

May 2017

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Edilberto L. Segura*

Executive Summary

- ❖ Russian-backed separatists in Eastern Ukraine continue to ignore the ceasefire agreed upon under Minsk-2. Despite some decrease in the number of attacks, separatists continue to use prohibited heavy weapons.
- ❖ The main reform efforts are concentrated on fighting corruption. During the past month the General Prosecutor Office (GPO) continued investigations against the former head of the State Tax Agency. Successful anticorruption and anti-organized crime operations were also implemented against two dozen former high-ranking authorities.
- ❖ Following the approval by the EC of granting a visa-free regime to Ukrainians starting around June 11th, it is likely that the EU-Ukraine Association and Free Trade Agreements will be ratified by mid-July. The Agreements should deepen cooperation and bring confidence to investors.
- ❖ On another positive note, a Swedish arbitration court ruled in favor of Naftogaz in its legal battle with Russia's Gazprom. Naftogaz will not be required to pay Gazprom under their take-or-pay gas contracts and Gazprom's ban on re-exports of gas was cancelled. Naftogaz may even receive reimbursements for Gazprom's excessive gas prices.
- ❖ In the first quarter of 2017, economic recovery was slowed down to 2.4% yoy by tensions in Eastern Ukraine caused by a trade blockade with the areas of Donbass controlled by separatists. Data for April shows that the most affected sector was industrial output, which declined by 6.1% yoy. On the other hand, other sectors showed positive growth in April: construction output (7.4% yoy), retail trade turnover (6.1% yoy) and agriculture (1.2% yoy).
- ❖ State and local budget revenues grew significantly faster than expenditures in April. As a result, the consolidated fiscal budget surplus expanded to UAH 38.6 billion for the January-April period (or about 4.5% of period GDP).
- ❖ In April, consumer inflation decelerated by almost 3 percentage points to 12.2% yoy. For the entire year, inflation is expected to be 10%.
- ❖ The UAH/USD exchange rate was on an appreciation trend in April, thanks to inflows of foreign currency from exporters and resumed cooperation with IMF and the EC. At the same time, the National Bank continuously purchased dollars on the interbank forex market to replenish the international reserves softening appreciation pressures. As a result, the exchange rate appreciated by less than 1% from 26.57 UAH/USD to 26.31 UAH/USD during the month.
- ❖ In April 2017, Ukraine's current account deficit declined to USD 146 million, compared to USD 732 million in March 2017. The reduction of the current account deficit was mainly due to a large decline in the primary income deficit to USD 13 million, compared to USD 544 million in March 2017. This current account deficit was fully covered by net inflows in the financial account, which amounted to USD 1,116 million in April. In addition, the country received the fourth tranche of the International Monetary Fund Program in April (amounting to USD 996 million). These funds increased international reserves by USD 1,966 million, leading to international reserves of USD 17.2 billion.

<i>Main Macroeconomic Indicators</i>	2011	2012	2013	2014	2015	2016	2017f
<i>GDP, USD billion</i>	163	173	180	130	87	93.4	97.2
<i>Real GDP Growth, % yoy</i>	5.5	0.2	0.0	-6.6	-9.9	2.3	2.5
<i>Fiscal Balance (incl. Naftogaz/Pension Fund), % of GDP</i>	-4.3	-5.5	-6.5	-11.7	-2.1	-2.3	-3.5
<i>Public Debt, External and Domestic, % of GDP</i>	36.4	36.6	40.4	69.4	79.1	81.2	82.0
<i>Consumer Inflation, eop, % yoy</i>	4.6	-0.2	0.5	24.9	43.3	12.4	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	-4.1	-3.5
<i>FDI, Net Annual Inflow, USD billion</i>	7.0	7.2	4.1	0.3	2.3	3.4	3.0
<i>International Reserves, USD billion</i>	31.8	24.5	20.4	7.5	13.3	15.5	16.0
<i>Public External Debt, USD billion</i>	33.3	32.1	31.7	34.9	42.6	42.5	47.0
<i>Private External Debt, USD billion</i>	92.7	102.3	110.3	91.2	76.0	69.9	65.0

