

October 2016

Oleg Ustenko, Julia Segura, Valentyn Povrozhnyuk
Edilberto L. Segura

Executive Summary:

- ❖ With the participation of Ukraine, France, Germany and Russia, a Normandy-Four Meeting was held in Berlin on October 19, with disappointing results. Russia insisted that the so-called “Donetsk and Luhansk People’s Republics” should hold elections and send their representatives to the Ukrainian Parliament. Moreover, Russia insisted that these quasi-republics should be granted high levels of autonomy, including the right to block any decision concerning Ukraine’s foreign policies. These proposals are unacceptable to the other parties.
- ❖ Ukrainian authorities have now been able to finalize the first stage of its electronic declaration system. Around 100,000 government officials submitted their declarations by the end of October. These declarations, which are now publicly available through the internet, include personal assets and incomes. The next stage is the examination of this information by the National Anticorruption Agency to determine whether these assets were obtained legally and what actions will need to be pursued.
- ❖ Monthly data released by the State Statistics Service show that the economy continued its recovery during September, with agricultural output increasing by 2.6% yoy, and industrial output by 2.0% yoy. Furthermore, during January-September, construction output increased by 13.2% yoy, cargo transport by 1.0% yoy, passenger transportation by 4.6% yoy, wholesale trade by 5.8% yoy and retail trade by 3.3% yoy. These positive developments were supported by a growth in real wages of 15.4% yoy in September.
- ❖ During September, an acceleration of growth in state budget expenditures, and a decline in state budget revenues, led to an expansion in the January-September state fiscal deficit to UAH 63.4 billion. As the fiscal budget of local governments was in balance in September, the monthly state budget deficit was transferred to the January-September consolidated budget deficit, expanding it to UAH 31.7 billion (about 1.7% of period GDP).
- ❖ The year-over-year rate of price inflation decelerated in September, returning to the level observed in July (7.9% yoy). As a result, inflation for 2016 is not likely to exceed 12%.
- ❖ The UAH/USD exchange rate appreciated in October at a slow pace. Inflows of USD to Ukraine increased thanks to agriculture exports. At the same time, Naftogaz secured foreign exchange resources to purchase natural gas from international markets, which removed the depreciatory pressure on the Hryvnia. As a result, the exchange rate moved to 25.6 USAH/USD
- ❖ Thanks to a surplus in the financial account that covered the deficit in the current account, as of October 2016, the level of international reserves amounted to USD 15.6 billion (about 3.9 months of future imports.)

<i>Main Macroeconomic Indicators</i>	2011	2012	2013	2014	2015	2016f	2017f
<i>GDP, USD billion</i>	163	173	180	130	98	95	100
<i>Real GDP Growth, % yoy</i>	5.5	0.2	0.0	-6.6	-9.9	1.5	3.0
<i>Fiscal Balance (incl. Naftogaz & Pension Fund), % of GDP</i>	-4.3	-5.5	-6.5	-11.7	-8.0	-4.0	-3.0
<i>Public Debt, External and Domestic, % of GDP</i>	36.4	36.6	40.4	69.4	79.4	84.4	82.0
<i>Consumer Inflation, eop, % yoy</i>	4.6	-0.2	0.5	24.9	43.3	12.0	10.0
<i>Hryvnia Exchange Rate per USD, eop</i>	8.0	8.1	8.2	15.8	24.0	27.0	28.0
<i>Current Account Balance, % of GDP</i>	-6.3	-8.3	-9.0	-4.1	0	-2.0	-2.0
<i>FDI, Net Annual Inflow, USD billion</i>	7.0	7.2	4.1	0.3	2.3	3.0	3.0
<i>International Reserves, USD billion</i>	31.8	24.5	20.4	7.5	13.3	17.0	20.0
<i>Public External Debt, USD billion</i>	33.3	32.1	31.7	34.9	47.0	55.0	60.0
<i>Private External Debt, USD billion</i>	84.6	92.0	99.2	82.0	70.0	65.0	62.0

