

*January 2016**Oleg Ustenko, Julia Segura, Valentyn Povrozhnyuk
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Executive Summary:

- ❖ Ukraine's political situation deteriorated rapidly during the recent past. The resignation of key government ministers, including the resignation of the Minister of Economic Development and Trade, highlight the high degree of corruption that still prevailing in the country and the low pace of reforms. The IMF has stated that without quick reforms, the IMF Program may be suspended.
- ❖ On the military front, in accordance to the Minsk-2 agreement, the Ukrainian army continues to hold the ceasefire in Donetsk and Luhansk regions, while Russia-backed separatists continue their military provocations.
- ❖ The NBU reported that in Q4 2015 the decline of GDP decelerated to 3.2% yoy, compared to declines of 7.2% yoy in Q3, 14.6% yoy in Q2 and 17.2% yoy in Q1. On this basis, GDP may fall by 10.5% in 2015 and show a positive growth of about 2% in 2016.
- ❖ High-frequency monthly data shows that in December 2015, the construction sector performed well, with construction output increasing by 10.4% yoy, compared to a decline of -9.5% yoy in November 2015.
- ❖ Other sectors showed moderation in their output contractions. In fact, in December 2015 the agricultural production index slowed down its decline to -6.4% yoy, compared to -11.1% yoy in the previous month. Similarly, the industrial production index declined by -2.1% yoy, compared to -4.9% yoy in November 2015. Likewise, retail trade turnover declined by -12.9% yoy compared to -16.4% yoy in the previous month.
- ❖ The consolidated budget deficit for 2015 reached about 1.5% of GDP. Including transfers to Naftogaz, the overall fiscal deficit for 2015 should be about 3.5% of GDP, a deficit smaller than previously anticipated.
- ❖ Contrary to the seasonal inflationary trend observed over the last couple of years, consumer inflation continued to decelerate during December 2015. Inflation reached 43.3% for the year 2015. In 2016, inflation is expected to be 12%.
- ❖ The level of lending by the banking system continues to be depressed. Both national currency loans and foreign currency loans denominated in USD further declined in December. High interest rates, additional requirements of banks to borrowers, and low business activity were the reasons of weak demand for lending resources.
- ❖ The Hryvnia foreign exchange rate showed significant volatility during the last month. Part of this volatility was due to seasonal factors. But fundamental factors also played a role. In particular, the recent political crisis has created uncertainties. In particular, doubts about the continuation of the IMF Program caused depreciation pressures. The trade and transportation restrictions imposed by Russia has also affected the currency. There are also concerns that low commodity prices for 2016 may deteriorate the balance of payments in 2016. Depending on the resolution of these issues the exchange rate for 2016 may be between 25 UAH/USD to 30 UAH/USD.
- ❖ According to the NBU, in 2015 the current account deficit of the balance-of-payment amounted to only USD 204 million (0.2% of GDP), compared to a deficit of USD 4.6 billion (3.5% of GDP) in 2014. This improved situation was due to the fact that imports of goods during 2015 declined at a faster rate of 33.5% than the decline in exports of goods (-30.5%). The agricultural sector has become now the largest exporter of goods, accounting for 41% of all Ukrainian exports.
- ❖ The outlook for the balance-of-payment has deteriorated due to recent declines in international prices for Ukrainian exports and the transport and trade restrictions imposed by Russia. Ukraine therefore will be dependent on the continuation of international financial assistance, particularly from the IMF. This dependency will encourage the government to address issues of corruption and low pace of reforms.

