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Ukraine Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

October 2018

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Executive Summary

- In October 2018, Ukraine and the IMF agreed to continue their cooperation under a new USD 3.9 billion Stand-by Arrangement. This agreement will support the country's financial stability until the end of 2019.
- The newly released World Bank Doing Business Report shows that Ukraine has made significant progress. The country climbed five spots in the ranking and currently occupies the 71st position among 190 countries.
- According to the latest information from the Office of the President, during the first nine months of 2018, GDP grew by 3.8% yoy. For the year as a whole GDP is expected to increase by a rate of 3.5% to 4.0%.
- During September the main engine of economic growth continued to be the agricultural sector, which expanded by 11.4% yoy (52.1% mom), supported by favorable weather conditions. Other sectors did not perform as well, with small declines in most activities. These declines were caused by a weakening of private consumption, caused by a 12.9% yoy decline in real wages and an increase of 17.1% yoy in wage arrears in September 2018.
- The consolidated fiscal budget remains satisfactorily, with a surplus of UAH 14.5 billion (about 0.6% of period GDP) for January-September 2018. For the entire year 2018, the consolidated fiscal budget is expected to have a deficit of 2.5% of GDP as agreed with the IMF.
- Consumer inflation has been relatively stable for a third month in a row. The all items price index remained at 8.9% yoy in September. Core inflation also remained unchanged at 8.7% yoy.
- In the banking sector, both deposits and lending activities posted improvements in September. Hryvnia deposits expanded by 11.8% yoy, while Hryvnia loans expanded by 13.2% yoy.
- During October, the exchange rate has remained stable, finishing the month at around 28.1 UAH/USD.
- In September 2018 the deficit in the current account of the balance of payments amounted to USD 1.7 billion. This deficit was caused by a 3.6% decline in goods exports alongside a 17.3% increase in imports of goods, principally of oil and gas. Financial inflows of USD 1.1 billion (principally from trade credits) financed the bulk of the CA deficit. International reserves amounted to USD 16.6 billion at the beginning of October.

Main Macroeconomic Indicators	2012	2013	2014	2015	2016	2017	2018f
***GDP**, USD billion*	173	180	130	87	93.4	113	125
***Real GDP Growth**, % yoy*	0.2	0.0	-6.6	-9.9	2.4	2.5	3.5
***Fiscal Balance** (incl. Naftogaz/Pension Fund),% of GDP*	-5.5	-6.5	-11.7	-2.1	-2.3	-1.4	-2.5
***Public Debt, External and Domestic,** % of GDP*	36.6	40.4	69.4	79.1	80.9	71.8	67.5
***Consumer Inflation,** eop, % yoy*	-0.2	0.5	24.9	43.3	12.4	13.7	10.0
***NBU Key Policy Interest Rate,** % eop*	7.5	6.5	14.0	22.0	14.0	14.5	18.0
***Hryvnia Exchange Rate per USD**, eop*	8.1	8.2	15.8	24.0	27.1	28.1	28.0
***Current Account Balance**, % of GDP*	-8.3	-9.2	-3.5	1.8	-1.9	-2.5	-3.0
***Merchandise Exports,** USD billons*	64	59	51	35	34	40	43
***Merchandise Imports,** USD billions*	86	81	58	39	40	49	52
***FDI,** Net Annual Inflow, USD billion*	8.4	4.5	0.4	3.0	3.3	2.3	5.0
***International Reserves**, USD billion*	24.5	20.4	7.5	13.3	15.5	18.8	18.0
***Public External Debt,** USD billion*	32.1	31.7	34.9	42.6	42.5	47.0	50.0
***Private External Debt,** USD billion*	102.3	110.3	91.2	76.0	69.9	70.0	71.0

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Political and Reform Developments

In October 2018, Ukraine and the IMF agreed to continue their cooperation under a new USD 3.9 billion Stand-by Arrangement which would be in place until the end of 2019. The new program would replace the current Extended Fund Facility. The IMF stated that the country has succeeded in reaching macroeconomic equilibrium, with stable exchange rates and inflation. Greater fiscal budgetary realism was achieved and monetary policy was supported by a restructured banking sector. Economic growth has resumed after a deep recession in 2014-2015. The new program should pave the way for opening Ukraine to other sources of international financing. This should ensure financial stability until the end of 2019.