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Political and Reform Developments

With the participation of Ukraine, France, Germany and Russia, a Normandy-Four Meeting was held in Berlin on October 19. The meeting was another attempt by Ukraine and its Western partners to stop Russian-supported aggression on its Eastern territory. The conflict has already killed more than 9,600 people since 2014. The outcome of the meeting is disappointing. Russia continued to argue that it is not a part of the conflict and Ukraine should resolve the conflict internally. Nevertheless, Moscow insisted that the so-called “Donetsk and Luhansk People’s Republics” should hold elections and send their representatives to the Ukrainian Parliament. Moreover, Russia insisted that these quasi-republics be granted high levels of autonomy, including the right to block any decision concerning the foreign policies of Ukraine. These proposals are unacceptable to the Ukrainian government. Ukraine maintains its original position that the first step is for Ukraine to regain complete control of its Eastern border. Only after will it hold elections that could be free from military and other pressures. Furthermore, the Ukrainian government is not prepared to grant any region veto power over its foreign policy. All participants of the meeting agreed to continue talks in the future. However, the date of the next meeting was not announced.

In a meantime, despite the ceasefire agreement reached in Minsk, Russian backed separatists continue their attacks against the Ukrainian army. In October, according to the Ukrainian Ministry of, the number of shots from the separatists increased by around 40% compared with the previous month. In several days during October, the daily number of shots against the Ukrainian army reached around 50.

Ukrainian authorities have now been able to finalize the first stage of its electronic declaration system. Around 100,000 government officials had submitted their declarations by the end of October. These declarations are publicly available through the Internet, including personal assets and income. Despite the general positive public attitude towards increased transparency, many Ukrainians expressed surprise about the large size of the declared assets. For instance, the total cash holding declared by Verhovna Rada members (419 deputies) is about USD 500 million. Moreover, many Ukrainian members of Parliament declared a large number of expensive luxury items, such as watches, art and antique collections, exotic items such as ownership of churches and holy relics, etc. The next stage is the examination of this information by the National Anticorruption Agency to determine whether these assets were obtained legally. The Agency expects to start these actions in January 2017 and finalize them by April. In case the investigations of the Agency discover legal violations, the corresponding cases would be transferred to the Anticorruption Court. However, the process of forming Anticorruption Courts has not yet been finalized, which is a necessary step to ensure that the cases will be properly handled.

In October 2016, the prime minister announced the plan of the Cabinet of Ministers to increase the minimum wage by 120% from its current level. The main government justification for such a step is the belief that it should decrease the size of the shadow economy, which today might be as high as 50%. On the other hand, the implementation of this decision might significantly increase fiscal budget expenditures, since the state wage schedule is fully related to the minimum wage. Moreover, some analysts have estimated that it might cause a hike in the level of unemployment in the country of around 5 p.p. to 15% (based on ILO methodology).

At the beginning of November, the IMF mission arrived in Ukraine to hold Article IV consultations and to carry out the third review of the IMF Extended Fund Facility Program. The IMF will evaluate the progress made in accordance with the memorandum of understanding within the framework of the Program. According to IMF statements, special attention will be paid to structural reforms and the new draft budget law. The government expects to receive a tranche release by the end of this year.

Headquarters

123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111
Fax: +1 (713) 621-4666
Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine

4A, Baseyna Street, «Mandarin Plaza», 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289
Fax: +38 (044) 284-1283
Email: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine

Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180
Fax: +38 (057) 714-1188
Email: kharkov.office@sigmableyzer.com.ua

