Executive Summary

According to early State Statistics Committee of Ukraine estimates, real GDP growth accelerated to 3% yoy in 2Q 2012, up from 2% yoy in the previous quarter. The acceleration may be attributed to stronger private consumption, an earlier harvesting campaign and co-hosting of the Euro-2012 football championship. Thus, loose fiscal policy and record low inflation underpinned a 16.5% yoy increase in real wages in 2Q 2012 compared to about 14.7% yoy in 1Q 2012. Thanks to strong real wage growth and the European football tournament held in June, retail sales picked up by 16% yoy over January-June 2012, while output production in food processing maintained growth momentum, advancing by 3% yoy in June.

Agriculture production, which was up by 28% yoy in June compared with 2.5% yoy a month before, helped offset weaker construction and industrial sector performance. With the completion of infrastructure upgrade projects related to the Euro-2012 football championship, construction declined by almost 9% yoy in June 2012. Renewed Eurozone sovereign debt woes and slowing world economic growth weighed on world commodity prices, which fell sharply in June. In addition, domestic lending remains sluggish, constraining economic activity. As a result, Ukraine’s industrial production declined by 1.4% yoy in June on weaker performance of export-oriented and capital intensive industries. Thus, the chemical industry lost steam, expanding by about 6% yoy in June from almost 15% yoy a month before. Output in metallurgy, machine building and manufacturing of construction materials fell by about 1% yoy, 9% yoy and 5% yoy in June, respectively. Although robust domestic demand will continue to support economic growth through the rest of the year, due to a more subdued global growth outlook in 2H 2012 and sluggish domestic credit growth than we initially expected, real GDP growth is forecast at around 2% yoy in 2012.

Ukraine witnessed a drop in its consumer prices in July, for the third consecutive month. In annual terms, however, the index fell by 0.1% in July compared to 1.2% the previous month. Slower decline may be attributed to an easing favorable statistical base impact on food prices and increases in railway transportation and phone service tariffs. Considering price developments from January to July 2012, our year-end inflation forecast was adjusted downwards to 6% yoy.

May-July 2012 showed that within the NBU’s complex policy mix of stimulating anemic credit growth and maintaining the Hryvnia exchange rate peg to the US Dollar, the latter target has prevalence over the former. To contain currency movements in July, the NBU continued to intervene in the foreign exchange market by selling almost $1.2 billion of its international reserves on a net basis and keeping banking sector liquidity tight. Liquidity constraints and high credit risks pressured credit rates upwards and affected credit availability for the real sector. The stock of bank credit grew by only 3.8% yoy in June and was only 0.1% higher since the beginning of the year.

The Balance of Payments switched to a $1.5 billion deficit in June amid higher external debt repayments and a worsened current account. While a deficit on the financial account was anticipated, the deterioration in the current account balance was sharper than expected. Weaker overseas demand and falling world commodity prices caused deep declines in exports of metals, chemicals and mineral products, which together accounts for more than half of Ukraine’s exports. Although agricultural exports kept growing at a solid pace, total export of goods fell by 11% yoy in US Dollar terms in June compared to a 9.6% yoy increase the previous month. A financial account balance is expected to turn into a surplus by July thanks to successful issuance of $2 billion of sovereign Eurobonds. Despite a favorable near-term outlook, Ukraine’s BoPs will remain under pressure in the short and medium term due to high external financing needs amid a challenging external environment.

At the beginning of 2Q 2012, Ukraine amended its state budget law to implement generous social spending increases. Unlike expectations, compensatory measures, such as a wealth tax, were not introduced. However, robust revenue growth and control over ‘non-social’ expenditures helped keep the state budget deficit 40% lower in 1H 2012 than in the respective period last year. Near-term fiscal financing needs have eased thanks to robust privatization receipts, a $2 billion Eurobond issuance and a VTB loan rollover. However, public finances are likely to remain strained in the short-term as the annual state budget revenue target looks overly optimistic, given

