

March 2017

**Oleg Ustenko, Julia Segura, Valentyn Povroznyuk
Edilberto L. Segura**

Executive Summary

- ❖ Military actions by Russian-backed separatists in Donbas have continued at high levels, despite several meetings of foreign ministers under the Minsk format in March and of diplomatic advisors under the Normandy format in April. The level of uncertainty about possible solutions to the conflict is high, due to the continuous blocking of all peace initiatives by the Russian Federation.
- ❖ The main item on the Ukrainian reform agenda continues to be the fight against corruption. On April 2017, the Ukrainian government articulated key priority reforms to revive economic growth over the medium term, including pension system reform, land market reform, transparent privatization, education reform, and reform of public health system. All these items are among the structural reforms agreed upon with the IMF in early April. This led to the disbursements of about USD 1.0 billion by the IMF on April 3rd.
- ❖ Recent GDP data shows that the Ukrainian economy performed better than expected in 2016, with a GDP growth rate of 2.3%. But after several months of growth, the Ukrainian economy was affected in February 2017 by a trade blockade in Eastern Ukraine. The blockade is likely to reduce GDP in 2017 to 2.0%.
- ❖ Deceleration in growth of state budget revenues and fast expansion of state budget expenditures resulted in a state budget deficit of UAH 14.4 billion in February. On the other hand, the surplus of local budgets amounted to UAH 7.3 billion. As a result, the consolidated budget surplus from the beginning of the year amounted to UAH 18 billion (4.4% of period GDP).
- ❖ Consumer inflation accelerated in February, with the CPI increasing by 14.2% yoy. But core inflation saw just a minor acceleration to 6.4% yoy. Therefore, we maintain our forecast of 10% inflation in 2017.
- ❖ The growth of national currency deposits in commercial banks recovered its pace in February after one month of deceleration. Its total growth of 9.2% yoy was the result of a 7.3% yoy increase in corporate deposits and a 9.5% yoy increase in household deposits. However, lending activities remained weak in February.
- ❖ The UAH/USD exchange rate fluctuated within the corridor of 26.9-27.2 UAH/USD for most of February and March. For the year as a whole, we anticipate that the exchange rate will depreciate only slightly to 28.0 UAH/USD by the end of the year.
- ❖ In February 2017, the current account of the balance-of-payments of Ukraine showed a deficit of USD 399 million. But this deficit was almost fully covered by financial inflows of USD 368 million coming principally from trade credits. As a result, in February 2017, the overall balance of payments had a deficit of only USD 27 million, maintaining international reserves at about USD 15.5 billion, equivalent to 3.4 months of imports.

Main Macroeconomic Indicators	2011	2012	2013	2014	2015	2016	2017f
GDP, USD billion	163	173	180	130	87	93.4	97.2
Real GDP Growth, % yoy	5.5	0.2	0.0	-6.6	-9.9	2.3	2.0
Fiscal Balance (incl. Naftogaz/Pension Fund), % of GDP	-4.3	-5.5	-6.5	-11.7	-2.1	-4.0	-3.5
Public Debt, External and Domestic, % of GDP	36.4	36.6	40.4	69.4	79.1	81.2	82.0
Consumer Inflation, eop, % yoy	4.6	-0.2	0.5	24.9	43.3	12.4	10.0
Hryvnia Exchange Rate per USD, eop	8.0	8.1	8.2	15.8	24.0	27.0	28.0
Current Account Balance, % of GDP	-6.3	-8.3	-9.0	-4.1	-0.2	-4.1	-3.5
FDI, Net Annual Inflow, USD billion	7.0	7.2	4.1	0.3	2.3	3.4	3.0
International Reserves, USD billion	31.8	24.5	20.4	7.5	13.3	15.5	16.0
Public External Debt, USD billion	33.3	32.1	31.7	34.9	42.6	42.5	47.0
Private External Debt, USD billion	92.7	102.3	110.3	91.2	76.0	69.9	65.0

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Political and Reform Developments

Military actions by Russian-backed separatists in Donbas have continued at high levels, despite several meetings of foreign ministers under the Minsk format in March and of diplomatic advisors under the Normandy format in April. The intensity of daily attacks from rebels against Ukrainian militants ranges from a few dozen per day to almost a hundred per day. Moreover, the number of casualties among civilian populations is also high. The Ukrainian, German and French participants of the April meeting denounced violation of the ceasefire regime by the separatists. The concluding statement of the Normandy format group calls for immediate consolidation of the ceasefire in Donbas and withdrawal of all heavy weapons. The level of uncertainty about possible solutions to the conflict is high, due to the continuous blocking of all peace initiatives by the Russian Federation.

