

February 2017

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### Executive Summary

- ❖ During the last two months, Russian-backed separatists have intensified their military hostilities in Eastern Ukraine. These actions have led to further efforts by Ukraine and the international community to seek a safe and long lasting solution to the conflict. The need to negotiate a "safe and secure solution for Ukraine" was discussed during the Washington meetings of Germany's Chancellor Angela Merkel and UK Prime Minister Teresa May with President Donald Trump.
- ❖ The main item on the Ukrainian reform agenda remains the fight against corruption. The on-going efforts in this direction are concentrated on punishment of corrupt officials and increasing capacity of the newly established anticorruption bodies.
- ❖ Ukrainian economic growth is continuing at a robust pace. Following a 4.7% yoy GDP growth in October-December 2016, and a 2.3% GDP growth in 2016, Ukraine experienced 35% yoy growth in construction output in January 2017, including a 57.4% yoy increase in residential construction. Ukrainian industrial production also continued to strengthen with a growth rate of 5.6% yoy, compared to 4.5% yoy in December 2016.
- ❖ Better economic performance led to reasonable increases in real and nominal monthly wages, which increased by 11.6% yoy and 23.8% yoy in January. Regarding GDP growth for 2017, our base case is a growth rate of 3.0%, but this could be reduced to 1.5% if the trade blockade in the East of Ukraine is not resolved soon.
- ❖ A sharp increase in state budget revenues in January led to a high state budget surplus. Local budgets were also executed with a surplus. Therefore, the consolidated budget surplus totaled UAH 25.1 billion in January.
- ❖ Consumer inflation sustained little changes in January, with the all-items CPI growing by 12.6% yoy, which was in line with forecasts.
- ❖ The UAH/USD exchange rate fluctuated within the corridor of 26.90-27.05 UAH/USD for most of February. 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, assuming that the current trade blockade in Eastern Europe is resolved soon and the IMF maintains its program in Ukraine.
- ❖ In January 2017, the current account of the balance-of-payments of Ukraine was close to equilibrium, with a small USD 26 million deficit. The financial account experienced net outflows of USD 177 million. As a result, in January 2017, the overall balance of payments had a deficit of USD 202 million, bringing international reserves to USD 15.4 billion as of February 1<sup>st</sup>, 2017, equivalent to 3.4 months of imports.

<i>Main Macroeconomic Indicators</i>	2011	2012	2013	2014	2015	2016f	2017f
<i>GDP, USD billion</i>	163	173	180	130	87	88	92
<i>Real GDP Growth, % yoy</i>	5.5	0.2	0.0	-6.6	-9.9	2.3	3.0
<i>Fiscal Balance (incl. Naftogaz/Pension Fund), % of GDP</i>	-4.3	-5.5	-6.5	-11.7	-2.1	-4.0	-3.0
<i>Public Debt, External and Domestic, % of GDP</i>	36.4	36.6	40.4	69.4	80.1	84.4	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	-3.7	-2.0
<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	17.0
<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***

During the last two months, Russian-backed separatists have intensified their military hostilities in Eastern Ukraine. The city of Avdiivka in Donetsk oblast continued to be a target for massive firings by rebels. Almost all communal services have been hit, including water and electricity supply. Smaller cities in Donbass have also been attacked by Russian-backed separatists. Along with the increased aggression in Donbass by separatists, there has been a significant increase in Russian military equipment and troops on Ukraine's eastern borders during the past month. According to the Ukrainian Ministry of Defense, the number of Russian troops concentrated on the Ukrainian border has reached around 50 thousand.

Despite significant efforts undertaken by Ukraine to re-introduce a ceasefire in the zone, the situation remains unpredictable. Ukraine has also sought the support of Western countries to put pressures on Russia to exercise its influence on separatists to stop aggression. On February 2, the members of the Security Council called all parties to stop military actions in the region and "expressed their full support for the sovereignty and territorial integrity of Ukraine and the need for strict compliance with Minsk Agreements." The situation in Ukraine was also brought to the agenda of the Munich Security Conference in mid-February. On the first day of the conference, President Poroshenko pointed out the necessity of collective actions of the West and Ukraine against the aggressors. He called on them to continue sanctions against the Russian Federation. As a result, in its meeting, on March 13, the EU made the decision to continue its sanctions against Russia for 6 months. Although the Russian Federation continues to deny direct involvement in the conflict, the united actions of the international community are expected to have an impact on Russia's behavior. There is also the expectation that the new administration in the United States could be more engaged in seeking a resolution to the conflict in Eastern Ukraine. Ukraine remains on the agenda of the major meetings of international leaders. More recently, the need to negotiate a "safe and secure solution for Ukraine" was discussed during the Washington meetings of Germany's Chancellor Angela Merkel and UK Prime Minister Teresa May with President Donald Trump.