Executive Summary

July 2012

Olga Pogarska, Edilberto L. Segura

• Further deterioration in the external environment hit the Ukrainian economy in June: industrial production fell by 1.4% yoy and exports dropped by 11.3% yoy in US Dollar terms.
• Robust domestic consumption and acceleration in agriculture supported real sector performance in June.
• Consumer prices fell for the third month in a row in July.
• The National Bank of Ukraine continued to support a strong Hryvnia peg to the US Dollar through sizable foreign exchange interventions and maintaining tight banking liquidity.
• Tight liquidity led to a notable increase in the cost of borrowing for the private sector, further undermining credit growth.
• Due to a wider current account deficit and larger external debt repayments, Ukraine’s BoPs switched to a $1.5 billion deficit in June, but may turn into a surplus by next month thanks to a $2 billion sovereign Eurobonds placement.
• Ukraine reported a 40% yoy lower state budget deficit in 1H 2012 thanks to strong budget revenue growth and control over non-social expenditures. At the same time, public finances will remain under pressure in the short-term, requiring solid fiscal consolidation measures after the elections.

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July 2012

slower economic growth and inflation than projected by the government, reliance on NBU profit transfers to the budget, and expected acceleration in expenditures through the end of the year. A notable increase in state budget guarantees at the end of July adds to fiscal sustainability concerns. Hence, solid fiscal consolidation measures will be needed to ease these concerns after the elections.

<table>
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<tr>
<th>Year</th>
<th>GDP growth, % yoy</th>
<th>GDP per capita, $</th>
<th>Industrial production, % yoy</th>
<th>Retail sales, % yoy</th>
<th>Budget deficit, % GDP</th>
<th>Government external debt, % GDP</th>
<th>Inflation, eop</th>
<th>Gross international reserves, $ billion</th>
<th>Domestic trade turnover</th>
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<th>Year</th>
<th>Industrial production Growth by Select Branches, % yoy</th>
<th>World Steel and Fertilizer Price Indices, % yoy</th>
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Economic Growth

Renewed fears over the Eurozone sovereign-debt crisis and worries of a faster-than-expected slowdown in Asian economies hit the export-dependent Ukrainian economy in June through weaker external demand and world commodity prices. However, economic growth remained relatively strong thanks to buoyant domestic consumption and acceleration in agriculture. Thus, according to State Statistics Committee of Ukraine estimates, real GDP growth sped up to 3% yoy in 2Q 2012, up from 2% yoy in the quarter before.

Agriculture was the largest contributor to economic growth in June. The sector’s output production leaped up by 28% yoy in June compared with 2.5% yoy a month before, according to NBU estimates. Such a rapid acceleration, however, should be primarily attributed to a favorable statistical base effect due to the early start of a harvesting campaign this year.

Thanks to loose fiscal policy and very low inflation, real wages grew by 15.6% yoy in 1H 2012, benefiting demand-driven sectors. In addition, the 2012 UEFA European Football Championship, which Ukraine co-hosted with Poland in June, contributed strongly to the growth momentum, expanding by 3% yoy in June compared with 15.5% yoy for the first five months of the year. Restaurants reported acceleration in turnover to almost 9% yoy in 1H 2012. Food processing has maintained growth momentum, expanding by 3% yoy in June. Passenger transportation also improved its performance that month.

At the same time, completion of large infrastructure projects and subdued credit growth weighed on construction sector activity. Real value of construction works was 1.9% yoy lower in June, while the growth in chemicals slowed to 0.8% yoy lower in June, while the growth in chemicals slowed to 6.2% yoy that month compared to almost 15% yoy a month before.

Output production in machine-building, the fourth largest industry after metallurgy, food processing and electricity production, declined by about 9% yow in June. Decaying demand (both domestic and foreign) for Ukraine’s automobiles has contributed the most to the decline in the industry and may be attributed to changing consumer preferences, high credit costs and intensified competition on foreign markets, particularly in CIS countries. The near-term

1According to Auto-consulting, the share of SUVs (sport utility vehicles, which also includes crossovers) in the Ukrainian car market grew from about 14% in 2007 to over 26% in 1H 2012.

2Although commercial banks have maintained their focus on car loans, a liquidity squeeze and higher political and economic uncertainties caused lending rates to increase in recent months.

