

June 2016

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Executive Summary:

- ❖ Military actions in Ukraine's East have intensified during the last few weeks. Members of the OSCE monitoring mission reported that truce violations during this past weeks were the highest since last fall. Armed units on both sides reported rising number of fatalities as the conflict is worsening.
- ❖ This long military conflict in Eastern Ukraine is now receiving closer attention by Western powers, which are concerned about the possibility that Russia or its proxies may also invade other countries, particularly in the Baltics, or further enter into Ukraine. In July, the European Union and the USA made a decision to continue sanctions against the Russian Federation until it fully implements the requirements of the Minsk-2 agreement.
- ❖ Although the pace of reforms is still slow, the newly appointed government is already accelerating the implementation of reforms. In particular, the government is giving renew impetus to its fight against corruption. Recently, there have been a number of arrests and investigations over government officials' corrupt practices.
- ❖ High-frequency data for May 2016 confirmed that Ukraine's economic situation is continuing its recovery though at a slow and uneven pace. In May manufacturing output increased by 2.5% yoy, the fourth month in a row with positive growth rates on a year-over-year basis. But mining activities declined by 3.5% yoy in May. During the month, other economic activities also showed recovery. In particular, the construction sector expanded by 5.5% yoy, with residential buildings leading with a growth rate of 8.2% yoy. Output in the agricultural sector showed a small increase of 0.1% yoy in May and 2.1% you in June 2016.
- ❖ Due to better tax collections and decelerating growth of fiscal expenditures, the consolidated budget deficit decreased to UAH 3.8 billion for the January-May period, or about 0.3% of period GDP.
- ❖ The overall growth of consumer prices further decelerated to 7.5% yoy in May from 9.8% yoy reported in April. Prices of all major groups of consumer goods and services saw deceleration in growth.
- ❖ The UAH/USD exchange rate continued to gradually appreciate in May-June thanks to seasonal factors and improvement in export revenues because of increased prices for traditional Ukrainian products on world markets.
- ❖ National currency bank deposits continued to expand at a moderate pace, while foreign exchange deposits returned to decline in May. Bank lending showed similar trends to those observed for deposits - national currency credits posted moderate growth, while foreign currency loans continued to decline. Further deceleration of consumer inflation and stabilization of the exchange rate were the major reasons for the third consecutive decrease in the policy rate (from 18% to 16.5%) by the NBU.
- ❖ In May 2016 the current account showed a surplus of USD 403 million. This surplus helped reduce the current account deficit of January-May 2016 to USD 424 million (or 1.4% of period GDP). This positive result in May 2016 was due to improvements in trade for goods and services that brought near equilibrium to these accounts, while primary and secondary foreign income generated positive balances amounting to USD 357 million in May. The current account in May 2016 was partly offset by financial outflows of USD 41 million. Nevertheless, the overall balance of payments showed a surplus of USD 374 million in May, which brought international reserves to USD 13.5 billion as of the beginning of June (3.5 months of imports).
- ❖ The IMF mission that visited Kyiv in May/June concluded that Ukraine has made considerable progress in restoring macroeconomic stability, but that additional structural and institutional reforms are required to turn the recent recovery into sustainable growth. The IMF is still waiting for government action on these matters. The government expects to receive a partial disbursement in August with another large disbursement by the end of the year. If the IMF proceeds with its program, in addition to about USD 1.0 billion from the IMF, Ukraine will be able to secure an additional USD 2.3 billion in financial aid from other multilateral and bilateral institutions.

<i>Main Macroeconomic Indicators</i>	2011	2012	2013	2014	2015	2016f
<i>GDP, USD billion</i>	163	173	180	130	98	95
<i>Real GDP Growth, % yoy</i>	5.5	0.2	0.0	-6.6	-9.9	2.0
<i>Fiscal Balance (incl. Naftogaz & Pension Fund), % of GDP</i>	-4.3	-5.5	-6.5	-11.7	-8.0	-4.0
<i>Public Debt, External and Domestic, % of GDP</i>	36.4	36.6	40.4	69.4	79.4	84.4
<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	-8.3	-9.0	-4.1	0	-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	24.5	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

Military actions in Ukraine's East have intensified during the last few weeks. Members of the OSCE monitoring mission reported that truce violations during this past weeks were the highest since last fall. Armed units on both sides reported rising number of fatalities as the conflict is worsening. Since the beginning of the hostilities, more than 10,000 Ukrainians have been killed, tens of thousands are injured, and hundreds of thousands were forced to move from their homes.

