Ukraine Macroeconomic Situation

July 2016

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Executive Summary:

- During the last few weeks, the military situation in Ukraine's East has further deteriorated. Truce violations have been the highest since last fall. This situation has led President Poroshenko to put the Ukrainian army on high alert and to state that he will call for martial law and mobilization if the conflict escalates. The US and the EU have assured Ukraine of support to its territorial integrity, but have stated their belief that Russia will not invade Ukraine further.
- Although the pace of reforms is still slow, the government is accelerating the implementation of reforms. In particular, the government is giving renewed impetus to its fight against corruption by forcing the rapid introduction of electronic declaration of incomes by government officials. Recently, there have been a number of arrests and investigations over government officials' corrupt practices. On the other hand, there have also been confrontations among vested-interest parties.
- The State Statistics Service reported that Ukraine's real gross domestic product (GDP) increased by 1.3% yoy in the second quarter of 2016. This is the second consecutive quarter with positive GDP increases since 2013.
- High-frequency data for June shows that the favorable GDP outcome in Q2 was due to good performance in April and May, but with June returning to contraction. However, data for July shows that the economy is gradually recovering, but at a slow pace. GDP growth in 2016 is likely to be around 1%-2%.
- Ukraine's fiscal budget situation slightly deteriorated in June as expenditures grew faster than revenues, both at central and local levels. Overall, the consolidated fiscal budget balance from the beginning of the year remained negative and expanded to UAH 11.3 billion. However, this deficit is still very small and represents less than 1% of period GDP.
- The country's inflation rate has declined to 6.9% yoy in June, thanks principally to deflation in foodstuffs and clothing prices. This led the NBU to lower the policy interest rate for the fourth time in four months to 15.5% starting on July 29th.
- Banking sector deposits in national and foreign currencies saw moderate increases in June, while bank lending activities posted another sluggish performance.
- The UAH/USD exchange rate saw only insignificant fluctuations in July, which did not exceed 0.3% per day following the common seasonal trend for the month on the back of favorable world market prices and significant supply of dollars among the population. However, concerns about the military situation in Ukraine's east caused volatility in the exchange rate in August, which reached 25.3 UAH/USD in the second half of the month.
- In June 2016, the current and financial accounts of the balance of payments showed surpluses of USD 241 million and USD 136 million, respectively. Because of these positive balances, the overall surplus of Ukraine's consolidated balance of payments in June amounted to $377 million. The consolidated balance of payments in January through June posted a surplus of $406 million compared to a deficit of $1.4 billion in January through June 2015. This led to an increase in international reserves to about USD 14.3 billion, sufficient to finance imports for 3.6 months.
- The level of international reserves of Ukraine has permitted the country to endure delays in disbursements under the IMF-Ukraine four-year Extended Fund Facility program. The IMF is still saying that although Ukraine has made considerable progress in restoring macroeconomic stability, there are some "technical measures" that are required to turn the recent recovery into sustainable growth. The government now expects to receive a partial disbursement of about USD 1.0 billion in September, with another large disbursement by the end of the year.

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

The Ukrainian government has reported an escalation in the use of heavy weapons by separatists in Eastern Ukraine. In addition, Ukrainian observers have reported a large increase of Russian military forces at the border and in Crimea. During the month, further tensions emerged in connection with Russia's statements that its security services had arrested a "group of Ukrainian saboteurs" on the Crimean Peninsula and that Russian soldiers in Crimea had been killed by the Ukrainian army. The Kremlin administration used this information to disavow international negotiations to resolve the conflict in Donetsk and Luhansk. However, Ukrainian, US and EU authorities have stated that there is no evidence of these incidents in Crimea.

These are worrisome developments, with many analysts in Ukraine fearing that Russia may be preparing itself for further aggression against Ukraine. Nevertheless, US and EU authorities believe that Russian actions do not represent an immediate risk for Ukraine, as they may be related only to regular Russian military drills. In any case, President Poroshenko has put the Ukrainian army on high alert and stated that he will call for martial law and mobilization if the conflict escalates. The US and the EU have assured Ukraine of support to its territorial integrity. They also confirmed their intentions to continue sanctions against the Russian Federation until it fully implements the requirements of the Minsk-2 agreement. These leaders also announced their intention to revive international peace negotiations. President Poroshenko has also asked for a greater international presence in Donbas through the expansion of OSCE Special Monitoring Missions and the deployment of OSCE armed police missions.