3Russia has been rapidly increasing production of light vehicles in recent years, to a notable extent, thanks to government policy of encouraging domestic production of foreign car brands. In 2011, production grew by 44.5% yoy, according to Rosstat, and 11 out of 15 global car-manufacturers had their assembly lines in Russia.
outlook for the industry looks even more challenging as Russia, the principal export destination for Ukraine’s vehicles, is introducing a salvage fee on cars, which will make imported automobiles more expensive. To stimulate the automobile industry in Ukraine, the Ukrainian government has been considering an increase in import duties on cars by about 6.5%-15%. The effectiveness of this measure looks doubtful, however. Domestic auto-making requires significant investments to renovate existing capacities. At the same time, limited access to financial resources (both domestic and foreign) and a complicated investment climate hinder investments in the sector. Moreover, it may raise concerns over the country’s compliance with WTO regulations and may further complicate the situation around FTA with the EU.

On the upside, mining and production of electricity continued to demonstrate healthy growth rates in June. Amid expensive Russian natural gas imports this year, Ukraine has been increasing domestic production of energy resources. Thus, extraction of fuels and energy minerals grew by 4% yoy in June and 3.4% yoy over 1H 2012. Improved export opportunities and higher domestic demand due to hot weather underpinned a 6.6% yoy increase in production of electricity in June.

For the rest of the year, we expect the Ukrainian economy to slow down, mainly as a result of sluggish global growth, tight domestic credit conditions, political uncertainty related to parliamentary elections and waning favorable effects (early harvesting, Euro-2012 championship). Real GDP is forecast to increase by about 2% yoy in 2012.

Fiscal Policy

The fiscal situation was also better than expected in 1H 2012, though deeper data readings present a less favorable picture. Rather unexpectedly, state budget revenue growth accelerated to almost 17% yoy in nominal terms in 1H 2012, up from about 12% yoy over January-May. The acceleration was achieved despite worsening industrial sector growth and foreign trade performance in June as well as record low inflation for the period. Strong consumption growth, higher excise taxes, tighter tax administration and improved customs procedures have supported the increase in budget revenues. Thus, proceeds from VAT, a consumption tax, rose by a nominal 13.6% yoy in 1H 2012, up from 10.4% yoy in the previous period. Receipts from excise taxes on imported goods and import duties soared by an impressive 47% yoy and 35% yoy in 1H 2012.

Despite a solid increase in tax revenues, the NBU transfer of its profits for 2011 in the amount of UAH 4.5 billion ($0.6 billion) in June was the principal contributor to June’s speed-up in state budget revenues. Thus, according to the 2012 state budget law, the NBU should quarterly transfer a tally of UAH 9.6 billion of its 2011 profits. As of the end of June 2012, the NBU had already transferred more than 80% of this amount. Moreover, at the beginning of July, the annual target for NBU profit transfers was raised to UAH 10.6 billion. These developments may signal that the government budget revenue plans are strained. An expected slowdown in economic growth in 2H 2012 and higher budget expenditures add to near-term fiscal pressures.

So far, state budget expenditures rose by a nominal 13.3% yoy in 1H 2012, virtually the same pace as in January-May as higher social spending (27.5% yoy vs. 21% yoy respectively) was offset by slower rise in other expenditures (infrastructure projects, security and defense, etc.). As a result, the state budget deficit, standing at UAH 6.7 billion ($0.8 billion), was almost 40% lower than in the corresponding period last year. At the same time, state budget expenditures are likely to accelerate through the rest of the year as fulfillment of pre-election social initiatives only started to gain momentum in May and expenditures are usually skewed toward the end of the year. Thanks to a more active privatization process this year, an issuance of $2 billion Eurobonds in July and a rollover of a $2 billion VTB loan, Ukraine may have sufficient resources to cover its short-term needs. However, recurrent pre-election social expenditures, a delay in energy sector reform, domestic borrowings in foreign currency and generous state guarantees, envisaged by July’s amendments to the 2012 State Budget Law, challenge fiscal sustainability in the medium term.

In particular, at the end of July, the parliament increased the maximum limit of state budget guarantees, which may be granted in 2012, by 4.6 times to UAH 68.8 billion (about $8.5 billion, or 4.6% of projected full-year GDP.) According to Ukrainian officials, the new guarantees will be provided for agriculture and natural gas substitution projects, principally in accordance with the Memorandum of Cooperation between Ukraine and China in energy and agricultural sectors. According to the Memorandum, Ukraine may receive up to $3 billion from the Export-Import Bank of China for agricultural projects and about $3.6 billion from China Development Bank for energy projects. So far, however, there are no details of the agreements. Such a notable increase in state budget guarantees adds to fiscal sustainability concerns as public and publicly guaranteed debt may approach 40% of GDP in 2012.