This long military conflict in Eastern Ukraine is now receiving closer attention by Western powers, which are concerned about the possibility that Russia or its proxies may invade other countries, particularly in the Baltics, or further enter into Ukraine. These apprehensions were fueled by the large recent increase of Russian military equipment on its borders.

In July, the European Union and the USA made a decision to continue sanctions against the Russian Federation until it fully implements the requirements of the Minsk-2 agreement. Moreover, the statement issued by the US State Department clearly states that sanctions will be continued while Crimea is occupied by Russia. NATO continues to show its support for Ukraine by increasing bi-lateral cooperation in different ways including training and supplying the Ukrainian army with non-lethal equipment. Moreover on its annual summer meeting in Warsaw, NATO officials re-confirmed their support for Ukraine. There is now increasing emphasis by Europe on finding a permanent solution to the situation in Donbas. Continued US support for Ukrainian economic and political reforms was re-confirmed during the recent visit of US Secretary of State John Kerry to Kiev on July 7th.

Although the pace of reforms designed to introduce a new institutional environment in the country is still slow, the newly appointed government chaired by Prime Minister Groysman is already accelerating the implementation of the reform agenda. In particular, the government is giving renewed impetus to its fight against corruption, as demanded by both civil society and Ukraine's international partners. All high profile visitors to Ukraine, including the EU, the US and international institution representatives, have expressed concerns about the slow progress in fighting corruption and the necessity of intensifying the anti-corruption fight. Recently, there have been a number of arrests and investigations over government officials' corrupt practices. In particular, three dozen government officials from the so-called "amber mafia" were arrested in July. This group included officers from the General Prosecutor's Office, Internal Security Service and Police.

Another important source of corruption has been the non-transparent system of public procurement, which has been highly criticized by major stakeholders. To deal with corruption in this area, the government

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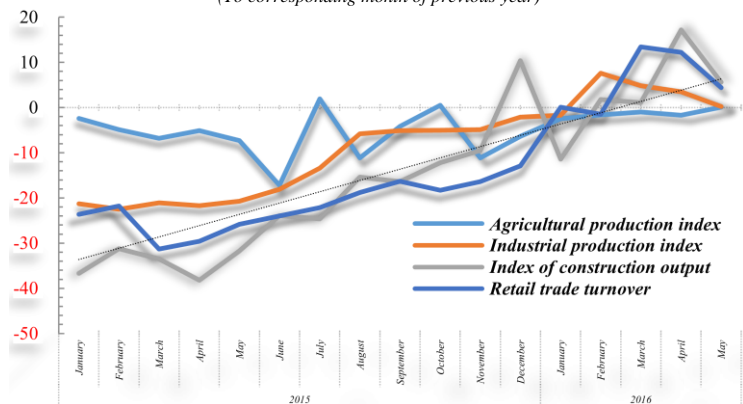
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has introduced a new automated and more transparent procurement system called ProZorro for most government purchases. In addition, the newly established Anti-Corruption Bureau has initiated several new investigations against some top government officials. In particular, there was a criminal investigation against the deputy minister of public health who is accused of corruption in public procurement of medicine.

Proceeding with international trade reform, on July 11, 2016, Ukraine and Canada signed a free trade agreement which would gradually eliminate imports duties for 98% of Ukrainian exports to Canada and for 72% of Canadian exports to Ukraine, over a seven year period. Among the Ukrainian products that would enjoy duty-free access to the Canadian market in the short-term are sunflower oil, sugar, confectionary and chocolate, alcohol and beer, juices, clothes, ceramics, metal products and chemicals. But Ukrainian exporters of many other agricultural products -- such as wheat, barley, dairy, poultry, eggs, beef, and pork-- will be subject to zero imports duty only as part of Canada's global quotas. The FTA envisages a gradual elimination of imports duties on Canadian agricultural products: within three years for live poultry and sheep, beef, lamb, nuts, sauces, flour products; within five years for sub-products from pigs, oilseeds, fat, vegetable oil; and within seven years for cooled pork and poultry, milk, cream, eggs honey, vegetable and sausages. Duties will also be gradually eliminated for industrial goods: Canada will have a seven-year transition period for revoking duties for some passenger cars, while Ukraine will have a three-year transition period for construction materials, industrial equipment and parts of aircraft, a five-year period for electric equipment, light pipes, motorcycles, trailers, vessels, photo cameras and a seven-year period for cars, tractors and spare parts for them.

