

**March 2015**
**Oleg Ustenko, Djulia Segura, Valentyn Povrozhnyuk  
 Edilberto L. Segura**
**Executive Summary**

- ❖ Following the Minsk II Agreement, military hostilities in Eastern Ukraine declined but have not ceased completely.
- ❖ In recent weeks, terrorist acts in other Ukrainian cities, such as Odessa, have increased.
- ❖ In early March 2015, the Board of the IMF approved an Extended Fund Facility of \$17.5 billion, of which \$5 billion will be disbursed shortly.
- ❖ The Ukrainian government has started negotiations with foreign creditors on Eurobond restructuring.
- ❖ During January and February 2015, GDP growth continued to decelerate, with industrial output declining by 21.7% yoy, and with major declines in Eastern Ukraine.
- ❖ The consolidated fiscal budget continues to improve, with the fiscal budget deficit expected to decline to 7.5% of GDP in 2015.
- ❖ The upward trend of consumer inflation continued in February 2015, with consumer prices reaching 34.5% yoy during the month.
- ❖ The banking sector continues to experience significant pressures, as large national currency depreciations have caused uncertainties that led to a continuation of outflows of bank deposits.
- ❖ Thanks to IMF lending and the NBU's administrative measures, the Hryvnia exchange rate has stabilized at around 23 UAH/\$ and is expected to remain around 25 UAH/\$ during 2015.
- ❖ Ukraine's balance of payments is improving, with the current account deficit for 2015 expected to be only 1.2% of GDP.
- ❖ With a low current account deficit and international financial support, the level of international reserves of the NBU is expected to increase to \$13 billion by the end of the year.

<b>Forecast of Main Macroeconomic Indicators for 2014-2015</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014e</b>	<b>2015'</b>
<b>GDP, \$ billion</b>	163.4	176.6	182.0	127.4	77.2
<b>Real GDP Growth, % yoy</b>	5.2	0.2	0.0	-6.8	-5.0
<b>Private Consumption, real growth, % yoy</b>	15.0	11.7	7.8	-7.0	-8.0
<b>Fiscal Balance, incl. Naftogaz and Pension Fund, % of GDP</b>	-4.3	-6.0	-6.5	-11.7	-7.5
<b>Public Debt, % of GDP</b>	36.3	36.6	40.5	72.0	94.0
<b>Consumer Inflation, eop, % yoy</b>	4.6	-0.2	0.5	24.9	30.0
<b>Hryvnia Exchange Rate per USD, eop</b>	8.0	8.0	8.0	15.8	25.0
<b>Current Account Balance, % of GDP</b>	-6.3	-8.1	-9.0	-4.1	-1.2
<b>FDI (\$ billion)</b>	7.0	6.6	3.3	0.2	0.5
<b>International Reserves (\$ billion)</b>	31.8	24.5	20.4	7.5	13.0
<b>External Debt (\$ billion)</b>	126.2	135.1	142.5	135.0	153.0

**Political and Stabilization Developments**

On February 11, 2015, the governments of Ukraine, Russia, Germany and France agreed to a number of measures to end military hostilities in the Donbas (the Minsk II Agreement). This agreement followed the collapse of the similar Minsk Protocol of September 2014, which had failed to bring peace to the region. Since the signing of the Minsk II agreement, casualties in the region have significantly decreased, although the ceasefire has not fully held. Nevertheless, this relief in military actions is being used by the Ukrainian government to improve its army, both by training and by supplying weapons that may enforce better security for those regions. These changes are considered necessary because several cities, including Mariupol's suburbs, are still under rebel attack. In fact, over the last few weeks, the number of terrorist acts in cities under control of the central government has increased.

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There are almost weekly explosions in the southern city of Odessa and there have been several in other parts of the country. It appears that separatists are using these acts to further destabilize the country and intensify tensions.

During March the political situation in the country was affected by difficult discussions within the Ukrainian government and with Parliament on the role of the state in managing companies in which the state has a share. The debates were intensified after the struggle over Ukrtransnafta and Ukrnafta between the Governor of Dnipropetrovsk region, on one side, and the President and Prime Minister, on the other side. The actions taken by the Governor of Dnipropetrovsk, including bringing armed people to the central offices of the above mentioned companies, were officially considered as unacceptable. The conflict was resolved after the President dismissed the Governor from his office. However, this conflict was reflected in the composition of Parliament. Four members of the President's in Parliament left the coalition. It affected the constitutional majority in Parliament (i.e., 300 seats). Now the coalition controls 298 mandates.

As part of its overall economic and social stabilization measures, Ukrainian authorities are moving forward with their macroeconomic stabilization agenda. The most important event in March was the start of a new program with the IMF. The new IMF Extended Fund Facility Arrangement (EFF) replaced the previous Stand-By program. The Program approved by the IMF board at the beginning of March opened a new four-year credit line for the country in the amount of a \$17.5 billion loan. \$10 billion is expected to be available for Ukraine in 2015. The first tranche of \$5 billion was already transferred with an equal distribution among the National Bank and the Ministry of Finance. The IMF program unblocked other sources of financing. Around \$8 billion of non-IMF financing for 2015 became immediately available for Ukraine.

