to be not fully justified. First, the existence of strict administrative restrictions did not eliminate the black market for foreign exchange transactions. Second, uncertainties surrounding the approval of a new, more sizable, foreign financial aid package added to market instability. Third, the announced IMF program failed to calm market concerns over the sufficiency of foreign funds to cover Ukraine's short-term foreign financing needs. Moreover, uncertainties related to the announced debt restructuring program increased the risks for foreign creditors, which likely led to early debt repayments and a further decline in rollover ratios. Fourth, a protraction with the implementation of prior IMF requirements led to a postponement of the IMF Board meeting to mid-March and raised the risks that the IMF would delay its financing to Ukraine. Finally, the escalation of the military situation during January and most of February as well as the fragile Minsk-II ceasefire agreement contributed to forex market nervousness.

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



Source: NBU, The Bleyzer Foundation

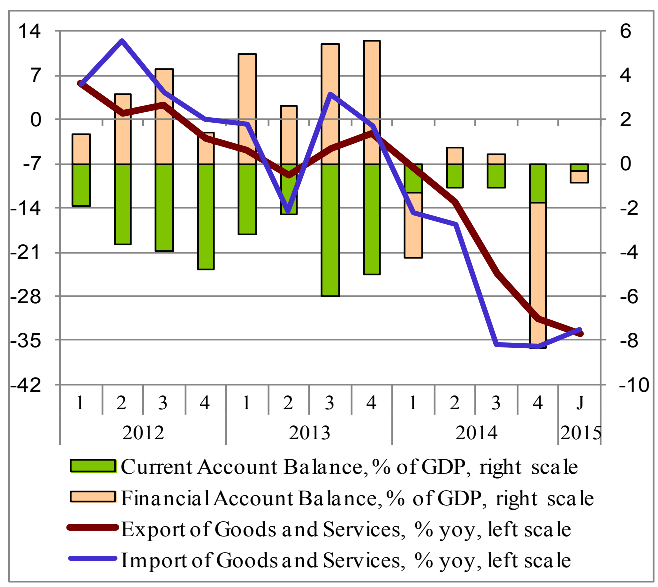
A combination of these factors led to the Hryvnia exchange rate overshooting to UAH 33 per USD on the interbank market by the end of February. Such a strong depreciation led the NBU to introduce new administrative restrictions, which virtually eliminated foreign currency trade on the interbank market on February 25th. Although some of the new regulations (such as a ban on commercial banks buying foreign currency on the interbank market at the request of their clients and permission for banks to purchase foreign currency within their open currency position limits but in amounts not exceeding 0.5% of the banks' regulatory capital) were abolished later the same day, the tightening of forex purchase regulations caused a notable reduction in foreign currency demand. Thus, the NBU prohibited the purchases of foreign currency for borrowed Hryvnia funds, required the NBU registration of advance payments for import contracts with the total value exceeding $50,000 and a letter of credit from the investment-grade banks for advance payments for imported goods if the total value of a contract exceeds $500,000. Foreign currency bids can be satisfied only on the fourth day or after the filing of all documents and a transfer of Hryvnia on a special account. Finally, a purchaser of foreign currency (legal entity) should supply a document from a tax administration confirming the absence of tax arrears. As a result of these measures, the Hryvnia slightly appreciated to UAH 28.5 per USD by February 27th, while the NBU was able to purchase small amounts of foreign exchange to replenish its depleted international reserves.

We believe that a favorable IMF board decision on a new loan program for Ukraine and an expedient and quite sizable disbursement of the first tranche should help stabilize the foreign exchange market. Until then, the NBU will keep using administrative restrictions to suppress Hryvnia depreciation pressures. However, considering the magnitude of the recent overshooting, anxiety over the debt restructuring program and risks to the smoothness of the IMF program implementation, the Hryvnia is now forecast to fluctuate at around UAH 25-30 per USD during 2015.

International Trade and Capital

Preliminary data on Ukraine's Balance of Payments in January showed continued improvements in the country's current account and protracted difficulties in the financial account. Following a substantial narrowing to about 4% of GDP in 2014, January's current account posted an 18% lower deficit than a year ago. The improvement was achieved on account of a narrower trade deficit, which offset lower surpluses on service trade balance and current transfers and a wider deficit on the income account. On the financial account, a moderate net inflow of direct investment and net sales of cash foreign exchange

Select External Balance Indicators of Ukraine



Source: NBU, The Bleyzer Foundation

by the private sector helped partially offset high net lending abroad (capital outflow) principally linked to repayments of external debt liabilities by the corporate sector of Ukraine (both financial loans and trade credits). As a result, the deficit on the financial account was about 60% lower than in January and December last year. However, as both the current and the financial accounts remained in deficit, the corresponding gap in the Balance of Payments was covered through a further decrease in reserve assets. Indeed, NBU gross international reserves fell another 14.8% in January and reached $6.4 billion as of the end of the month.

