Executive Summary:

- The intense military actions experienced in Eastern Ukraine during August calmed down starting on September 1st, in accordance with the agreement reached in Minsk. However, Ukrainian and international observers have reported an increase in the volume of Russian arms and weapons held by separatists in Donetsk, Luhansk and Crimea.

- Ukraine was on the agenda for the latest G-20 meetings in China. US and EU leaders re-confirmed their support for Ukraine’s territorial integrity. Moreover, prior to the meetings, these leaders re-confirmed their intention to continue sanctions against Russia until it fully implements the requirements of the Minsk-2 agreement.

- Ukraine continues to move its socio-economic reform agenda forward, with an emphasis on macroeconomic stabilization and fighting corruption. A key part of this effort is the new system of electronic income declaration for key government employees, which was put in place on September 1st. However, it is not yet operational presumably due to interferences by some vested interests.

- July 2016 data recently released by the State Statistics Committee shows that Ukraine’s economic situation is relatively stable, with a small decline in industrial output of 0.2% yoy in July, based on new methodology. Based on earlier methodology, industrial output increased by 0.9% yoy in July. On a month-over-month basis, industrial output in July increased by 7% mom, or by 4% mom after seasonal adjustment. In July, the industrial production index showed recovery in the following sub-sectors: chemicals, metallurgy, coke- and oil-refining, and electricity, gas and steam. Other sub-sectors, however, continued to experience declines.

- Other economic sectors also showed recovery in July. Ukraine’s construction output index increased by 12.9% yoy in July. Ukrainian retail trade turnover also increased by 4.5% yoy during the month. The agricultural production sector showed 1.2% yoy expansion in July 2016. Ukraine passenger transportation turnover increased by 9.1% yoy in July. However, freight transportation turnover fell to -8.4% yoy, compared to -1% yoy in June 2016. For the entire year 2016, we maintain our forecast for GDP growth at about 2%.

- The consolidated fiscal budget deficit increased to UAH 22.9 billion for January-July 2016. This is still satisfactory at about 1.5% of GDP. Typical for July, both state budget revenues and expenditures saw negative developments in dynamics due to the vacation period. Furthermore, tax revenues of the state budget saw a marginal decline.

- Despite continued monthly deflation, year-over-year consumer inflation reversed its trend, accelerating to 7.9% yoy in July. However, this change was expected and is in line with the inflation forecast of 12% by year-end.

- Hryvnia deposits in the banking sector continued to expand in July, while foreign currency deposits saw little change. Bank lending activities posted another sluggish performance in both Hryvnias and foreign currencies. According to the results of the latest banking sector survey conducted by the NBU, banks expressed more optimism in relation to growth of both loans and deposits over the next 12 months, despite little progress in crediting.

- The UAH/USD exchange rate saw significant depreciation (around 6%) in the second half of August, which was related to the worsening situation on the border with occupied Crimea and escalation of warfare in Eastern Ukraine.

- In July 2016, the overall balance of payments showed a surplus of USD 110 million, increasing international reserves to USD 14.3 billion. This surplus was caused by a surplus in the financial account of USD 447 million, and despite a deficit in the current account of USD -554 million. For January-July, the deficit in the current account amounted to 1% of GDP.

- The level of international reserves of Ukraine is expected to increase further by the end of September, given the recent decision by the IMF to approve the disbursement of the USD 1.0 bln on September 14th. Ukraine will be able to secure an additional financial aid from the USA (USD 1.0 bln) and the EU (USD 600 mln).
Political and Reform Developments

The intense military actions in Eastern Ukraine during August calmed down after September 1st, in accordance with the agreement reached in Minsk. However, despite this relief, Ukrainian and international observers have reported an increase in the volume of Russian arms and weapons held by separatists in Donetsk and Luhansk. Moreover, according to Ukrainian and international observers, there is also an increase in the number of Russian military forces on the border with Donbas and the temporary border with Crimea. Russia has explained this buildup in its forces as routine military training operations, but these actions have raised concerns about Russia’s real intentions, with Ukraine's President warning “a full-scale invasion from Russia could be on the horizon.” As a reaction to this risk, the Ukrainian Ministry of Defense announced a 10-day training for reservists who already have experience in antiterrorism operations. The number of reservists who may receive extra training is as high as 80,000 people. The President has also put the Ukrainian army on high alert and stated that he will call for martial law and mobilization if the conflict escalates.

