February 2016

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Executive Summary:

- Ukraine continues to experience a deep political crisis. A number of Parliamentary parties left the ruling coalition, making it unviable. A compromise currently under discussion within the Parliament is the re-shaping of the Cabinet and appointment of a new Cabinet, without new Rada elections.
- On the military side, Ukraine continues to suffer from military aggression on its Eastern border, as Russian-backed rebels are not honoring the ceasefire. For the resolution of the conflict, Ukraine may insist on new talks in a Budapest-memorandum format, which would include the USA and the UK.
- According to the latest update of the State Statistics Committee, in the last quarter of 2015, Ukraine's GDP fell by only 1.2% yoy, compared to a decline of 7.2% yoy in the third quarter of the year. This result confirms that the country's economy is recovering and GDP may grow by about 2% in 2016. However, GDP recovery during 2016 is likely to be uneven. High-frequency data shows that industrial output declined by 1.7% yoy in January 2016, a slight deterioration over the decline of 1.5% yoy in December 2015.
- Within the manufacturing sector, two subsectors had positive rates of growth yoy in January 2016. They were the manufacture of refined products and coke (5.2% yoy) and manufacturing of electrical equipment (4.7% yoy). All other subsectors continued to show negative rates of growth year-on-year, though the declines were generally less negative than during 2015.
- The military hostilities in the East of Ukraine have changed the product structure of industrial output in the country, with food processing increasing its share of total industrial output from 18% in 2012 to 23% in 2015. Dnipropetrovsk has now become the largest industrial oblast, with 19.2% of the total industrial output.
- The fiscal budget continues to perform well. Contrary to the pattern observed over the last couple of years, Ukraine finished the first month of 2016 with a fiscal budget surplus. In fact, fiscal budget revenues exceeded expenditures at both central and local levels.
- Consumer inflation has continued to decelerate, with inflation declining from 43.3% yoy in December 2015 to 40.3% yoy in January 2016. Utilities were the only major groups of goods and services reporting accelerated year-over-year growth. In 2016, inflation is expected to be 12%.
- In January, bank deposits in national currency declined by 1.3% mom, due to a 4.0% mom decrease in deposits of households, and despite a 1.6% mom increase in corporate sector deposits. Unlike the national currency deposits, foreign currency deposits denominated in USD increased 0.5% mom in January.
- The current political crisis was the major reason for exchange rate depreciation pressures. It led market players to limit dollar supply and increase demand, which immediately led to higher prices for the dollar. Nevertheless, under a base case scenario, the Hryvnia should remain relatively stable during 2016.
- According to the NBU, in January 2016, the current account deficit of the balance of payments amounted to USD 379 million, compared to a deficit of USD 288 million in January 2015. The January 2016 deficit was composed of a deficit of USD 580 million in goods, a surplus of USD 106 million in services, and a surplus of USD 95 million in foreign income. The deficit in the goods balance was due to a sharper decline in goods exports (-32.1% yoy) than in imports (-22.9% yoy). But a surplus in the financial account more than compensated for the current account deficit and led to a small increase in international reserves to USD 13.4 billion.
- Regarding future international financial support, the IMF has reiterated its decision to hold the third tranche release from its support program until Ukraine has satisfied a number of conditions, including anti-corruption measures, reform of the banking sector, tax reform and others. Furthermore, the recent political crises caused by the resignation of key government officials led the IMF to warn that the IMF program may be suspended until there is clarity about the permanency of the current government.

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

Political and Reform Developments

Ukraine continues to experience a deep political crisis. A number of Parliamentary parties -- Samopomich, Radical Party and Batkivshina -- have left the ruling coalition, making it unviable. Currently the ruling coalition has 217 deputies, which is 9 votes less than required for the routine work of the Parliament. Moreover, the breakdown of the ruling coalition raises questions related to legitimacy of the current Cabinet of Ministers. A compromise currently under discussion within the Parliament is the re-shaping of the Cabinet and appointment of a new Cabinet. Under this scenario, the coalition may be re-established as it was before the current political crisis, including Petro Poroshenko's block, People's Front, Samopomich, Radical Party and Batkivshina. At this stage, it seems unlikely that a more dramatic outcome, involving the dismissal of the current Parliament and new elections will be take place.