<i>Main Macroeconomic Indicators</i>	2011	2012	2013	2014	2015f	2016f
<i>GDP, USD billion</i>	163	173	180	129	98	99
<i>Real GDP Growth, % yoy</i>	5.5	0.2	0.0	-6.8	-10.5	2.0
<i>Fiscal Balance (incl. Naftogaz & Pension Fund), % of GDP</i>	-4.3	-6.0	-6.5	-11.7	-3.5	-4.0
<i>Public Debt, External and Domestic, % of GDP</i>	36.4	36.7	39.9	70.3	94.0	89.0
<i>Consumer Inflation, eop, % yoy</i>	4.6	-0.2	0.5	24.9	43.3	12.0
<i>Hryvnia Exchange Rate per USD, eop</i>	8.0	8.1	8.2	15.8	24.0	25.0
<i>Current Account Balance, % of GDP</i>	-6.3	-8.2	-9.2	-3.6	-0.2	-2.0
<i>FDI, Net Annual Inflow, USD billion</i>	7.0	7.2	4.1	0.3	2.3	3.0
<i>International Reserves, USD billion</i>	31.8	24.6	20.4	7.5	13.3	17.0
<i>Public External Debt, USD billion</i>	33.3	32.1	31.7	34.9	47.0	55.0
<i>Private External Debt, USD billion</i>	84.6	92.0	99.2	82.0	70.0	65.0

Political and Reform Developments

During the recent past, Ukraine's political situation has deteriorated rapidly. The resignation of key government ministers, including the resignation and statements of the Minister of Economic Development and Trade Abromavicius, highlight the high degree of corruption that still prevailing in the country and the low pace of reforms. The February 3rd statement by the Ambassadors to Ukraine of Canada, France, Germany, Italy, Japan, Lithuania, Sweden, Switzerland, United Kingdom, and the United States of America shows disappointment and urges "Ukraine's leaders set aside their parochial differences, put the vested interests that have hindered the country's progress for decades squarely in the past, and press forward on vital reforms." It also adds that "Ukraine's stable, secure and prosperous future will require the sustained efforts of a broad and inclusive team of dedicated professionals who put the Ukrainian peoples' interests above their own." Furthermore, the Managing Director of the IMF, issued the following statement on February 10th: "I am concerned about Ukraine's slow progress in improving governance and fighting corruption, and reducing the influence of vested interests in policymaking. Without a substantial new effort to invigorate governance reforms and fight corruption, it is hard to see how the IMF-supported program can continue and be successful. Ukraine risks a return to the pattern of failed economic policies that has plagued its recent history. It is vital that Ukraine's leadership acts now to put the country back on a promising path of reform."

On a positive note, these recent developments may encourage the President, the Rada and the COM to take necessary reform measures, particularly to address corruption. The international community will be watching Ukraine to see whether the country's leaders can respond to the challenges ahead.

In addition to fighting corruption Ukraine needs to show significant progress in other reform directions including ensuring rule of law, business deregulation and public administration reform. Although some progress in improving its business climate has been made, the country is still well below of its neighbors in Eastern and Central Europe. For instance, in the World Bank's *Doing Business Report*, Ukraine ranks 83 out of 189 countries, which is only 4 knots higher than in the previous year, while Poland is ranked number 25, Slovakia – 29 and Hungary - 42. According to the *World Justice Project* based on the rule of law indicator Ukraine is ranked number 70 out of 102 countries, while neighboring Poland was ranked as number 21.

More progress in its reform agenda is a must for Ukraine to continue cooperation with international financial institutions, including IMF. Moreover the level of social tensions in the country might be increasing if authorities are not able to ensure rapid changes in the country. There is a good level of understanding among Ukrainian political elites on the necessity to deliver results in structural reforms. Moreover, the rapidly maturing civil society in the country is putting additional pressure on Ukrainian authorities to fulfill their promises given during the Revolution of Dignity.

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On the military front, in accordance to the Minsk-2 agreements, the Ukrainian army continues to hold the ceasefire in Donetsk and Luhansk regions, while Russia-backed separatists continue their provocations. Both international observers including OSCE and Ukrainian authorities continue close monitoring of the situation along the line of fire. The monthly number of casualties in Ukrainian army and among civilians is around 15 victims.

The Ukrainian security service significantly increased its efficiency in preventing terrorist attacks. This led to substantial decrease in terrorist acts in other Eastern cities of the country, which were targeted by rebels in the past. International support in conflict resolution is a crucial element for ensuring stability on the Eastern borders of Europe. The Minsk-2 format consultations and those in a Norman format are still on-going and aiming to prevent a further aggression to Ukraine.

