Executive Summary

- Despite several meetings of representatives of Foreign Ministers of Ukraine, Germany, France, and Russia in Minsk in December, the military conflict in Donbas has not stopped. Nevertheless, the intensity of daily attacks from Russian-backed separatists against Ukrainian soldiers has decreased to around 20 per day.

- In December, the Ukrainian government introduced a strategy for socio-economic reforms for 2017-2020. The strategy included fighting corruption and improving business conditions as its main elements. Electronic declaration of income and assets continues to be an important element of the fight against corruption.

- According to the State Statistic Service of Ukraine, GDP grew by 2% yoy in the third quarter of 2016. On the production side of GDP, the sectors with the highest growth rates were construction (17.5% yoy) and wholesale and retail trade (3.8% yoy). On the other hand, the social sectors suffered declines of 8.5% yoy on education and 4.8% yoy on health. The financial sector also suffered a decline of 6.3% yoy.

- High frequency data for November 2016 show that the economy has continued to pick up momentum. During this month, the construction sector experienced a high growth rate of 11.6% yoy. Agricultural production grew by 4.7% yoy, while industrial production output increased by 3.7 % yoy and retail trade turnover by 3.8% yoy.

- Acceleration of growth of state budget revenues and restrained growth of expenditures helped expand the state budget surplus to UAH 14.8 billion in November. As a consequence, from the beginning of the year, the deficit of the state budget decreased to UAH 45.5 billion. In addition, the surplus of local budgets increased to UAH 2.1 billion. As a result, the cumulative consolidated (state and local) budget deficit decreased to almost UAH 10.0 billion (less than 0.5% of period GDP, excluding subsidies to Naftogaz and the pension system).

- Faster than expected deceleration in the growth of prices of foodstuffs more than compensated the faster acceleration in the growth of regulated prices and tariffs. Therefore, total inflation slightly decelerated in November (from 12.4% yoy to 12.1% yoy). Core inflation decelerated to 6.2% yoy.

- The nationalization of PrivatBank is re-establishing the solvency and confidence on Ukraine’s banking sector. In November, national currency deposits further expanded by 1.6 percentage points to 12.4% yoy. Similarly, the growth of national currency loans accelerated to 10.0% yoy thanks to the expansion of corporate loans.

- Thanks to a surplus in the financial account that covered the deficit in the current account, as of November 2016, the level of international reserves remained at USD 15.3 billion (about 3.7 months of future imports). The UAH/USD exchange rate was mostly stable in November.

### Main Macroeconomic Indicators

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<tbody>
<tr>
<td><strong>GDP, USD billion</strong></td>
<td>163</td>
<td>173</td>
<td>180</td>
<td>130</td>
<td>87</td>
<td>88</td>
<td>92</td>
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<tr>
<td><strong>Real GDP Growth, % yoy</strong></td>
<td>5.5</td>
<td>0.2</td>
<td>0.0</td>
<td>-6.6</td>
<td>-9.9</td>
<td>1.3</td>
<td>3.0</td>
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<tr>
<td><strong>Fiscal Balance (incl. Naftogaz &amp; Pension Fund), % of GDP</strong></td>
<td>-4.3</td>
<td>-5.5</td>
<td>-6.5</td>
<td>-11.7</td>
<td>-2.1</td>
<td>-4.0</td>
<td>-3.0</td>
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<tr>
<td><strong>Public Debt, External and Domestic, % of GDP</strong></td>
<td>36.4</td>
<td>36.6</td>
<td>40.4</td>
<td>69.4</td>
<td>80.1</td>
<td>84.4</td>
<td>82.0</td>
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<tr>
<td><strong>Consumer Inflation, eop, % yoy</strong></td>
<td>4.6</td>
<td>-0.2</td>
<td>0.5</td>
<td>24.9</td>
<td>43.3</td>
<td>12.4</td>
<td>10.0</td>
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<tr>
<td><strong>Hryvnia Exchange Rate per USD, eop</strong></td>
<td>8.0</td>
<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><strong>Current Account Balance, % of GDP</strong></td>
<td>-6.3</td>
<td>-8.3</td>
<td>-9.0</td>
<td>-4.1</td>
<td>0.0</td>
<td>-2.0</td>
<td>-2.0</td>
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<tr>
<td><strong>FDI, Net Annual Inflow, USD billion</strong></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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<tr>
<td><strong>International Reserves, USD billion</strong></td>
<td>31.8</td>
<td>24.5</td>
<td>20.4</td>
<td>7.5</td>
<td>13.3</td>
<td>15.5</td>
<td>17.0</td>
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<tr>
<td><strong>Public External Debt, USD billion</strong></td>
<td>33.3</td>
<td>32.1</td>
<td>31.7</td>
<td>34.9</td>
<td>47.0</td>
<td>55.0</td>
<td>60.0</td>
</tr>
<tr>
<td><strong>Private External Debt, USD billion</strong></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>
<td>62.0</td>
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</table>
**Political and Reform Developments**