On the military side, Ukraine continues to suffer from military aggression on its Eastern border. Russian-backed rebels are not honoring the ceasefire in full and continue provocations against Ukrainian troops. These facts are constantly mentioned in the OSCE monitoring mission reports. The most recent meeting of the Normandy Four Ministers for Foreign Affairs in Paris was not able to move forward the conflict resolution agenda. The position of the Russian Federation was unchanged – that is, holding elections on the temporarily occupied territories without granting control to Ukrainian military forces over its Eastern border. This proposal is unacceptable to the Ukrainian side, which insists on having border control as a requirement for holding democratic local elections on the occupied territories. For the resolution of the conflict, it is likely that Ukraine will insist on new talks following a Budapest-memorandum-format, in which the list of participants will be extended to include the USA and the UK.

Despite the current political crisis and military hostilities in Eastern Ukraine, authorities continue to make some progress in reforming the country. During the month, some measures were undertaken to improve the business climate of the country. In particular, there were some important developments in fighting corruption, privatization and EU integration.

The Cabinet of Ministers of Ukraine adopted a resolution to establish the State Bureau of Investigation (SBI). This new agency will take up most of the investigative functions that are now within the scope of jurisdiction of the Prosecutor General Office of Ukraine. The SBI should start its operations immediately after the appointment of its Director and the hiring of investigators. To launch this process, the government approved six out of nine members of the Commission, which will be selecting the SBI Director and who were appointed by the President of Ukraine and the Cabinet of Ministers. Another three candidates should be

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submitted by the Parliament within several days. The first meeting of the selection commission for the Director will be called in March. By the end of March, the Bureau should become fully operational.

The Cabinet of Ministers approved a list of companies that will be offered for privatization over the course of 2016. This list includes around 450 state companies, of which 20 are large and 50 are medium-sized enterprises. The State Property Fund plans to use various models for bidding, including tenders with and without price increase conditions, Dutch auctions and sales on the stock exchange.

According to the requirements of the Association Agreement between Ukraine and the European Union for 2016-2019, the Ukrainian government approved a detailed Action Plan to implement a number of actions in the economic area. The main efforts will be concentrated on developing and adjusting (i) technical regulation, (ii) sanitary and phytosanitary controls, (iii) intellectual property rights, (iv) public procurement, and (v) customs issues.

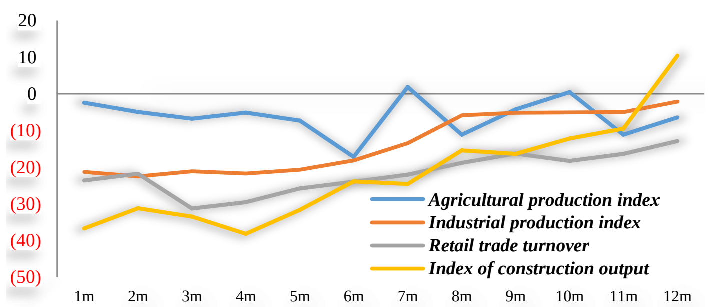
Economic Growth

According to the latest update of the State Statistics Committee, in the last quarter of 2015, Ukraine's GDP fell by only 1.2% yoy, compared to a decline of 7.2% yoy in the third quarter of the year. This result confirms that the country's economy is recovering and GDP may grow by about 2% in 2016.

However, GDP recovery during 2016 is likely to be uneven and will be affected by political uncertainties as well as lower purchasing power. In fact, real wages in Ukraine in January 2016 fell by 13.2% yoy and by 19.7%, from December 2015.

Economic Performance of Ukraine by Sector, % yoy

(To corresponding month of previous year)



Source: The Bleyzer Foundation

High-frequency data shows that industrial output declined by 1.7% yoy in January 2016, a slight deterioration over the decline of 1.5% yoy in December 2015. Within the industrial sector, both mining and manufacturing contracted by 2.6% yoy, whereas electricity and gas supply increased by 2.2% yoy. During January 2016 the index of agricultural output declined by a lower rate of 2.5% yoy, compared to a decline of 6.4% yoy in December 2015. On the other hand, during the same month, construction output declined by 11.4% yoy, compared to an increase of 10.4% yoy in December.