Economic Growth

According to NBU estimates, in the last quarter of 2015, the decline of GDP slowed down to 3.2% yoy, compared to declines of 7.2% yoy in Q3, 14.6% yoy in Q2 and 17.2% yoy in Q1. On this basis, GDP may fall by 10.5% in 2015 and show a positive growth of about 2% in 2016.

High-frequency monthly data shows that in December 2015, the construction sector performed well, with construction output increasing by 10.4% yoy, compared to a decline of -9.5% yoy in November 2015. Other sectors showed some moderation in their contraction. In fact, in December 2015 the agricultural production index slowed down its decline to -6.4% yoy, compared to -11.1% yoy in the previous month. Similarly, the industrial production index declined by -2.1% yoy, compared to -4.9% yoy in November 2015. Likewise, retail trade turnover declined by -12.9% yoy compared to -16.4% yoy in the previous month.

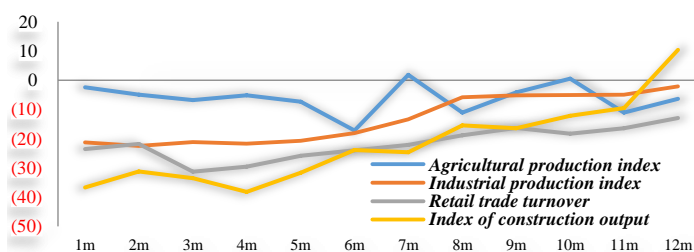
Within the industrial sector, mining/quarrying showed a positive rate of growth of 2.7% yoy in December 2015.

Within manufacturing, the production of capital goods showed a better performance in December 2015 with a rate of growth of 3.3% yoy, compared to a decline of 5.9% yoy for consumer goods.

Manufacturing subsectors with positive rates of growth in December 2015 yoy, included manufacturing of motor vehicles (14.2% yoy), rubber and plastic products (8.5% yoy), minerals and cement (6.2% yoy), coke/oil-refining (6.2% yoy), machine-building (5.8% yoy), pharmaceutical production (5.1% yoy), and textiles (2.6% yoy).

Economic Performance of Ukraine by Sector, % yoy

(To corresponding month of previous year)



Source: The Bleyzer Foundation

Real Sector Indicators of Ukraine, % yoy

	2015 12 m*	2014	2013	2012	2011	2010
Agriculture	-4.8	2.8	13.3	-4.5	17.5	-1.5
Industry	-13.4	-10.7	-4.3	-1.8	7.6	11.2
Construction works	-14.9	-21.7	-11.1	-14	11.1	-5.4
Domestic trade, turnover:						
Wholesale trade	-12.2	-15	-2	-4.4	0.6	0.4
Retail trade	-20.7	-8.6	9.5	15.9	14.7	9.8
Transportation, turnover:						
Cargo	-6.0	-10.8	-3.9	-7.6	5.7	6.4
Passenger	-8.5	-11.7	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service of Ukraine, the Bleyzer Foundation

* Excluding Crimea

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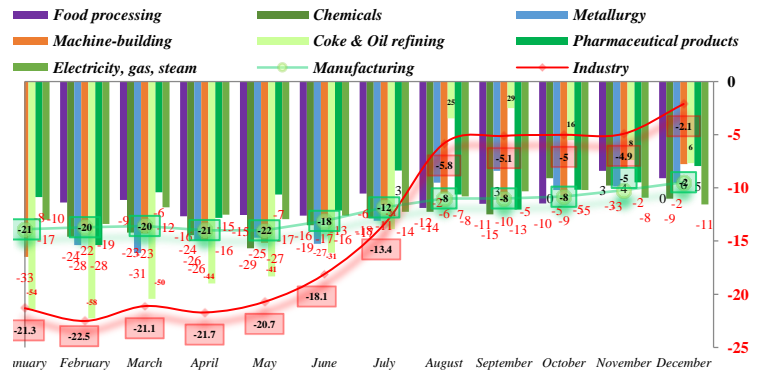
On the other hand, the following subsectors continued to show output declines yoy in December 2015: electricity production (-10.9% yoy), chemicals (-8.5% yoy), food processing (-7.3% yoy), and metallurgy production (-1.9% yoy).