Despite several meetings of representatives of Foreign Ministers of Ukraine, Germany, France, and Russia in Minsk in December, the military conflict in Donbas has not stopped. Nevertheless, the intensity of daily attacks from Russian-backed separatists against Ukrainian soldiers significantly decreased to around 20 per day. Moreover, the number of casualties was limited by 10 persons during December. The Ukrainian initiative to exchange hostages from both sides before the New Year holiday season was observed only by the Ukrainian side, with around 20 captured separatists sent back to the self-proclaimed republics. In exchange, only a few hostages imprisoned by the rebels were sent back to Ukraine. The level of uncertainty about the resolution of the conflict is still high.

In December, the Ukrainian government introduced a strategy for socio-economic reforms for 2017-2020. The strategy included fighting corruption and improving business conditions as its main elements. Electronic declaration of income and assets continues to be an important element of the fight against corruption. Criminal investigations were initiated for several members of Parliament. But the names of these persons have not been disclosed by the National Anticorruption Bureau of Ukraine (NABU). On January 1st, the second stage of income e-declaration was completed. At this stage, all judges and non-top government officials submitted statements on their assets and incomes. Based on this information, the NABU has started investigations. The Agency expects to finalize its work before April 2017.

In December, the Prosecutor General Office (PGO) reported several arrests of low-level government officials. According to the PGO, a number of officials from the Security Service and customs office were captured while receiving bribes.

Nevertheless, despite these actions, some surveys show that the Ukrainian society is unsatisfied with the progress made in fighting corruption. In particular, despite the innumerable cases of corruption reported by the Ukrainian local press, the lion share of them were not brought to the courts. On a positive note, the process of fighting corruption has become more transparent and is under close watch by Ukraine’s civil society and the country’s international partners.

Other structural reforms carried out during the year include the unification of energy tariffs, which has eliminated a main source of high-level corruption through re-commercialization of subsidized gas, and the introduction of the electronic ProZorro public procurement procedure, which has made the public procurement system more transparent and automatic.

Although with some delays, Ukraine continues the implementation of measures agreed with the IMF to regain access to the IMF Extended Fund Facility Program. In particular, at the end of December, the government nationalized the largest Ukrainian bank – PrivatBank, which had become insolvent due to a large volume of non-performing loans. This step should path a way for the further stabilization in the country’s banking sector. However, the additional cost of this nationalization for Ukrainian taxpayers might be as high as USD 5.5 billion (more than 6% of the country’s annual GDP).

At the end of the year, the Verhovna Rada voted for the new state budget for 2017 with a deficit of 3% to GDP (270 votes in favor, while only 226 were required). The NBU also introduced some measures aiming at the liberalization of foreign exchange currency controls. In particular, the NBU introduced measures to facilitate the repatriation of capital. All above should provide a platform for the future positive decision of the IMF board regarding a new disbursement of the next tranche to Ukraine.