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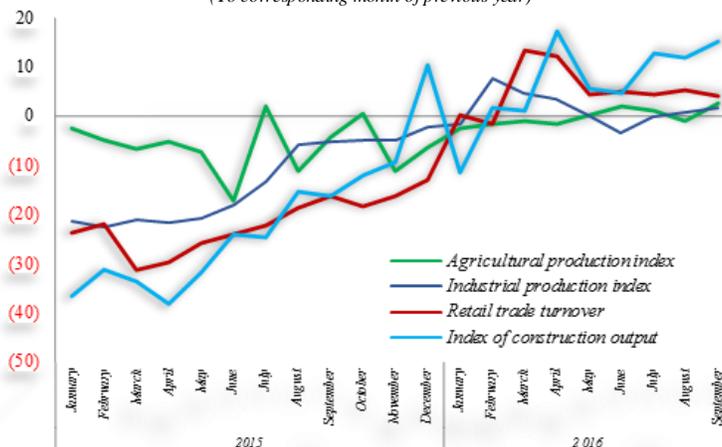
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Economic Growth

Monthly data released by the State Statistics Service shows that the economy continued its recovery during September, with agricultural output increasing by 2.6% yoy, and industrial output by 2.0% yoy. During January-September, construction output increased by 13.2% yoy, cargo transport by 1.0% yoy, passenger transportation by 4.6% yoy, wholesale trade by 5.8% yoy and retail trade by 3.3% yoy. These positive developments were supported/associated by a growth in real wages of 15.4% yoy in September and a reduction in wage arrears of 5.1% in the same month. On this basis, GDP is likely to increase by 1% to 2% during the entire year 2016.

Economic Performance of Ukraine by Sector, % yoy

(To corresponding month of previous year)

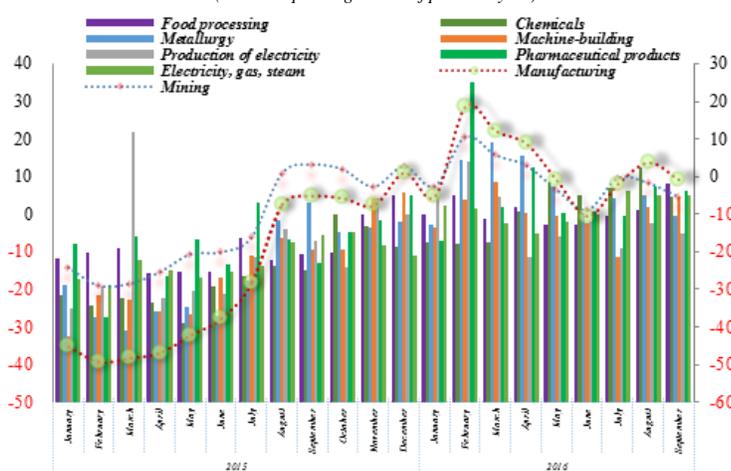


Source: The Bleyzer Foundation

During September 2016, industrial production grew by 2.0% yoy, the same rate of growth achieved in January-September 2016. Nevertheless, this rate of growth in September is below the high rate of 3.4% yoy recorded in August. The slowdown in September was caused by a contraction of 5.4% yoy in mining and quarrying output. Manufacturing, on the other hand, increased 4.6% yoy in September, driven by large increases in computers and electronics (190% yoy), leather products (16.1% yoy), food products (8.1% yoy), wood and paper products (6.0% yoy), and pharmaceuticals (6.0% yoy). On the other hand, negative growth was recorded in basic metals (-2.2% yoy), electrical equipment (-5.0% yoy), and motor vehicles (-12.1% yoy).

Industrial Production by Sectors, % yoy

(To corresponding month of previous year)



Source: State Statistics Committee, The Bleyzer Foundation

On a regional basis, in September 2016, the recovery in South-Eastern Ukraine was uneven with higher rates of industrial output in Luhansk (19.0% yoy), Mykolayiv (14.7% yoy), and Odesa (21.4% yoy), and contractions in Donetsk (-1.4% yoy) and Dnipropetrovsk (-5.8% yoy). In other parts of the country, the highest industrial growth rates in September were experienced in Zhytomyr (25.0% yoy), Kirivohrad (23.9% yoy), Cherkasy (21.8% yoy), and Khmelnytsky (19.2% yoy). On the other hand, negative growth in September was experienced in Lviv (-6.5% yoy), Ivano-Frankivsk (-2.2% yoy), and Poltava (-5.2% yoy).