Regarding the regional composition of Ukraine's industrial production, positive growth rates in December 2015 were shown in the following regions: Zhitomir by 17.8% yoy, Kirovograd by 6.5% yoy, Lugansk by 67% yoy, Nikolayev by 0.9% yoy, Odessa by 10% yoy, Poltava by 8.7% yoy, Rivne 0.1% yoy, Cherkasy 2.3% yoy, Chernihiv 5.4% yoy and m. Kyiv by 6.2% yoy, in December 2015.

Nevertheless, other regions continued to show reduction in industrial output, particularly in Donetsk by -14.7% yoy, Trans Carpathian by -24% yoy, Zaporizhia by -1.7% yoy, Ivano-Frankivsk by -18.8% yoy, Lviv by -9% yoy, Sums by -9.9% yoy, Ternopol by -14.8% yoy, Kharkiv by -1.2% yoy, Herson by -2.3% yoy, Khmelnytsky by -13.7% yoy and Chernivtsi by -10.4% yoy.

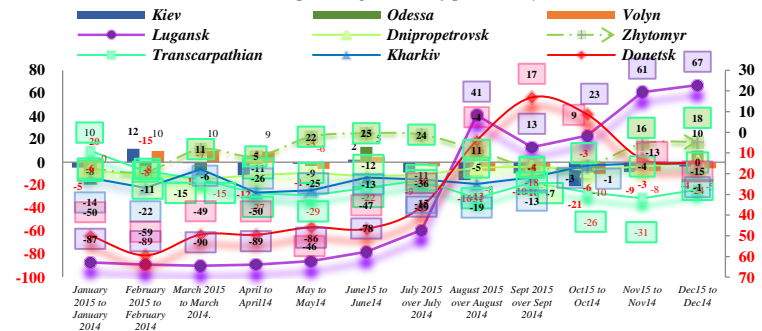
Industrial Production by Sectors, % yoy

(To corresponding month of previous year)



Industrial Production by Regions, % yoy

(To corresponding month of previous year)



Source: The Bleyzer Foundation

Fiscal Policy

Because of boosted expenditures at the end of 2015, the consolidated budget balance turned negative for 2015 despite a significant surplus of UAH 19.7 billion as of the end of November. However, the 2015 deficit was still significantly below the planned level for the year and much smaller than the deficit in 2014. In fact, the consolidated fiscal deficit dropped by 57.1% yoy to UAH 30.8 billion in 2015 (1.5% of GDP).

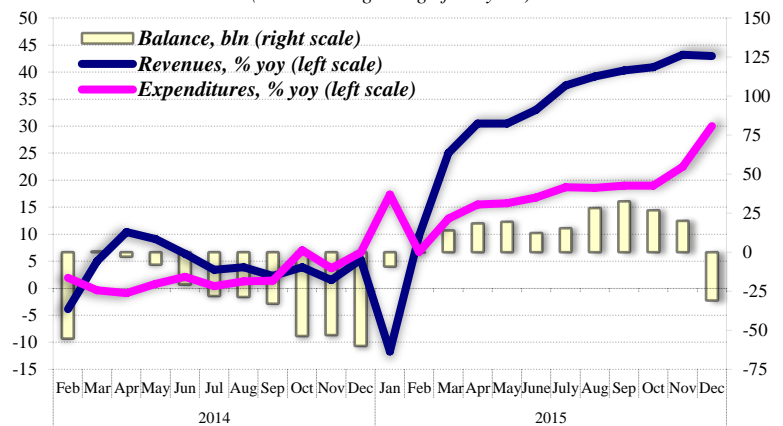
Consolidated budget revenues grew by 43% yoy which is slightly below the level observed in January-November, while growth of general government expenditures accelerated at a lower rate of 30% yoy.

The deceleration in growth of the consolidated budget revenues was the result of slower expansion of the major revenue contributor – tax revenues.

