Executive Summary:

- The recent political crisis in Ukraine was overcome with the appointment of the new Cabinet of Ministers. The new Ukrainian authorities have reconfirmed their commitment to move the reform agenda forward as was agreed during the formation of the new parliamentary coalition.

- With the support of Parliament, fighting corruption was named as the number one priority of the new Cabinet of Ministers. The new ruling coalition was able to secure a constitutional majority in the Verhovna Rada (i.e., two-thirds of the parliamentarians) to approve amendments to the Ukrainian Constitution to reform the court system. It also appointed a new General prosecutor.

- The ceasefire in the Donetsk and Luhanks regions is not being fully observed by Russia-backed terrorists. In fact, at the end of May, the terrorists’ activities increased. According to the OSCE mission statement more than 9,000 people have already been killed in this conflict so far.

- The State Statistics Committee confirmed that year-over-year growth of GDP in the first quarter of 2016 was positive, though by a small percentage of 0.1%. High-frequency data for April 2016 also confirmed that Ukraine’s economic situation is recovering. In April 2016, industrial production increased by 3.5% compared to April 2015, the third month in a row with positive growth rates on a year-over-year basis. During April, other economic activities also showed recovery. In particular, in April 2016 the construction sector expended by 17% yoy, with non-residential buildings leading with a growth rate of 32% yoy.

- As of the end of April, Ukraine’s consolidated budget balance since the beginning of the year turned slightly negative for the first time in 2016. The deficit totalled UAH 5.1 billion (less than one-half of 1% of GDP). This was due to a significant deceleration in the growth of state revenues, while growth of expenditures decelerated but at a much slower pace. Local budgets reported growth in both revenues and expenditures, but the total balance of local budgets remained positive and even expanded to UAH 17.1 billion by the end of April.

- Consumer inflation further decelerated and fell below 10% yoy in April thanks to sharp deceleration in growth of utility tariffs.

- Bank deposits saw monthly increases in both national and foreign currency, same as in corporate and household segments in April. But bank credit activities remained rather weak in April. National currency loans posted monthly declines in corporate and in household segments, while foreign currency loans saw almost no changes.

- Continuing the trend in April, during most of May the UAH/USD exchange rate remained on an appreciating path. The short term depreciation in the middle of the month was the result of lower supply of foreign exchange and speculative activities by some banks.

- In the first quarter of 2016 the current account deficit increased to USD 942 million in Q1 2016 (or about 4.0% of period GDP), compared to a deficit of USD 429 million in Q1 2015. This result was due to a deterioration of trade in goods, with commodity exports declining at a faster pace (-20% yoy) than imports (-13% yoy). The current account in Q1 2016 was partly offset by capital and financial inflows of USD 129 million, with international reserves declining by USD 813 million during the quarter. Due to balance of payment surpluses in April and May 2016, the level of international reserves stood at USD 13.5 billion as of the end of May 2016.

- The IMF mission that visited Kyiv in May concluded that Ukraine had made considerable progress in restoring macroeconomic stability over the past year, but that additional measures were required in the implementation of structural and institutional reforms, which were critical to turn the recent recovery into sustainable growth. The IMF will wait until July to see evidence of progress in structural reforms, particularly in anti-corruption. If the IMF proceeds with its program, in addition to the UAD 1.7 billion from the IMF, Ukraine will be able to secure an additional USD 2.3 billion in financial aid from other multilateral and bilateral institutions.
Main Macroeconomic Indicators

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<th>2011</th>
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<td>GDP, USD billion</td>
<td>163</td>
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<td>Real GDP Growth, % yoy</td>
<td>5.5</td>
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<td>0.0</td>
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<td>Fiscal Balance (incl. Naftogaz &amp; Pension Fund), % of GDP</td>
<td>-4.3</td>
<td>-6.0</td>
<td>-6.5</td>
<td>-11.7</td>
<td>-3.5</td>
<td>-4.0</td>
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<tr>
<td>Public Debt, External and Domestic, % of GDP</td>
<td>36.4</td>
<td>36.7</td>
<td>39.9</td>
<td>70.3</td>
<td>94.0</td>
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<td>Consumer Inflation, eop, % yoy</td>
<td>4.6</td>
<td>-0.2</td>
<td>0.5</td>
<td>24.9</td>
<td>43.3</td>
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<td>Hryvnia Exchange Rate per USD, eop</td>
<td>8.0</td>
<td>8.1</td>
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<td>Current Account Balance, % of GDP</td>
<td>-6.3</td>
<td>-8.2</td>
<td>-9.2</td>
<td>-3.6</td>
<td>-0.2</td>
<td>-2.0</td>
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<tr>
<td>FDI, Net Annual Inflow, USD billion</td>
<td>7.0</td>
<td>7.2</td>
<td>4.1</td>
<td>0.3</td>
<td>2.3</td>
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<tr>
<td>International Reserves, USD billion</td>
<td>31.8</td>
<td>24.6</td>
<td>20.4</td>
<td>7.5</td>
<td>13.3</td>
<td>17.0</td>
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<tr>
<td>Public External Debt, USD billion</td>
<td>33.3</td>
<td>32.1</td>
<td>31.7</td>
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<td>Private External Debt, USD billion</td>
<td>84.6</td>
<td>92.0</td>
<td>99.2</td>
<td>82.0</td>
<td>70.0</td>
<td>65.0</td>
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Political and Reform Developments