Despite progress in delivering the reform agenda, Ukraine continues to suffer from confrontations among vested interests. For example, the newly founded National Anti-Corruption Agency (NACA) was accused by the General Prosecutor's Office (GPO) of carrying out illegal investigations against several prosecutors of GPO. Thanks to significant support from the head of the GPO, the President and civil society, the conflict was resolved. Nevertheless, this case shows the difficulties in trying to address judiciary corruption on an individual case-by-case basis. A more comprehensive approach to address corruption in the judiciary is needed.

Another element of the anti-corruption drive is to grant citizens the right to monitor income and expenditures of government officials. The main instrument approved by the government is to increase transparency by introducing electronic income declarations. This item was also on the agenda of all major international partners, including international financial institutions and the EU. The IT platform was developed by a UNDP contractor, which certified that it was in accordance with international standards. Government officials were expected to start reporting their incomes electronically starting on August 15th. However, several

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days before the introduction of the system, the government institution responsible for protecting information announced that it would not certify the system. Without such certification, government officials could not be subjected to criminal investigation if they do not report correct income information. Instead, authorities proposed that this system should be operating in test mode. However, non-governmental institutions, such as Transparency International, made public announcements that such a "test-operating-regime" of e-governance was not acceptable. The government has now indicated that all safety issues would be resolved shortly and the system should be fully operational in September. This case illustrates the positive role of civil society in enhancing political will and commitment to reform.

The number of corruption investigations also increased in June. Over the month, several government employees were charged with corruption practices by the NACA. Those involved were officials from several agencies, including local and central state bodies and the court system. However, deficiencies in Ukrainian criminal law procedures allowed the accused officials not to appear in court. All these cases are under the scrutiny of Ukraine's civil society and international partners.

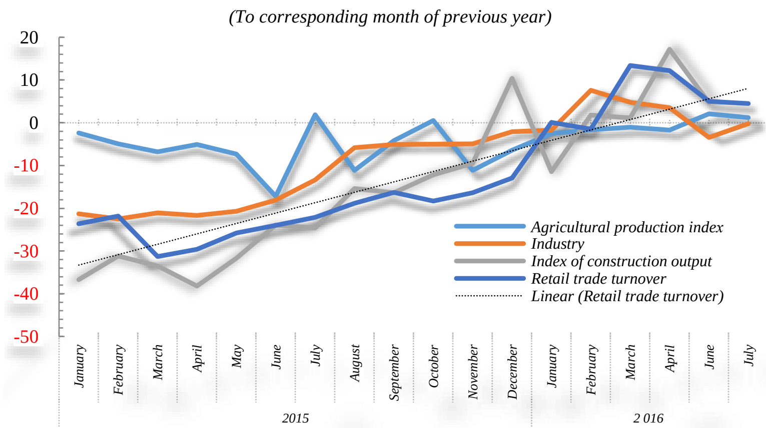
On a more positive note, the newly appointed Acting Minister of Public Health reported that the recent transfer of public procurement of medicine to international specialized institutions working within the UN has already allowed the ministry's budget to save a significant sum. Similar positive results have been reported by the expert community monitoring the newly introduced general system of public procurement called ProZoro. This system has increased the level of transparency in procurement for different public institutions.

Economic Growth

The State Statistics Service has reported that Ukraine's real gross domestic product (GDP) increased by 1.3% yoy in the second quarter of 2016. This is the second consecutive quarter with positive GDP increases yoy since 2013. In the first quarter of this year, GDP had increased by 0.1% yoy.

High frequency monthly data show that the favorable outcome in Q2 was due to good performance in April and May, but with June returning to contraction after several months of expansion. Following positive rates of growth year-over-year of 7.6% in February, 4.8% in March, 3.5% in April, and 0.2% in May, industrial output contracted by –3.4% yoy in June.

Economic Performance of Ukraine by Sector, % yoy



Source: The Bleyzer Foundation

The main reasons for this poor performance in June were declines in the production of motor vehicles (-8% yoy), machinery and equipment (-4% yoy), electrical equipment (-2% yoy), and furniture (-13% yoy). Other industrial subsectors showed either lower declines or small output increases. These output declines were likely due to a large decline of Ukrainian exports in June (-8.3% yoy), which may have been caused by a slowdown in to a slowdown in the world economy and increasing uncertainties in Ukraine and its main trading partners.