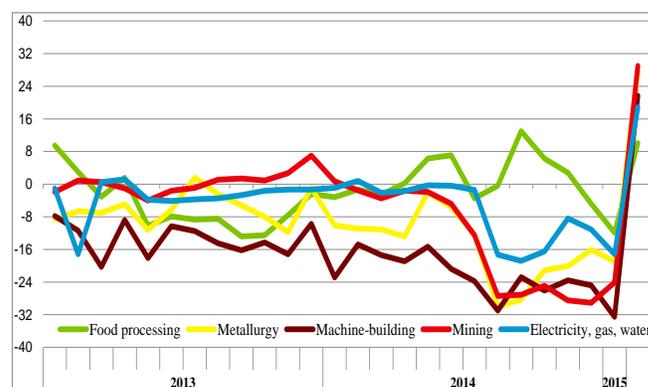
To meet its foreign financial needs, the Ukrainian government has started negotiations with foreign creditors on Eurobond restructuring. The Ministry of Finance has signaled that this debt restructuring may include (i) a "haircut", which might be on in the order of 25% of principal amounts, (ii) an extension of maturities – by at least 3 years and (iii) a decrease in bond coupons by around 2-3 percentage points. It is expected that with the IMF program, successful debt restructuring and international donors' financial support, Ukraine should be able to stabilize the macroeconomic situation over the next few months.

In order to achieve social stabilization in the conflict areas, the efforts of the government should now be concentrated on developing initiatives to gain the support and confidence of the local population with short and medium term programs to improve the quality of life in these areas. This will require developing programs such as funding a Social Stabilization Fund to finance communal micro-projects, improving international trade and capital inflows from other countries around the world to improve incomes, and delivering a broad-based reform agenda. These measures should help in resuming growth in 2016.

### Economic Growth

During February 2015, GDP growth continued to decelerate due to (i) persistent military hostilities in the East of Ukraine, (ii) uncertainties regarding the Hryvnia exchange rate, and (iii) accelerating inflation (which reached about 35% yoy). The ongoing fighting in the occupied territories is fed by a steady supply of military equipment by Russia, disguised as "humanitarian" aid and contrary to the Minsk II Agreement. These hostilities have made it impossible to revive output in these oblasts. In addition, the deteriorating trade relationship between Russia and Ukraine is yielding additional pressure on the Ukrainian economy.

### Monthly Output Production by Select Industries, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

**Headquarters**  
 123 N. Post Oak Ln., Suite 410  
 Houston, TX 77024 USA  
 Tel: +1 (713) 621-3111  
 Fax: +1 (713) 621-4666  
 Email: sbleyzer@sigmableyzer.com

**Kyiv Office, Ukraine**  
 4A, Baseyna Street, «Mandarin Plaza», 8th floor  
 Kyiv 01004, Ukraine  
 Tel: +38 (044) 284-1289  
 Fax: +38 (044) 284-1283  
 Email: kiev.office@sigmableyzer.com.ua

**Kharkiv Office, Ukraine**  
 Meytin House, 49 Sumska Street, Office 4  
 Kharkiv 61022, Ukraine  
 Tel: +38 (057) 714-1180  
 Fax: +38 (057) 714-1188  
 Email: kharkov.office@sigmableyzer.com.ua

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On the positive side, the first disbursement of \$5 billion in March 13 by the IMF should help increase confidence and should help recover and stabilize Ukraine's macroeconomic conditions. Furthermore, the approval of the EFF will permit Ukraine to receive additional funds from other international financial organizations and governments amounting to about \$ 8 billion.

According to preliminary estimates, with financial support, in 2015 Ukraine's real GDP may drop by around 5%, compared to a 6.8% decrease in 2014. Under this scenario, GDP may reverse its negative trend and start posting some growth at the end of 2015. Nevertheless, this is an optimistic scenario, as the government's own analysis envisages scenarios under which GDP may decline in 2015 by as much as 5.5%, 8.6% and 11.9% if the hostilities in the East do not cease and adequate financing fails to materialize.

The government's pessimistic scenarios are the consequence of deep declines in output experienced during January-February 2015.

During these two months, the index of industrial production declined by 21.7% yoy. The largest output drops were felt in mining and quarrying (by 26.5% yoy), manufacturing (by 20.5% yoy) and electricity, gas, steam and air conditioning supply (by 17.1% yoy).

A substantial portion of these sectors are located in the occupied territories of Ukraine. Within the manufacturing subsectors, the most affected industries were chemicals and chemical products (which declined by 22.9% yoy in January-February), coke and refined petroleum products (by 55.4% yoy), basic metals and metal products (23.1% yoy) and basic pharmaceutical products (18.4% yoy). Reversing the situation of the past, even the production of food products and beverages suffered declines during January-February by 10.9% yoy. The output declines in agro-based products might be due to the implementation of 5-10% tax duties.

From a regional point of view, major declines in industrial production took place in Donetsk and Lugansk, where output declined by 54.3% yoy and 88% yoy, respectively, during January-February 2015. Other regions affected by large industrial output drops include Odessa (by 16% yoy), Nikolayev (by 18.6% yoy) and Kharkiv (by 18.1% yoy.)