In the goods foreign trade balance, exports kept declining at a strong pace of 31.5% yoy, which was attributed to military escalation in the East, ongoing downward correction of world commodity prices, continuing deterioration of trade with Russia and limited domestic supply response to Hryvnia depreciation due to structural restrictions (poor business environment, high dependence on imported raw materials, outdated technology, etc.). Hostilities in Donbas led not only to the loss of control over a number of industrial enterprises and transportation hubs, which are now located on rebel-held territories, significant infrastructure damages in the area of active fighting, but also caused heavy disruptions in production links with other companies and traditional transportation routes (e.g., a significant enhancement of fighting in close proximity to Mariupol exerted a heavy toll on the workload of the city's sea trading port, the largest sea port in the eastern Ukraine used to be called "Sea Gates of Donbas"). The warlike operation in the region, combined with downward trending world commodity prices, particularly hit Ukraine's metallurgical industry. As a result, exports of metallurgical products fell by 32.5% yoy in US Dollar value terms in January 2015. Shipments abroad of machinery and equipment and transport vehicles plummeted by 45% yoy, suffering from deteriorating trade relations with Russia (as a result of both Russia's trade restrictions and Ukraine's voluntary limitations on deliveries of military and dual-purpose equipment to Russia). A continuing deep depression in domestic oil refining industry and shortages of coal supplies led to a 57% yoy decline in exports of mineral products. Despite a record high agricultural harvest in 2014, exports of agro and food products fell by almost 16% yoy in value terms in January, dampened by falling international grain prices amid ample supply and high inventories and unfavorable base for comparison related to Russia's expansion of restrictions on Ukrainian food imports in the second half of 2014.

On the import side, due to lower volumes of natural gas purchases from abroad, particularly from Russia, a notable reduction in economic activity and domestic demand, and falling world energy prices, imports continued to decline at a faster pace than exports. In January 2015, the US Dollar value of merchandise imports was more than 1/3 lower than in the corresponding period last year. However, despite sharp Hryvnia depreciation, Ukraine continued to import more than it exports. Domestic supply side structural rigidities (related to a poor business environment and high costs of running a business) may be the reason that prevents Ukrainian producers and exporters from fully benefiting from weakened domestic currency and limiting import substitution. At the same time, amid further strong depreciation of the Ukrainian Hryvnia in February and government initiatives to introduce additional 5-10% import duties, the decline in imports may be even more significant than was previously anticipated.

Despite anticipated lower surplus on services, likely due to lower exports of pipeline transportation (as a result of Russia's greater reliance on alternative to Ukrainian pipelines and lower natural gas transit due to a warm winter in Europe this year and the EU diversification of energy supplies) and travel, Ukraine's current account is forecast to report a small deficit of around 0.5% of GDP in 2015.

On the financial account, escalation of military conflict in Donbas and uncertainties related to the foreign financial aid package led to a continuing decline in external debt rollover ratios for Ukraine's private sector in January (to 28% and 74% for banking and corporate sectors, respectively, according to NBU data). Strong capital outflows are likely to persist over the next few months amid the lack of details over the external debt restructuring program announced by Ukrainian authorities at the beginning of February. In particular, the government plans to save around $15 billion on bond restructuring; however, no other details of the plan (such as whether haircuts will be requested or just extensions, whether the program will refer only to sovereign bonds or will include private sector Eurobonds, whether $3 billion debt to Russia due in 2015 will be included, etc.) were revealed. These uncertainties coupled with more protracted negotiations on a new foreign financial assistance program for Ukraine likely led to further decline in rollover ratios, feeding strong Hryvnia depreciation pressures. Approval of the IMF program and a relatively sizable and quick first tranche disbursement should help enhance foreign investors' confidence. The international practice suggests that the market reaction to the debt restructuring may be subdued if it is discussed ex-post. In the Ukrainian case, the foreign investors' response and behavior may be softened if greater details about government debt restructuring plans are provided. Overall, the financial account is forecast to stay in deficit in 2015. At the same time, according to our baseline scenario, a sizable foreign financial aid program will be sufficient to cover the forecast Balance of Payments deficit and to replenish NBU gross international reserves to about $13 billion as of the end of 2015.