Economic Performance of Ukraine by Sector, % yoy

(To corresponding month of previous year)



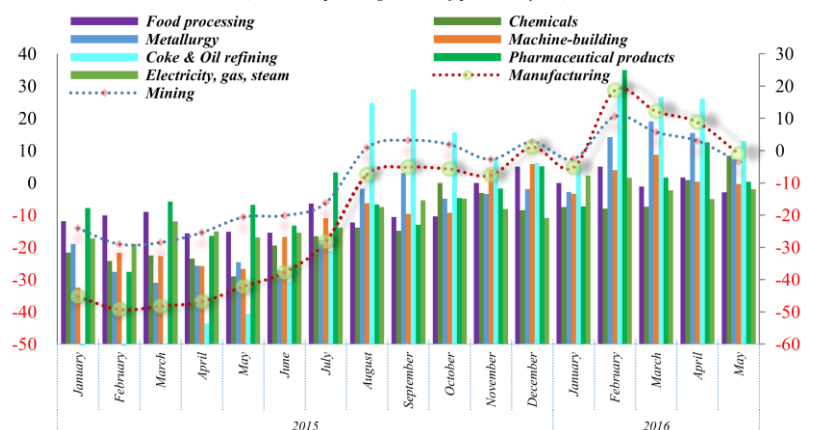
Source: The Bleyzer Foundation

Economic Growth

High-frequency data for May 2016 show that Ukraine's economy continues to recover though at a slow and uneven pace. In May, manufacturing activities expanded by 2.5% yoy, but mining declined by 3.5% yoy and electricity and gas supply also declined by 1.9% yoy. As a result, in May the overall industrial sector grew only by 0.2% yoy. Within manufacturing, the main growth activities included manufacture of coke and refined petroleum, which grew by 13.0% yoy, rubber and plastic products (8.5% yoy), chemicals (8.4% yoy), metallurgy (7.4% yoy), wood

Industrial Production by Sectors, % yoy

(To corresponding month of previous year)



Source: The Bleyzer Foundation

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products (5.3% yoy), furniture and other manufacturing (7.7% yoy). On the other hand, in May, the following subsectors experienced declines in output on a year-over-year basis: food products (-2.9% yoy), textiles and leather products (-4.4% yoy), and electricity and gas supply (-1.9% yoy). Other activities such as manufacturing of machinery and equipment, and pharmaceuticals saw little change in output on a yoy basis.

Regarding industrial production by regions, the major expansions in May 2016 on a year-over-year basis took place in Lugansk (with a 183% yoy increase), Kharkov (12%), Kyiv (10%), Zakarpattia (10%), and Vinnytsia (10%). On the other hand, the regions with the largest declines were Zaporozhzhia (-12% yoy), Chernivtsi (-10% yoy), Rivne (-10% yoy), Ivano-Frankivsk (-10% yoy), and Sumy (-6% yoy).

During May, other economic activities also showed recovery. In particular, in May 2016 the construction sector expanded by 5.5% yoy, with residential buildings leading with a growth rate of 8.2% yoy. Similarly, retail trade turnover showed a rate of growth of 4.4% yoy in May. Cargo transportation expanded by 4.2% yoy in January-May 2016, while passenger transportation grew by 1.4% yoy. Output in the agricultural sector showed a small increase of 0.1% yoy in May and 2.1% yoy in June 2016.