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Political and Reform Developments

Russian-backed separatists in Eastern Ukraine continue to ignore the ceasefire agreed upon under Minsk-2. Despite some decrease in the number of attacks, separatists continue to use heavy weapons, which are prohibited by the Agreements. The daily number of attacks is still high and varies from 10 to 40. Moreover, Ukrainian civilians have become the main victims of such violations. The OSCE mission was under the fire of separatists as well, which negatively affected the presence of international observers in the region.

Implementation of the peace agreements in Ukraine remains one of the most important items in the agenda of major bilateral and international entities. This issue was discussed during the recent G-7 summit in Italy. Leaders of the G-7 countries recalled that the duration of existing sanctions is clearly linked to Russia's complete implementation of the Minsk Agreements and its respect for Ukraine's sovereignty. Later in May, the same message was passed by the new French President Emmanuel Macron to Russian President Vladimir Putin during his visit to Paris. President Macron emphasized that he wanted "...to take part in talks on Ukraine in Normandy format - with German, Russian, and Ukrainian leaders - as soon as possible". It is expected that such a high level meeting might be held in late-June or early-July.

In May, Ukrainian authorities continued to implement the country's reform agenda. The detailed agenda was agreed with international partners of Ukraine including the EU and international financial institutions.

The main efforts of reform are concentrated on fighting corruption. During the past month, the General Prosecutor Office (GPO) continued investigations against the former head of the State Tax Agency who is currently prohibited from leaving the country. Successful anticorruption and anti-organized crime operations were also implemented against two dozen high-ranking authorities of the previous regime that used to work in the State Tax Agency. All anticorruption efforts are visibly supported by the Ukrainian general population. On a negative note, due to the absence of an anticorruption court, the majority of the arrests initiated by state tax authorities were not followed up on and the concerned parties are currently under house arrest. This could significantly reduce the efficiency of the on-going investigation.

The Ukrainian Cabinet of Ministers presented its proposal for pension system reform. The key element of the proposal is an increase in the minimum working-duration requirement. This should indirectly increase the retirement age. As a result, the government expects to eliminate the pension fund deficit from the current 6% of GDP by 2024. However, the exact road map would be developed jointly by all principal stake holders.

Introduction of land market reform may be delayed due to the absence of consensus in Ukrainian society. It is likely that the issue will continue to be debated and the final decision could be made by the Parliament in the Fall. It is expected that a compromise will be reached by dividing the reform process into two stages. In the first phase, only state land will be privatized. As soon as the first phase is implemented, the full land market will be introduced as a second phase of the reform.

Following the approval by the EC granting a visa-free regime to Ukrainians starting around June 11th, it is likely that the EU-Ukraine Association and Free Trade Agreements will be ratified by mid-July. The last EU country to endorse the agreements was the Netherlands, whose Parliament approved it in May. The Agreements should deepen cooperation and bring confidence to investors of the irreversibility of the process of economic integration.

On another positive note, a Swedish arbitration court ruled in favor of Naftogaz in its legal battle with Russia's Gazprom. Naftogaz will not be required to pay Gazprom under their take-or-pay gas contracts and Gazprom's ban on re-exports of gas was cancelled. Naftogaz may even receive reimbursements for excessive gas prices charged by Gazprom.