In February, several Ukrainian Parliamentarians joined former Ukrainian militants to block trade with the temporarily-occupied territories of Donbass. In particular, railway connections were blocked. The main goal of the pro-Ukrainian protesters was to stop the provision of revenues to the terrorists, revenues that are financing their military operations against Ukraine. Initially, the Ukrainian government attempted to lift the trade blockade, principally because many Ukrainian companies located in Donbass (particularly in coal production) had recognized their Ukrainian jurisdiction and paid taxes to the Ukrainian budget which amounted to about USD 1.5 billion last year. However, the separatists responded by seizing these Ukrainian enterprises and simultaneously Russia decided to recognize the passports issued by separatist authorities. On this basis, the Ukrainian National Security and Defense Council decided to maintain the blockade until the Ukrainian enterprises are returned to its original owners. The resolution of the conflict is pending. If it is not resolved soon, Ukraine may lose USD 1.5 billion in tax revenues and USD 2.0 billion in exports.

The main item on the Ukrainian reform agenda remains the fight against corruption. The on-going efforts in this direction are concentrated on the punishing of corrupt officials and increasing the capacity of the newly developed anticorruption bodies. On a positive note, the National Anticorruption Agency already initiated several court cases against government officials, including the head of the State Fiscal Service of Ukraine, Mr. Roman Nasirov. A key pending action is the establishment of a specialized anticorruption court that may be able to deal with court cases more effectively and impartially. The overall expectation is that the speed of these key reforms will be accelerated, under the pressure of both international partners of Ukraine (including IFIs) and the rapidly developing and highly active civil society.

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### Economic Growth

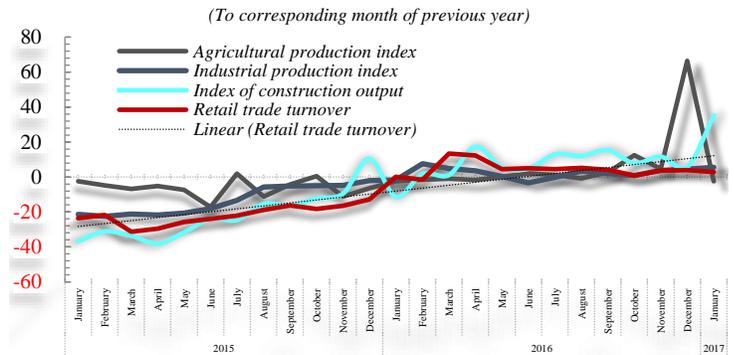
Ukrainian economic growth is continuing at a robust pace. Following a 4.7% yoy GDP growth in October-December 2016, and a 2.3% GDP growth in 2016, Ukraine experienced a 35% yoy growth in construction in January 2017, including a 57.4% yoy increase in residential construction. Ukrainian industrial production has also continued to strengthen with a growth rate of 5.6% yoy, compared to 4.5% yoy in December 2016. Moreover, Ukraine freight and passenger turnover performed well, increasing by 23.7% yoy and 13.8% yoy, compared to 2.7% and 8.9% yoy in December 2016. On the other hand, the agricultural sector had a 2.4% yoy decline in output, in part due to bad weather and the fact that in the previous month, output had been abnormally high at 66.4% yoy.

The 5.6% yoy growth of industry was supported by a 9.9% yoy growth in manufacturing. The following industrial activities made the largest contributions to the 5.6% yoy industrial growth: production of food products, 26.0 % growth contribution (with 8.1% yoy growth); metallurgy, 22.5% contribution (8.5% yoy growth); machinery and equipment, 13.6% contribution (16.1% yoy growth); non-metallic mineral products, 10.2% contribution (20.3% yoy growth); and wood products, 3.6% contribution (7.3% yoy growth). Nevertheless, some industrial activities made negative contributions to industrial growth in January 2017, as follows: coke and refined petroleum products, -4.2% contribution (-7% yoy growth); and chemicals and chemical products, -3.5% contribution (-8.9% yoy growth).