During January and February 2015, the agricultural sector did not perform as poorly as the industrial sector. Nevertheless, agricultural production declined by 3.6% yoy, including output of agriculture enterprises (by 2.3% yoy) and household agriculture (by 5% yoy drop). In agriculture enterprises, their cattle and poultry output fell by 1.8% whereas pig production increased by 7% yoy. On the positive side, agricultural enterprises benefited from higher prices in local currency. In fact in January-February 2015, the average price for agriculture product sales from agro-enterprises increased by 60% yoy compared to an inflation rate of about 35% during the last 12 months. On March 1<sup>st</sup>, 2015, agriculture enterprises engaged in storage reported a stock of 19.3 million tons of grain, which is 22% higher than on March 1<sup>st</sup> of 2014.

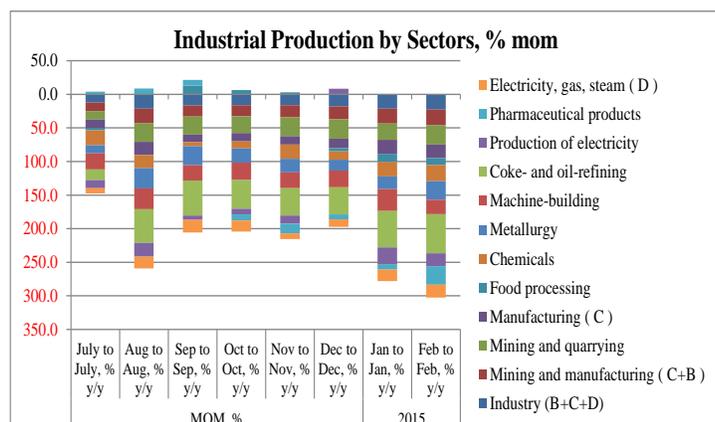
### Real Sector Indicators of Ukraine, % yoy

	2015 2m*	2014	2013	2012	2011	2010
<b>Agriculture</b>	-3.6	2.8	13.3	-4.5	17.5	-1.5
<b>Industry</b>	-21.7	-10.7	-4.3	-1.8	7.6	11.2
<b>Construction works</b>	-32.0	-21.7	-11.1	-14	11.1	-5.4
<b>Domestic trade, turnover</b>						
Wholesale trade	-17.3	-15	-2	-4.4	0.6	0.4
Retail trade	-21.2	-8.6	9.5	15.9	14.7	9.8
<b>Transportation, turnover</b>						
Cargo	-22.3	-10.8	-3.9	-7.6	5.7	6.4
Passenger	-13.8	-11.7	-2.9	-1.2	3.3	-0.2

\* Excluding Crimea

Source: State Statistical Service of Ukraine, The Bleyzer Foundation

### Monthly Output Production by Select Industries, % mom



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

**Headquarters**  
 123 N. Post Oak Ln., Suite 410  
 Houston, TX 77024 USA  
 Tel: +1 (713) 621-3111  
 Fax: +1 (713) 621-4666  
 Email: sbleyzer@sigmableyzer.com

**Kyiv Office, Ukraine**  
 4A, Baseyna Street, «Mandarin Plaza», 8th floor  
 Kyiv 01004, Ukraine  
 Tel: +38 (044) 284-1289  
 Fax: +38 (044) 284-1283  
 Email: kiev.office@sigmableyzer.com.ua

**Kharkiv Office, Ukraine**  
 Meytin House, 49 Sum'ska Street, Office 4  
 Kharkiv 61022, Ukraine  
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 Email: kharkov.office@sigmableyzer.com.ua

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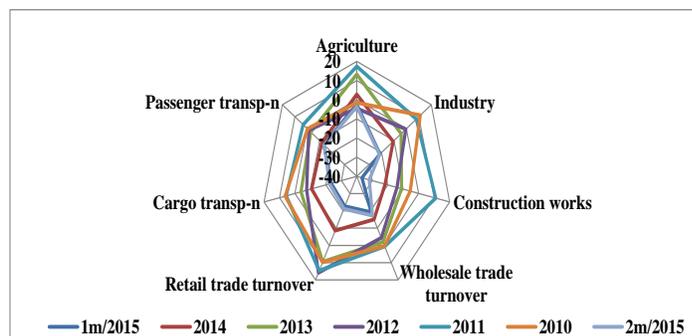
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The construction sector is also performing poorly. In February 2015, construction work declined by 31.2% mom, with declines in all areas (with non-residential declining by 49.2% mom and engineering facilities by 48.8% mom). The largest drop in construction in January-February 2015 also took place in Donetsk and Lugansk (by 69.2% yoy and 89.8% yoy) followed by Odessa, Kirovograd, Kherson and Kyiv by 60.1% yoy, 57.9% yoy, 49.6% yoy and 30.2% yoy, respectively.

Transportation services were negatively affected by increases in freight tariffs. Freight cargo tariff increases are expected to continue with an increase of 25% planned this year (from May 2015). These increases are due to higher local fuel prices and the large Hryvnia devaluation. In January-February 2015, cargo and passenger transportation turnover declined by 22.3% yoy and 13.8% yoy, respectively. Similarly, seaport transit cargo transshipment fell by 12.3% yoy.

On the demand side of GDP, although statistical information is not yet available, it appears that private consumption is also performing poorly. For instance, new car sales dropped by 80% yoy in February 2015. Similarly, domestic trade turnover dropped during January-February 2015, with wholesale trade declining by 17.3% and retail trade by 21.2% yoy.