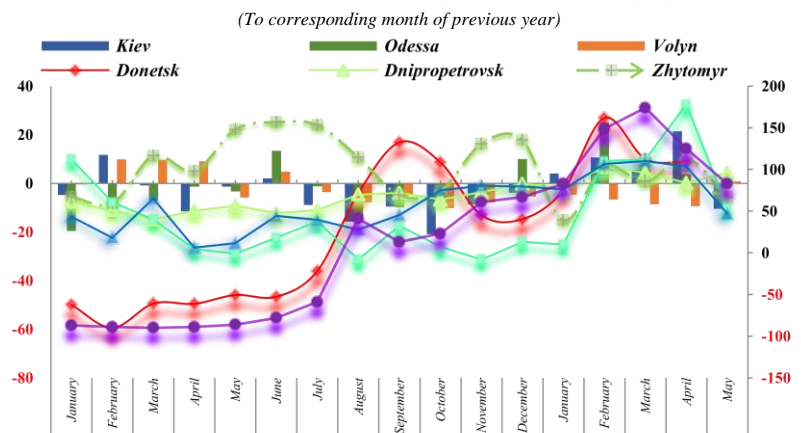
For the entire year 2016, we maintain our forecast of GDP growth at about 2%.

Fiscal Policy

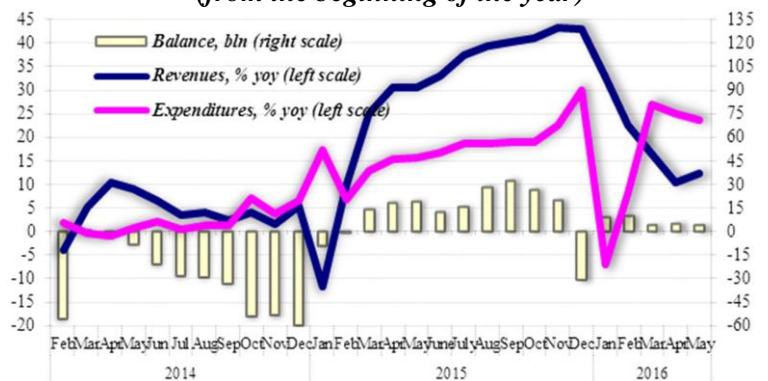
The fiscal budget balance improved in May 2016 but the consolidated budget balance from the beginning of the year remained negative. In fact, the May state budget deficit totaled UAH 4.3 billion which is lower than the deficit in April. But the total state budget deficit reached UAH 26.4 billion in January-May. On the other hand, local budgets generated a surplus of UAH 5.6 billion in May. As a result, the total surplus of local budgets expanded to UAH 22.7 billion for the period. The January-May consolidated budget deficit, correspondently, decreased to UAH 3.8 billion (about 0.4% of period GDP).

Increased state **tax revenues** in May were generated by improvements in economic conditions, including reactivation of retail trade, and full introduction of tax legislation changes. The monthly growth in state budget revenues caused an expansion of cumulative revenues from the beginning of the year by 1.3 percentage points to almost 7% yoy. This was

Industrial Production by Regions, % yoy



Consolidated Fiscal Budget components (from the beginning of the year)



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

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secured by an acceleration of the growth in tax revenues as well as a deceleration of decline in nontax revenues. The acceleration of tax revenues was the result of faster increase in receipts from taxes on incomes, profits, and enhanced market value; and in receipts from domestic taxes on goods and services. In particular, growth in receipts from corporate profit tax left negative territory, increasing by 27.7 percentage points to 18.6% yoy. Among the taxes on goods and services, the VAT on domestically produced goods and services posted the most significant acceleration in growth which almost doubled to 14.4% yoy. Although growth of revenues of local budgets slightly decelerated in May, it still was much higher than that of the state budget revenues. As a result, growth of the consolidated budget revenues was also higher than the respective growth of the state budget revenues. Cumulative consolidated budget revenues from the beginning of the year grew by 12.2% yoy as of the end of May which is a 1.8 percentage point acceleration compared to growth at the end of April.