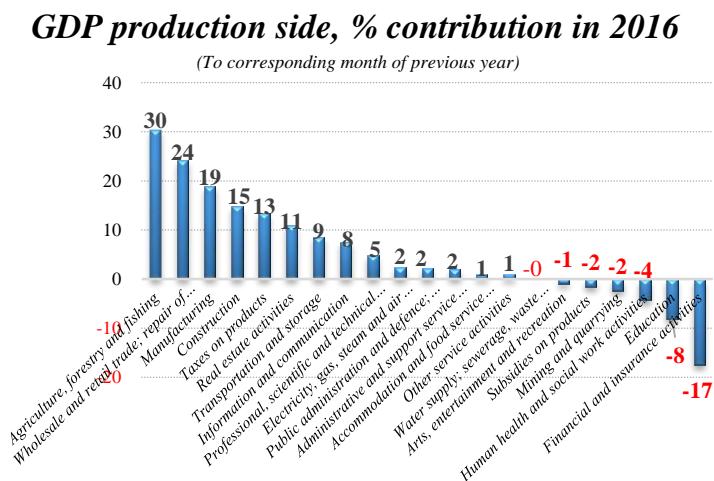
On March 15, the Ukrainian government gave support to the blockade of trade with the temporarily-occupied territories of Donbass that had been illegally initiated by Ukrainian militants in February. This government action was prompted by the fact that Russian-backed rebels had seized a number of Ukrainian companies located in their controlled territory. The trade blockade has affected the transportation of coal and other industrial goods, and is having a negative effect on the Ukrainian economy, with industrial production declining in February.

In April, the Ukrainian government articulated its key priority reforms to revive economic growth over the medium term. The list of priorities includes: (i) pension system reform; (ii) land market reform; (iii) transparent privatization; (iv) reform of the education system; and (v) reform of public health system. All these items are among the structural key performance indicators in the Ukrainian memorandum with the IMF, which was signed in early April. This led to the disbursements of about USD 1.0 billion by the IMF on April 3rd.

In March, the main efforts in implementation of the reform agenda were concentrated on fighting corruption. In particular, by April 1st all government officials, including local level officials, were obligated to submit their income and asset declarations. As in the first wave of e-declarations by top government officials, the Ukrainian public learned that even low level public servants owned significant amount of foreign cash, luxury real estate, cars, paintings, watches, jewelry etc. As in the previous case, the majority of the declared wealth was reported as wealth of family members of government officials. The Ukrainian public and international partners of Ukraine expect serious investigations of all suspicious cases by the newly created anti-corruption agencies. On a negative side, the process of wealth declaration, which was closely watched by civil society representatives, was darkened by a new law to put pressure on civil society activists. According to this law, civil society activists were required to submit their own wealth declarations as if they were government officials. This law was highly criticized by local NGOs and received negative assessments of EU institutions and the U.S. State Department.

Economic Growth

GDP data recently released by the State Statistics Committee showed that the Ukrainian economic performed better than expected in 2016, with a GDP growth rate of 2.3%. On the production side of GDP, the sectors with the highest growth rates were construction (16.3% yoy), agriculture (6% yoy), information and communication (4.6% yoy), wholesale and retail trade (4% yoy), and real estate activities (4.2% yoy). On the other



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hand, other sectors continued depressed, including financial activities (which fell by -15.7% yoy), education (-4.8% yoy), health and social work (-4.1% yoy), arts/entertainment (-3.8% yoy), and mining (-1% yoy).

In terms of contribution to the GDP growth of 2.3% in 2016, five sectors contributed 99% of this growth, as following: agriculture (with 30.3% of the total), wholesale and retail trade (24.2%), manufacturing (18.8%), construction (14.8%) and real estate activities (11.0%).

On the expenditure side of GDP, the main contributors to 2016 GDP growth were gross capital formation, which increased by 40.8% yoy, and household's consumption, which increased by 1.8%. However, these gains were partially offset by a negative trade balance of Ukraine, with export of goods and services declining by -1.6% yoy and import raising by 8.4% yoy.