The recent political crisis in Ukraine has been overcome with the appointment of the new Cabinet of Ministers. The new Ukrainian authorities have reconfirmed their commitment to move the reform agenda forward as was agreed during the formation of the new parliamentary coalition. With the support of Parliament, fighting corruption was named as the number one priority of the new Cabinet of Ministers. The new ruling coalition was able to secure a constitutional majority in the Verhovna Rada (i.e., two-thirds of the parliamentarians) to approve amendments to the Ukrainian Constitution to reform the court system. The new law seeks to set up an independent regulatory body to oversee the court system. A new General Prosecutor (GP) - the former head of the Poroshenko’s Block in the Parliament, Yuriy Lutsenko - was also approved by Parliament. The broad agenda of the newly appointed prosecutor is to reform the GP service. The first task for the new GP may be prosecuting high-profile corruption criminal cases.

In May, the Verhovna Rada undertook another important step in fighting corruption. In particular, the burdensome registration procedures for imported drugs were significantly simplified. Medicines produced in the United States, Canada, EU, Australia and Switzerland should have an official Ukrainian registration within 17 days without extra tests and procedures. This bill, which was highly supported by Ukrainian patients, should provide better access to high quality drugs and reduce corruption.

In order to simplify doing business in Ukraine, the Ukrainian Parliament cancelled the existing requirements for mandatory registration of foreign investment. This measure should slice away red tape for foreign companies operating in Ukraine. In addition, more responsibilities were granted to the Business Ombudsman Council – an independent advisory body – to oversee the activities of government officials vis-à-vis businesses.

The ceasefire in the Donets and Luhanks regions is not being fully observed by Russia-backed terrorists. International observers including OSCE and Ukrainian authorities continue to closely monitor the situation along the line of fire. According to the OSCE mission statement, more than 9,000 people have already been killed in this conflict. At the end of May, the terrorists’ activities increased. Despite this negative development Ukrainian commanders were able to finalize a rotation in the army. Moreover the number of those who want to serve in the military on a contractual basis increased significantly. On this basis, the number of Ukrainian militants should be significantly improved. Ukraine is actively using this uncertain time to free those Ukrainian who were imprisoned by the Russian Federation and the rebels. On a very positive note, as a result of the joint efforts of Ukrainian authorities and international partners, Nadiya Savchenko was freed.
Economic Growth

The State Statistics Committee confirmed that year-over-year growth of GDP in the first quarter of 2016 was positive, though by a small percentage of 0.1%.

High-frequency data for April 2016 also confirmed that Ukraine’s economy is recovering. In April 2016, industrial production increased by 3.5% compared to April 2015, the third month in a row with positive growth rates on a year-over-year basis. As in the previous month, industrial growth in April was supported by good performance of manufacturing output, which expanded by 5.8% yoy, and by mining and quarrying, which grew by 4.9% yoy. But growth was restrained by the poor performance of electricity, gas & steam production, which declined by -5.5% yoy in April. In terms of main industrial groupings, the major growth in April took place in consumer durables (with a growth of 11% yoy).

In April 2016, major expansions in manufacturing production took place in the production of coke and refinery products (26% yoy), furniture (17% yoy), metallurgy (15% yoy), rubber and plastic products (14% yoy), and basic pharmaceutical products (13% yoy). The manufacture of food products showed a modest increase of 2% yoy in April. On the other hand, the following subsectors showed the largest declines in industrial output in April 2016: manufacturing and distribution of gas (-27% yoy), computer and electronics (-23% yoy), electrical equipment (-11% yoy), and paper products (-7% yoy).