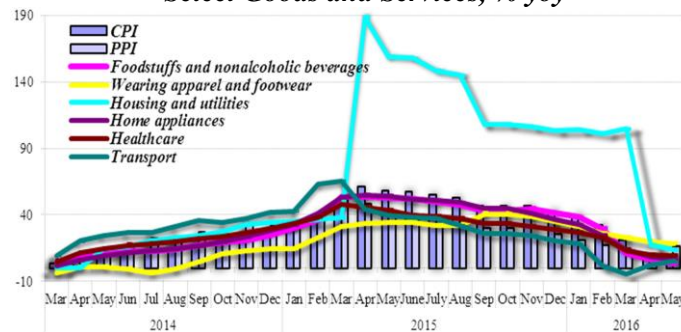
Growth of **budget expenditures** continued to slow down at both central and local level in May. State budget expenditures expanded by 14.5% yoy in the May which is a 5.7 percentage point lower compared to April. Slower expenditure growth was the result of decrease in spending on utility subsidies to population and some slowing down in growth of payroll expenditures as a result of demobilization. As a result, growth of cumulative state budget expenditures from the beginning of the year decelerated by 2.7 percentage points to 23.6% yoy as of the end of May. Expenditures on general public administration functions saw the sharpest deceleration in growth (from 30.1% yoy to 17.9% yoy) among the major budget lines under functional classification. At the same time, social security expenditures saw the largest acceleration in growth (from 39.9% yoy to 48.7% yoy). Expenditures of local budgets also saw deceleration in growth due to lower increase in social security expenditures and inter-budget transfers. Therefore, the consolidated budget expenditures grew at the same rate as the state budget expenditures.

Monetary Policy

Inflation.

In May, consumer prices remained almost unchanged compared to April. Minor increases in prices of foodstuffs, home appliances, healthcare, transport, communication services, education, restaurants and hotels, and other goods and services were almost fully offset by declines in prices of leisure and culture and tariffs for utilities. Alcohol and tobacco products saw the largest increase in prices at 3.3% mom in May. Transport prices posted a 2.8% mom growth of prices as increasing world oil prices led to growth of prices on fuel and lubricants at 5.8% mom. However, this growth was partially compensated for by declines in prices of cars and railroad and air transportation at around 1.0% mom each. Education services saw a 0.7% mom growth in prices, while healthcare prices grew by 0.6% mom. Other price increases ranged from 0.1% mom to 0.4% mom. Leisure and culture services saw a 1.8% mom decrease due to seasonal factors. As for utilities tariffs, they posted a 2.0% mom decrease, which was the result of a 4.3% mom decline in the natural gas tariff. Prices of apparel and footwear were flat in May. Stability of consumer prices in monthly terms led to

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



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

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further deceleration of their growth in year-over-year terms though a significantly slower pace compared to previous months. The overall growth of consumer prices decelerated to 7.5% yoy in May from 9.8% yoy reported in April. All the major groups of consumer goods and services saw deceleration in growth of their prices except for alcohol and tobacco products and transport. Prices of the former grew by 9.9% yoy in May which was 1.1 percentage points faster than a month ago. Growth of transport prices doubled from 2.5% yoy in April to 5.1% yoy in May but remained one of the lowest growth rates among all the groups of consumer goods and services. The largest growth in prices was reported for apparel and footwear at 18.4% yoy, while the lowest was reported for foodstuffs at 3.9% yoy.

Low inflation was among the major reasons of further decrease in the policy rate by the NBU to 16.5% starting on June 24th (the third decrease over the last three months). According to the NBU, inflationary pressure reduction was of a fundamental nature confirmed by core inflation slowdown. The reasons for this were mentioned in our previous reports, such as moderated domestic demand and stabilization of the exchange rate. Therefore, we are leaving our forecast for consumer inflation unchanged at 12% yoy in 2016.

Banking Sector.

Growth of national currency bank deposits continued in May, while foreign currency deposits denominated in USD returned to decline. Similar to the previous month, the corporate sector played a decisive role in the dynamics of both types of deposits. In particular, 2.0% mom growth in national currency deposits was the result of a 4.5% mom increase in deposits by the corporate sector. At the same time, household deposits remained almost unchanged. On the other hand, a 4.3% mom decrease in corporate sector deposits fueled a 1.6% mom decline in total foreign currency deposits denominated in USD. The corresponding deposits of households also decreased but at a small 0.2% mom change. On a year-over-year basis, the growth of national currency deposits accelerated to 14.6% in May which is 2.8 percentage points more than a month ago. At the same time, the year-over-year decline in foreign currency deposits denominated in USD decelerated to 14.1% in May from 15.9% observed in April.