Within the manufacturing sector, two subsectors had positive rates of growth in January 2016 compared to the same month of 2015. They were the manufacture of refined products and coke (5.2% yoy) and manufacture of electrical equipment (4.7% yoy). All other subsectors continued to show negative rates of growth year-on-year, although the declines were

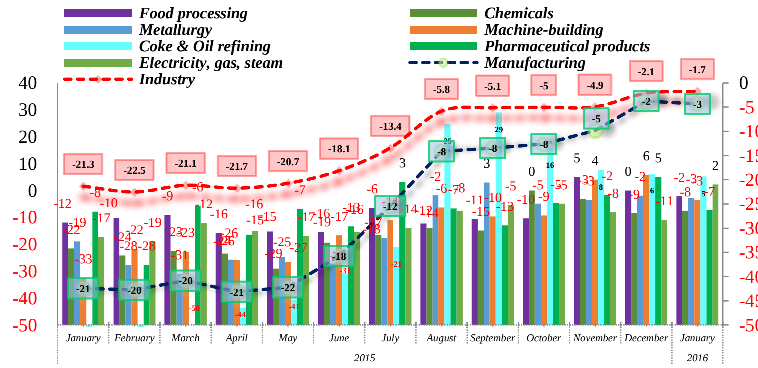
Real Sector Indicators of Ukraine, % yoy

	2016 1m	2015	2014	2013	2012	2011	2010
Agriculture	-2.5	-4.8	2.8	13.3	-4.5	17.5	-1.5
Industry	-20	-13.4	-10.7	-4.3	-1.8	7.6	11.2
Construction works	-76	-14.9	-21.7	-11.1	-14	11.1	-5.4
Domestic trad, turnover:							
Wholesale trade	-7	-12.2	-15	-2	-4.4	0.6	0.4
Retail trade	-1.4	-20.7	-8.6	9.5	15.9	14.7	9.8
Transportation, turnover:							
Cargo	-3.8	-6.0	-10.8	-3.9	-7.6	5.7	6.4
Passenger	-2.8	-8.5	-11.7	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service of Ukraine, the Bleyzer Foundation generally less negative than during 2015. During January 2016, compared to January 2015, output declines were as follows: chemicals (-7.5% yoy), machinery and equipment (-7.2% yoy), pharmaceuticals (-7.3% yoy), wood products (-3.3% yoy), metallurgy (-2.8% yoy), plastics (-2.7% yoy), and textiles (-0.3% yoy).

Industrial Production by Sectors, % yoy

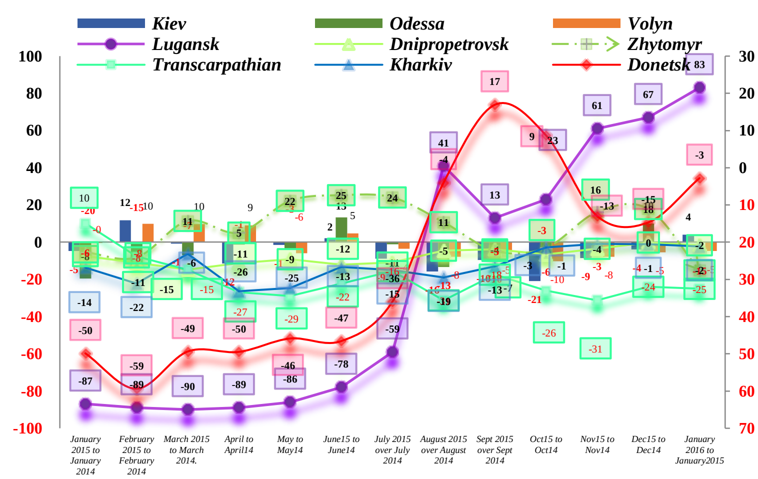
(To corresponding month of previous year)



Source: The Bleyzer Foundation

The military hostilities in the East of Ukraine have changed the product structure of industrial output in the country, with food processing increasing its share of total industrial output from 18% in 2012 to 23% in 2015. In 2015, the major categories of industrial goods in Ukraine were as follows (percent of total in parenthesis): food products (23%), electricity and gas supply (19%), metallurgy (18%), mining and quarrying (12%), plastics and cement (5%), machinery and equipment (5%), chemicals (4%), oil refining and coke (4%), wood products (4%), motor vehicles (3%), furniture (2%), textiles (1%), and pharmaceuticals (1%).