Deceleration in growth of tax revenues, in turn, was attributed mainly to slow increase in receipts of taxes on goods and services and in the VAT in particular.

Dynamics of Consolidated Budget Components

(From the beginning of the year)



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

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Growth of receipts from VAT lowered by 6.7 percentage points to 28.4% yoy which may be the result of increased repayment of VAT paid for exported goods. Other tax revenues saw acceleration in growth except for receipts from excise taxes on imported goods. Transfers from the NBU remained the major source of increase in non-tax budget revenues and posted the highest increase among all consolidated budget revenues. They grew by 2.7 times yoy to UAH 64.803 billion ensuring growth of non-tax revenues at 73.8% yoy.

Acceleration in growth of general government expenditures was caused by faster increase of all major expenditure items. However, utility, social security, and defense expenditures saw the sharpest increases in December which led to faster growth for the year as a whole. In particular, utility expenditures amounted to UAH 6.0 billion in December which is 6.9 times larger than the monthly average during the eleven previous months. December monthly expenditures on defense and on social security of UAH 10.0 billion and UAH 34.1 billion, respectively, were 2.6 times higher than their monthly average in January-November. Natural environment protection expenditures were 3.5 times higher than the average over first 11 months of the year. But they were the lowest among the major expenditure items at UAH 1.3 billion in December and UAH 5.5 billion for 2015 as a whole having little influence on the general growth of budget expenditures. Utility expenditures remained the only major expenditure item observing decline in year-over-year terms despite the mentioned jump in December. Other expenditure items posted reasonable growth rates ranging from 14.1% yoy for education expenditures to 90.1% yoy for defense expenditures.

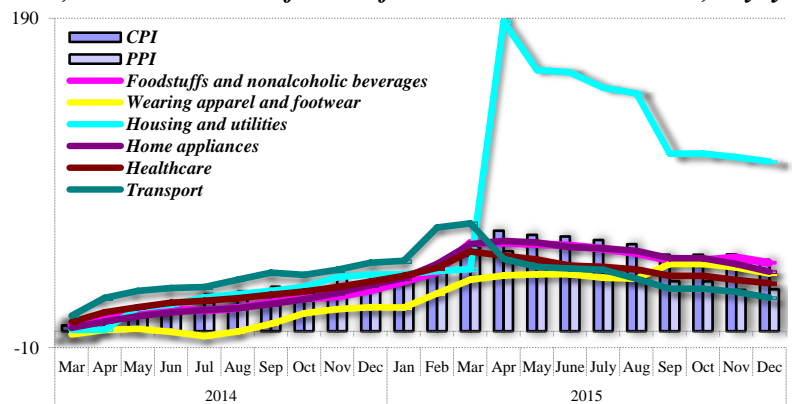
Taking into account the deficit of Naftogaz (the deficit of the Pension Fund is already included into the consolidated budget deficit), the total fiscal deficit for 2015 may be around 3.5% of GDP which is slightly below expectations.

Monetary Policy

Inflation. Contrary to the seasonal trend observed over the last years, consumer inflation posted just a minor monthly increase of 0.7% in December 2015. Therefore, the 2015 inflation rate further decelerated to 43.3%.

As expected, the largest increase in prices was observed for foodstuffs at 1.7% mom, which is still lower than growth in November. Among other groups of goods and services, the growth rates in prices for leisure services and culture, for restaurants and hotels were 0.9% mom each; and for healthcare, 1.1% mom. On the other hand, the declines in prices for alcohol and tobacco were not expected. This decline of 1.9% mom was fully attributed to lower tobacco prices as prices of alcohol increased by 0.5% mom. The decrease in prices of tobacco may be explained as the result of early price competition between major producers in light of higher excise taxes from the beginning of 2016.

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



Source: State Statistical Service of Ukraine, the Bleyzer Foundation

Prices for wearing apparel and footwear decreased by 1.7% mom. The rest of major groups of goods and services observed only minor changes.