On the lending side of the banking sector, the dynamics of loans were similar to those observed for deposits. National currency credits posted moderate growth, while foreign currency loans continued to decline. At the same time, the pace of growth in national currency loans was significantly lower than that for the correspondent deposits. The total national currency loans inched up by 0.2% mom as both corporate and household loans posted small increases of 0.1% mom and 0.3% mom, respectively. The mentioned monthly growth of total national currency loans led to deceleration of their year-over-year decline by 0.6 percentage points to 13.1%.

The monetary base expanded again in May but the source of increase was the opposite of that in April. Unlike in the previous month, cash funds posted some decline which was more than compensated for by growth in balances at the correspondent accounts of commercial banks. As a result, the monetary base increased by 0.5% mom accelerating year-over-year growth by 0.7 percentage points to 2.4%. Money supply also increased at a comparable pace of 0.4% mom in May. The year-over-year growth in money supply accelerated to 5.9% in May from 3.7% observed in April.

Hryvnia Exchange Rate.

The UAH/USD exchange rate was on an appreciating trend in June. Summer is usually the season during which the national currency either remains stable or becomes stronger. This is because of lower business activity due to summer vacations. In addition, the economy started to recover, prices for traditional Ukrainian exports started to grow on international markets following the trend of world oil prices, and the situation with state finances is relatively good. All these factors played in favor of a stronger Hryvnia. There were attempts of

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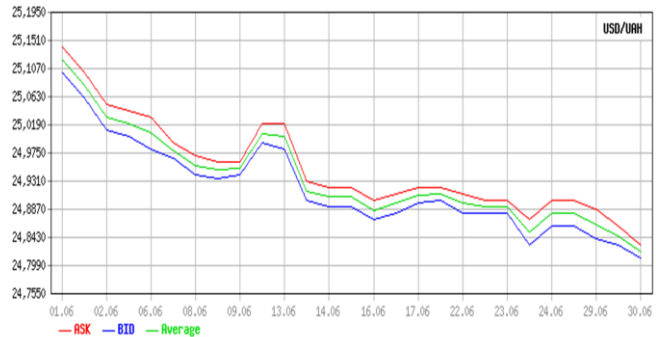
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some interbank forex market players to reverse the trend, usually on the weekends, but the most successful one led just to a temporary depreciation of the exchange rate by 0.05 UAH/USD which was reversed by the end of the same trading session on June 10th. Furthermore, due to the interventions of the NBU, which was regularly holding forex auctions in June, the exchange rate would have appreciated even faster. Apart from international reserves replenishing, the regulator used auctions to mitigate Hryvnia appreciation to avoid hurting Ukrainian exports which are now recovering. As a result, the exchange rate appreciated from around 25.12 UAH/USD to around 24.83 UAH/USD in June.