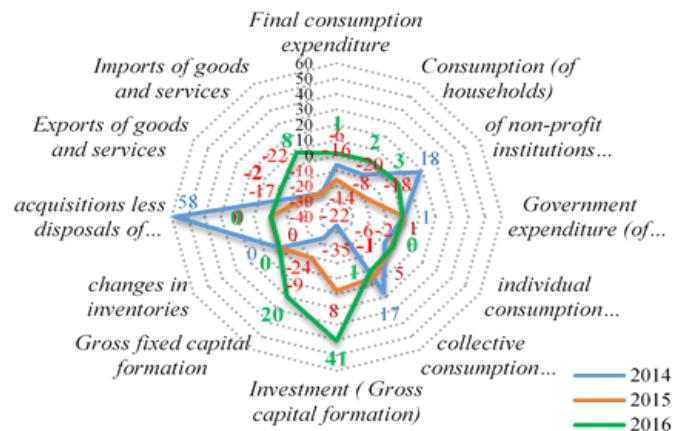
High frequency data for February 2017 show the most recent negative economic effects of the trade blockade in Eastern Ukraine, with industrial production declining by -4.6% yoy in February and agricultural production falling by -1% yoy. Construction, on the other hand, increased by only 4.8% yoy in February. These developments are likely to reduce GDP in 2017 to 2.0%, compared to our earlier forecast of 3.0%,

Within the industrial sector, only four sub-sectors provided positive growth in February: textiles (by 4.6% yoy), wood products (2.0% yoy), rubber/plastic products (1.6% yoy), and electricity, gas and a/c (1.8% yoy). Other industrial sub-sectors had negative growth rates: mining and quarrying (-11.5% yoy), foodstuffs (-0.6% yoy), wood products (-0.8% yoy), coke & refined petroleum products (-23.3% yoy), chemicals (-0.8% yoy), pharmaceuticals (-17.4% yoy), metals (-4.3% yoy), machinery and equipment (-1.4% yoy), and furniture (-12.1% yoy).

From the point of view regional representation of industrial output, due to the trade blockade, the Eastern Oblasts performed poorly in

GDP expenditure side of 2016, % yoy

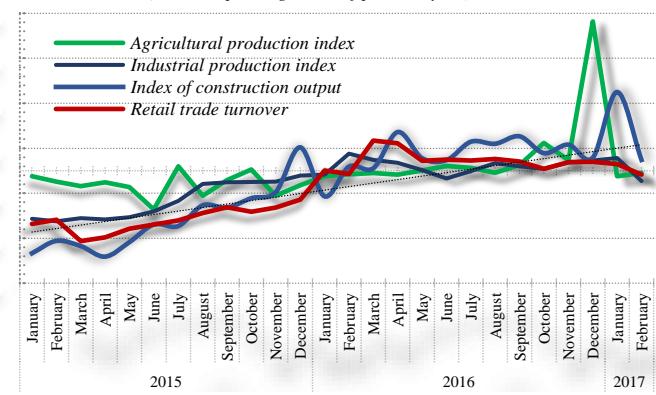
(To corresponding month of previous year)



Source: The Bleyzer Foundation

Economic Performance of Ukraine by Sector, % yoy

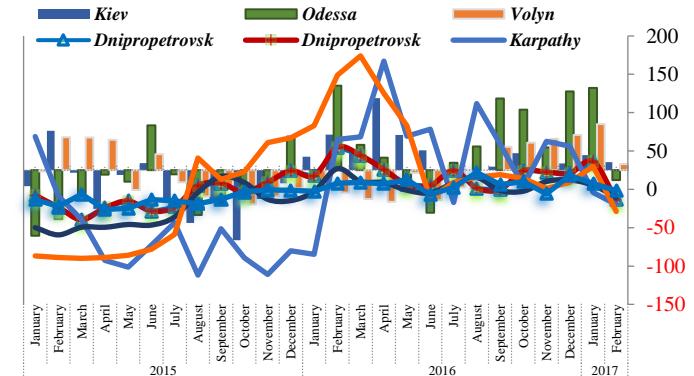
(To corresponding month of previous year)