Ukraine was on the agenda of the latest G-20 meetings in China. US and EU leaders re-confirmed their support for Ukraine’s territorial integrity. Moreover, prior to the G-20 meetings, these leaders re-confirmed their intention to continue sanctions against the Russian Federation until it fully implements the requirements of the Minsk-2 agreement.

Ukrainian authorities continue to move its socio-economic reform agenda forward, as requested by their international partners and their own civil society. The key direction of the reform efforts is in fighting corruption. As of September 1st, the new system of electronic income declaration for key government employees is officially in place. However, it is not yet fully operational. The IT platform for this system was developed by a UNDP contractor and has received a quality certificate from the corresponding Ukrainian state agency. However, numerous technical mistakes were introduced to the system by various agencies, raising questions about sabotage by vested interests in order to delay implementation. International agencies, civil society and high-level government officials have called for a rapid and full implementation of this measure. Non-government institutions working in this field expect that significant progress will be made immediately after all key government officials submit their declarations. This is due to the fact that all citizens will have the right to access this information and report to the Anti-Corruption Agency any suspicious misinformation anonymously. These measures are being implemented in accordance with existing European practices.

<table>
<thead>
<tr>
<th>Main Macroeconomic Indicators</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016f</th>
<th>2017f</th>
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<tr>
<td>GDP, USD billion</td>
<td>163</td>
<td>173</td>
<td>180</td>
<td>130</td>
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<td>100</td>
</tr>
<tr>
<td>Real GDP Growth, % yoy</td>
<td>5.5</td>
<td>0.2</td>
<td>0.0</td>
<td>-6.6</td>
<td>-9.9</td>
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<td>3.0</td>
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<tr>
<td>Fiscal Balance (incl. Naftogaz &amp; Pension Fund), % of GDP</td>
<td>-4.3</td>
<td>-5.5</td>
<td>-6.5</td>
<td>-11.7</td>
<td>-8.0</td>
<td>-4.0</td>
<td>-3.0</td>
</tr>
<tr>
<td>Public Debt, External and Domestic, % of GDP</td>
<td>36.4</td>
<td>36.6</td>
<td>40.4</td>
<td>69.4</td>
<td>79.4</td>
<td>84.4</td>
<td>82.0</td>
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<tr>
<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>
<td>12.0</td>
<td>10.0</td>
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<tr>
<td>Hryvnia Exchange Rate per USD, eop</td>
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<td>8.1</td>
<td>8.2</td>
<td>15.8</td>
<td>24.0</td>
<td>27.0</td>
<td>28.0</td>
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<tr>
<td>Current Account Balance, % of GDP</td>
<td>-6.3</td>
<td>-8.3</td>
<td>-9.0</td>
<td>-4.1</td>
<td>0</td>
<td>-2.0</td>
<td>-2.0</td>
</tr>
<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>
<td>3.0</td>
<td>3.0</td>
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<td>International Reserves, USD billion</td>
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<td>20.4</td>
<td>7.5</td>
<td>13.3</td>
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<td>20.0</td>
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<tr>
<td>Public External Debt, USD billion</td>
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<td>34.9</td>
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<tr>
<td>Private External Debt, USD billion</td>
<td>84.6</td>
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<td>99.2</td>
<td>82.0</td>
<td>70.0</td>
<td>65.0</td>
<td>62.0</td>
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</table>

Oleg Ustenko, Julia Segura, Valentyn Povroznyuk
Edilberto L. Segura
Despite a significant increase in the number of government officials accused of corruption, only a few cases were heard in court. The common practice in Ukraine for government officials to escape prosecution for their criminal actions is to use their immunity and leave the country. This has raised questions about the real political will to move forward with the reform agenda.