In the newly released World Bank Doing Business Report, Ukraine showed significant progress. The country climbed five spots in the ranking of "Easy of Doing Business", and currently occupies the 71st position among 190 countries. The most significant progress was achieved in (i) international trade and (ii) enforcement of contracts. At the same time, the country dropped in the ratings of (i) taxation and (ii) connection to the power supply system. However, it is expected that newly adopted regulations in energy should significantly liberalize this sphere and improve the country's overall position in the next year rating.

On November 1st, during her visit to Kyiv German Chancellor Angela Merkel reconfirmed European support to Ukraine. On Russia's military activities, Chancellor Merkel recognized that despite numerous attempts to end violence, aggression against Ukraine continues. The Chancellor signaled that starting a future peace keeping operation in the East of the country is the number one priority for the Western partners of Ukraine.

Economic Growth

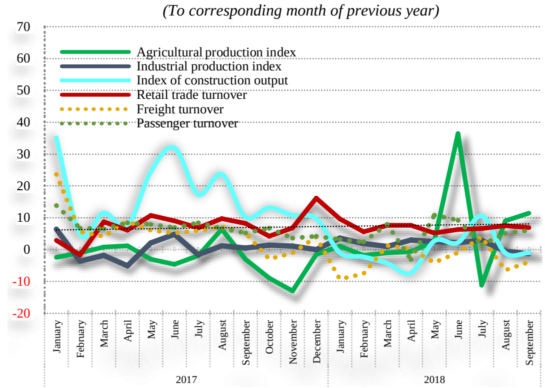
According to the latest information from the Office of the President, during the first nine months of 2018, Gross Domestic Product (GDP) grew by 3.8% yoy. For the year as a whole, GDP is expected to increase at a rate of 3.5% to 4.0%. These are significant improvements over the GDP growth rate of 2.5% achieved in 2017.

During September, the main engine of economic growth continued to be the agricultural sector, which expanded by 11.4% yoy (52.1% mom), supported by favorable weather conditions.

Other sectors painted a less favorable picture, with declines in retail trade turnover of -6.9% yoy, construction output by -1% yoy, industrial production by -1.3% yoy, and freight and passenger turnover by 0.5% mom and 1.2% mom, respectively. These declines were associated with a weakening of private consumption. In turn, this weakening was caused by a 12.9% yoy decline in real average wages and an increase of 17.1% yoy in wage arrears per employee in September 2018.

Ukraine Economic Performance, % yoy

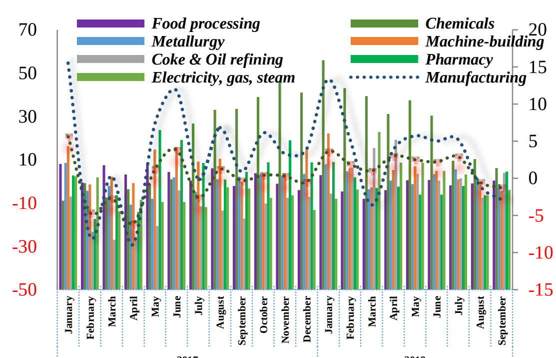
(To corresponding month of previous year)



Source: State Statistics Committee, the Bleyzer Foundation

Industrial Production by Sectors, % yoy

(To corresponding month of previous year)