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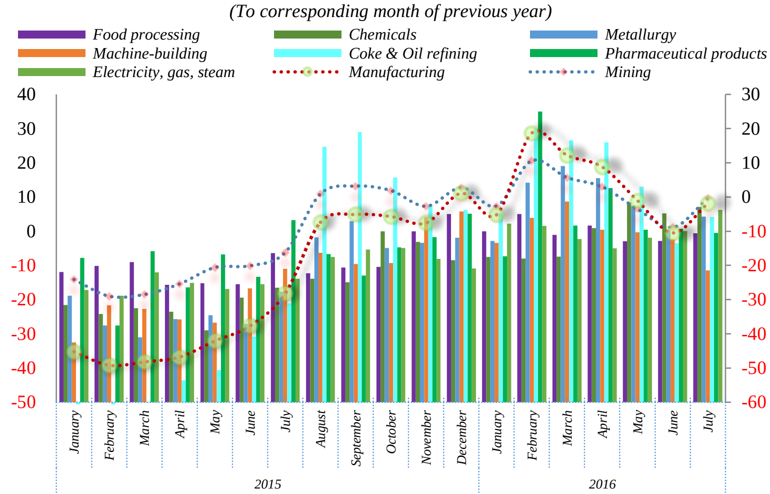
More recent data for July, however, showed some improvements. The State Statistics Service changed its methodology in July, introducing a new form of data presentation, adjusted for calendar days. Based on the previous methodology, industrial output in July increased by 0.9% yoy. Based on the new methodology, industrial production in July decreased by a small rate of 0.2% yoy. On a month-over-month basis, industrial output in July increased by 7% mom, or by 4% mom after seasonal adjustment.

During January-July 2016, the regions that showed the highest increases in industrial output compared to last year were Lugansk (75.0% yoy), Chernihiv (9.9% yoy), Kyiv (9.2% yoy), and Cherkasy (7.1% yoy). The largest industrial output declines took place in Sums (-11.4% yoy), Ivano-Frankivsk (-8.8% yoy), Chernivtsi (-8.5% yoy), and Volyn (-5.8% yoy).

The most recent information on other economic activities confirms that the Ukrainian economy is indeed recovering, though at a slow pace. In fact, agricultural production in June increased by 2.1% yoy; wholesale and retail trade increased by 5.0% yoy in June; construction activities increased by 4.7% yoy in June, with residential building construction increasing by 21.9% yoy; cargo and passenger transportation increased by 2.4% yoy and 2.9% yoy, respectively. After two years of contractions, GDP should grow by about 1% to 2% in 2016.

Industrial Production by Regions, % yoy

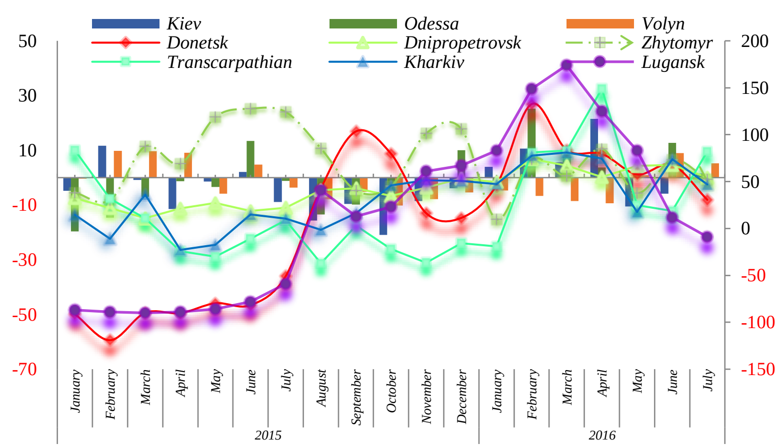
(To corresponding month of previous year)



Source: The Bleyzer Foundation

Industrial Production by Sectors, % yoy

(To corresponding month of previous year)



Source: The Bleyzer Foundation

However, the risks of further economic declines will remain high until the military situation in Eastern Ukraine is brought under full control.