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Economic Growth

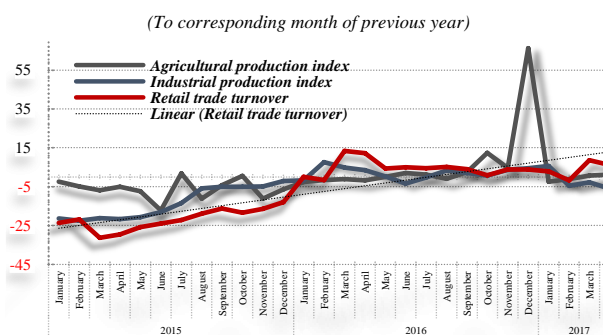
Ukraine experienced significant economic recovery in the second half of 2016, with GDP growing by 2.3% yoy in Q3 and 4.8% yoy in Q4. However, in the first quarter of 2017, the recovery was slowed down to 2.4% yoy by tensions in Eastern Ukraine caused by a trade blockade with the areas of Donbass controlled by the separatists, as noted in previous reports. The blockade disrupted trade and affected mainly industrial output. This economic impasse has continued in the second quarter of the year, with GDP growth in the quarter expected to be around 2.2% yoy.

High frequency data for April 2017 shows that Ukraine's industrial production fell by 6.1% yoy, compared to the same month of the previous year. The largest decline took place in mining (-12.3% yoy), followed by electricity and gas supply (-8.5% yoy), while manufacturing declined less severely (-2.8% yoy). On the other hand, during the month Ukraine's construction output increased by 7.4% yoy. Similarly, Ukraine retail trade turnover performed well with a 6.1% yoy raise. Ukraine's agricultural production also showed good results, increasing by 1.2% yoy, compared to 0.8% yoy in March 2017. Ukraine's freight and passenger turnover also performed well with growth rates of 8.8% yoy and 8.4% yoy, respectively. These positive developments were supported by growth in real and nominal average monthly wages by 18.7% yoy and 37.2% yoy, respectively, in April 2017.

Within Ukraine's manufacturing sector (which dropped by 2.8% yoy in April), the only subsectors with positive growth were the manufacturing of foodstuffs and furniture, which increased by 3.1% yoy and 1.6% yoy, respectively, during the month. The subsectors with the poorest performance were: coke and refined petroleum products (-27.3% yoy); basic pharmaceuticals (-14.1% yoy); metallurgy (-10.7% yoy); and wood products (-4.3% yoy).

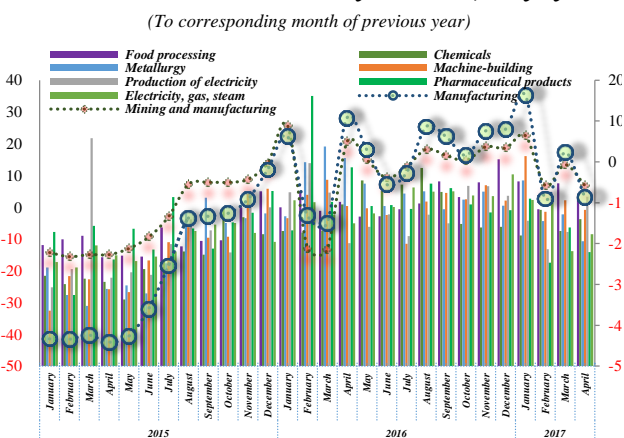
On a geographical basis, the major industrial output declines in April took place in Donbass, due to the trade blockade, with Lugansk declining by 46% yoy, and Donetsk by 23.6% yoy. But declines in industrial output also took place in most other oblasts. Positive growth performance was shown only in the following six oblasts: Odessa (24.3% yoy), Vinnytsia (17.4% yoy), Rivne (11.1% yoy), Zaporizhzhya (10% yoy), Kharkiv (5.5% yoy), and Zhytomyr (2.7% yoy).