UAH/USD Exchange Rate Quotations in the Interbank Forex Market in June

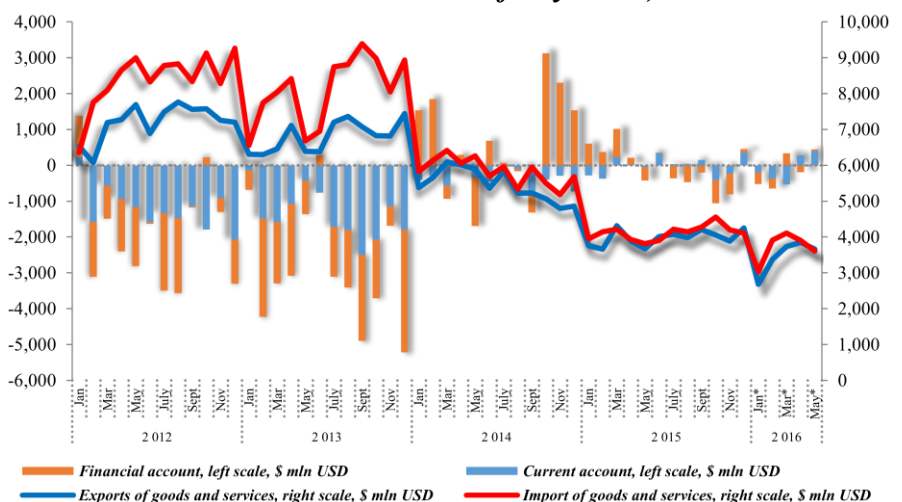


Source: Ukrdealing, The Bleyzer Foundation

Further gradual appreciation of the exchange rate allowed the NBU to continue liberalizing its foreign exchange regulations. The regulator introduced further liberalization measures through its Regulation No. 342 of June 7th. In particular, the share of foreign currency revenues obligatory for sale on the interbank forex market was decreased from 75% to 65% which is supposed to have a positive impact on exporters. The regulator doubled the maximum amount of cash foreign currency and banking metals one can buy in a bank to UAH 12,000 equivalent and lifted the limitation on sales of precious coins, including the investment coins of Ukraine. By its Regulation No. 341 of June 7th, the NBU also simplified the procedure for foreign exchange operations. The banks are now allowed to change the exchange rate during the operational day and set different exchange rates in their different branches. These measures will help banks to quicker react to changes in the foreign exchange market and to have regional differences in the exchange rate dynamics. Also the regulator widened the list of foreign currencies for banks to conduct foreign exchange operations with and simplified paperwork for foreign exchange operations.

Taking into account the current dynamics of the economy in general and of the exchange rate in particular, as well as political developments in the country, we forecast that the exchange rate will remain at around 25 UAH/USD at the end of the year.

Ukraine's External Balance of Payments, mln USD



Source: NBU, The Bleyzer Foundation

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International Trade and Capital

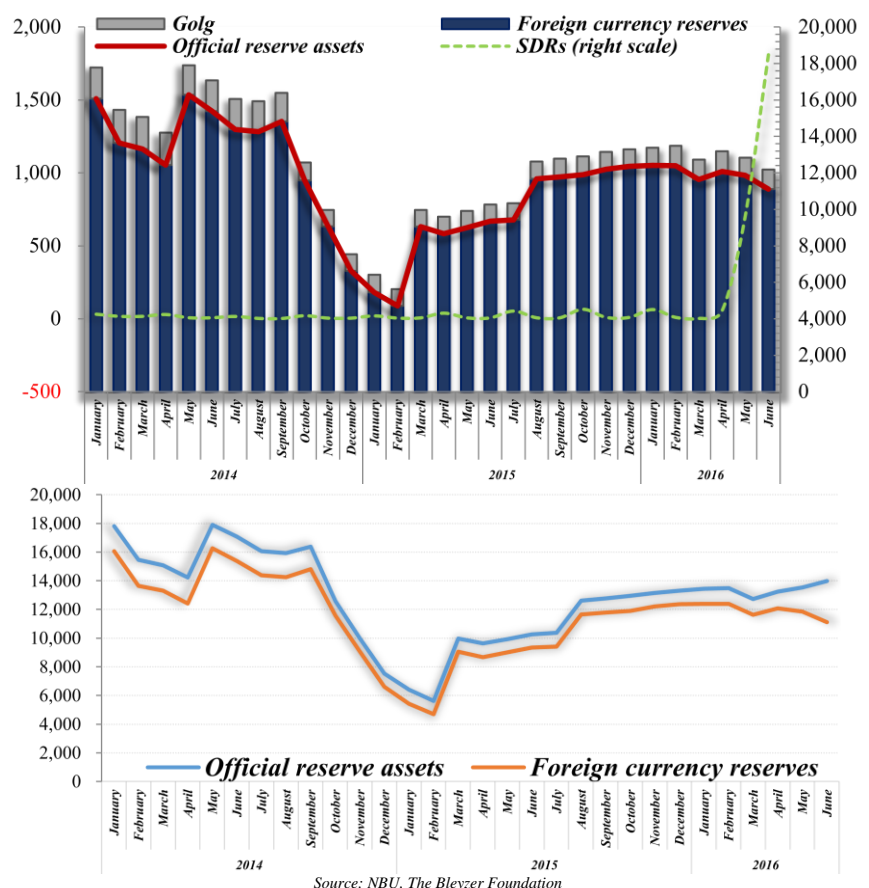
According to the NBU, in May 2016, the surplus in the current account of the balance of payments reached USD 403 million, compared to a deficit of USD 54 million in May 2015. Although in May 2016 exports declined by 2.3% yoy, imports declined by a larger percentage of 8.5% yoy. On a month-over-month basis, in May exports of goods decreased by 7.4% while imports declined by 10.9%. These improvements brought a near balance to the goods and services accounts. But significant surpluses in May in primary foreign income (USD 130 million) and secondary foreign income (USD 227 million) generated a May current account surplus of USD 403 million. This surplus in May helped reduce the cumulative current account deficit from the beginning of the year. In fact, in January-May 2016, the current account deficit totaled USD 424 million (or 1.4% of GDP), compared with USD 461 million in January-May 2015.