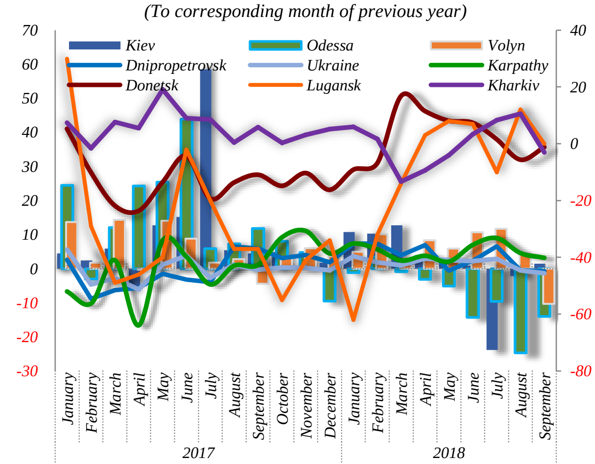


Source: *State Statistics Committee, the Bleyzer Foundation*

The September declines in industrial output affected most subsectors. Positive year-on-year sector performances in September were registered in chemical products (6.1% yoy); pharmaceutical products (4.5% yoy); coke and refined petroleum products (3.9% yoy); and foodstuffs, beverages and tobacco products (0.3% yoy). Other economic sectors showed negative results, in particularly the textile industry (-11% yoy); wood products, paper & printing (-4.9% yoy); furniture, repair, installation of machinery & equipment (-4.7% yoy); machinery manufacture (-4.5% yoy); rubber, plastic, & non-metallic mineral products (-1.7% yoy); and metal products (-1.3% yoy). Electricity, gas, steam and air conditioning supply, also showed negative results, with a decline of 3.9% yoy.

Industrial Production by Region, % yoy

(To corresponding month of previous year)



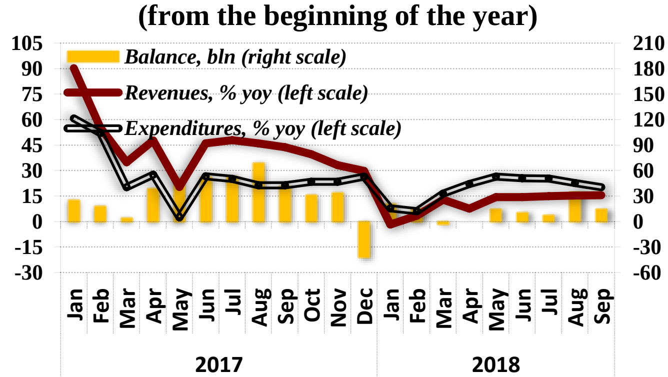
Source: *State Statistics Committee, the Bleyzer Foundation*

As to the regional distribution of industrial production, in September 2018 the highest output growth took place at the following regions: Sumy (41.7% yoy), Ternopil (4.9% yoy), Zaporizhzhya (4.4% yoy), Zakarpattya (3.2% yoy), Ivano-Frankivsk (2% yoy), Kyiv (1.5% yoy), Poltava (1.2% yoy), Chernivtsi (0.9% yoy), and Kherson (0.8% yoy). The worst output performances continued to be in Odesa (-14% yoy), Volyn (-10% yoy), Kyiv city (-6.3% yoy), Lviv (-5.4% yoy), Zhytomyr (-5.1% yoy), Rivne (-4.9% yoy), Kirovohrad (-3.4% yoy), Cherkasy (-3.3% yoy), Kharkiv (-3% yoy), Khmelnytskiy (-2.7% yoy), Vinnytsya (-2.4% yoy), Donetsk (-1.2% yoy), Mikolayiv (-0.9% yoy), Chernihiv (-0.8% yoy), and Dnipropetrovsk (-0.8% yoy).

Fiscal Policy

From the beginning of the year to September, the cumulative consolidated fiscal budget balance remained positive at UAH 14.5 billion (about 0.6% of period GDP). However, in September the consolidated fiscal budget showed a deficit, despite some acceleration in growth of revenues and a lower rate of growth of expenditures. The deficits of both the state fiscal budget (UAH 19.1 billion) and the local budgets (UAH 0.7 billion) generated a total consolidated deficit of UAH 19.8 billion. The government used all its intsruments to finance the deficit. It made new borrowings in both domestic and external markets. Also, the governemnt pumped previously withdrawn cash back into the economy and used other means to increase liquidity.