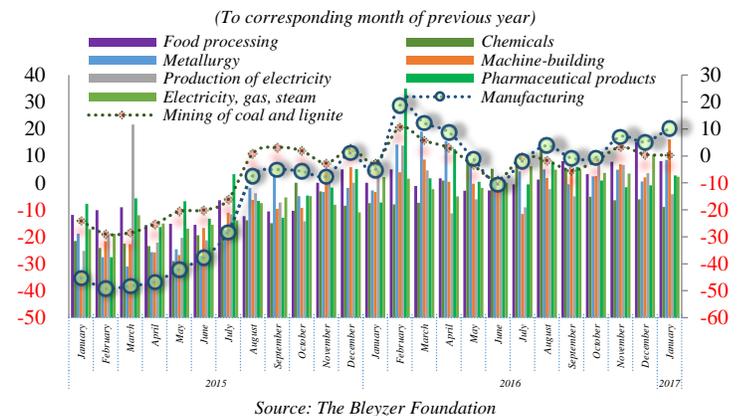
On a regional basis, most oblasts enjoyed positive rates of industrial growth in January 2017, with the highest growth rates in the following regions: Zhytomyr (42.7 % yoy); Luhansk (30% yoy), Vinnytsa (26.2% yoy), Odessa (24.5% yoy), Kirovograd (21.4% yoy), Volyn (13.7% yoy), Ternopil (13.2% yoy), Ivano-Frankivsk (10.0% yoy), m. Kyiv (9.6% yoy), Kharkiv (7.4% yoy), Zaporizhia (7.2% yoy), Donetsk (5.3% yoy), Kyiv (4.5 % yoy), Lviv (4.2% yoy), Khmelnytsky (3.5% yoy), Kherson (3.5% yoy), Chernivtsi (3.3% yoy), Dnipropetrovsk (2.6% yoy), Poltava (0.7% yoy), and Cherkasy (0.5% yoy). On the other hand, several oblasts continued to experience negative growth rates in January, as follows: Rivne (-15.0% yoy), Chernihiv (-9.3% yoy), Zakarpattia (-6.7% yoy), Sums (-2.7% yoy), and Mykolaiv (-2.4% yoy).

Better economic performance led to reasonable increases in real and nominal monthly wages, which increased by 11.6% yoy and 23.8% yoy in January. Regarding GDP growth for 2017, our base case is a growth rate of 3.0%; but could be reduced to 1.5% if the trade blockade in the East of Ukraine is not resolved soon.

### Economic Performance of Ukraine by Sector, % yoy



### Industrial Production by Sectors, % yoy



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## Fiscal Policy

A sharp increase in state budget revenues in January led to a high state budget surplus. The surplus of the state budget of UAH 15.8 billion was two-thirds higher than in January 2016. Local budgets were also executed with a surplus of UAH 9.3 billion. Therefore, the consolidated budget surplus totaled UAH 25.1 billion in January, which provides the Ukrainian government some fiscal space to accommodate future fiscal shocks.

State budget revenues doubled in January, compared to their level a year ago. This growth was fueled mostly by an increase in receipts from tax revenues (which grew by 108.5% yoy) thanks to further recovery of economic activities and expansion of import revenues. In addition, some changes to tax legislation were introduced that increased revenues, such as taxing of gas imports at customs clearance, lifting of privileged taxation of agricultural companies, and increases in excise tax rates. Also, the VAT reimbursements were low in January ensuring high receipts from this tax. The increase in the minimum wage led to an increase in receipts from personal income tax (by 27.1% yoy). Growth of local budget revenues was lower than that of state budget revenues, but still high at 51.3% yoy. Thus consolidated budget revenues grew by 90.3% yoy in January. Increased budget revenues was also supported by some “de-shadowing” of the economy caused by recent economic reforms, such as increased energy prices.

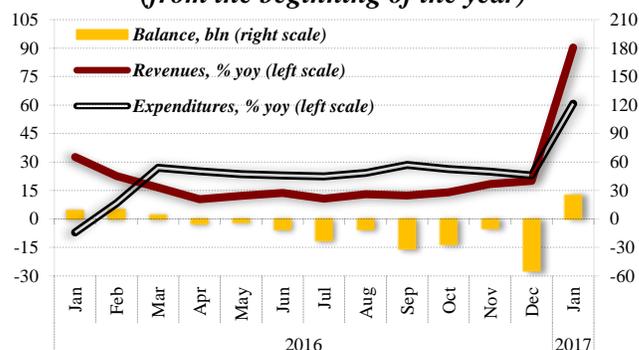
Growth of state budget expenditures was almost two times lower compared to that of revenues, at 57.9% yoy. This growth was caused mainly by expansion of payroll expenditures due to increases in minimum wages. At the same time, expenditures on privileges and subsidies to the population also increased because of higher utilities tariffs. Altogether, consolidated budget expenditures expanded by 60.7% yoy in the reporting month.

## Monetary Policy

**Inflation.** Consumer inflation sustained little change in January. The all-items CPI grew by 12.6% yoy, which was in line with forecasts. This inflation was the result of increased production costs, higher commodity prices on world markets, and some depreciation of the national currency at the end of 2016. Core inflation accelerated to 6.2% yoy.