Regarding industrial production by regions, the major expansions in April 2016 took place in Lugansk (with a 130% yoy increase), Chernihiv (14% yoy), Kirovograd (13% yoy), Kyiv (11% yoy), Donetsk (10% yoy), and Ternopil (9% yoy). On the other hand, the regions with the largest declines were Sumy (with an output decline of -11% yoy), Ivano-Frankivsk (-8% yoy), Chernivtsi (-8% yoy), Vinnysya and Volyn (both -7% yoy).

During April, other economic activities also showed recovery. In particular, in April 2016 the construction sector expanded by 17% yoy, with non-residential buildings...
leading with a growth rate of 32% yoy. Similarly, retail trade turnover showed a healthy rate of growth of 12.2% yoy in April. Cargo transportation expanded by 3.3% yoy in January-April 2016, while passenger transportation grew by 1.2% yoy (with aircraft transportation increasing by 20.5% yoy). On the other hand, the agricultural sector continued to show declines in output on a year-over-year basis, with a decline of -1.7% yoy in April.

For the entire year 2016, we maintain our forecast of GDP growth at about 2%.

Fiscal Policy

The government’s fiscal budget situation deteriorated in April due to significant deceleration in growth of budget revenues. This deceleration in revenues was the major reason for the monthly state budget deficit expansion to UAH 11.6 billion, which is more than a half of the deficit incurred from the beginning of the year (UAH 22.2 billion). Such a high state budget deficit more than offset the total surplus of local budgets, which expanded by UAH 2.7 billion in April to UAH 17.1 billion in total from the beginning of the year. As a result, the total consolidated budget balance turned negative for the first time from the beginning of the year, amounting to UAH 5.1 billion (or about one-half of 1% of period GDP).

Budget Revenues. As it happened in March, the April monthly decrease in the state budget revenues year-over-year was due to a statistical effect. During April last year, the state budget had received significant nontax revenues consisting of the second part of funds from the sale of 3G communication licenses and a large transfer from the NBU. None of these nontax revenues were received in April 2016. Therefore, during April 2016, non-tax revenues decreased by 74.5% yoy. On the other hand, tax revenues in April increased by 14.8% yoy; however, this increase could not compensate for the decrease in nontax revenues with the result that total state budget revenues decreased by 13.5% yoy in April. This slowed the cumulative growth of total state budget revenues from 14.1% yoy in Q1 to 5.7% yoy in January-April, still a positive number. Unlike state budget revenues, in April revenues of local budgets saw acceleration in year-over-year terms. The acceleration was the result of increases in tax receipts and official transfers. Nevertheless,
this accelerated growth was still not enough to compensate for deceleration in growth of state budget revenues. Therefore, consolidated budget revenues saw further deceleration in growth from 16.5% yoy observed in Q1 to 10.4% yoy for January-April.

**Budget Expenditures.** State budget expenditures expanded in April, but at a decelerated pace. Growth of state expenditures slowed to 20.2% yoy due to lower capital expenditures and expenditures on public debt servicing and repayment. These declines more than offset the increase in social expenditures and payroll expenditures. At the same time, the mentioned deceleration did not impact the dynamics of state budget expenditures from the beginning of the year. Total state budget expenditures expanded by 26.3% yoy in January-April, which is 2.5 percentage points lower than in Q1. Social security expenditures saw significant acceleration in growth from 26.9% yoy to 39.9% yoy. This to a large extent offset deceleration in growth of other major state budget expenditures, such as expenditures on general public administration functions (from 52.9% yoy to 30.1% yoy) and defense (from 54.8% yoy to 47.3% yoy). The growth of local budget expenditures, in contrast, further accelerated in April due to expanded spending on economic activities, utilities, and healthcare. This acceleration partially compensated for the deceleration in growth of state budget expenditures both in April alone and from the beginning of the year. In particular, consolidated budget expenditures posted 25.1% yoy growth in January-April. This is a 1.9% yoy deceleration compared to growth observed in Q1.