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111
Fax: +1 (713) 621-4666
Email: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
4A, Baseyna Street, «Mandarin Plaza», 8th floor
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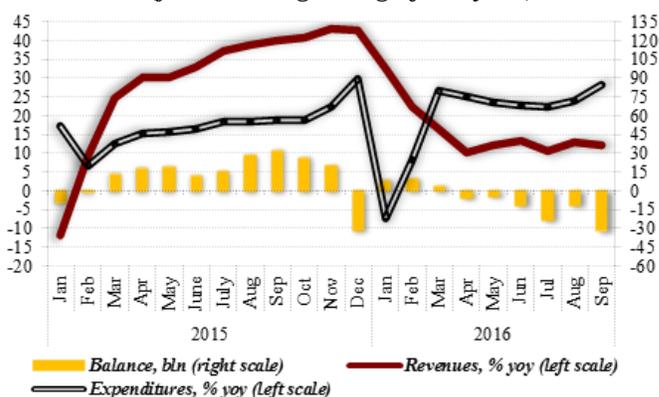
Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180
Fax: +38 (057) 714-1188
Email: kharkov.office@sigmableyzer.com.ua

Fiscal Policy

An acceleration of growth in state budget expenditures, accompanied by a small decline in revenues, led to a monthly state budget deficit of UAH 20.5 billion in September. This deficit expanded the cumulative state fiscal deficit from the beginning of the year to UAH 63.4 billion. As the fiscal budget balance of local budgets was around zero in September, the monthly state budget deficit almost fully transferred to the cumulative consolidated budget deficit, expanding it to UAH 31.7 billion, which is about 1.7% of period GDP.

The decline of total state budget revenues of 0.6% yoy in September was caused by a decline in non-tax state budget revenues and a deceleration of growth in tax revenues, which still grew by 16.4% yoy. As in previous months, the decline in nontax revenues was due to the absence of transfers from the NBU. Tax revenues were negatively affected by changes in administration procedures for corporate profit taxes and non-uniformity in VAT reimbursements from month to month. Receipts from excise taxes continued to grow at high rates, along with a higher growth rate of personal income taxes. As a result, growth of total state tax revenues remained high at 16.4% yoy.

**Dynamics of consolidated budget components
(from the beginning of the year)**



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

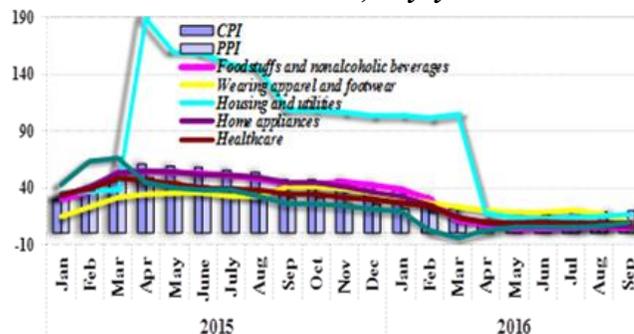
Scheduled principal and servicing payments on external debt and social security expenditures were the major reasons of acceleration in growth of state budget expenditures. They posted a 53.8% yoy growth in September. According to conditions for the restructuring of external sovereign bonds, the peak payments on those bonds are scheduled for March 1st and September 1st every year. Social security expenditures continued to grow at a high pace, as did payroll spending and capital expenditures.

Monetary Policy

Inflation. In September, year-over-year consumer inflation decelerated in September. It returned to the level observed in July (7.9% yoy). Therefore, inflation is likely to be below 12% in 2016.