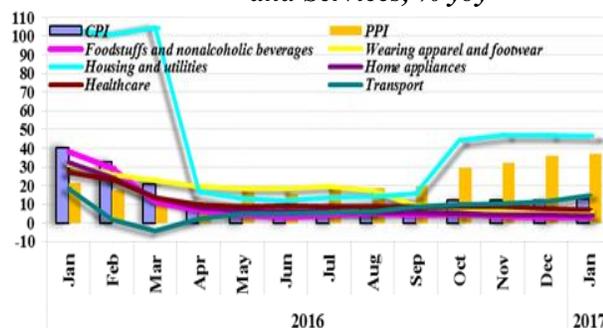
Most of the groups of goods and services saw negligible changes in prices in January. However, some deceleration in growth of prices of foodstuffs, housing and utilities, healthcare, education, and leisure were more than offset by accelerated growth in prices of alcohol and tobacco products (due to increases in VATs on these products), restaurants and

**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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hotels, and transport. Transport saw the largest acceleration in price growth from 11.4% yoy in December 2016 to 14.9% yoy in January. We leave our forecast for consumer inflation for 2017 unchanged at 10% yoy.

**Banking Sector.** Growth of deposits slightly decelerated in January, which is common for this period in Ukraine, as the New Year holidays induce both population and businesses to withdraw deposits. In particular, growth of national currency deposits edged down just by 0.4 percentage points, as a 3.5 percentage point deceleration in growth of corporate deposits to 8.5% yoy was partially offset by a 2.8 percentage point acceleration in growth of household deposits to 8.0%. The negative developments in foreign exchange deposits denominated in USD were more significant. Their decline accelerated from 0.4% yoy to 2.4% yoy, mostly due to some deceleration in growth of their corporate sector component to 3.0% yoy. The decline in household foreign currency deposits denominated in USD remained almost unchanged at 3.7% yoy.

Crediting activities of banks weakened a bit in January. Growth of corporate sector loans slightly decelerated but remained significant at 22.6% yoy. This more than offset the effects from deceleration of the decline in household loans to 2.4% yoy. Thus, growth of total national currency loans decelerated only by 0.7 percentage points to 16.2% yoy. The decline in foreign currency loans accelerated to 21.9% yoy in January on the back of accelerated declines in both corporate sector and household sector components (to 22.3% yoy and 19.3% yoy respectively).

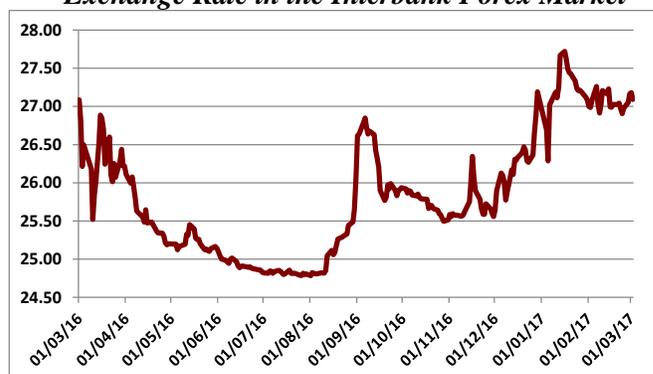
The monetary base declined by 5.1% mom in January due to significant decreases in cash balances. This led to significant deceleration in its year-over-year growth from 13.6% yoy in December 2016 to just 0.8% yoy in January. Similarly, dynamics of deposits and decrease in cash out of banks caused a 3.3% mom decline in money supply, decelerating its year-over-year expansion by 3.7 percentage points to 7.1% yoy.

**Hryvnia Exchange Rate.** The UAH/USD exchange rate fluctuated within the corridor of 26.90-27.05 UAH/USD for most of February. At

the same time, active purchases of dollars by banks with foreign capital for dividends repatriation purposes led to a short-term depreciation of the exchange rate at the beginning of the month. The rise by the NBU of the foreign exchange position limit for banks led to another short period of depreciation closer to the middle of the month. 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, assuming that the current trade blockade in Easter Europe is resolved soon, and the IMF resumes its lending program in Ukraine soon.

Thanks to a relatively stable situation with the exchange rate, the NBU further softened temporary exchange rate regulations. In particular, the regulator lifted the mandatory sale of foreign exchange inflows of non-residents, when those inflows were in the form of cash collateral. It also softened requirements on purchases of foreign currency by banks for their clients by raising the amounts allowed for purchases (from USD 25,000 to USD 100,000) and allowing not to include the amounts of cash collateral to the total balance at the account of a resident. Finally, the regulator also increased the foreign exchange position limit from 0.1% to 0.5% of regulatory capital of a bank.