**Economic Growth**

In July 2016, the latest information from the State Statistics Service showed some improvements in most economic sectors of Ukraine. Based on the previous statistical methodology, industrial output in July increased by 0.9% yoy (the State Statistics Service had changed its methodology in July, introducing a new form of data presentation, adjusted for calendar days.) Based on the new methodology, industrial production in July decreased by a small rate of 0.2% yoy, compared to a decline of -3.4% yoy in June. On a month-over-month basis, industrial output in July increased by 7% mom, or by 4% mom after seasonal adjustment.

In July 2016, the industrial production index showed recovery in the following sub-sectors: chemicals, by 7.1% yoy; metallurgy, by 4.3% yoy; coke- and oil-refining, by 4.2% yoy; electricity, gas and steam, by 6.2% yoy. Other sub-sectors, however, continued to experience declines, including machine-building manufacturing, with an -11.5% yoy decline; electricity production, -9.1% yoy; pharmaceutical products manufacturing, -0.5% yoy. Food processing fell to -0.6% yoy, compared to a drop of -2.8% yoy in June. These declines were associated with a large decline in exports, principally to Asia.

In July 2016, the regions that showed the highest increases in industrial output, compared to last year, were: Cherkasy by 19.7% yoy; m. Kyiv by 10.6% yoy; Lugansk by 9.0% yoy; Donetsk by 8.1% yoy; Ternopil
by 4.4% yoy; Kharkiv by 2.5% yoy; Odessa by 2.2% yoy; Nicholas by 2.2% yoy; and Zhytomyr by 0.6% yoy. Negative growth rates were experienced in Chernivtsi by -14.3% yoy; Khmelnytsky by -12.8% yoy; Ivano-Frankivsk by -11.5% yoy; Transcarpathian by -9.6% yoy; Sums by -9.3% yoy; Herson by -5.4% yoy; Volyn by -5.2% yoy; L'viv by -4.6% yoy; and Zaporizhzhia by -3.4% yoy.

Other economic sectors also showed recovery in July. Ukraine’s construction output index increased by 12.9% yoy in July. Ukrainian retail trade turnover increased by 4.5% yoy during the month. The agricultural production sector showed 1.2% yoy expansion in July 2016. Passenger transportation turnover increased by 9.1% yoy in July, while freight transportation turnover fell to -8.4% yoy, compared to -1% yoy in June 2016. For the entire year 2016, we maintain our forecast of GDP growth at about 1.5%.

**Fiscal Policy**

As is typical for the month of July, business activities were lower last month, which led to lower budget revenues and expenditures. State budget revenues declined faster than expenditures, which led to expansion of the state budget deficit to UAH 14.9 billion solely in July and to UAH 49.9 billion over the January-July period. At the local level, the situation was different, with local expenditures declining faster than local revenues. As a result, the surplus of local budgets tripled to UAH 3.3 billion in July compared to June. Thus, the surplus of local budgets reached UAH 27.1 billion in January-July. The consolidated budget deficit more than doubled in one month, reaching UAH 22.9 billion for the January-July period. At about 1.5% of GDP, this deficit is still within the limits agreed with the IMF.

In July, state budget revenues posted a decline of 17.5% yoy. The main reason for this was significant decrease in nontax revenues, while tax revenues posted just a minor decline (0.3% yoy). Similarly to previous months, nontax revenues decreased because of a lack of transfers from the NBU, which amounted to over UAH 32 billion at the end of July 2015. The main reason for the decrease in tax revenues was a decline in VAT
revenues. There were insignificant changes in receipts from the VAT on both domestic and imported goods, but the need to catch up with the VAT reimbursement schedule, due to much lower reimbursement payments in June, caused a 4.9% yoy decrease in total VAT proceeds in July. A decline in receipts from corporate profit tax was caused by changes in these tax administration procedures. At the same time, receipts from excise taxes and from personal income tax continued to grow at high rates. The mentioned monthly developments caused some changes in dynamics of state budget revenues from the beginning of the year. The decrease in nontax revenues accelerated by 3.4 percentage points to 53.1% yoy. At the same time, growth of tax revenues decelerated by 3.7 percentage points to 21.6. The above-mentioned developments with VAT proceeds in July and the statistical base effect led to a 14.6 percentage point deceleration in growth of state budget revenues from the VAT to 30.3% yoy. Growth of total state budget revenues reached 4.5% yoy in January-July, which is about half of the 8.5% yoy growth reported in January-June. As growth of budget revenues at the local level remained much higher at 37.9% yoy in January-July, it pushed the growth of the consolidated budget revenues to 10.7% yoy for the period. However, this is still below the 13.7% yoy reported for the first half of the year.