**Monetary Policy**

**Inflation.** Consumer inflation in April continued to decelerate in year-over-year terms despite some acceleration from the previous month. Monthly growth of consumer prices more than doubled to 3.5% from 1.5% observed in March. The major factor causing the acceleration was the change in natural gas tariffs, which grew by 48.4% leading to subsequent increases in housing, water, electricity, gas and other fuel tariffs by 20.1% overall. Among other groups of goods and services posting quite significant monthly price growth were alcoholic beverages and tobacco products (2.8% mom price growth) and transport (2.4% mom price growth). The former posted an increase in prices mainly on the back of a 3.5% mom increase in prices of tobacco products, which is related to higher excise taxes rates, while the latter saw a 5.4% mom increase in prices of fuels and lubricants and a 3.3% mom increase in prices of rail transportation, which together more than offset a 2.0% mom decrease in prices of cars. Other groups of goods and services observed much lower monthly price increases. In particular, prices of foods remained almost flat as most of the major groups of foodstuffs posted just minor increases, which were almost fully offset by decreases in prices of eggs (by 15.2% mom), sugar (by 2.7% mom), vegetables (by 2.1% mom), and milk (by 0.8% mom). In year-over-year terms, consumer inflation in April more than halved compared to March. Growth of consumer prices decelerated from 20.9% yoy to 9.8% yoy. The major reason for that was significant slowdown in growth of housing, water, electricity, gas and other
fuel tariffs due to a statistical base effect. Since the major increase in the named tariffs took place in March 2015, they posted a 17.0% yoy increase in April compared to 104.3% yoy growth in the previous month. All the other major groups of goods and services also observed deceleration in the year-over-year growth of prices except for communication services and transport. Rate of deceleration varied from 1.1 percentage points for alcoholic beverages and tobacco products to 6.6 percentage points for other goods and services. Growth of prices for communication services accelerated by 0.5 percentage points to 4.7% yoy, while growth of prices for transport turned positive again, accelerating from -4.2% yoy to 2.5% yoy.

The major factors causing deceleration of year-over-year consumer inflation remained the same: low domestic demand, stabilized inflationary expectations thanks to restrictive monetary policy, and some appreciation of the exchange rate. Fast deceleration of inflation led to further decline of the policy rate by the NBU. The regulator decreased the policy rate to 18% starting on May 27th through the Decision of the NBU No. 25-rs of May 26th. Taking this into account and the overall downward trend in consumer inflation, we leave our forecast for consumer inflation intact for now at 12% yoy in 2016.

**Banking Sector.** In April, both national currency deposits and foreign currency deposits denominated in USD showed increases. These increases in deposits took place in both corporate and household sectors, although growth rates differed significantly. In particular, national currency deposits increased by 2.0% mom overall thanks to a 3.2% mom growth of corporate deposits and a 2.1% mom increase in household deposits. A 1.7% mom increase in the foreign exchange deposits denominated in USD was almost fully attributed thanks to a 5.4% mom growth of the corporate deposits as the household ones posted just a minor increase of 0.3% mom. Due to these monthly changes, the year-over-year growth of national currency deposits reached 11.8%, while the decline in foreign currency deposits denominated in USD decelerated to 15.9%. One more positive moment was a 2.0% yoy increase in corporate sector foreign currency deposits denominated in USD, as it was the first growth over the last two years.

Unlike deposits, bank lending activities did not show any progress and remained weak in April. National currency loans declined by 1.0% mom due to decreases in both corporate and household loans (by 0.7% mom and 1.4% mom respectively). As a result, the over-year decreases in both corporate and household loans and in national currency loans in general accelerated to 13.7%, 26.8% and 17.2% respectively. At the same time, foreign currency loans remained almost flat at all levels in monthly terms in April. This led to some deceleration of their year-over-year decrease to 19.8%.

Growth in cash funds more than offset the decline in amount of funds at the correspondent accounts of commercial banks leading to expansion of the monetary base by 2.6% mom (1.7% yoy). As a result, money supply increased by 0.9% mom. In year-over-year terms, growth in money supply accelerated to 3.7% yoy.

**Hryvnia Exchange Rate.** For most of May, the UAH/USD exchange rate was relatively stable around 25.10-25.25 UAH/USD. However, there was a period of lower dollar supply to the market in the middle of the month and some players tried to benefit from that by pushing the dollar price upwards to around 25.45-25.56
UAH/USD. This group of players was led by banks with foreign capital and some medium domestic banks usually involved in speculation games. The mentioned time period was short, however, and the exchange rate appreciated back in a week. The NBU continued its policy of minimum involvement into the market but still kept the dollar prices higher than expected by placing higher cut-off prices at forex auctions. Those auctions were more or less regular as they provide a good opportunity for the regulator to replenish the international reserves.

In May, the NBU continued its staged liberalization of the temporary anti-crisis forex measures introduced in 2014-2015. On May 5th, the regulator issued the Regulation No. 308 introducing some changes to its legal acts. First of all, the regulator lifted the regulation obliging sale of forex funds transferred to Ukraine for the purposes of investment. Second, the term for hryvnia funds to be reserved at the special account prior to purchase of the foreign exchange was shortened from three to two days and then to one day through the Regulation No. 332 of May 25th. Third, the ban on foreign exchange purchases for funds obtained from sales of products imported by January 1st, 2015, under agreements for which the debtor and/or creditor have been changed in the obligating document, was lifted. On May 24th, the NBU issued the Regulation No. 331, which reduced red tape on forex operations for both private persons and legal entities. The changes introduced in these regulations were aimed at increasing inflow of foreign exchange for the purposes of investment and at simplifying purchase of foreign exchange in the interbank forex market.