Economic Performance by Sector, % yoy



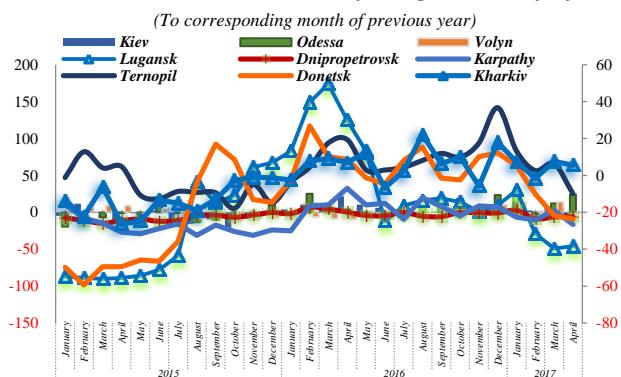
Source: The Bleyzer Foundation

Industrial Production by Sectors, % yoy



Source: The Bleyzer Foundation

Industrial Production by Regions, % yoy



Source: The Bleyzer Foundation

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Fiscal Policy

State budget revenues grew significantly faster than expenditures in April. As a result, the state budget was executed with a surplus of UAH 29.2 billion. At the local level, growth of revenues, accompanied by decelerated growth of expenditures, ensured a total surplus of UAH 5.4 billion in local budgets. Thanks to these developments, the consolidated budget surplus expanded to UAH 38.6 billion for the January-April period (or about 4.5% of period GDP).

State budget revenues almost doubled in year-over-year terms in April thanks to non-systemic receipts. These receipts consisted of transfers of confiscated funds to a special fund of the state budget, and transfers of last year's NBU profits. Thus, growth of non-tax revenues accelerated from 18.6% yoy in March to 285.3% yoy. On the other hand, growth of tax revenues decelerated by 2.2 percentage points to 2.8% yoy, for several reasons. First, VAT reimbursements significantly increased, which led to a significant decline in net receipts from VAT. Second, domestic taxes on goods and services also decelerated. And third, a 57.3% yoy growth in rent payments turned into a 46.1% yoy decline in net rentals.

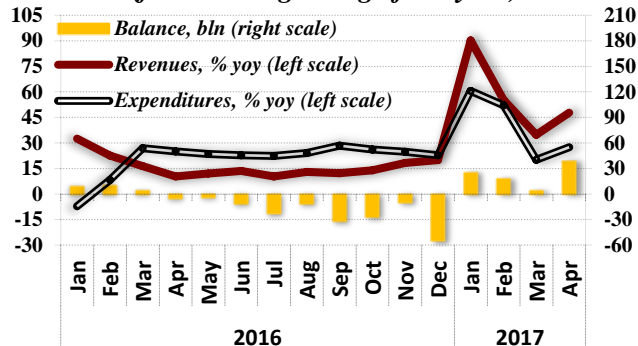
The growth of state budget expenditures continued to slow down in April. The growth rate declined from 10% yoy observed in March to 4.1% yoy in April. This deceleration was the result of lower social security expenditures. Also, deceleration in growth of current transfers continued due to lower transfers to local budgets on subsidies to the population. Finally, payroll expenditures and expenditures on purchases of goods and services saw deceleration in growth. Expenditures of the local budgets also saw deceleration in growth due to lower payroll expenditures, current transfers, and social security expenditures.

Monetary Policy

Inflation. In April, consumer inflation decelerated by almost 3 percentage points to 12.2% yoy. Such deceleration was caused by statistical base effects, as the last significant increase in natural gas tariffs took place in April 2016. Core inflation remained unchanged at 6.3% yoy.

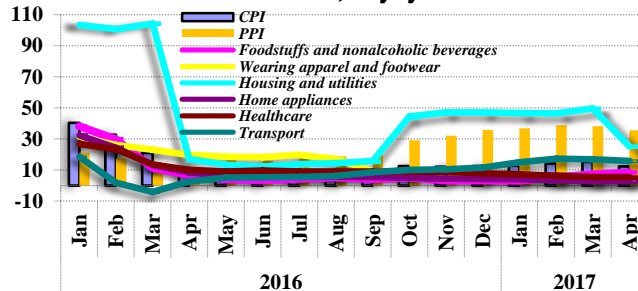
Several major groups of goods and services observed significant increases of prices in April. In particular, growth in prices of foodstuffs and nonalcoholic beverages accelerated by 1.1 percentage points to 8.3% yoy. Communication prices also grew at an accelerated pace due to the increase in tariffs of the JSC Ukrposhta and in prices of private postal services. On the other hand, the largest deceleration in growth of prices was observed for housing and utilities (from 49.5% yoy to 25.1% yoy), followed by lower price growth in alcohol and tobacco products, and transport prices (caused by slower growth in fuel prices.) Other major groups of goods and services observed little or no changes in price dynamics in April. Despite faster than expected deceleration in inflation in April we leave our forecast for consumer inflation unchanged at 10% yoy for 2017.