Unlike revenues, state budget expenditures continued to expand in July, although the pace of growth decelerated to 13.5% yoy. A decrease in expenditures on goods and services accompanied by slower growth of spending on domestic debt servicing more than offset faster growth of social expenditures and capital expenditures. In particular, increased housing and utilities tariffs led to growth in amounts of subsidies to the population, while increased wages of several civil servant categories, particularly military servicemen, caused an increase in payroll expenditures. From the beginning of the year, growth of social security expenditures reached 55.8% yoy, which is 4.0 percentage points more than growth over the first half of the year. This acceleration in growth was slightly offset by deceleration in growth of other important budget lines such as general state administration, defense, and public order and security expenditures. Therefore, total state budget expenditures decelerated in their growth by just 1.3 percentage points to 21.0% yoy in January-July. Even though growth of expenditures of the local budgets (32.1% yoy) was much higher than that of state budget expenditures, their share in the consolidated budget expenditures was still too low to have any significant impact on their dynamics. Therefore, consolidated budget expenditures equaled 22.5% yoy in January-July, which is almost the same as in the first half of the year.

**Monetary Policy**

**Inflation.** Consumer inflation accelerated in year-over-year terms by one percentage point to 7.9% in July despite experiencing another monthly deflation rate. Such dynamics were quite expected and in line with expectations of inflation reaching 12% yoy by the end of the year. The major reasons for accelerated inflation in July were increases in administratively regulated prices and tariffs, and in higher fuel prices.

In monthly terms, consumer prices posted just a minor decline. This is because the effect of a decline in food prices and in prices of apparel and footwear only slightly exceeded the effects from an increase in prices of all other major
groups of goods and services (prices of communication services remained almost flat). Food prices decreased by 0.9% mom, the result of a 20.1% mom decline in prices of vegetables. Minor declines were also reported for prices of sugar, butter, milk, and fish and fish products. Prices of other food products were either flat (bread and pasta products) or posted small increases. The highest increases were observed for eggs (3.9% mom) because of a further decline in production, and for fruits (2.7% mom) because of lower harvest compared to the previous year. Pricing policy of some tobacco producers led to a 3.7% mom growth in prices of tobacco and tobacco products, which was the major reason for a 2.5% mom increase in prices of alcoholic beverages and tobacco products as a whole. The UAH/USD exchange rate was the main factor causing the 3.5% mom decline in prices of wearing apparel and footwear. A 1.6 fold increase in tariffs for hot water fueled a 1.7% mom growth of prices and tariffs for housing and utilities. Some rebound in world oil prices pushed the prices of fuels and lubricants upwards, causing 0.4% mom growth in transport prices. In over-year terms, half of the major groups of goods and services saw acceleration in growth of prices due to a statistical base effect, while another half reported further price growth deceleration. In particular, the following groups of goods and services reported faster growth in prices: foodstuffs, alcoholic beverages and tobacco products, wearing apparel and footwear, housing and utilities, and transport. At the same time, most of the changes in price dynamics were insignificant and did not exceed 0.5 percentage points. The most significant deceleration in price growth was reported for recreation and culture services at 1.3 percentage points (to 8.3% yoy). As for groups of goods and services with significant acceleration in price growth, there were three such groups. Housing and utilities saw a 1.7 percentage point acceleration of price growth to 13.8% yoy, which is the sharpest price growth acceleration. Wearing apparel and footwear followed with a 1.5 percentage point acceleration in growth of prices to 19.7% yoy, while foodstuffs reported the smallest acceleration in price growth of the three leaders at 1.2 percentage points to 4.4% yoy.

The above-mentioned acceleration of consumer inflation was expected. Furthermore, the pace of inflation after the acceleration was in line with previous forecasts. Therefore, we leave our forecast for consumer inflation unchanged at 12% yoy in 2016.