In year-over-year terms, all the major groups of goods and services saw deceleration in growth of prices except for education and communication services which saw their prices almost unchanged. For most of the groups deceleration in growth of prices was well above 3 percentage points including foodstuffs (3.2% yoy). Therefore, the all items consumer inflation index dropped 3.3 percentage points to 43.3% yoy which is below our expectations.

Both the monetary base and money supply increased in monthly terms in December.

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Furthermore, the accelerated growth in the monetary base of 4.6% mom led to reverse of its trend from a decline of 3.6% yoy in January-November to a 0.8% yoy growth for the year. The over-year growth rate of the money supply increased 2.5 times to 3.4% on the back of a 1.9% monthly increase.

Taking into account weak consumer demand, expensive imports after the national currency depreciation, and zero or very low increase in expenditures on social programs in the new budget, we expect consumer prices to grow by around 12% in 2016.

Banking Sector. Similarly to the situation during the last months, national and foreign currency deposits denominated in USD followed opposite trends. Despite further decline of interest rates, national currency deposits continued to expand in December. Furthermore, their growth accelerated from 0.6% mom in November to 6.7% mom. Excluding insolvent banks and banks under liquidation, Hryvnia deposits grew at an even faster rate of 10.2% mom. This growth was caused by similar increase in deposits of both legal entities (9.7% mom) and private persons (10.7% mom). At the same time, foreign currency deposits denominated in USD continued to decline even though the pace of decline decelerated to just 0.6% mom (excluding deposits in insolvent banks or banks under liquidation).

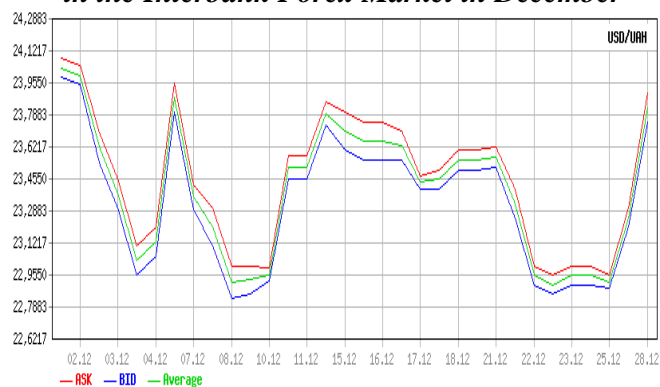
However, even though the trend remained the same, the processes which led to it were exactly the opposite. Unlike in previous month, the foreign currency deposits of private persons denominated in USD posted a 0.9% mom increase which was more than offset by a 3.2% mom decline in foreign currency deposits of corporate sector. Limited access to credit resources forced companies to use their foreign currency resources to support their operational activities.

Both national currency loans and foreign currency loans denominated in USD further declined in December. High interest rates, additional requirements of banks to borrowers, and low business activity were the reasons of weak demand for lending resources. Statistical base effect also contributed into decline of loans because of liquidation of several banks. National currency loans dropped 4.8% mom fueled by declines in loans to households and to companies. This high monthly decline led to acceleration of the national currency loans' year-over-year decline to 19.1%. Foreign currency loans denominated in USD also continued to decline in December.

Total loans inched down by 0.6% mom (20.3% yoy). The decline was fully attributed to an 11.7% mom decline in corporate loans which more than offset a 4.8% mom growth in loans of private persons. The later, however, was not the result of actual increase in amount of provided loans but the result of changes in methodology which came into effect from December 1st (reflection of overdue arrears in accordance with IFRS).

Hryvnia Exchange Rate. Typically for Ukraine, most businesses were on New Year vacations until January 13th, 2016. Therefore, demand for US dollar was low in the interbank forex market. As a result, the USD/UAH exchange rate appreciated from around 24 UAH/USD to around 23.1 UAH/USD during the first two weeks of the year. However, because of deferred demand and low dollar supply (the US FX market was closed on January 18th because of celebrations of M.L.King Jr. Birthday) the exchange rate depreciated back and even exceeded 25 UAH/USD on January 19th. After one day of appreciation on increased supply (exporters got their dollar revenues and decided to sell it on peak prices), the exchange rate has been depreciating by the end of the month. The last couple of trading sessions were characterized by faster pace of depreciation as the NBU announced its plans of the FX market liberalization and stopped intervening into trade in the interbank forex market (the regulator ceased holding the FX auctions and continued to cut only obvious speculative requests for dollar purchases).