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



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

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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Banking Sector. Growth of national currency deposits remained unchanged from March at 14.2% yoy in April. Acceleration in growth of household national currency loans to 12.5% yoy was offset by deceleration in growth of corporate national currency loans to 14.1% yoy. On the other hand, the dynamics of total foreign currency loans significantly improved in April. Their growth returned to positive territory (from a 3.4% yoy decline to a 3.9% yoy growth) despite significant declines in corporate deposits (from 0.6% yoy to 3.7% yoy). The reason was growth of deposits of central authorities after transfer of funds confiscated from the accounts of former President Yanukovych and his entourage.

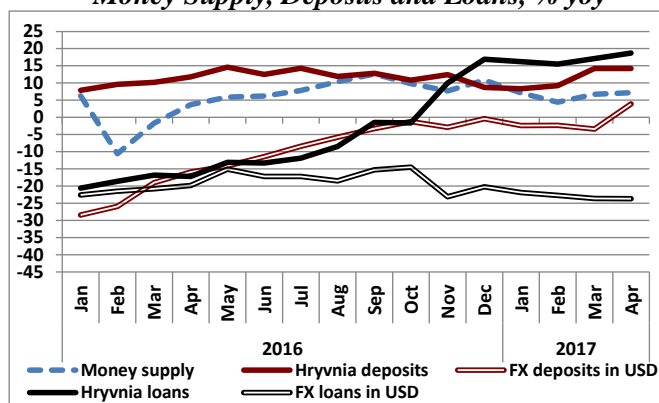
There were little improvements in the crediting activities of banks in April, as crediting risks and the level of debt within the corporate sector remained high. Furthermore, strict requirements of banks in relation to mortgages, terms, and size of loans also limited the pace of loan portfolio growth. Nevertheless, growth of national currency loans accelerated by 1.6 percentage points to 18.7% yoy on the back of faster growth in both household and corporate loans. At the same time, foreign currency loans denominated in USD continued to decline, though at slightly decelerated pace of 23.7% yoy. The reason for that was a 0.4 percentage point deceleration in decline of the household foreign currency loans to 18.7% yoy, which more than offset a 0.3 percentage point acceleration in the decline of corporate foreign currency loans to 24.7% yoy.

The increase in balances on the correspondent accounts of commercial banks at the end of the month, together with further expansion of cash funds, ensured growth of the monetary base by 3.2% mom, which accelerated its over-year expansion to 9.7%. Both the increase in deposits and further growth of cash resources outside banks led to a monthly expansion of money supply by 1.3%. As a result, the year-over-year growth of money supply accelerated to 7.2%.

Hryvnia Exchange Rate. The UAH/USD exchange rate was on an appreciation trend in April. The reasons for that appreciation were inflows of foreign currency from exporters and resumed cooperation with IMF and other IFIs. At the same time, the National Bank continuously purchased dollars on the interbank forex market to replenish international reserves and to protect the interests of exporters through softening of the appreciation. As a result, the exchange rate appreciated by less than 1% from around 26.57 UAH/USD to around 26.31 UAH/USD during the month.

Taking into account the dynamics of the exchange rate and inflation, the NBU decided to lower its policy rate to 13%.

Money Supply, Deposits and Loans, % yoy



Source: The NBU, The Bleyzer Foundation

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



Source: The NBU, The Bleyzer Foundation

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International Trade and Capital

In April 2017, Ukraine's current account deficit declined to USD 146 million, compared to USD 732 million in March 2017. The reduction of the current account deficit was mainly due to a large decline in the Primary Income deficit to USD 13 million, compared to USD 544 million, in March 2017.