*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 January 2017, the current account of the balance-of-payments of Ukraine was close to equilibrium, with a small USD 26 million deficit, compared to a USD 315 million deficit in January 2016. This improvement was due to a reduction in the deficit of the goods and services account from USD 652 million in December 2016 to USD 236 million in January. In January, Ukraine merchandise exports reached USD 2.8 billion, a growth of 52.6% yoy, compared to 9.2% yoy in December 2016. At the same time, Ukraine merchandise imports slowed down to 32% yoy, reaching USD 3.1 billion, compared to 35% yoy in December 2016.

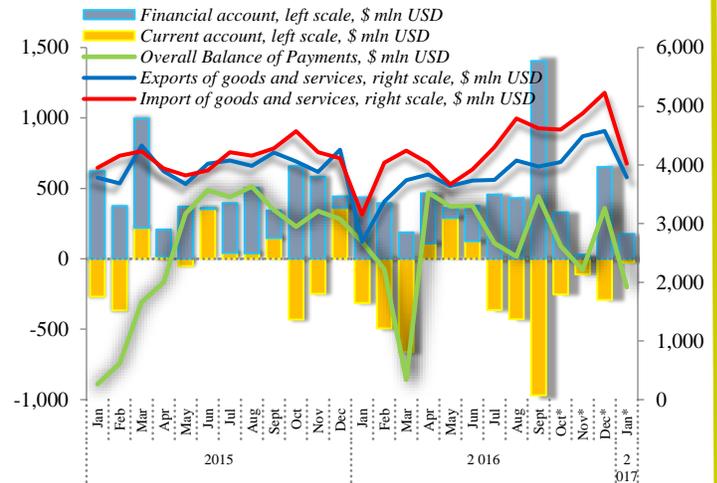
The best export performance took place in the following goods: mineral products (71.9% yoy growth), metallurgy (70.1% yoy), agricultural products (55.4% yoy), industrial goods (46.3% yoy), and machinery and equipment (34.3% yoy). On the other hand, exports of chemicals dropped by 8.7% yoy. Agricultural products now represent 48.6% of total exports, followed by metallurgy with 26.5%. On the import side, the categories with the highest growth were mineral products, including energy (65.1% yoy), machinery and equipment (61.3% yoy), and industrial goods (32.8% yoy).

As to the region representation of international trade, Ukraine's exports to Asia significantly rose by 61.5 % yoy (35% share amount) due to increased grain exports. Exports to the EU increased by 29.5 % yoy, less than the average growth rate and therefore its share declined to 35% of exports. Exports to CIS countries increased rapidly by 75.8 % yoy with its share of total exports increasing to 14.6% in January 2017 (Russia retained an 8% share of exports). On the import side, Ukraine increased imports from CIS countries by 58.4% yoy, Europe, by 34.1% yoy, and Asia, by 17.7% yoy.

In January 2017, the financial account had net outflows of USD 177 million, compared with net inflows of USD 436 million in January 2016. Foreign direct investment amounted to only USD 17 million.

Altogether, in January 2017, the overall balance of payments had a deficit of USD 202 million, bringing NBU's reserves to USD 15.4 billion as of February 1<sup>st</sup>, 2017, equivalent to 3.4 months of imports. The IMF decided to withhold its planned disbursement of USD 1.0 billion until the economic effects of the trade blockage in Eastern Ukraine and the seizure of Ukrainian enterprises by separatists are fully assessed. The government is currently updating its macroeconomic forecasts in view of these developments and expects to submit its analysis to the IMF in the nearest future.

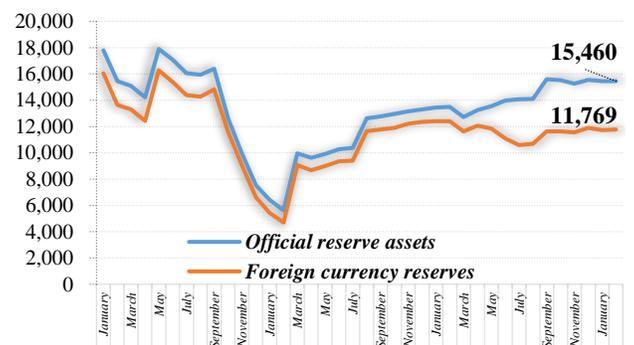
### Ukraine's External Balance of Payments, mln USD



*Source: NBU, The Bleyzer Foundation*

### International Reserves of Ukraine, mln USD

*Source: NBU, the Bleyzer Foundation*



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