Exports of goods totaled USD 2,646 million in May 2016, compared to USD 2,857 million in the previous month of April 2016, and USD 2,707 million in May 2015. On a year-over-year basis, the most significant improvements in Ukraine's merchandise exports in May took place in agricultural products, which increased by 11.1% yoy in May and reached USD 1,088 million (about 41% of total exports). Exports of mineral products also showed a positive growth rate of 8.4% yoy. Similarly, exports of timber and wood products increased by 6.1% yoy. On the other hand, all other export categories showed declines in May 2016: chemicals by -26.8% yoy, machinery and equipment by -26.4% yoy, and metallurgy by -11.5% yoy.

Regarding the regional destination of exports, during January-May 2016, exports to Russia decreased by 37.9% yoy, and now represent 7.9% of the total, compared to 11.1% one year ago. During the same period, exports to Europe increased by 4.4% yoy and now represent 34.1% of total exports, compared to 28.6% in January-May 2015. Asia's share in total exports remained nearly unchanged at 35.1% of the total.

On the import side, in May 2016 merchandise imports declined by 8.5% yoy and totaled USD 2,696 million. The major drop in imports took place in energy products, which declined by 59.1% yoy. On the other

International Reserve of Ukraine, mln USD



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hand, non-energy imports increased by 18.0% yoy, including machinery and equipment imports by 56.6%, metallurgical imports by 23.6%; chemical imports by 11.9%; and food imports by 4.5%. In January–May 2016, imports from Russia continued to decrease with its share in total imports decreasing to 11.7% yoy. Imports from the EU increased by 3.0% yoy and now they represent 38.6% of the total. With a growth of 13.9% yoy, Asia’s share in total imports increased to 21.2% of total imports.

In May 2016, the financial account of the balance of payments was near balance, with small net financial outflows of USD 41 million. This brought net financial inflows since the beginning of the year (January–May 2016) to USD 410 million, compared with USD 1.6 billion of net outflow in January–May 2015.

Thanks to the surplus in the current account, the overall balance of payments surplus amounted to USD 374 million in May 2016, compared with USD 320 million in May 2015. As of June 1st, 2016, the volume of international reserves amounted to USD 13.5 billion, covering 3.5 months of future imports.

The IMF-Ukraine four-year Extended Fund Facility program of USD 17.5 billion originally foresaw quarterly revisions of the program, with four tranches expected to be disbursed in 2015, and another four in 2016. However, so far, the country has received only the first tranche of USD 5 billion in March 2015, and the second one of USD 1.7 billion in August 2015. The IMF has recently stated that Ukraine has made considerable progress in restoring macroeconomic stability over the past year and that most of the structural changes that were to be carried out by the authorities have already been implemented. It added that Ukraine is very close to the end of the second revision of the EFF program. But it also said that additional technical measures were required to turn the recent recovery into sustainable growth and that the IMF Board will consider further cooperation with Ukraine on the EFF program after the country fulfills these technical obligations. The government expects to receive a partial disbursement of about USD 1.0 billion in August with another large disbursement by the end of the year. If the IMF proceeds with its program, in addition to the USD 1.7 billion from the IMF, Ukraine will be able to secure an additional USD 2.3 billion in financial aid from other multilateral and bilateral institutions.

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