**Banking Sector.** In July, national currency deposits continued to expand in monthly terms, while foreign currency deposits remained virtually unchanged. Total national currency deposits grew by 0.8% mom on the back of an accelerated increase in corporate deposits (1.6% mom), as national currency household deposits inched down by 0.2% mom. In year-over-year terms, growth of national currency deposits accelerated from 15.0% to 16.6%. Once again, corporate deposits played the lead role as their growth was almost twice as high as that of household deposits (18.1% yoy against 10.4% yoy). Foreign currency deposits remained unchanged in monthly terms, their over-year decline decelerating to 8.4%.

The lending activities of banks remained rather sluggish in July, although there was a small increase in national currency loans (0.8% mom). The effect
from a 1.6% mom increase in national currency corporate loans overwhelmed the effect from a 2.3% mom decline in national currency household loans. The corporate and household sectors also saw opposite changes in year-over-year dynamics. The decline in corporate loans slightly decelerated by 2.0 percentage points to 8.3% yoy, while the decline in household loans accelerated by 0.8 percentage points to 25% yoy. At the same time, foreign currency loans denominated in USD continued to decline in both monthly and over-year terms.

Growth in cash balances was the major factor causing further expansion of the monetary base in July. It expanded by 0.6% mom. At the same time, this monthly growth did not have any significant effect on the over-year dynamics of the monetary base, as its growth remained unchanged at 6.7% yoy. An increase in deposits into the banking system and expansion of cash outside of the banking system led to a 0.8% mom growth of the money supply, which accelerated its over-year growth by 1.6 percentage points to 7.8%.

Results of the regular survey conducted among 66 banks (holding 96% of the total assets of the banking system) show more optimism about the situation with both loans and deposits. Banks expect activation of crediting activities among households and a marginal decline in corporate loans. In particular, the share of banks expecting an increase in their corporate loan portfolio was slightly lower than the share of those expecting a decline. At the same time, the share of banks expecting growth in household loans at 27% was 1.5 times more than the share of banks expecting declines in household loans. Yet most of the banks expect improvement in the quality of loan portfolios in both the household and corporate sectors over the last four quarters. More than half of the banks (53%) reported increased demand for loans in Q2 2016, especially among businesses. This is an improvement over 45% of banks reporting the same in Q1. The highest increase in expected demand is for loans to small and medium enterprises and for national currency loans. The major reasons for these increases in demand are lower interest rates, the need of enterprises for current assets, and the need to restructure existing loans. Similarly, demand for consumer and mortgage loans among households also increased thanks to lower interest rates and increased spending on durables. Banks expect a further increase in demand for loans among both households and businesses in Q3. As for deposits, banks reported positive expectations concerning increases in deposits for the fifth consecutive quarter. The most significant improvement is expected in corporate deposits. Three-quarters of banks expect increases in corporate deposits over the next 12 months. Around one-third of banks are also optimistic about increases in household deposits.

**Hryvnia Exchange Rate.** The UAH/USD exchange rate was stable in the first half of August. However, after worsening of the military situation on the border with the temporarily occupied Crimea and escalation of warfare in Eastern Ukraine, the exchange rate started to depreciate. Furthermore, appreciation of the dollar on the world forex market imposed depreciatory pressures on the Hryvnia. Banks with foreign capital started to purchase dollars on the interbank forex market regardless of price, causing the depreciation of the Hryvnia. 

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**Dynamics of UAH/USD Exchange Rate Quotations in the Interbank Forex Market in September**

Source: Ukrdealing, The Bleyzer Foundation
most significant depreciation of the Hryvnia since the beginning of the year. The NBU tried to slow down the depreciation by dollar interventions through auctions on the interbank forex market during the last couple of trading sessions. However, those attempts had little effect. In the near term, higher demand for dollars will be maintained by purchases of natural gas to prepare the country for the heating period.

Taking into account recent developments, the depreciatory pressure on the exchange rate will remain during September. We expect the exchange rate to be around 27 UAH/USD at the end of the year.