Industrial Production by Regions, % yoy



(To corresponding month of previous year)

From a regional viewpoint, a number of oblasts experienced positive growth rates of industrial output in January 2016, compared to the same month of 2015. These oblasts were as follows: Luhansk, 83% yoy (due to recovery from a low base); Mykolaiv, 15.6% yoy; Chernihiv, 13% yoy; Kyiv, 4% yoy; and Kirovograd, 3.7% yoy. Other oblasts continued to shows industrial output declines in January 2016, as follows: Zakarpatya, -25.1% yoy; Sumy, -16.5% yoy; Zhytomyr, -15.2% yoy; Ivano-Frankivsk, -13% yoy; Zaporizhzhya, -6.8% yoy; Lviv, -6.6% yoy; Rivne, -5.5 yoy; and Volyn, -4.7% yoy.

Military hostilities have also affected the regional structure of industrial output in the country: in 2015, the major industrial regions were as follows: Dnipropetrovsk (19.2% of the total), Donetsk (11.4%), Zaporizhzhya (8.7%), Kyiv city (8.3%); Poltava (7.2%), Kharkiv (6.8%), and Kyiv region (4.6%).

During 2015, capital investment put into service amounted to UAH 251.1 billion (about 12% of GDP). These capital investments were made in the following economic activities: manufacturing (17.7%), construction (16.3%), transportation (12.3%), agriculture, forestry & fishing (11.1%), information and communication (8.7%), electricity and gas supply (8.4%), wholesale and retail trade (7.2%), public administration and defense (7.0%), mining and quarrying (6.9%), real estate (3.5%) and financial activities (2.5%). The major sources of financing for the capital investments during 2015 were as follows: own funds of enterprises and organizations (67.4%), public funds for construction of own housing (12%), bank loans and

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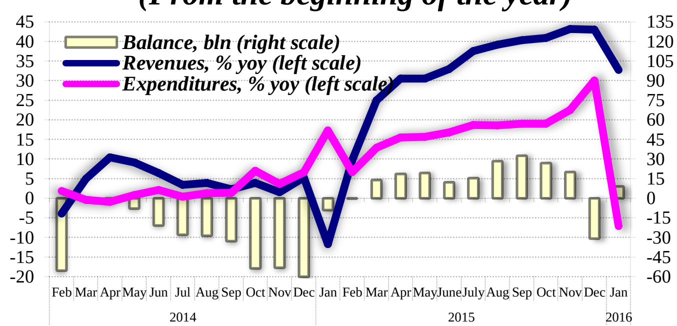
other lending (7.3%), local budgets (5%), funds of foreign investors (3.1%), the state budget (2.4%) and other financing sources (2.8%).

Fiscal Policy

Contrary to the pattern observed over the last couple of years, Ukraine finished the first month of 2016 with a budget surplus. In fact, fiscal budget revenues exceeded expenditures at both the central and local levels. The improvement in budget execution in January was expected because of lower expenditures caused by advance pension payments made in December 2015. But less expected was the 32.6% growth of state budget revenues in January, which became the major factor contributing to the state budget surplus. The state budget surplus amounted to UAH 2.5 billion in January. The surplus of the local budgets was even larger at UAH 6.6 billion, despite faster growth of expenditures compared to that of revenues. The overall consolidated budget surplus for January 2016 was reported at UAH 9.0 billion.