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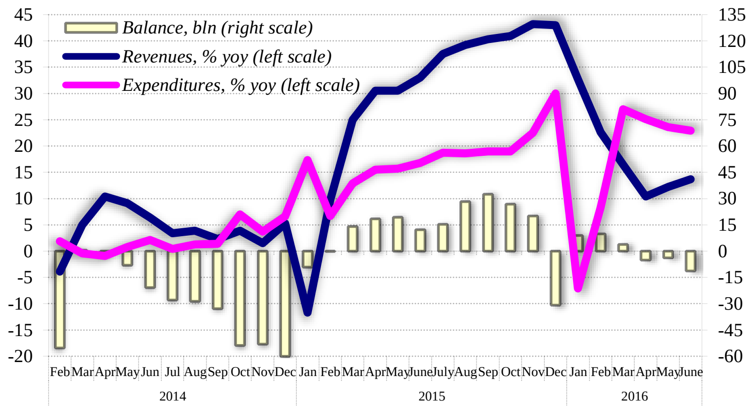
Fiscal Policy

Ukraine's fiscal budget situation is still satisfactory, but it deteriorated slightly in June as expenditures grew faster than revenues, both at central and local levels. In particular, the state budget deficit expanded by UAH 8.6 billion in June, reaching UAH 35.1 billion from the beginning of the year. Although the local budgets in June still generated a positive balance of UAH 1.1 billion, it was five times lower than in May. Overall, the consolidated fiscal budget balance from the beginning of the year remained negative and expanded to UAH 11.3 billion. However, this deficit is still very small and represents less than 1% of period GDP.

Dynamics of consolidated budget components

(from the beginning of the year)



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

The fiscal budget deteriorated in June despite the fact that fiscal revenues increased. In fact, the growth of the state budget revenues accelerated in June due to faster growth of tax revenues, particularly VAT and personal income taxes. Accelerated increases in VAT receipts were the result of abnormally low VAT refunds, while personal income tax receipts expanded thanks to growing nominal wages. On the other hand, the dynamics of non-tax state budget revenues remained negative because of lack of transfers from the NBU. Overall, total state budget revenues in the first half of the year posted an 8.6% yoy growth, about 1.6 percentage points higher than in January-May. Tax revenues grew at an accelerated rate of 25.3% yoy, while the decline in nontax revenues decelerated by 3.9 percentage points to 49.7% yoy. The largest increase among tax revenue categories took place in rents on special utilization of natural resources, at 48.0% yoy. Increases in receipts from VAT on domestic goods and services led to acceleration in growth of internal taxes on goods and services from 32.0% yoy to 37.7% yoy. Revenues of local budgets continued to expand at a rate higher than the growth rate of state budget revenues for 2016, despite some deceleration in growth in June. As a result, consolidated budget revenues increased by 13.7% yoy over in the first half of the year.

As noted earlier, fiscal budget expenditures grew at a faster pace than revenues in June. The increase in state budget expenditures was due to a high growth rate of payroll expenditures. Some increases were also observed in expenditures on goods and services and in capital expenditures. Growth of social expenditures decelerated mostly because of a seasonal decline in heating subsidies for the population. At the same time, the growth of total expenditures for H1 decelerated compared to growth in January-May (by 1.4 percentage points to 22.3% yoy). Social security expenditures continue to have the highest share in total state budget expenditures and had the sharpest increase of 51.8% yoy as of the end of June. Expenditures on public order, security, and judiciary and defense expenditures also posted high growth rates in H1 2016 (33.3% yoy and 27.6% yoy respectively). Expenditures of local budgets grew at virtually the same rate as state budget expenditures. Therefore, consolidated budget expenditures also posted nearly the same growth of 22.9% yoy in January-June.