Most of the major groups of goods and services saw deceleration of price growth. In particular, growth of prices of wearing apparel and footwear almost halved to 9.2% yoy. Growth in prices of education also decelerated to 13.8% yoy. Food prices grew by 4.2% yoy in September, which is almost one percentage point slower than a month ago. Deceleration in price growth of the other groups of goods and services was less significant ranging from 0.1 to 0.4 percentage points. Significant acceleration of price growth was reported only for two groups of

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



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Headquarters
123 N. Post Oak Ln., Suite 410
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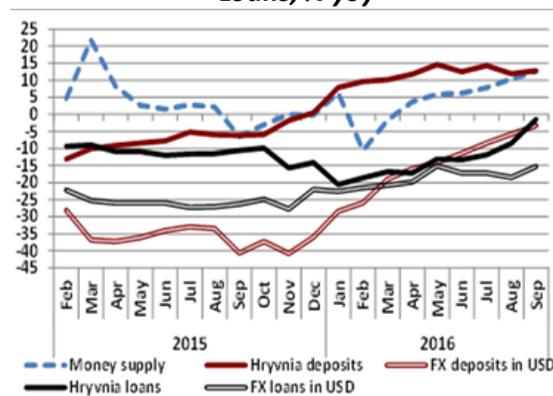
goods and services: transport and housing and utilities.

As consumer inflation continued to develop in line with expectations, the NBU decided to lower the policy rate again to 14.0% starting on October 28th.

Banking Sector. Stabilization of the foreign exchange market in the second half of September contributed to an expansion of national currency bank deposits. They expanded by 12.8% yoy. Deposits of both households and businesses expanded by 15.1% yoy and 13.3% yoy respectively. As for foreign currency USD deposits, the situation also improved as their decline decelerated from 5.8% yoy to 3.3% yoy. Corporate sector foreign currency deposits continued to expand but at a halved rate of 6.7% yoy. At the same time, the decline in household foreign currency deposits denominated in USD also almost halved to 6.9% yoy.

Slower inflation and a gradual decrease in the NBU's policy interest rate finally resulted in a gradual decline of interest rates on bank loans. This combined with activation of economic activities in the country led to improvements in bank crediting activities in September. In particular, the decline in national currency loans shrank by around 5.5 times to just 1.5% yoy. This happened because of positive changes in both the corporate and household sector. Corporate sector national currency loans returned to growth of 1.4% yoy (compared to a 3.2% yoy decline in August), while national currency loans to households saw a decline that significantly decelerated to 6.5% yoy (by 17.1 percentage points). Improvements in foreign currency loans denominated in USD were less significant in September. Total foreign currency loans declined by 15.3% yoy, which is 3.2 percentage points slower than in August.

Dynamics of Money Supply, Deposits, and Loans, % yoy

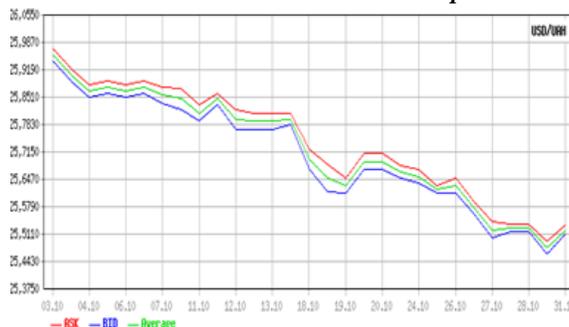


Source: The NBU, The Bleyzer Foundation

The decline in balances at the correspondent accounts of banks led to a small decrease in the monetary base in October. Money supply expanded in both monthly and year-over-year terms in October (by 0.6% and 12.6% respect.) thanks to growth in national currency deposits.

Hryvnia Exchange Rate. The UAH/USD exchange rate appreciated in October but at a very slow pace. Inflows of USD to Ukraine increased thanks to exports, mainly of agricultural products. At the same time, Naftogaz secured foreign exchange resources to purchase natural gas from international markets, which removed the depreciatory pressure on the Hryvnia. As a result, the supply of dollars exceeded demand on both cash and interbank forex markets, pushing the price of the dollar downwards. The NBU held numerous dollar-purchasing auctions to mitigate fluctuations on the interbank forex market. Therefore, the UAH/USD exchange rate appreciated by just around 1.7% in October. Taking into account the dynamics of the exchange rate over the last couple of months, we expect it to be around 26.00 UAH/USD by the end of the year.