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



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

### Fiscal Policy

The execution of the consolidated fiscal budget significantly improved in February 2015. According to preliminary data, consolidated budget revenues totaled UAH 74.7 billion by the end of the month. This represents a 9.7% yoy growth in nominal terms and a significant improvement over January, when revenues declined by 11.8% yoy. Furthermore, consolidated fiscal budget expenditures grew at a lower rate in February compared to growth of revenues. They increased by 6.7% yoy to UAH 75.41 billion.

The faster growth of revenues than expenditures led to a significant decline in the consolidated budget deficit. Taking into account excess repayments over lending by UAH 384.4 million, the consolidated fiscal budget deficit amounted to UAH 272.0 mln at the end of February, which represents an almost 90% decline over its value at the end of January. The government expects the consolidated budget to be executed in full accordance with the plan in Q1 2015 as agreed with the IMF.

According to the Cabinet of Ministers, the ongoing changes in budget legislation related to fiscal decentralization and anticorruption measures have increased efficiency in collection and distribution of budget revenues. On March 24<sup>th</sup>, Mr. Yatseniuk announced that the first stage of budget decentralization was successfully executed, as revenues of local budgets increased by 25% yoy to UAH 13 billion in January-February 2015. Furthermore, the Prime Minister pointed out that the government accumulated UAH 15.5 billion at the Single Treasury Account as of March 24<sup>th</sup>, while there was just UAH 106 thousand during the same period of time last year. In order to further improve state finances and raise the level of transparency and accountability of the government, the Prime Minister has ordered the heads of oblast state administrations to regularly publish reports on utilization of funds of local budgets. On March 4<sup>th</sup>, the Ukrainian Parliament adopted amendments to the law on the state budget which were submitted in mid-February. Adoption of amendments was crucial for the approval of the new EFF Program for Ukraine by the IMF. As we pointed out in our previous report, the government developed the mentioned amendments in accordance with recommendations of the IMF. On March 11<sup>th</sup>, the IMF approved the EFF Program for Ukraine and signed the Memorandum of Economic and Financial Policies with the Ukrainian government. The first tranche under the new program of USD 5 billion equivalent was disbursed almost immediately and Ukraine received it on March 13<sup>th</sup>.

**Headquarters**  
 123 N. Post Oak Ln., Suite 410  
 Houston, TX 77024 USA  
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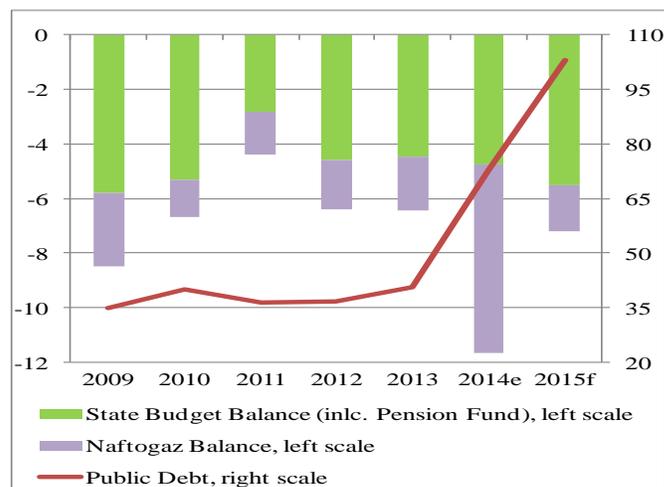
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Half of the amount was transferred to the account of the Ministry of Finance of Ukraine aimed at general budget deficit financing, while another half was transferred to the foreign exchange reserves of the NBU.

Upon approval of the Program, the IMF issued its staff report on Ukraine. The report recognizes that the government successfully met the 2014 general government deficit target with a large margin and introduced a package of important tax reforms which include tax simplification, reduction of labor tax burden and elimination of a distortive payroll tax along with both permanent and temporary revenue-raising measures. The report also lists fiscal institutional reforms for Ukraine under the Program which include:

- ❖ strengthening of fiscal institutions to achieve lasting improvements in revenue collection and expenditure transparency and control;
- ❖ strengthening the efficiency of tax administration operations;
- ❖ public financial management reforms aiming to strengthen budgetary framework and cash management over the medium term.

**Ukraine's Public Sector Fiscal Deficit, % of GDP**


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

The Memorandum on Economic and Financial policies submitted to the IMF specifies particular goals of reforms and particular measures to be implemented. In fact, it clearly states that the government has to lower external debt below 71% of GDP by 2020. The combined general government and Naftogaz deficit for 2015 is set at 7.4% of GDP. Naftogaz itself is required to reduce its deficit to 3.1% of GDP in 2015 and to zero by 2017 and thereafter. Taking into account recent developments in the execution of the consolidated fiscal budget and government obligations enshrined in the Memorandum, we are forecasting a fiscal deficit of 7.5% of GDP for 2015.

### Monetary Policy

**Inflation.** The upward trend of consumer inflation continued in February 2015.

Furthermore, growth of consumer prices significantly accelerated during the month and reached 34.5% yoy. Growth in prices was due in part to the increases in indirect taxes introduced through amendments to the Tax Code of Ukraine in late 2014. But the major impact on prices was due to the further depreciation of the national currency, which had both a direct and indirect impact on consumer prices. Its direct impact was reflected in growing prices of imported goods during the reporting month.