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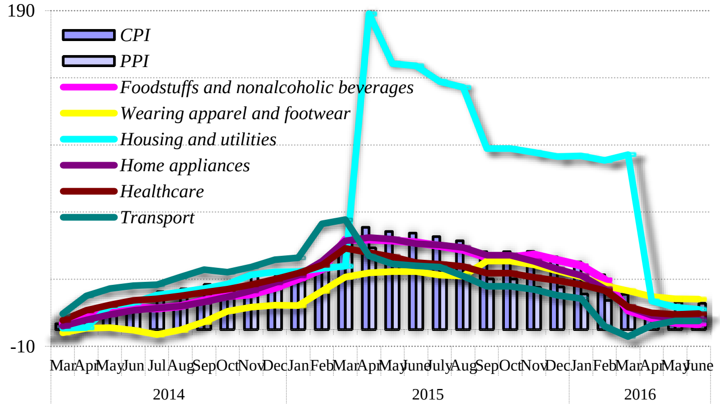
Monetary Policy

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



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Inflation. Consumer prices declined in June on a month-over-month basis. This was principally the result of seasonal decreases in prices of foodstuffs and wearing apparel and footwear. In particular, prices of foodstuffs posted a 0.6% mom decline, while wearing apparel and footwear saw a 2.0% mom decrease. The prices of other groups of goods and services were either stable (such as in communications, utilities, and leisure and culture) or increasing at low rates, ranging from 0.3% mom for healthcare and home appliances to 2.7% mom for alcoholic beverages and tobacco products. As a result, the overall monthly decline in consumer prices was at 0.2% mom. The decline in foodstuffs prices was driven by a seasonal decrease in prices of fruits and vegetables, while lower prices of apparel and footwear were the result of seasonal sales. Prices of alcoholic beverages continued to grow on the back of excise tariffs increases in March and the price policies of some tobacco producers that led to higher tobacco prices.

In year-over-year terms, consumer inflation decelerated from 7.5% in May to 6.9% in June. Most of the major groups of goods and services reported deceleration in growth of prices on a year-over-year basis. The most significant deceleration was observed in prices of leisure and culture services at 1.7 percentage points to 9.6% yoy. Prices of utilities also saw significant deceleration in growth from 13.3% yoy to 12.1% yoy. Just three major groups of goods and services reported acceleration in growth of prices in June. Those were healthcare, alcoholic beverages and tobacco products, and transport. However, acceleration in transport prices was insignificant (0.1 percentage point to 5.2% yoy). Healthcare saw the most significant acceleration in growth of prices from 9.0% yoy to 9.5% yoy.

The rapid softening of inflationary pressures supported by further improvement in inflationary expectations allowed the NBU to soften its monetary policy. In particular, the regulator lowered its interest policy rate by 1.0 percentage point to 15.5% starting on July 29th, marking the fourth policy rate decrease in recent months. The NBU admitted that resumed over-year growth of real wages did not have any impact on consumer prices, as consumer demand remained depressed. Taking into account current dynamics of consumer prices, we leave our forecast for consumer inflation unchanged at 12% yoy in 2016.

Banking Sector. Bank deposits in national currency and foreign currency further expanded in June. A 3.2% mom growth in household national currency deposits fueled the increase of total national currency deposits of 1.8% mom. National currency deposits of the corporate sector also increased but at a much slower pace of 0.6% mom. On the other hand, the increase in total foreign currency deposits denominated in USD of 2.1% mom was attributed to a 6.5% mom growth of corporate sector deposits. In year-over-year terms, growth of national currency deposits decelerated by 2 percentage points to 15.0% yoy, while foreign exchange deposits denominated in USD further decreased at 11.4% yoy.

As the banking sector continues to recover, the resource base of the banks expands. However, this has very little effect on the banks' lending activities, which posted another sluggish performance in June. In particular, national

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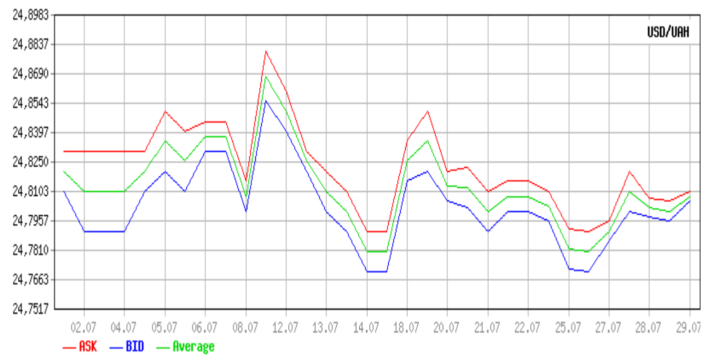
currency loans declined by 0.7% mom as loans of both the corporate and household sector posted small decreases of 0.5% mom and 1.4% mom, respectively. A 2.7% mom decrease in the foreign currency loans denominated in USD was the result of a 2.0% mom decline in household loans and a 2.8% mom decline in loans provided to the corporate sector. In year-over-year terms, the decline of national currency loans remained almost unchanged at 13.3% yoy. Foreign currency loans denominated in USD continued to decline at a faster pace than national currency loans (17.2% yoy).