Taking into account the above mentioned developments we leave our forecast for the exchange rate at the end of 2016 unchanged at about 25 UAH/USD.
International Trade and Capital

In April 2016, Ukraine’s current account of the balance of payments achieved a surplus of USD 327 million, compared to a deficit of USD -460 million in March. Such improvement was caused by a surplus in the primary income account of USD 125 million (compared to a deficit of USD -425 million in March), a surplus of USD 237 million in the secondary income account, and a near balance in the merchandise and services trade account (with a deficit of only USD -35 million compared to deficits of $ -445 million and USD -276 million in February and March, respectively.

In April, merchandise exports increased by 0.1% yoy while imports decline by -2.2% yoy. The most significant improvements in Ukraine’s merchandise exports in April took place in agricultural products, which increased by 18.5% yoy in April and reached USD 1,274 million (about 45% of total exports). Exports of mineral and timber products also showed a positive growth rate of 1.2% yoy and 7.6% yoy, respectively. On the other hand, all other export categories (metallurgy, chemicals, machinery and equipment, and other industrial products) continued to show declines.

Regarding the geographical distribution of exports, in January-April 2016 exports to Europe increased 0.1% yoy, whereas exports to the CIS countries declined by -32% yoy. Europe now absorbs 35.1% of Ukrainian exports, whereas the share of the CIS countries is only 15.7% (7.6% Russia), compared to 20.4% in in January-April 2015. Asia continues to be the largest recipient of Ukrainian exports taking 35.5% of the total. The US takes only 1% of Ukrainian exports.

On the import side of the balance of payments, in April 2016, imports fell by -2.2% yoy. During the month, the main declines took in mineral products (-54.3% yoy) which offset import increases in all other categories: machinery and equipment (58.6% yoy), agriculture (28.3% yoy), chemicals (17% yoy), timber and wood (16.7% yoy), metallurgy (12.3% yoy), and other industrial goods (15.6% yoy). In April 2016, Machinery and equipment, and exports represented 52% of total imports. Ukraine’s imports of energy were reduced by 55.1% yoy in April (57.3% in March), while the volume of non-energy imports increased by 20.8% yoy (15.5% in March). Geographically, in January-April 2016, imports from CIS countries represent 22.8% of the total, with Russian Federation supplying a share of 11.2% of the total. The share of Europe in imports increased to 41% in January-April 2016. Asia supplied 21% of Ukrainian imports.

Ukraine financial account derived net inflows of USD 138 million in April 2016, compared to net outflows of USD 450 million in March 2016. These financial inflows in April 2016 were generated by foreign direct investments principally to the banking sector of USD 484 million during the month, which offset outflows in other categories of financial flows.

As a result of surpluses in the current and financial accounts in April, the overall balance of payments in
April had a surplus of USD 468 million, compared to a deficit of USD 859 million in March. This April surplus increased the level of international reserves to USD 13,200 million as of the end of April 2016 (equivalent to about 3.4 months of imports).

As noted earlier, the IMF-Ukraine four-year Extended Fund Facility program of USD 17.5 billion originally foresaw quarterly revisions of the program, with four tranches expected to be disbursed in 2015, and another four in 2016. However, so far, the country has received only the first tranche of USD 5 billion in March 2015, and the second one of USD 1.7 billion in August 2015. The IMF mission that visited Kyiv in May concluded that Ukraine had made considerable progress in restoring macroeconomic stability over the past year, but that additional measures were required in the implementation of structural and institutional reforms that were critical to turn the recent recovery into strong and sustainable growth. In particular, it stated that unwavering determination in the fight against corruption is the test for the government's ability to retain broad domestic and international support for its policies. It added that the authorities must boost their efforts to entrench fiscal and financial stability, decisively enhance transparency and the rule of law, and reform the large and inefficient state-owned enterprise sector. The IMF will wait until July to see evidence of progress in structural reforms, particularly in anti-corruption. If the IMF proceeds with its program, in addition to the USD 1.7 billion from the IMF, Ukraine will be able to secure an additional USD 2.3 billion in financial aid from other multilateral and bilateral institutions.