The indirect impact was manifested in increasing transportation expenditures as prices of fuel saw sharp acceleration in growth to 83.8% yoy in February. Furthermore, as a consequence of the sharp depreciation of the Hryvnia, the population started to purchase more durable goods and foodstuffs with a long shelf life (i.e., sunflower oil, sugar, grits, flour, pasta etc.) trying to invest their shrinking real savings into merchandise.

To stop this “agiotage” some retail chains even introduced purchase restrictions and increased prices for the most demanded goods, which also contributed to acceleration of consumer inflation. Finally, a large m-o-m depreciation of the Hryvnia inevitably raised inflation and depreciation expectations of population, which had a negative impact on inflation in February and will impose an upwards pressure on prices in subsequent months.

A closer look at the CPI components shows that the categories of goods and services depending most on imports observed the sharpest monthly increase in prices in February. In particular, the sharpest increase was observed for fuels, at 19.8% mom, followed by fruits (17.5% mom), vegetables (15.2% mom), and fish products (10.0% mom). Quite significant increases were also observed in prices of such import dependent sectors as

**Headquarters**  
 123 N. Post Oak Ln., Suite 410  
 Houston, TX 77024 USA  
 Tel: +1 (713) 621-3111  
 Fax: +1 (713) 621-4666  
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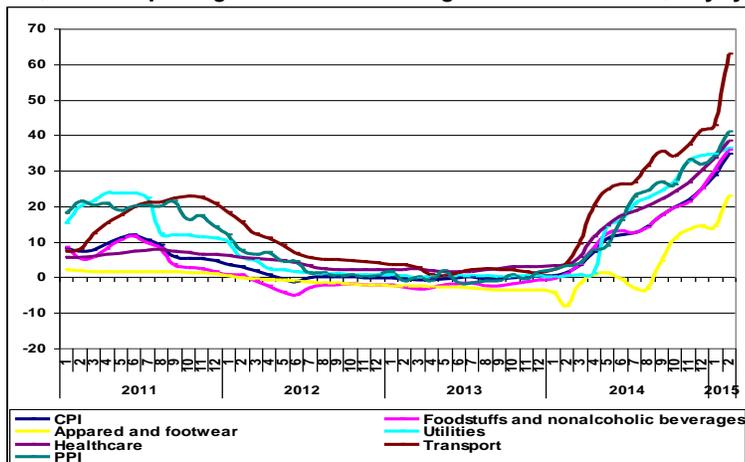
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pharmaceuticals and home appliances. Relatively low monthly inflation in apparel and footwear (by 2.3% mom and 2.2% mom, respectively), which are also dependent on imports, may be explained by the change of season from winter to spring, which is usually accompanied by sales with high discounts on winter apparel and footwear.

As for other CPI components, the statistics show high growth of prices on pasta, sunflower oil, and sugar, which illustrates the statement above concerning foodstuffs with long shelf life. The only CPI component posting a decline in February was chicken eggs. However, in year-over-year terms, prices of eggs posted one of the sharpest increases in February, coming in third after fruits and fuels. There were no major utilities tariffs increases during the reporting month. Therefore, the main source of monthly increase in housing prices was the quite high growth of prices for apartment maintenance and repairs, 8.9% mom. This growth is explained by the Hryvnia depreciation, as maintenance and repair depends on parts and materials, many of which are imported. As for services, their prices posted noticeable increases in February as the impact of Hryvnia depreciation offset the impact of falling domestic demand.

### CPI, PPI and price growth for selected goods and services, % yoy



Source: State Statistical Service of Ukraine. The Bleyzer Foundation

As a result, growth in costs of education, of culture and recreation, and of restaurants and hotels accelerated.

Based on all of the above, we have left our forecast for consumer inflation at the end of 2015 unchanged at 30% yoy despite some measures of the NBU aimed at anchoring inflation. The National Bank sharply raised the policy rate from 19.5% to 30.0% starting on March 4<sup>th</sup> and increased amounts of funds withdrawn from the banking sector through auctions of deposit certificates. These measures were introduced to both anchor inflation and stop a sharper Hryvnia depreciation through narrowing of banking sector liquidity. In principle, the NBU has chosen an adequate instrument to fulfill the mentioned goal. But, as recently observed, it has also negative effects. In particular, the sharp increase in the policy interest rate makes business loans too expensive and may stop business crediting. This will further slowdown business activity and yield a sharper economic decline. Inflation may slow down (to 10% in 2016) but at a high price for growth. Some analysts feel that it would have been more efficient to raise the policy rate in several stages, giving business time to adapt. Therefore, we expect the NBU to reduce the policy rate back in the near future.

**Banking Sector.** In February, the banking sector continued to experience significant pressures, mainly as a result of the large national currency depreciation. In particular, currency uncertainties caused a continuation of the outflows of bank deposits. Nevertheless, there were some positive developments. Despite a 1.7% mom decline in deposits in national currency, and a 3.7% mom decline in foreign currency deposits, the year-over-year decline slightly decelerated in both deposit categories. Deceleration was more pronounced in national currency deposits as the rate of decline fell by about 3.0 percentage points to 10.2% yoy, while foreign currency deposits saw a 36.9% yoy decrease, which is 1.1 percentage points deceleration. In any event, these deposit declines have caused significant problems to the banking sector, including lack of liquidity, deterioration of credit portfolio quality, and together with currency depreciation, stress in the ability to serve external debts.