The monetary base further expanded in June on the back of increases in the balances on correspondent accounts of commercial banks and of cash balances. The monthly increase in the monetary base was at 4.5% mom, which more than doubled the year-over-year growth to 6.7%. The increase in deposits was the major reason for further money supply increase of 1.5% mom. In year-over-year terms, money supply growth accelerated to 6.2%.

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



Source: Ukrdealing, The Bleyzer Foundation

Hryvnia Exchange Rate. In July, the UAH/USD exchange rate was relatively stable. Favorable conditions on external markets and significant supply of foreign currency among the population imposed some appreciation pressures on the exchange rate. However, the NBU continued its practice of holding foreign exchange auctions as an alternative for direct foreign exchange market interventions to level the exchange rate fluctuations. Increased demand for dollars on Fridays (as it is safer for businesses to stay in dollar during the weekend in Ukraine because of difficulties in the economy) and Mondays (lack of dollar supply due to big difference in time with world dollar exchange markets) led to several short periods of minor increases in the price of dollars. However, subsequent trading sessions pushed prices back down. As a result, the exchange rate fluctuated within the interval of 24.78-24.84 UAH/USD for most of July.

However, the growth of volatility in the hryvnia exchange rate during August has been caused by uncertainties about the military situation in Eastern Ukraine and Crimea, with the exchange rate depreciating to 25.3 UAH/USD in the second half of August. If the military situation is calmed, the exchange rate should remain at around 25 UAH/USD at the end of the year.

International Trade and Capital

In June 2016, Ukraine's current account of the balance of payments showed a surplus of USD 241 million, reducing the cumulative current account deficit for January-June to only USD 184 million or less than one-half of 1% of period GDP. This surplus in June was caused principally by positive inflows of primary and secondary foreign income (particularly workers remittances) and despite a negative merchandise trade balance of USD 190 million.

Exports of goods totaled USD 2,691 million in June 2016, compared to USD 2,936 million in June 2015, a decline of 8.3% yoy. On a year-over-year basis, the most significant declines in merchandise exports in June took place in chemicals (-39% yoy), energy and mineral products (-27% yoy), metallurgy (-11% yoy), machinery and equipment (-10% yoy), and industrial goods (-10% yoy). Only agricultural products increased exports by 7% yoy in June. Regarding the regional destination of exports, during January-June 2016, exports to Russia

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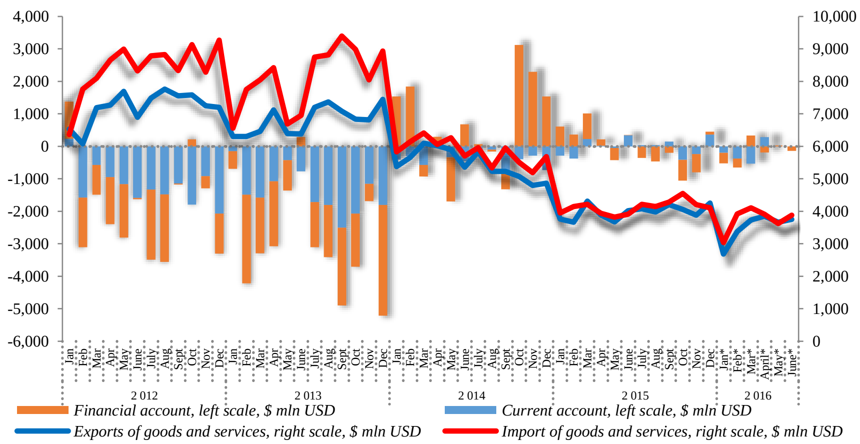
decreased by 36.5% yoy, and now represent 8.4% of the total, compared to 11.6% a year ago. During the same period, exports to Europe increased by 6.8% yoy and now represent 34.5% of total exports, compared to 28.5% in January–June 2015. Asia's share in total exports remained nearly unchanged at about 35% of the total.