Dynamics of Consolidated Budget Components
(from the beginning of the year)



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

Consolidated budget revenues continued to expand at a high rate of 18.7% yoy in September. This growth rate was the result of a faster increase in both tax and nontax revenues. At the same time, tax revenues expanded faster at the local level at the expense of central level tax revenues. This is because a larger local share of the excise tax receipts for September and their transfer of several previous months from the state to the local budgets. Overall, excise tax receipts expanded by 29.7% yoy in September. Receipts from corporate profit taxes posted the fastest growth of 116.0% yoy, while growth of total VAT receipts signficantly decelerated due to large VAT reimbursements this month. Changes in the schedule of transfers of Naftogaz' devidends to the state budget were reasons for the increase in nontax consolidated budget revenues. Growth of cumulative consolidated budget revenues slightly accelerated to 15.6% yoy in January-September 2018.

Regarding consolidated budget expenditures, their growth further decelerated in September, contracting to 5.9% yoy. Similar to tax revenues, a reduction in local-level expenditures were largely responsible for the overall lower rate of growth in consolidated total expenditures. In fact, the deceleration of growth of expenditures at the local level more than offset the effect from acceleration in growth of expenditures at the central level, caused by fast growth of capital spenditures (82.0% yoy). Overall, slower growth was observed in the purchases of goods and services, payroll expanditures, and expenditures on goods and services. The decline in current transfers was the result of a decrease in targeted spending for local budgets on subsidies and benefits to population. Expenditures on debt servicing continued to decrease, following declines in domestic debt servicing. Growth of cumulative consolidated budget expenditures decelerated again reaching to 20.3% yoy in January-September.

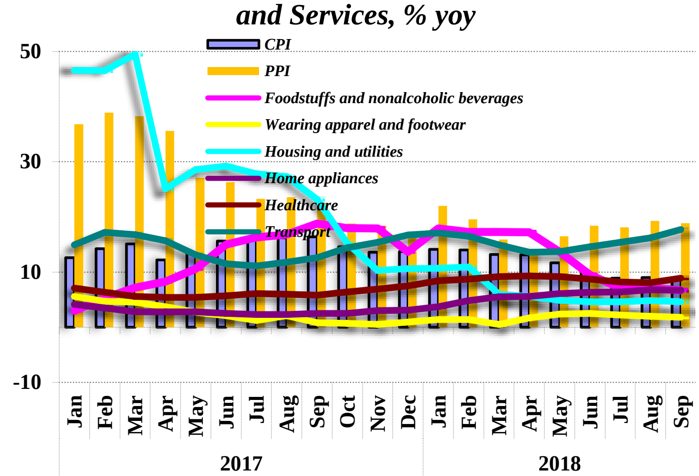
Government spending on principal and service payments of external debt increased again in September. Total spending totaled USD 711.2 million equivalent. Out of this amount, USD 562.3 million was spent on servicing external sovereign bonds and USD 103.2 million was spent on principal and servicign payments on domestic sovereign bonds.

Monetary Policy

Inflation. Consumer inflation has been relatively stable for a third month in a row. The all items price index slightly inched down by 0.1 percentage points to 8.9% yoy in September. Core inflation though, remained unchanged at 8.7% yoy.

Only a few major groups of goods and services showed significant changes in price growth. Deceleration in growth of prices of alcoholic and tobacco products (by 2.2 percentage points to 15.7% yoy), education (by 2.1 percentage points to 13.3% yoy), and restaurants and hotels (by 1.0 percentage points to 13.7% yoy) more than offset acceleration in growth of prices of communication (by 1.9 percentage points to 10.9% yoy), transport (by 1.5 percentage points to 17.7% yoy), and healthcare (by 0.8 percentage points to 8.9% yoy). Changes in price growth of other major groups of goods and services did not exceed 0.4 percentage points in September.

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



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Taking into account the fact that consumer inflation was above expectations over the last couple of months and the upcoming increase in gas price for population, we have revised our forecast for inflation to 10.0% for 2018.