The NBU is supporting banks to cover the existing financial gap by providing refinancing facilities. However, this refinancing is provided only to banks that have liquidity problems but are fundamentally solvent. As a result, the number of banks classified as insolvent has continued to increase. During February and the first three weeks of March, the NBU made decisions on the liquidation of 10 banks, while 9 other banks were classified as insolvent.

**Headquarters**  
 123 N. Post Oak Ln., Suite 410  
 Houston, TX 77024 USA  
 Tel: +1 (713) 621-3111  
 Fax: +1 (713) 621-4666  
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 Fax: +38 (044) 284-1283  
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The later includes Delta Bank with the amount of deposits to be repaid through the Deposit Guarantee Fund estimated at UAH 16.4 billion. This amount is not just the largest one to be returned from one banking institution in the history of Fund since independence, but also a threat to the stability of the forex market, as many clients may be using these payments to buy dollars in order to save their money from depreciation. In addition, the NBU has provided some liquidity stabilization loans to several banks.

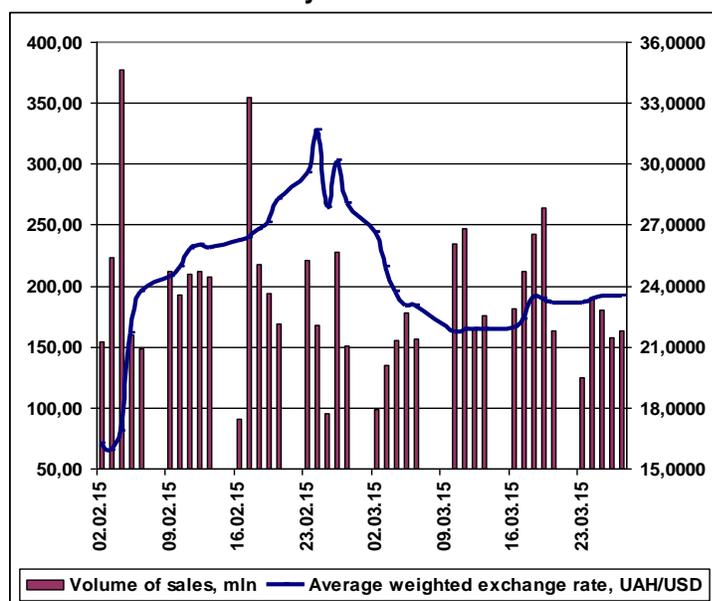
Among those was Privatbank, which is the largest bank in the country based on the amount of capital. The bank suffered from significant outflow of deposits in an amount around UAH 63 billion, which represents half of total deposit outflow from the Ukrainian banking sector in 2014. Overall, the NBU provided UAH 30.8 billion of refinancing, UAH 23.3 billion of which were overnight loans.

Even though the banking sector is under pressure, banks have continued to repay their external debt. As a result, the stock of external debt liabilities dropped 8.5% qoq to \$18.8 billion in Q4 2014. This follows a reduction in the stock of external debt liabilities of banks by 17% at the end of 2014, compared to that at the end of 2013. Although these debt reductions represent good progress, external debt remains a serious problem to banks as around 60% of their debt has to be repaid within a year and the national currency lost one-third of its value from the beginning of 2015.

**Hryvnia Exchange Rate.** Following rapid currency depreciations, at the end of February 2015, the NBU managed to stabilize the exchange rate with the help of administrative measures.

However, those measures have imposed significant restrictions on business activities of importers. In addition to measures we described in our previous report (i.e., ban on foreign exchange purchases using borrowed resources, limitation of foreign exchange purchases for advance import contract payments, prolonged term for obligatory stay of funds for foreign exchange purchases at the transit account in the bank to four days, and introduction of a special document certifying absence of tax arrears), the NBU introduced a set of new measures with its Decree No. 160 on March 3<sup>rd</sup>. In particular, the NBU introduced daily limits on purchases of non-cash foreign exchange and banking metals for Hryvnia. The limitations cover banking operations under “tod”, “tom”, “spot”, and “forward” conditions but do not cover “swap” operations. Furthermore, the NBU prohibited provision of national currency loans by banks in cases where a client provides as security property rights on foreign exchange funds on accounts in banks. However, the most painful regulation for importers was introduction of a ban on purchases of foreign exchange by banks on behalf of the client-resident of Ukraine, if the client has more than \$10,000 equivalent on accounts in banks.

**Sales of US Dollar within the banking system of Ukraine, February 2<sup>nd</sup> –March 27<sup>th</sup>**



Source: NBU, The Bleyzer Foundation

Taking into account the fact that the NBU returned to its practice of cutting requests for foreign currency purchases submitted by banks, this ban almost halted purchases of USD by importers on the interbank forex market for a couple of days, which led to further appreciation of the UAH/USD exchange rate from around 28 UAH/USD to around 22 UAH/USD.

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 Houston, TX 77024 USA  
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 Fax: +1 (713) 621-4666  
 Email: sbleyzer@sigmableyzer.com

**Kyiv Office, Ukraine**  
 4A, Baseyna Street, «Mandarin Plaza», 8th floor  
 Kyiv 01004, Ukraine  
 Tel: +38 (044) 284-1289  
 Fax: +38 (044) 284-1283  
 Email: kiev.office@sigmableyzer.com.ua

**Kharkiv Office, Ukraine**  
 Meytin House, 49 Sumska Street, Office 4  
 Kharkiv 61022, Ukraine  
 Tel: +38 (057) 714-1180  
 Fax: +38 (057) 714-1188  
 Email: kharkov.office@sigmableyzer.com.ua

**March 2015**

 Oleg Ustenko, Djulia Segura, Valentyn Povroznyuk  
 Edilberto L. Segura

On the other hand, the administrative measures introduced in February and March led to further growth of the black forex market, return of the multiple exchange rate system (official exchange rate, official cash market exchange rate, and black market exchange rate), and slowdown in activities of exporters.