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



Source: Ukrdealing, the Bleyzer Foundation

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Other factors have also led to depreciation pressures, including uncertainties resulting from the current political crises, the worsening of the balance-of-payments due to lower international prices for Ukrainian exports, and the new trade and transportation restrictions imposed by Russia.

At the end of 2016, we expect the exchange rate to be at 25-30 UAH/USD. The actual number will to a great extent depend on results of further reforms, implementation of the Association Agreement with the EU, relations with Russia, and situation in Eastern Ukraine. The more positive events will take place in relation to listed factors, the lower will be the exchange rate and vice versa.

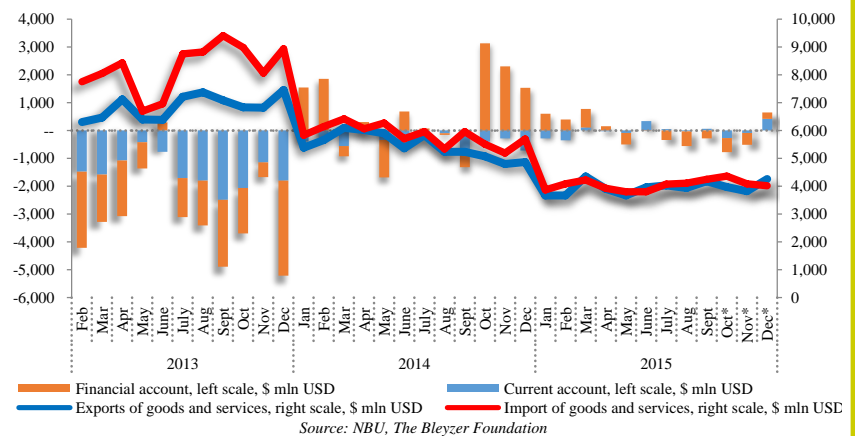
International Trade and Capital

According to the NBU, in 2015, the current account deficit of the balance-of-payment amounted to only USD 204 million (0.2% of GDP), compared to a deficit of USD 4.6 billion (3.6% of GDP) in 2014.

This improved situation was due to the fact that imports of goods during 2015 declined at a faster rate of 33.5% than the decline in exports of goods (-30.5%).

During the month of December 2015, Ukraine current account reached a surplus of USD 418 million, compared to a deficit of USD 727 million in December 2014. This surplus was caused by a sharp reduction in goods imports during the month (-34% yoy), while goods exports declined by only -14.1% yoy.

Ukraine's External Balance of Payments, mln USD



For the entire year 2015, total exports of goods amounted to USD 35.1 billion (a major drop of USD 15.5 billion, compared to USD 50.6 billion of goods exports in 2014.) The major declines in goods exports in 2015 were in the following products: mineral products (-49.5%), machinery and equipment (-42.7%), ferrous and non-ferrous metals (-38.8%), and chemical products (-34.8%).

Exports of agricultural products, including grain, reached USD 14.5 billion in 2015. Although this represents a decline of 13.1% over 2014, agriculture now accounts for 41.3% to total Ukrainian exports. Exports of agricultural products to Russia have declined from 6% in 2014 to 2% in 2015. But the country was successful in diversifying its agricultural export markets, with the share of Asian countries reaching almost 45%, the EU, 28.2% and Africa, 13.6% of total agricultural exports.

In terms of regional orientation to total Ukrainian exports, the main reduction in goods exports in 2015 was in export to Russia, whose share in total Ukrainian exports was reduced to 11.8%, compare to 17.2% in 2014. Export to the EU countries fell by 27.2%, but its share in overall export rose to 29.3% (compared to 28% in 2014).