**Economic Growth**

According to the State Statistic Service of Ukraine, in the third quarter of 2016, GDP grew by 2% yoy. On the production side of GDP, the sectors with the highest growth rates were construction (17.5% yoy) and wholesale and retail trade (3.8% yoy). On the other hand, the social sectors suffered declines of 8.5% yoy on education and 4.8% yoy on health. The financial sector also suffered a decline of 6.3% yoy. In terms of contributions to the 2.0% yoy GDP growth, three sectors contributed with 58% of this growth: wholesale and retail trade (with 27% of the total), construction (with 20% of the total) and agriculture (with 11% of the total).

On the expenditure side of GDP, the fastest rate of growth in the third quarter of the year took place in investments, which increased by 32.8% yoy. This was followed by final consumption expenditures which increased by 5.1% yoy, compared to 2.3% yoy in the 2nd quarter of 2016). These gains were partly offset by negative trade balances, with exports declining by 5.5% yoy and imports increasing by 13.9% yoy.

High frequency data for November 2016 show that the economy has continued to pick up momentum. During that month, the construction sector experienced a high growth rate of 11.6% yoy. At the same time, Ukraine agricultural production index grew by 4.7% yoy in November, while industrial production output increased by 3.7% yoy and retail trade turnover by 3.8% yoy. In addition, in November 2016, Ukraine’s transportation sector saw rises in freight and passenger turnover of 5.3% yoy and 6.8% yoy, respectively. Within the industrial sector, in November 2016 the best performing subsectors were food processing (7.8% yoy), machine-building 6.9% yoy), electricity production (6.6% yoy) and metallurgy (4.9% yoy).
Fiscal Policy

Acceleration of growth in state budget revenues and restrained growth of state budget expenditures helped expand the state budget surplus to UAH 14.8 billion in November. As a consequence, from the beginning of the year, the deficit of the state budget decreased to UAH 45.5 billion. In addition, the surplus of local budgets increased to UAH 2.1 billion. As a result, the cumulative consolidated (state and local) budget deficit decreased to almost UAH 10.0 billion (less than 0.5% of period GDP, excluding subsidies to Naftogaz and the pension system).

The 52.4% yoy growth of state budget revenues in November was caused by faster expansions of both tax and nontax revenues (by 67% yoy and 38.7% yoy respectively). Tax revenues in November expanded thanks to advance payments of corporate profit taxes for the quarter. VAT receipts continued to grow based on good performance of agricultural producers, while growth of the VAT reimbursements was rather restrained. Growth of revenues from personal income tax and excise taxes somewhat decelerated but still remained high.

State budget expenditures grew at a rate of 11.4% yoy in November. This high growth rate was the result of revived capital expenditures and higher expenditures on energy subsidies to the population, higher current transfers to enterprises, and higher social expenditures. At the same time, expenditures on principal repayments and servicing of state debt significantly decreased. Cumulative state budget expenditures from the beginning of the year saw their growth decelerating to 22.4% yoy as of the end of November from 24.0% yoy a month ago.

Monetary Policy

Inflation. Faster than expected deceleration in growth of foodstuffs more than compensated the faster than forecasted acceleration in the growth of regulated prices and tariffs. Therefore, total inflation slightly decelerated in November (from 12.4% yoy to 12.1% yoy). Core inflation decelerated to 6.2% yoy. A few major groups of goods and services sustained significant changes in prices, while the majority of groups saw just minor movements in year-over-year price growth. Significant deceleration in price growth was observed for foodstuffs (by 1.5 percentage points to 3.4% yoy), wearing apparel and footwear (by 1.4 percentage points to 6.7% yoy), and leisure and culture (by 1.3 percentage points to 6.0% yoy). Those declines were enough to more than offset acceleration in growth of prices for alcohol and tobacco products by 2.2 percentage points to 16.4% yoy and for housing and utilities by 2.8 percentage points to 47.2% yoy.