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



Source: Ukrdealing, The Bleyzer Foundation

Headquarters
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International Trade and Capital

In September 2016, Ukraine's current account of the balance of payments had a deficit of USD 875 million (compared to a surplus of USD 146 million in September 2015). This monthly deficit increased the cumulative current account deficit for January-September to USD 2,292 million (or 3.5% of GDP).

The September current account deficit was fully covered by net financial account inflows of USD 1,343 million, which were provided by the issuance of debt securities by the government (about USD 1.0 billion) and about USD 450 million in FDI.

The major cause of the current account deficit in September was a reduction in merchandise exports of 7.1% yoy and an increase in merchandise imports of 6.8% yoy, which led to a negative goods trade balance of USD 625 million. In addition, in September, the primary income account had a deficit of USD 525 million, due mainly to large interest payments on government bonds issued in 2015.

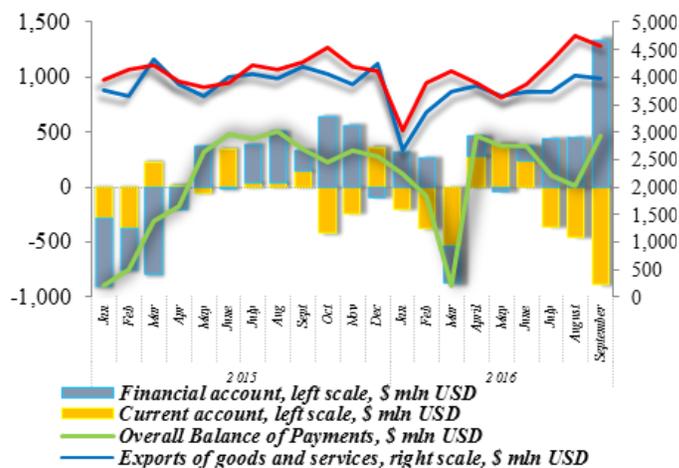
In September 2016, Ukraine's merchandise export amounted to USD 2,902 million. Major export declines took place in chemical products (-26.9% yoy), minerals (-24.6% yoy), and machinery and equipment (-8.5% yoy). Positive export growth in September was registered only in industrial exports (4.9% yoy), and timber and wood products (2.0% yoy).

Regarding the regional destination of exports, in January-September 2016, exports to Russia declined by 31.8% yoy, and now account for 9.1 of total exports, compared to 12.0% a year ago. On the other hand, Ukraine's exports to Europe increased by 3.8% yoy, and now represent 33.1% of total exports, compared to 28.8%, in January-September 2015. Asia's share in total exports declined by 11.3% yoy (principally to Asia's CIS countries following Russian pressures) and now amount to 34.9% of the total.

On the imports side, in September, Ukrainian merchandise imports increased by 6.8% yoy to USD 3,527 million. Imports increased in all categories of goods, with the highest increases in machinery and equipment (19.4% yoy), wood products (12.6% yoy), metals (11.7% yoy) and food products (10.7% yoy). Regional-wise, during January-September 16, the largest drop in imports was from Russia with a reduction of 35.1% yoy, which brought imports from Russia to 12.6% of the total. On the other hand, imports from the EU increased by 2.4% yoy and now represent 39.6% of the total amount. Merchandise imports from Asia showed a large increase of 20.8% yoy, bringing Asia's share in total imports to 20.7%, from 16.7% a year ago.

Thanks to a surplus in the financial account that covered the deficit in the current account, as of October 2016, the level of international reserves amounted to USD 15.6 billion (about 3.9 months of future imports.)

Ukraine's External Balance of Payments, million USD



Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
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Fax: +38 (057) 714-1188
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