Banking Sector. Bank deposits posted moderate improvements in September. In particular, growth of national currency deposits slightly accelerated, while foreign currency deposits denominated in USD showed no changes in their dynamics. National currency deposits expanded at 11.8% yoy thanks to accelerated growth of household deposits by 19.8% yoy, which more than compensated for some deceleration in growth of corporate deposits (4.4% yoy). The decline of total foreign currency deposits denominated in USD remained unchanged at 1.2% yoy as neither corporate nor household deposits posted any significant changes in dynamics compared to the previous month.

Bank lending activities continued to improve in September. National currency lending grew at slightly lower pace, while growth of the foreign currency loans further increased. National currency loans increased by 13.2% yoy (13.5% yoy in August) on the back of a 6.9% yoy growth of corporate loans and a 43.9% yoy expansion of household loans.

The monetary base expanded at an accelerated pace (0.6% mom and 13.6% yoy) in September, mainly due to fast growth of cash resources. Money supply grew even faster in monthly terms (at 1.3%) on the back of faster growth in hryvnia deposits. In year-over-year terms, however, growth of money supply decelerated to 11.1%.

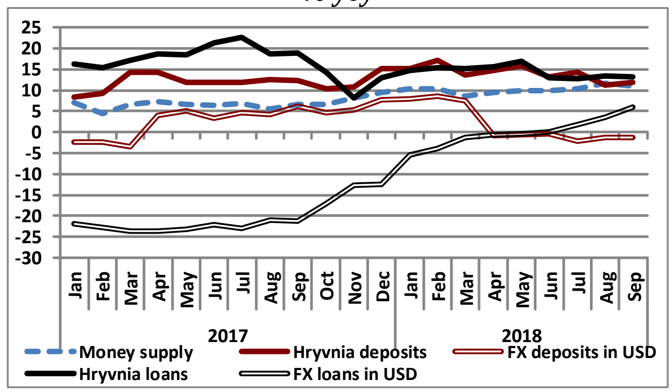
Hryvnia Exchange Rate. After a brief depreciation period at the beginning of the month due to dividends repatriation by non-residents, the UAH/USD exchange rate entered an appreciation trend which lasted for two weeks. On October 18th, this trend at the interbank foreign exchange market reversed. This effect happened because the State Treasury made several tranches of VAT reimbursements which increased Hryvnia resources. However, the Hryvnia returned to appreciation in the last few days of trading sessions as, businesses required Hryvnia to fulfill their fiscal obligations. At the end of October the exchange rate was back to 28.1 UAH/USD.

International Trade and Capital

In September 2018, the current account of the balance-of-payments had a deficit of USD 1.7 billion, compared to a deficit of USD 688 million in September 2017. This monthly deficit increased the cumulative current account deficit for January-September to USD 3.9 billion (or 4.2% of GDP).

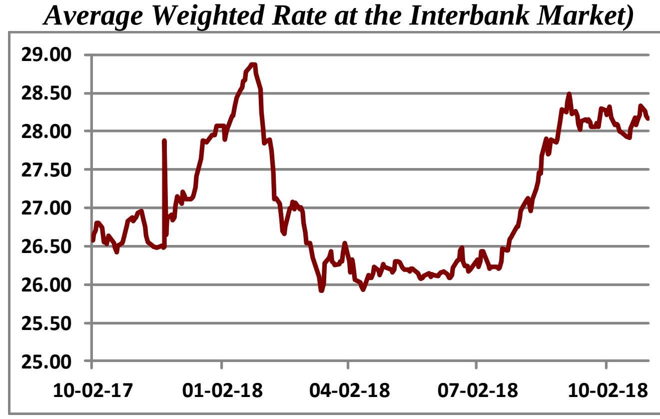
The major cause of the current account deficit in September was a decrease in merchandise exports of 3.6% yoy (to USD 3.31 billion) alongside an increase in merchandise imports (principally in oil and gas) of