In 2015, import of goods amounted to USD 38.3 billion (compared to USD 57.7 billion in 2014). Energy import fell by 26.8% (compared to 28.6% in 2014), while non-energy imports dropped by 35.9% (compared to 29.1% in 2014). The major drop in imports was on food products, which declined by 43.5%. Regional-wise, import from Russia fell by 40.3% yoy, with its share in overall imports reduced from 21.5% in 2014 to 19.3% in 2015. Import from EU countries decreased by 28% yoy, but its weight in overall amount rose to 34.3% from 31.7%.

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In 2015, the trade in services account also showed a surplus which amounted to USD 2 billion (compared to a surplus of USD 2.5 billion in 2014). This surplus was offset in part by a deficit of USD 1.2 billion in the primary income account. On the other hand, the surplus in the secondary income account (principally workers remittances) increased to USD 2.1 billion in 2015, compare to USD 1.5 billion in 2014.

Regarding the financial account, in 2015, the overall net financial inflows from the rest-of-the-world reached USD 488 million, compared to net outflows of USD 9,111 million in 2014. A large source of finance in the year was net foreign direct investments, principally for the recapitalization of subsidiaries of foreign banks, which reached USD 3.1 billion (compared to a net FDI inflow of USD 299 million in 2014).

But the largest sources of financing were external lending to the central government and the NBU, which amounted to USD 5.3 billion in 2015. These included lending by the World Bank (USD 1.0 billion), the placement of Eurobonds with US government guarantees, and credits from the EC (USD 0.9 billion).

The IMF also provided below-the-line financing of (USD 6.5 billion, principally to rebuild international reserves). The population also participated in financing the BOP, selling foreign exchange and reducing the amount of foreign cash currency outside the banking sector by USD 2.2 billion (compared to net purchases of foreign exchange of USD 3.5 billion in 2014.)

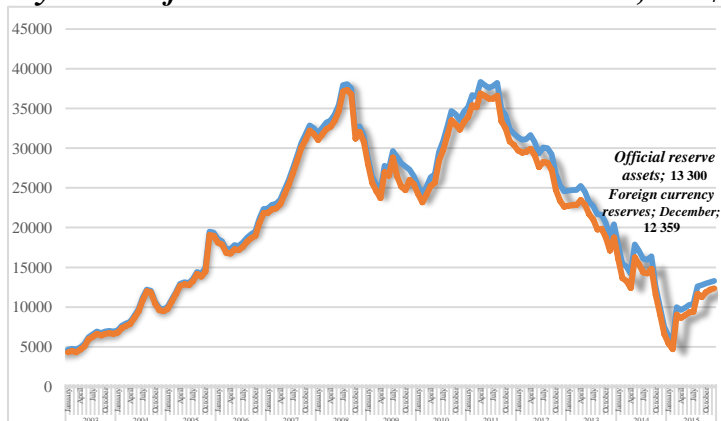
The overall surplus of the consolidated balance of payments in 2015 amounted to USD 849 million, which enabled international reserves to increase to USD 13.3 billion.

The future outlook for Ukraine's balance of payments will depend fundamentally on the strength of the balance of payments and the continuation of international financial support, which is led by the IMF.

The balance of payments outlook has become less promising, given the recent declines in international prices for Ukrainian export commodities. In fact, in January 2016, international prices of wheat were 25% lower than one year ago; steel prices were 31% lower, and iron ore prices were 38% lower. Ukraine will need to find way to compensate for these developments, including accelerating reforms to improve its business environment to attract FDIs that can boost non-traditional exports. It should also accelerate the privatization of state enterprises, which may be able to bring significant FX resources.

Regarding international financial support, the November IMF mission had concluded that Ukraine would receive the third tranche from the IMF program only when it had satisfied a number of conditions, including anti-corruption measures, reform of the banking sector, tax reform and others. The recent political crises caused by the resignation of key government officials has led the IMF to warn that the IMF program may be suspended if now immediate actions are taken in the reform front. The government is fully aware of the consequences of a suspension of the IMF program and should be taking necessary measures in the near future.

Dynamic of Ukraine International Reserves, mln \$



Source: the NBU, the Bleyzer Foundation

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