In January 2016, tax revenues increased by 37% compared to January 2015, and were the main contributors to growth of the total state budget revenues. This increase was the result of growth in receipts from almost all the major taxes. In particular, receipts from personal income tax increased more than two fold, mainly thanks to both unification of the tax rate at 18% and the increase in nominal wages. Receipts from internal taxes on goods and services also posted a significant growth of 50.8% yoy thanks to some retail trade activation and increase in imports. Furthermore, increases in excise tax rates from fuel and tobacco products also ensured additional revenues. In particular, revenues from the VAT posted a 46.2% yoy increase (receipts from the VAT on both domestically produced and imported goods minus the VAT repayments). Receipts from excise taxes on domestically produced goods expanded by 83.1% yoy, while receipts from excise taxes in imported goods grew by 36.4% yoy. Due to some changes in accounting treatment and the lifting of advance payments, receipts from the corporate profit tax posted a 77.5% yoy decline. As for non-tax revenues, they posted just a minor increase of 2.3% yoy. The 62.7% yoy decline in revenues from property and entrepreneurial activity was more than offset by a 18.5% yoy growth in administrative charges and revenues from non-commercial business activity, 7.5% yoy growth in other non-tax revenues, and 7.3% yoy increase in own revenues of budget institutions. Revenues of local budgets also observed growth but at much lower pace of 14.4% yoy. This growth was ensured by acceleration in growth of own revenues to 32.2% yoy, which was supported by significantly decelerated but still high growth of transfers from the state budget of 14.4% yoy.

Dynamics of consolidated budget components (From the beginning of the year)



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

State budget expenditures posted a decline in January 2016. The 13.9% decrease was the result of the December 2015 transfers of funds to the Pension Fund of Ukraine as advance payments of pensions, and by underperformance in the execution of expenditure plans of the general fund of the state budget (by 17.2%). In addition, expenditures on state debt servicing declined by 26% yoy, while capital expenditures saw an 86.1% yoy decline. The mentioned declines were partially compensated for by a 40.5% yoy increase in payroll expenditures and 45.2% yoy subsidies and transfers to companies. Expenditures of the local budget expanded much faster than revenues at 23.3% yoy. This growth was ensured by increases in receipts from all sources, but especially from economic activities, utilities, and social protection.

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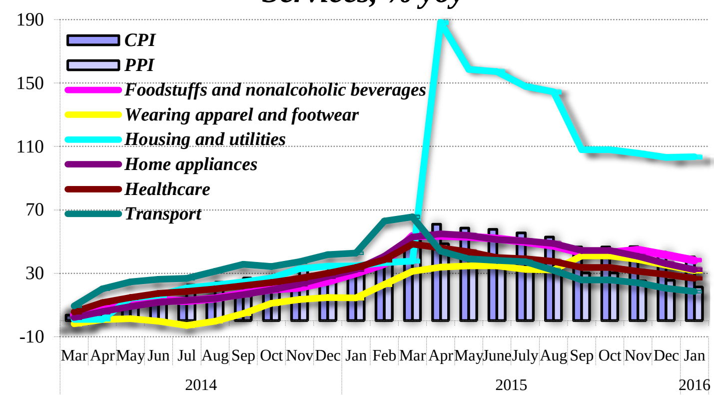
Monetary Policy

Inflation. In January 2016, the growth of consumer prices decelerated in almost all major groups of goods and services, except for foodstuffs, utilities and education. One of the highest monthly price increases was in foodstuffs prices by 2.2% mom, which is in line with seasonal trends. Prices of utilities grew by 0.7% mom due to the increase in tariffs for water supply and sewerage (by 12.1% mom and 3.5% mom respectively). Growth in prices of education of 2.5% mom was related to the increase in prices of services of the pre-school educational institutions by 8.4% mom.

Other groups of goods and services observed monthly decreases in prices in January. For example, the group alcohol and tobacco products had a 1.9% mom decline in prices caused by the declines in prices of tobacco products. Prices of tobacco products decreased for the second consecutive month as a reaction of producers to increased excise taxes. Producers initiated a price war in order to maintain their shares of the market in light of possible drops in sales as the final prices of their products could grow significantly. Transport also observed a 0.4% mom decline in prices, which was related to lower prices of fuel and lubricants (by 1.3% mom).