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



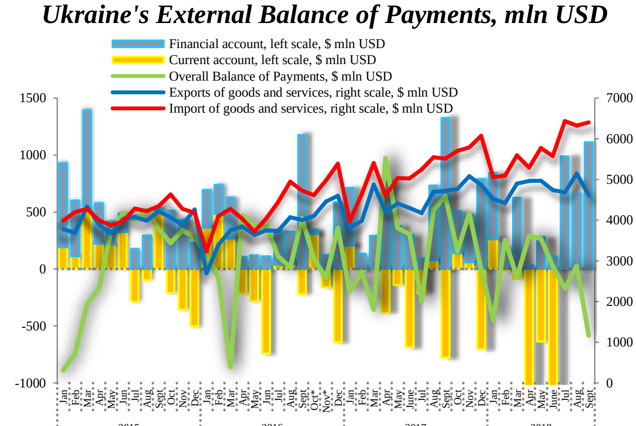
Source: The NBU, The Bleyzer Foundation

Official UAH/USD Exchange Rate (based on the Average Weighted Rate at the Interbank Market)



Source: The NBU, The Bleyzer Foundation

Ukraine's External Balance of Payments, mln USD



17.3% yoy (to USD 5.07 billion), which led to a negative goods trade balance of USD 1.76 billion. Other items in the current account (such as services, primary and secondary income) remained relatively stable.

In September 2018, the following export commodities experienced declines in exports, compared to the same period last year: agricultural products (-9.8% yoy, to USD 1.4 billion), followed by informal trade (-9.7% yoy, to USD 114 million), mineral products (-9.2% yoy to USD 305 million), machinery and equipment (-1.8% yoy to USD 203 million). On the other hand, exports of goods increased in the following categories: ferrous and nonferrous metals (8.3% yoy to USD 862 million), chemicals (4.8% yoy to USD 195 million), industry goods (2.3% yoy to USD 57 million), and timber and wood products (1.4% yoy to USD 157 million).

On the imports side, Ukrainian energy imports increased by 25.8% yoy, principally because of temporary imports of gas and oil products to prepare for the winter season. At the same time, in September 2018 non-energy merchandised imports showed growth of all categories, particularly in industrial goods (36.3% yoy to USD 272 million), mineral products (24.9% yoy to USD 1.367 billion), machinery & equipment (22.6% yoy to USD 1.436 billion), informal trade goods (15.8% yoy to USD 395 million), timber and wood products (8.6% yoy to USD 106 million), ferrous and nonferrous metals (7.7% yoy to USD 294 million), chemicals (5.4% yoy to USD 838 million) and agricultural products (3.4% yoy to USD 365 million).

Regarding the geographical distribution of merchandised trade of Ukraine, the largest deficit of trade turnover was with the Russian Federation which grew by 55% yoy to USD 3.517 billion, in January-September 2018. Meanwhile, Ukrainian trade deficit with CIS countries increased by 41% yoy (to USD 5.25 billion). In fact, Ukraine merchandised export to Russian Federation decreased by 9.3% yoy (to USD 2.274 billion), while import increased by 21.1% yoy (to USD 5.791 billion), in January-September 2018. At the same time, Ukrainian goods exports and imports with Europe grew by 16.2% yoy (to USD 11.987 billion) & 12% yoy (to USD 16.331 billion), respectively.

In September 2018, the financial account showed net inflow growth by 16% yoy to USD 1.112 billion, compared to previous year inflows of USD 1.324 billion in September 2017. The main reason of the inflow growth was private sector's transactions of USD 1.1 billion, in particular from trade credits (USD 894 million), reduction of foreign cash outside banks (USD 142 million) and net borrowings loans (USD 104 million) in September 2018.

Financial inflows covered the bulk of the current account deficit, with the result that the Ukrainian consolidated Balance of Payments showed a smaller deficit of USD 582 million. This led to a reduction of the international reserves to USD 16.6 billion, as of October 1st, 2018 (enough to withstand 2.8 months of the future imports).

International Reserve of Ukraine, mln USD