The NBU continued liberalization of foreign exchange regulations. In particular, starting on August 10th, private persons are allowed to purchase foreign currency of UAH 150,000 equivalent without provision of any ID. Furthermore, businesses are now allowed to use modern communication technologies, electronic documents, and copies of documents in electronic form to purchase and transfer foreign exchange. Finally, the regulator lifted the requirement for businesses to provide a price expertise certificate of the State Information and Analytical Center for import operations payments with total cost over EUR 50,000.

**International Trade and Capital**

In July 2016, Ukraine’s current account of the balance of payments had a deficit of USD -354 million, increasing the cumulative current account deficit for January-July to USD -538 million. This deficit was within expectations, amounting to about 1.0% of period GDP. This deficit was caused principally by a negative merchandise trade balance of USD -576 million, due to continued reductions in exports and a significant increase in goods imports. Merchandise imports increased by USD 378 million in July, reaching USD 3,259 million, compared to June 2016 imports of USD 2,881 million. In addition, Ukraine also presented negative outflows of primary foreign income of USD -19 million in July 2016. On the other hand, Ukraine continued to enjoy positive inflows of secondary foreign income, in particular workers’ remittances, which amounted to USD 362 million.

In July 2016, Ukraine exports of merchandise trade amounted to USD 2,683 million, which represented a 10.1% yoy reduction, compared to USD 2,984 million in July 2015. On a year-over-year basis, the most significant declines in merchandise exports in July took place in machinery and equipment (-24.8% yoy), energy and mineral products (-17.8% yoy), metallurgy (-14.6% yoy), industrial goods (-14.5% yoy), other goods including informal trade (-13.7% yoy), timber and wood products (-8.9% yoy), and chemicals (-6.4% yoy). Even agricultural products fell in exports by -1.2% yoy in July. Regarding the regional destination of exports, during January-July 2016 exports to Russia were reduced by 34.2% yoy and now represent 8.8% of the total amount, compared to 11.3% one year ago. At the same time, Ukraine’s exports to Europe grew by 4.8% yoy and now represent 34.1% of total exports, compared to 28.8% in January–July 2015. Exports to Asia declined by -13.7% yoy during this period, but its share in total exports remained almost unchanged amounting 34.5% of the total.
On the import side, in July 2016, Ukraine’s merchandise imports increased on a month-to-month basis, but shrunk by 1.4% on a year-over-year basis and totaled USD 3,259 million. The major reduction in imports took place in mineral products, which fell by -27.9% yoy, and chemicals products, which dropped by -1.9% yoy. Nevertheless, in contrast to above, all other categories of non-energy imports increased in July, including machinery and equipment imports, by 31.8% yoy; industrial goods by 17.3% yoy; agricultural products by 5.2% yoy; metallurgical imports by 5.7%; and timber and wood products imports by 1.8%. In January–July 2016, imports from Russia continued to drop by -41.4% yoy, with its share in total Ukrainian imports amount reduced to 12.3%. Moreover, imports from the EU also declined by -2.2% yoy and now represent 39.7% of the total. Furthermore, merchandise imports from Asia saw 18.4% yoy growth, underlining Asia’s share in the total amount rising to 21.0% of total imports of Ukraine.

On the financial account, net financial inflow reached USD 447 million in July 2016. From the beginning of the year, financial inflows amounted to USD 994 million, compared to outflows of $1.2 billion in the same period of 2015. These inflows were caused principally by net increases in foreign direct investments. In fact, net inflow of FDI in January–July 2016 reached $2.3 billion, principally for the recapitalization of subsidiaries of foreign banks, as required by the NBU.

Because of positive inflows in the financial accounts and despite negative balances in the current, the overall surplus of Ukraine’s consolidated balance of payments in July amounted to $110 million. The consolidated balance of payments in January–July 2016 posted a surplus of $516 million compared to a deficit of $862 million in January–July 2015. This led to an increase in international reserves to about USD 14.3 billion, sufficient to finance imports for 3.6 months.

The level of international reserves of Ukraine is expected to increase further by the end of September, given the recent decision by the IMF to approve the disbursement of the USD 1.0 bln on September 14th. Ukraine will be able to secure an additional USD 1.6 bln in financial aid from the USA USD 1.0 bln and the EU (USD 600 mln). The government expect to receive another IMF disbursement by the end of the well as additional financing from the World Bank and EBRD.