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

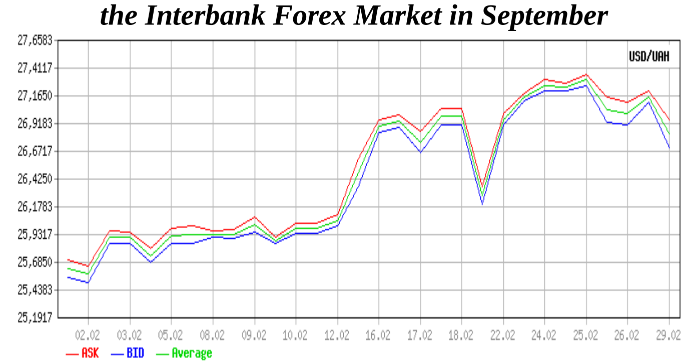


Source: State Statistical Service of Ukraine, The Bleyzer Foundation

The overall consumer inflation dropped 3.0 percentage points to 40.3% yoy in January 2016, from 43.3% yoy in December 2015. The main reason for lower inflation is that total consumer demand remains weak, with large declines in real wages in December and January, as noted earlier. Furthermore, social expenditures suffered some funding shortfall as did all the major state budget expenditures. Based on current trends, consumer inflation in 2016 should be about 12%.

Banking Sector. In January, bank deposits in national currency declined by 1.3% mom. This decline was fully attributed to a 4.0% mom decrease in deposits of households, which is common for the month because of increased personal spending during the New Year holidays. At the same time, national currency deposits of the corporate sector grew by 1.6% mom. Unlike national currency deposits, foreign currency deposits denominated in USD increased by 0.5% mom in January. This growth was the result of increases in deposits of both households and corporate sector (by 0.4% mom and 1.0% mom respectively). On the other side of the banking sector balance sheet, demand for loans remained low because of high costs and very strict lending conditions. National and foreign currency loans further declined in January. They both inched down by 0.3% mom, accelerating the year-over-year decline to 20.6% and 22.6% respectively. National currency loans of households posted faster declines compared to those of the corporate sector. In monthly terms, the difference was not significant (0.3% against 0.1%) but was very high in

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



Source: Ukrdealing, The Bleyzer Foundation

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year-over-year terms (27.1% against 17.7%). All of these developments reflected the reduced borrowing capacity of the population because of declines in real incomes.

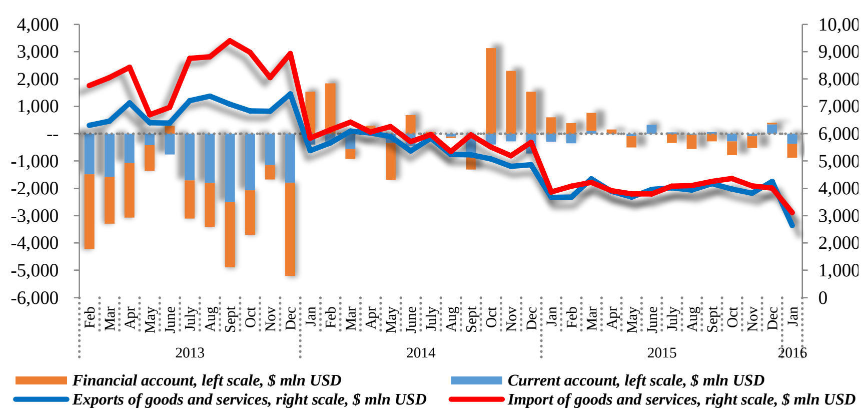
Hryvnia Exchange Rate. For most of February, the UAH/USD exchange rate was under depreciation pressures. The main reason for this was the political crisis in the country caused both by a conflict between the government and the parliament, and by a growing dissatisfaction of the population with progress in fighting corruption and in structural reforms. The crisis led exporters to postpone mandatory sales of their foreign currency revenues as much as possible. As a result, the dollar supply decreased dramatically, which led to the continuous depreciation of the exchange rate. Some appreciation happened on February 18th, when some agricultural exporters were forced to sell their dollar revenues as the time for mandatory sales of those revenues was expiring. The depreciation pressures were reversed towards the end of the month, when exporters finally started selling their foreign currency revenues en masse on the interbank forex market. The NBU delivered on promises made in January and did not intervene in the market for most of the time of the exchange rate depreciation. But when it actually made interventions, they were in the form of open foreign exchange auctions. The regulator did not cut the requests for dollar purchases actively and did not introduce any other administrative measures.