The positive aspect, however, was the fact that it was known from the very beginning, when the NBU will start gradually lifting all of those measures. It appears that these measures were originally passed because the NBU had to demonstrate to the IMF that the forex market situation is under control prior to the meeting of the IMF Board concerning approval of the new EFF Programme for Ukraine on March 11<sup>th</sup>. After the positive decision of the Board, the NBU plans to start canceling some of these administrative measures. For example, it is allowing some requests for foreign exchange purchases. Therefore, more importers obtained access to the interbank forex market, which led to some depreciation of the Hryvnia to around 23.5 UAH/USD. The NBU regulates the access of importers to the market through “request-scissors” to keep the official exchange rate around this number. In any event, the Ukrainian authorities have to develop a plan for the removal of administrative exchange restrictions and capital controls by May 15<sup>th</sup>, 2015 as set forth by the Memorandum of Economic and Financial Policies signed between the IMF and the government of Ukraine.

The above-mentioned Memorandum of Economic and Financial Policies foresees restrictions on the amounts of foreign exchange that can be sold to Naftogaz directly from reserves. The rest of the needed foreign currency resources to pay for imported gas will be bought by Naftogaz on the interbank forex market. These purchases will impose additional pressure on the exchange rate along with the removal of administrative measures. At the same time, the NBU managed to purchase USD 579 million from exporters over the first half of March. These funds will be used for interventions on the forex market. The mentioned resources are enough for at least several months of interventions taking into account the fact that the interbank forex market is very thin right now. Total turnover within the banking system rarely exceeded USD 250 million per day from the beginning of the year, which is a very small amount for a country with 40 million people and large industrial and agricultural potential. Considering the developments related to the forex market, and assuming that the foreign financing envisaged by the IMF becomes available, we are forecasting that the exchange rate during the rest of 2015 will be about 25 UAH/USD, provided that the conflict in Eastern Ukraine remains frozen.

### International Trade and Capital

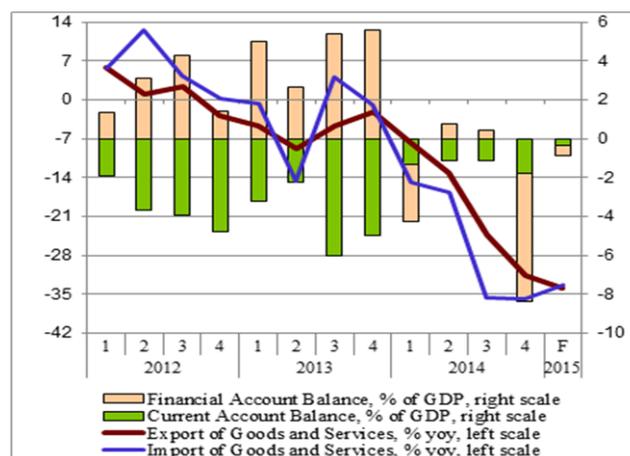
According to preliminary data, the consolidated balance of payments deficit reached \$743 million in February 2015, an improvement of 65% compared to the BOP deficit of \$2.1 billion experienced in February 2014.

The current account deficit also improved somewhat, amounting to \$405 million during February 2015, a 3% reduction compared to the same month of 2014. But the largest improvement in the BOP was due to improvements in the capital account of the BOP, and in particular on the deficit of the population (cash in foreign exchange outside banks), which improved by about \$1.2 billion yoy during February 2015.

Due to the continuation of military hostilities in the East, trade restrictions imposed by Russia, and sluggish economic recovery in Ukraine’s other main trading partners, exports of goods and services have continued to decline both month-over-month and also compared to the same month of 2014.

In February 2015, exports of goods and services amounted to \$3.1 billion, a decline of 35% compared to exports of \$4.8 billion in February 2014. On a positive note, on a month-to-month basis exports in February 2015 increased by 2% compared with January 2015.

**Select External Balance Indicators of Ukraine**



Source: NBU, The Bleyzer Foundation

**Headquarters**  
 123 N. Post Oak Ln., Suite 410  
 Houston, TX 77024 USA  
 Tel: +1 (713) 621-3111  
 Fax: +1 (713) 621-4666  
 Email: sbleyzer@sigmableyzer.com

**Kyiv Office, Ukraine**  
 4A, Baseyna Street, «Mandarin Plaza», 8th floor  
 Kyiv 01004, Ukraine  
 Tel: +38 (044) 284-1289  
 Fax: +38 (044) 284-1283  
 Email: kiev.office@sigmableyzer.com.ua

**Kharkiv Office, Ukraine**  
 Meytin House, 49 Sumska Street, Office 4  
 Kharkiv 61022, Ukraine  
 Tel: +38 (057) 714-1180  
 Fax: +38 (057) 714-1188  
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Year-on-year, the main export declines in February 2015 took place in mineral products (with a decline of 58% yoy), machinery and equipment (-49% yoy), ferrous and nonferrous metals (-44% yoy), chemicals (-38% yoy), and industrial goods (-26% yoy).