Source: The Bleyzer Foundation

Industrial Production by Regions, % yoy

(To corresponding month of previous year)



Source: The Bleyzer Foundation

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February: Lugansk (-29.0% yoy), Donetsk (-10.1% yoy), Dnipropetrovsk (-8.8% yoy), Kharkov (-1.6% yoy), Sums (-5.0 % yoy), and Mykolaiv (-3.5 % yoy). Positive growth in February was registered in Zhytomyr (18.8% yoy), Vinnitsa (10.1% yoy), Poltava (2.8% yoy), Ivano-Frankivsk (2.6% yoy), Ternopil (2.6% yoy), Kiev (2.4% yoy), Volyn (1.8% yoy), and Zaporozhe (0.4% yoy).

Fiscal Policy

Deceleration in growth of state budget revenues and fast expansion of state budget expenditures resulted in a state budget deficit of UAH 14.4 billion in February. On the other hand, the surplus of local budgets amounted to UAH 7.3 billion. As a result, the consolidated budget surplus from the beginning of the year amounted to UAH 18 billion (4.4% of period GDP).

Growth of state budget revenues decelerated to 28.5% yoy in February due to slower growth of tax receipts (26.7% yoy compared to 108.5% yoy in the previous month). The major reason was an increase in VAT reimbursements, with VAT receipts increasing just by 7% yoy in February. These negative developments were more than offset by increases in receipts from personal income tax and from corporate profit tax which were supported by fast growth of nontax revenues. As the growth of budget revenues at the local level remained high, the pace of expansion of the consolidated budget revenues remained high at 55.3% yoy in January-February.

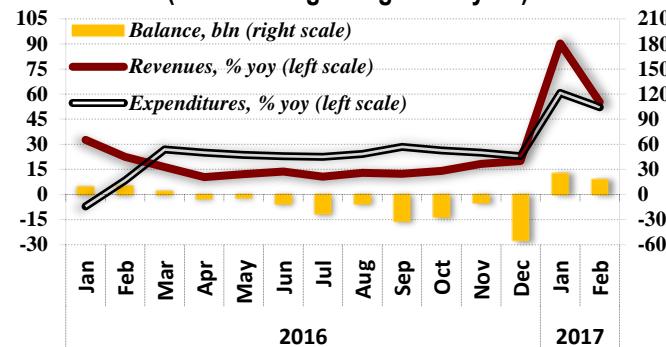
At the same time, state budget expenditures continued to expand at a fast pace in February. The 48% yoy increase was the result of fast growth in current expenditures. In particular, current transfer expenditures posted a fast growth of 103.1% yoy. This growth was the result of both higher tariffs and higher consumption due to harsher winter weather this year. Higher minimum wages caused further growth of payroll expenditures. In functional classification, expenditures on social protection and social security and expenditures on general state administration functions remained the most significant among state budget expenditures in terms of size. They also posted comparable growth rates in February (18.6% yoy and 17.1% yoy respectively). Defense expenditures posted the first decline in many months at 12.1% yoy. Local budget expenditures supported fast growth of those at the central level in January-February. Therefore, consolidated budget expenditures grew by 52.1% yoy over the period.

Monetary Policy

Inflation. Consumer inflation accelerated in February. The all items CPI increased by 14.2% yoy compared to 12.6% yoy in January. But core inflation saw just a minor acceleration to 6.4% yoy.

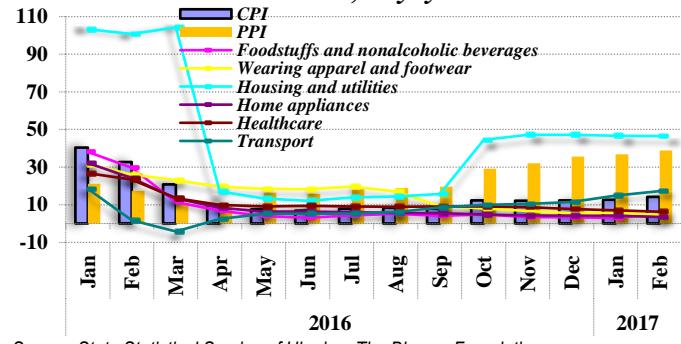
There were little changes in price growth among most goods and services. However, in February there were increases in prices of such socially important items as foodstuffs, transport, and communication. In particular,

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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the price growth of foodstuffs accelerated by 2.3 percentage points to 5.3% yoy. The growth of alcoholic and tobacco products' prices accelerated by 2.0 percentage points to 28.3% yoy. Finally, the growth of transport prices accelerated by 1.1 percentage points to 16.0% yoy. For the time being we leave our forecast for consumer inflation unchanged at 10% yoy for 2017.