Despite recent negative events, the UAH/USD exchange rate may still return to the level of about 25 UAH/USD in case the political crisis is resolved quickly, reforms will recover their momentum, the IMF program is revived, and there will be no escalation in the East of Ukraine. Therefore, for the moment we leave our forecast for the exchange rate at the end of 2016 unchanged at 25-30 UAH/USD. The key assumptions for the lower end of the FX rate are that the IMF program will be revived in the near future and that military hostilities will be contained.

International Trade and Capital

According to the NBU, in January 2016, the current account deficit of the balance of payments amounted to USD 379 million, compared to a deficit of USD 288 million in January 2015. The January 2016 deficit was composed by a deficit of USD 580 million in goods, a surplus of USD 106 million in services, and a surplus of USD 95 in foreign income.

Ukraine's External Balance of Payments, mln USD



Source: NBU, The Bleyzer Foundation

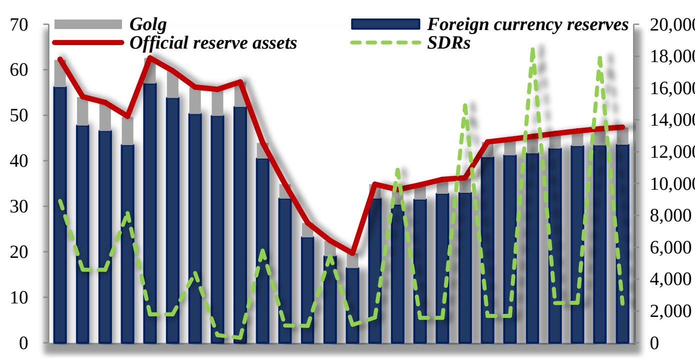
The deficit in goods trade was due to the fact that merchandise exports declined by a larger percentage (32.1% yoy) than imports (22.9%). Exports of goods amounted to USD 1,846 million in January 2016, compared to exports of USD 2,717 million a year ago. Exports were affected by the trade restrictions imposed by Russia, unfavorable weather conditions, low commodity prices, and international tensions, particularly in the Middle East. Exports declined for all major products, including: metallurgy (-46.8% yoy); food products (-19.8% yoy); minerals (-44.5%); chemicals (-40.3%); and machinery and equipment (-32.4%). Geographically, in January 2016 goods exports to Russia decreased by 48% yoy and now represent only 6.6% of total exports, compared to 8.6% in January 2015. Exports to Asia decreased by 43.3% yoy, representing 32.7% of total Ukrainian exports. Exports to Europe declined by only 6.3% yoy and now account for 41.6% of exports (compared to 30.2% in

January 2015).

Imports of goods amounted to USD 2.4 billion, a decline of 22.9% yoy. The major declines took place in mineral products, particularly energy, which declined by 51% yoy. But these products still represent 23.3% of total imports. The second largest product category, chemical imports, declined by 4.8% yoy, and account for 21.9% of total imports. Imports of machinery and equipment are the third largest import category and declined by 6.3% yoy in January and represent 18.9% of total imports. Food imports represent the fourth largest import group (with 13.5% of the total) and declined by 4.1% yoy. Geographically, Europe is the largest supplier of goods to Ukraine, with a 39.1% share; followed by Asia with a 20% share. The share of Russia in Ukrainian imports has been reduced to 10.1% of the total, compared to 19.9% in January 2015.

In January 2016, the financial account showed net inflows of USD 500 million, compared to net outflows of USD 602 million in January 2015. The major inflows in January were due to long-term loans (USD 287 million), sales of FX by the population (USD 298 million), and trade credits (USD 208 million). Foreign direct investments amounted to only USD 18 million.

Dynamic of Ukraine International Reserves, mln $



Source: the NBU, the Bleyzer Foundation

Thanks to the surplus in the financial accounts, the surplus of the overall balance of payments amounted to USD 120 million. This surplus allowed the NBU to increase its international reserves to USD 13.4 billion, sufficient to cover 3.5 months of imports.

Regarding future international financial support, the IMF has reiterated its decision to hold the third tranche from the IMF support program until Ukraine had satisfied a number of conditions, including anti-corruption measures, reform of the banking sector, tax reform and others. Furthermore, the recent political crises caused by the resignation of key government officials led the IMF to warn that the IMF program may be suspended until there is clarity about the permanency of the current government.