* A new salvage fee will be enforced from September 1st, 2012. Though it will be levied on both foreign-made and domestically produced cars, domestic car makers will be allowed to issue a warranty that ensures the future car recycling, while importers will be required to pay the fee upon importation of the vehicle.
Monetary Policy

Consumer prices in Ukraine have been falling for the third month in a row. Deflation, however, was relatively moderate in July, as the index fell by 0.1% yoy compared to 1.2% yoy a month before, which may be attributed to a waning favorable base effect. For the same reason, the decline in food prices, the main contributor to easing inflationary pressures over the last year, slowed to 4% yoy compared to 6.4% yoy in June. Moreover, dry hot weather during July-beginning of August may adversely affect yields of locally produced fruit and vegetables, which means they are likely to be dearer this summer and fall. On a positive note, food inflation is projected to stay moderate through the rest of the year, benefiting from high grain and other foodstuff stockpiles, a solid harvest this year, lower energy costs and a modest increase in utility costs and other administratively-regulated prices.

In particular, domestic petroleum prices reported a monthly decline for the second month in a row in July amid easing world energy prices. In annual terms the growth moderated to 4.9% that month compared to 6.2% yoy a month before. The existence of floating excise duties on fuels, introduced at the end of May 2012, hampered faster disinflation within this sub-group. However, the fall in fuel prices was sufficient to offset the cost increases in phone services and railway transportation. Due to government reluctance to raise tariffs ahead of parliamentary elections, utility services were only 1.4% yoy more expensive in July 2012. Early summer sales in clothes and footwear stores this year were behind a 1.2% yoy drop in clothing and footwear prices in July 2012. As a result, the overall consumer price index in July 2012 was 0.1% lower than in December 2011. Expected adjustments in administered prices after parliamentary elections will cause consumer price inflation to accelerate to about 5% at the end of the year. However, it will be the third lowest in Ukraine’s independent history.

Monetary conditions remained tight in July 2012. Sizable NBU sale interventions, which amounted to $1.2 billion on a net basis in July, to support the Hryvnia exchange rate had a sterilizing effect on Hryvnia supply. At the same time, due to higher refinancing operations in July and a decline in cash balances on government accounts with the NBU (by almost 35%), the monetary base increased by 0.7% mom in July. In annual terms the growth moderated to 3.9% in July compared to 6.6% yoy a month ago.

In contrast, the growth of money supply (M3) accelerated from 8.9% yoy in June to 9.6% yoy in July, which may be attributed to a faster increase in deposits. Amid liquidity shortages (overnight credit rates on interbank market, one of the most common measure of liquidity in the banking sector, stood at about 15-20% pa during most of July), commercial banks have been raising deposit rates to attract more deposits. In July, the average weighted rate grew on Hryvnia term deposits grew to 13.8% pa, up from 12.6% pa in June. Intensified rate competition among commercial banks, coupled with still high share of non-performing loans and high credit and economic risks, made financial institutions follow an even more conservative lending strategy and increase lending rates. In particular, interest rates on Hryvnia loans grew to 19.6% pa on average in July, up from 17.7% pa in June. The nominal cost of borrowing was always relatively high in Ukraine, which was one of the main causes driving the massive entry of foreign banks into the Ukrainian market during 2004-2008. However, strong credit growth during those years (in excess of 50% pa), inter alia, was the result of declining and even negative real interest rates. This year, the deflationary environment made the borrowing particularly expensive for the private sector. As a result, the stock of deposits rose by 12.4% yoy in July compared to 9.9% yoy in June.