Banking Sector. The growth of national currency deposits recovered its pace in February after one month of deceleration. Its total growth of 9.2% yoy was the result of a 7.3% yoy increase in corporate deposits and a 9.5% yoy increase in household deposits. The trend of decelerating decline in foreign currency deposits denominated in USD continued in February. A 3.6% yoy increase in corporate foreign currency deposits only partially offset a 4.3% yoy decline in deposits of households. Therefore, total foreign currency deposits denominated in USD decreased by 2.3% yoy which is still an improvement over a 3.7% yoy decline a month ago.

The lending activities of banks remained weak in February. In particular, the growth of total national currency loans decelerated to 15.5% yoy, while the decline of total foreign currency loans denominated in USD further accelerated reaching 22.7% yoy. The decline in foreign currency loans denominated in USD was caused by declines in both corporate and household loans of 23.0% yoy and 20.2% yoy, respectively. At the same time, a 21.5% yoy growth in corporate national currency loans more than compensated a 1.8% yoy decline in household national currency loans.

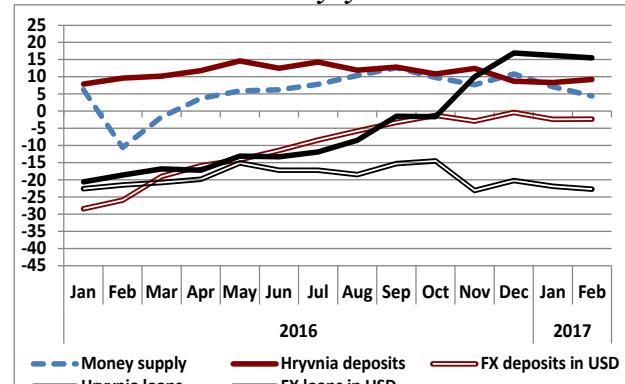
The monetary base did not change from January to February, since the increase in cash balances at the correspondent accounts of banks almost fully compensated for the decline in cash funds. At the same time, in a year-over-year basis, the monetary base increased by 10.0% yoy. The decline in total deposits (denominated in Hryvnias) and the decrease in cash funds outside banks caused a 0.6% mom decline in money supply, which, in turn, led to deceleration of its year-over-year growth to 4.4%.

Hryvnia Exchange Rate. Fluctuations of the UAH/USD exchange rate in March were related either to changes of banking sector liquidity or to the size of dollar supply in the market. In particular, the curtailing by the NBU of banking sector liquidity - through placement of certificates of deposit - led to appreciation of the exchange rate from 27.21 UAH/USD on March 1st to around 26.8 UAH/USD on March 10th. Then the exchange rate sustained some minor fluctuations, but remaining within the corridor of 26.8-27.0 UAH/USD until March 23rd, when a short-term decrease in dollar supply led to depreciation of the exchange rate back to 27.2 UAH/USD. Since then the exchange rate saw rather minor daily changes till the end of month.

Softening of temporary exchange rate regulations continued in March. First of all, the NBU simplified purchases of foreign exchange for some transactions which have no critical influence on the stability of the foreign exchange market. Second, the regulator simplified the procedures

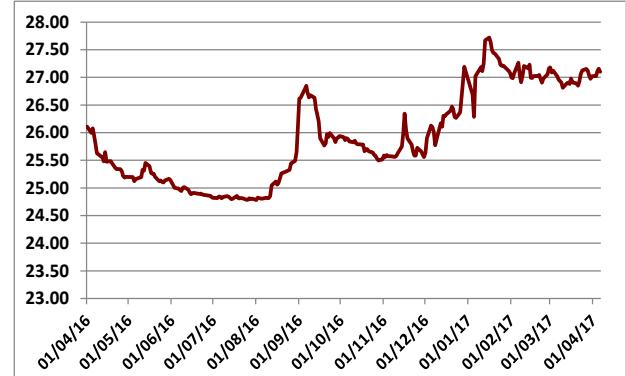
recovered its pace in February after one month of

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



Source: 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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for the transportation of foreign exchange funds across the border. And third, the NBU reduced the red tape residents have to deal with while raising external financing from non-residents.