On the import side, in June 2016 merchandise imports declined by 2.4% yoy and totaled USD 2,881 million. The major drop in imports took place in energy products, which declined by 43.2% yoy. On the other hand, all categories of non-energy imports increased in June, including machinery and equipment imports by 42.5% yoy, industrial goods by 26.1% yoy, agricultural products by 13% yoy, metallurgical imports by 9.3%, and chemical imports by 2.2%. In January–June 2016, imports from Russia continued to decrease with its share in total imports decreasing to 12% yoy. Imports from the EU also declined by 2.7% yoy and now they represent 40.2% of the total. With a growth of 16.9% yoy, Asia's share in total imports increased to 21.1% of total imports.

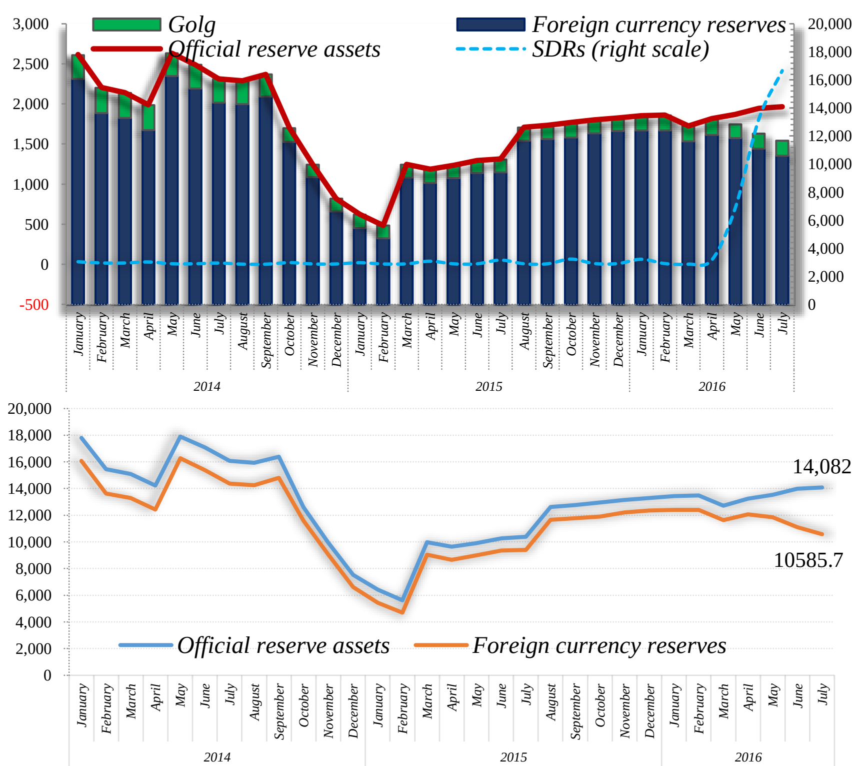
On the financial account, net financial inflow reached USD 136 million in June 2016. From the beginning of the year, financial inflows amounted to USD 547 million, compared to outflows of $1.6 billion in the same period of 2015. These inflows were caused principally by net increases in foreign direct investments. In fact, net inflow of FDI in January-June 2016 amounted to about $2 billion,

Ukraine's External Balance of Payments, mln USD



Source: NBU, The Bleyzer Foundation

International Reserve of Ukraine, mln USD



Source: NBU, The Bleyzer Foundation

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principally for the recapitalization of subsidiaries of foreign banks, as required by the NBU.

As a result of positive balances in the current and financial accounts, the overall surplus of Ukraine's consolidated balance of payments in June amounted to $377 million. The consolidated balance of payment in January through June posted a surplus of $406 million compared to deficit of $1.39 billion in January through June 2015. This led to an increase in international reserves to about USD 14.3 billion, sufficient to finance imports for 3.6 months.

The level of international reserves of Ukraine has permitted the country to endure delays in disbursements under the IMF-Ukraine four-year Extended Fund Facility program. The IMF is still saying that although Ukraine has made considerable progress in restoring macroeconomic stability, there are some “technical measures” that are required to turn the recent recovery into sustainable growth. The IMF Board will consider further cooperation with Ukraine on the EFF program after the country fulfills these technical obligations. The government now expects to receive a partial disbursement of about USD 1.0 billion in September with another large disbursement by the end of the year. If the IMF proceeds with its program, in addition to the 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.