A rise in the cost of funds for commercial banks, coupled with still high share of non-performing loans and high credit and economic risks, made financial institutions follow an even more conservative lending strategy and increase lending rates. In particular, interest rates on Hryvnia loans grew to 19.6% pa on average in July, up from 17.7% pa in June. The nominal cost of borrowing was always relatively high in Ukraine, which was one of the main causes driving the massive entry of foreign banks into the Ukrainian market during 2004-2008. However, strong credit growth during those years (in excess of 50% pa), inter alia, was the result of declining and even negative real interest rates. This year, the deflationary environment made the borrowing particularly expensive for the private sector. As a result, the stock of bank loans was only 3% yoy higher in nominal terms at the end of July and declined 0.1% since the beginning of the year.
Stimulation of credit growth was declared one of the priority tasks of monetary policy in 2012. In 1H 2012 the NBU took some steps to boost lending activity (the regulator cut its discount rate and the cost of refinancing resources, relaxed procedures for commercial banks to form reserve obligations, etc.). However, with intensified Hryvnia depreciation pressures since mid-May 2012, the NBU policy measures to maintain a strong Hryvnia peg to the US Dollar undermined the effectiveness of credit stimulus efforts. Although the NBU officials announced the gradual shift towards a more flexible exchange rate regime, we do not expect foreign exchange policy to change until after parliamentary elections. Hryvnia exchange rate stability for this period will be maintained thanks to NBU interventions and a tight monetary stance (liquidity squeeze, administrative measures to reduce demand for foreign currency, etc.). As a result, credit growth is likely to remain weak this year.

International Trade and Capital

Deepening concerns over the Eurozone debt crisis and fears about a faster-than-expected slowdown in Asian economies weighed on business sentiments globally, leading to further weakening in world commodity prices and external demand for Ukrainian goods in June. Exports fell by 11.3% yoy in US Dollar terms in June compared to a 9.6% yoy increase the previous month. Poor export performance was mainly the result of deep declines in export of metals, chemicals and mineral products (-21% yoy, -6% yoy, and -42% yoy, respectively), which together account for more than half of Ukraine’s exports. In addition, exports of machinery and equipment decelerated sharply from 26% yoy in May to only 3% yoy in June amid intensifying competition on the CIS markets (the main destination of Ukraine’s machinery exports) and Russia’s indirect protective measures of its local car industry. On the upside, export of grains and food products kept growing at a solid 11% yoy rate in June, although the growth also lost momentum in June compared to the previous two months. While the deceleration may be attributed to a lower agricultural harvest this year, we believe expectations of a further increase in world grain prices amid poorer harvest outlooks in a number of grain-producing countries (such as US, Kazakhstan, some EU countries, etc.) are a more probable reason.

Due to weaker industrial and export performance, imports also decelerated in June, advancing by 2% yoy, down from almost 11% yoy a month before. Despite deceleration, imports notably outpaced exports, which led to worsening of both foreign trade and current account balances. In June, the current account deficit widened to $1 billion, bringing the cumulative balance to -$3.6 billion in 1H 2012. In addition, due to higher external debt repayments, the financial account switched to a $0.5 billion deficit that month. As a result, the Balance of Payments (analytic presentation) reported a $1.5 deficit in June, which was covered by a reduction in gross international reserves.

The financial account balance may turn into a surplus by July thanks to a $2 billion issuance of Ukraine’s sovereign Eurobonds. Moreover, there are signs that world commodity prices may have bottomed out in June. In addition, grain prices on international markets are likely to continue growing, supporting Ukraine’s export performance. As a result, in the near-term outlook for the BoP looks relatively favorable. However, high external debt obligations and strengthening population demand for foreign currency ahead of parliamentary elections will continue straining Ukraine’s BoP in the short and medium term. As a result, the Hryvnia is likely to be under depreciation pressures, but they are expected to be minimized by NBU interventions and administrative measures to contain demand for foreign currency.

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7The NBU relaxed a requirement for commercial banks on the amount of funds that should be kept on a separate account with the NBU, from 60% to 50% of total obligatory reserves. The decision took effect at the end of May. At the same time, the amount of obligatory reserves that should be kept on the correspondent account at the NBU at the beginning of the operating day was increased from 30% to 40%. The latter move was made to better control commercial banks liquidity. In the second half of June, the NBU further raised the portion of obligatory reserves to be kept on the correspondent account at the NBU at the beginning of the operating day to 50%. In addition, reserve requirements for forex-denominated current deposits were increased by 1-1.5 percentage points.

7See footnote 4 in this report for greater details.