On merchandise trade, in April 2017 exports of goods amounted to USD 3,100 million, an increase of 7.5% yoy, compared to the same month of the previous year. Imports of goods increased by 13.4% yoy to USD 3.6 billion. The main increases in merchandise exports took place in the following products: mineral products (by 54.6% yoy), chemicals (by 19.6% yoy), food products (by 15% yoy), and industrial goods (by 6.6% yoy). On the other hand, Ukraine's exports felt in metallurgy (by 7.1% yoy), machinery (by 6.4% yoy) and wood products (by 12.3% yoy). At the same time, imports of goods reached USD 3.6 billion in April, an increase of 13.4% over last year. The major import increases took place in mineral products (by 62.2% yoy), metallurgy (29% yoy), machinery and equipment (19.7% yoy), industrial goods (3.8% yoy), and chemicals (0.9% yoy). Reduction in merchandise imports took place in agricultural products (-6% yoy) and wood products (-0.2% yoy).

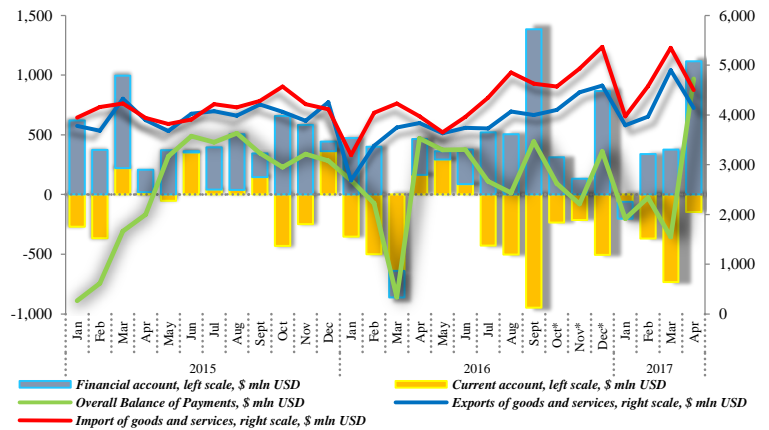
On a geographical basis, in January-April 2017, the highest increases of exports were to the USA (by 182% yoy), Australia (75.3% yoy), Africa (54.2% yoy), Asia (32.8% yoy) with USD 3.3 billion, and the EU (26.7% yoy increase) with also USD 3.3 billion. Asia's share in total exports decreased from 35% to 34.3%, while the share of EU countries fell from 36.7% to 34.3%. Exports to Russia raised by 50.6% yoy and its share in total exports increased from 7.5% to 8.4%, in January-April 2017.

On the imports side, the highest increase in Ukraine imports were from the EU with USD 4.6 billion (raised by 27.8% yoy) and Asia with 2.2 billion (20.1% yoy), respectively. Russian imports increased by 50.2% yoy, due principally to coal, petroleum and chemical products (Russia's share in imports increase from 11.0% to 13.1%.) Import's share from the EU increased from 39.8% to 40.6% in January-April 2017.

The current account deficit was fully covered by net inflows in the financial account, which amounted to USD 1,116 million in April (net inflows amounted to USD 302 million in April of last year). These inflows originated from increases in government debt (USD 589 million) principally from the European Commission, increases in private trade credits (USD 156 million) and purchases of foreign exchange from the public (USD 226 million). Net inflows of foreign direct investments amounted to only USD 54 million in April.

In April, the overall surplus of the consolidated balance of payments amounted to USD 970 million (compared to USD 469 million in April 2016). In addition, during April, the country received the fourth tranche of the International Monetary Fund Program (amounting to USD 996 million). These funds increased international reserves by USD 1,966 million, leading to international reserves of USD 17.2 billion (about 3.6 months of imports).

Ukraine's External Balance of Payments, mln USD



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