International Trade and Capital

In February 2017, the deficit in the current account of the balance-of-payments of Ukraine amounted to USD 399 million, compared to USD 502 million deficit in February 2016. During the month, Ukraine merchandise exports grew by 21% yoy to USD 3.0 billion, compared to USD 2.5 billion in February 2016. At the same time, Ukraine merchandise imports grew at a lower rate of 16.7% yoy, amounting to USD 3.8 billion.

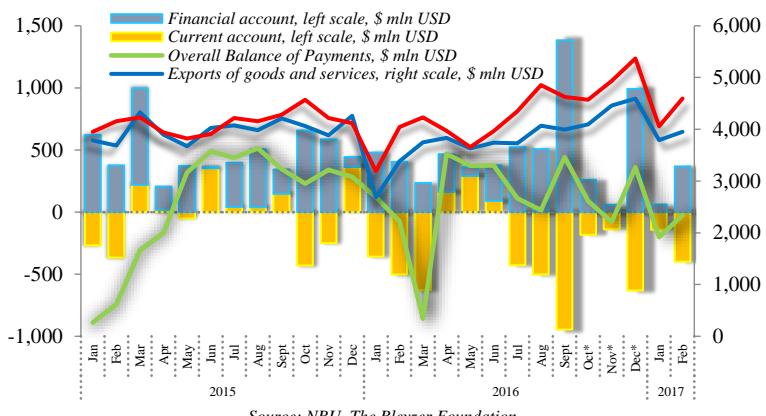
The best performances of merchandise exports were achieved in the following goods: mineral products (98.7 % yoy); metals (30.6% yoy); industrial goods (20.1% yoy); agriculture (15.9% yoy); informal trade (6.4% yoy) and machinery and equipment (3.3% yoy). However, exports of chemicals fell by 7% yoy, and timber and wood products by 6% yoy. In terms of product share in total merchandise export, in February 2017 Ukraine agricultural products continued to be the most important exports with 45% of the total, followed by metallurgy with 26%.

Regarding merchandise imports of Ukraine, the highest growth rates were experienced in mineral products, including energy (54% yoy); metallurgy (24.5% yoy); machinery and equipment (21.5% yoy); chemicals (7.3% yoy), industrial goods (4.1 % yoy) and wood products (1% yoy).

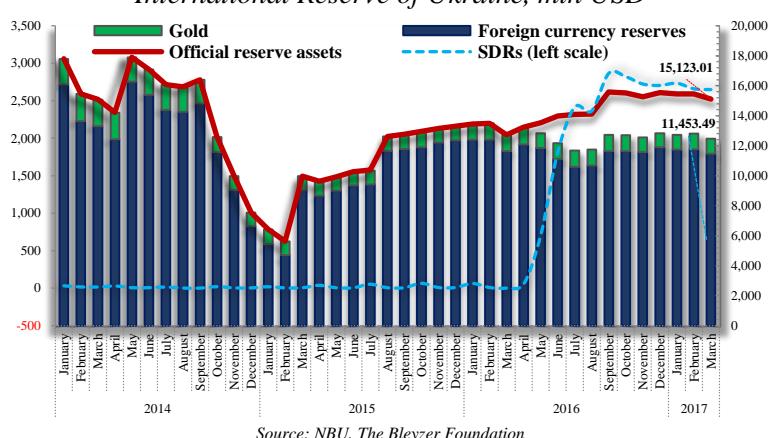
In February 2017, the Ukrainian financial account obtained net financial inflows of USD 368 million, compared to a net inflows of USD 403 million in February 2016. The main sources of finance in February were trade credits (UAD 505 million), short term loans (USD 99 million), and foreign direct investments (USD 45 million). These inflows were partly offset by loan repayments.

Financial inflows covered most of the deficit in the current account, with the result that the overall balance of payments deficit was only USD 27 million in February 2017. Hence, as of March 01 2017, the volume of international reserves remained at about USD 15.5 billion, covering 3.4 months of future imports.

Ukraine's External Balance of Payments, mln USD



International Reserve of Ukraine, mln USD



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