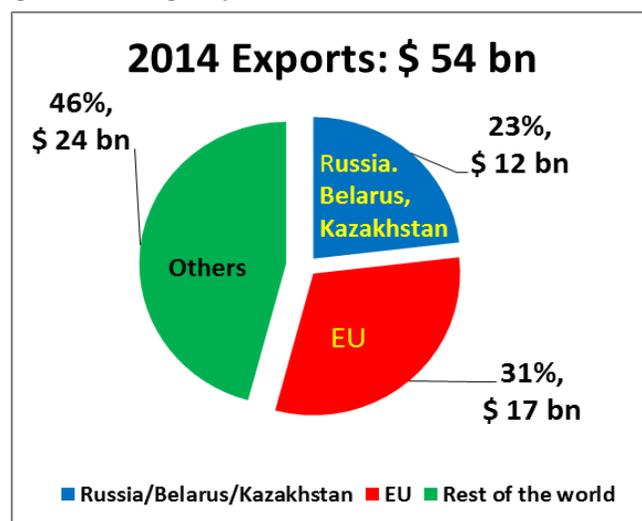
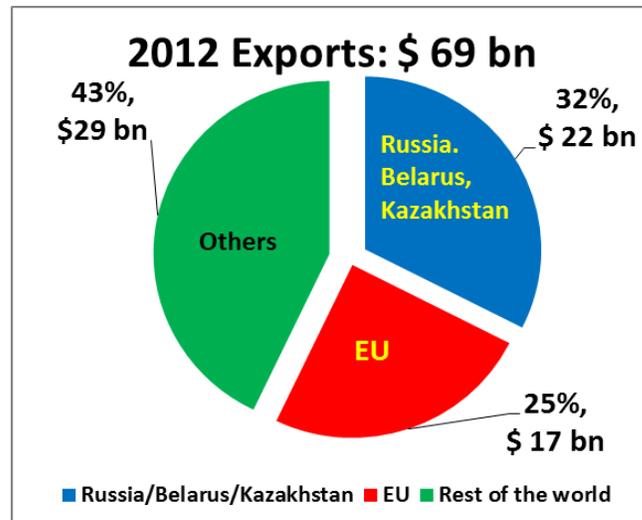
Agricultural products suffered the lowest decline in exports during this period (-9% yoy). In fact, on a month-to-month basis, agriculture showed positive growth of 10% mom. In terms of the country orientation for Ukrainian exports, the trends of the last two years have continued: exports to Russia, Belarus and Kazakhstan, which represented 32% of total exports in 2012, declined to 23% of the total in 2014 and to 13% in January 2015. In fact, declines in exports of about 50% yoy to these countries are accountable for the largest share of Ukraine's overall export decline. Exports to the European Union have remained stable in dollar terms during the last two years at about \$17 billion per year; but they have increased their percentage share in total exports to 31%, due to the overall decline in exports. Exports to the rest of the world now amount to about 46% of the total, but they declined in dollar terms from \$29 billion in 2012 to \$24 billion in 2014, due to the fact that military hostilities damaged a large portion of Ukraine's industrial productive capacity and infrastructure.

The large reductions in exports have not been reflected in major increases in the current account deficits of Ukraine because imports of goods and services also declined by about 33% in February 2015, compared to the same month last year. In fact, the following products experienced import decline in February 2015, yoy: machinery and equipment (by 50% yoy), ferrous and non-ferrous metals (by 47% yoy), agricultural products (by 42% yoy), industrial goods (by 40% yoy) and chemicals (by 34% yoy).

In the financial account of the BOP, the bright spot was that foreign direct investments showed some improvement in February 2015. FDI amounted to \$274 million in that month, compared to a negative flow of \$205 million in the same month last year.

On the other hand, the flows of foreign debt have continued to be negative. The outflows of medium and long term debt (net repayments) reached \$898 million in February 2015, compared to outflows of \$562 million in January 2015 and \$486 million in February 2014. The breakdown of net repayments of short, medium and long term debt in February 2015, by sector, were as follows: government (\$86 million), banks (\$363 million) and corporate (\$587 million). Given all these outflows, the level of reserves of the NBU declined by \$743 million during February 2015.

Based on the successful implementation of the IMF program, the balance of payments of Ukraine should improve considerably during 2015. For 2015, the current account deficit would be reduced to 1.2% of GDP, compared to a deficit of 4.1% of GDP in 2014. And the level of international reserves should increase from \$5.6 billion as of March 3, 2015 to \$13 billion at the end of 2015. With more stable balance of payments and higher reserves with IMF support, the Hryvnia foreign exchange rate should stabilize during the year at around 25 UAH/\$, provided that hostilities in the East are contained.



**Headquarters**  
 123 N. Post Oak Ln., Suite 410  
 Houston, TX 77024 USA  
 Tel: +1 (713) 621-3111  
 Fax: +1 (713) 621-4666  
 Email: sbleyzer@sigmableyzer.com

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 Fax: +38 (044) 284-1283  
 Email: kiev.office@siemableyzer.com.ua

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 Tel: +38 (057) 714-1180  
 Fax: +38 (057) 714-1188  
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