Recent developments in CPI and its components makes have ensured that consumer inflation stood at 12.4% yoy in 2016.
Banking Sector. As noted earlier, the nationalization of PrivatBank is re-establishing the solvency and confidence on Ukraine’s banking sector. In November, national currency deposits further expanded by 1.6 percentage points to 12.4% yoy. While the growth of household deposits remained unchanged at 11.7% yoy, corporate deposits enjoyed an accelerated growth of 15.6% yoy. Foreign currency deposits denominated in USD experienced mixed developments during November. Household foreign currency deposits denominated in USD continued to improve as their decline further decelerated to 4.8% yoy (6.4% yoy in October). At the same time, corporate foreign currency deposits denominated in USD saw their dynamics deteriorated as their growth of 3.5% yoy was almost three times lower than a month ago. Thus, total foreign currency deposits denominated in USD declined by 2.9% yoy.

Gradual economic recovery and lower interest rates on banks loan led to further reactivation of crediting activities. The growth of national currency loans accelerated to 10.0% yoy thanks to the expansion of corporate loans which grew by 15.8% yoy. This expansion more than compensated a 6.2% yoy decline in household loans. The decline in the foreign currency loans accelerated to 23.1% yoy in November because of faster declines in both corporate and household sectors (to 23.1% yoy and 22.5% yoy respectively).

The monetary base expanded by 0.8% mom in November, while its year-over-year growth decelerated for the second month in a row (by 0.3 percentage points to 11.2%). The growth of money supply further decelerated reaching 7.7% year-over-year.

Hryvnia Exchange Rate. The UAH/USD exchange rate was around the target level of 26.0 UAH/USD during the first half of the month. Then it depreciated, especially during the last three trading session of the year, reaching the level of 27.2 UAH/USD. This depreciation was mostly related to the purchases of dollar by banks with foreign capital for dividends repatriation purposes. The privatization of PrivatBank also had an effect, as it significantly reduced its dollar supply in the interbank forex market, causing a dollar deficit. In order to counter these effects, the NBU held dollar-selling auctions during the last trading sessions of 2016 to mitigate the exchange rate fluctuations but was not fully successful. Since the depreciation was not the result of any political developments or macroeconomic shocks, we expect the exchange rate to remain at a level close to 26-27 UAH/USD from the beginning of 2017.
International Trade and Capital

In November 2016, the Ukrainian current account of the balance of payments had a deficit of USD 165 million, which was lower than the deficit of USD 233 million experienced in October 2016. The cumulative deficit from January to November 2016 reached USD 3.1 million (3.7% of GDP).

The November, current account deficit was covered by net financial account inflows of USD 84 million, principally in the form of net inflows of direct foreign investments (USD 132 million).

The overall balance of payments had a small deficit of USD 80 million, with international reserves staying almost flat at about USD 15.3 billion (3.6 months of imports).

The improvement in the current account in November was due to surpluses in the primary and secondary income balances of USD 25 million and USD 256 million, respectively. Trade in goods and services also developed favorably. During the month of November, exports of goods and services raised by 11.7% mom to USD 4,034 million, whereas imports of goods and services increased by 8.4% mom to USD 4,951 million.

On a year-over-year basis, during November 2016, the major improvements in merchandise exports (which grew by 15.4% yoy) were contributed by agricultural products (which increased by 22.1 % yoy), followed by metallurgy (21.8 % yoy), and mineral products (23.8 % yoy). On the other hand, Ukrainian merchandise export suffered reductions in machinery and equipment (-21.1 % yoy), chemicals (-5.7% yoy) and industrial goods (-0.6%). In January-November 2016, the regional destination of exports shows that exports to Russia fell by 28.9% yoy, and now their share account for 9.1 of total exports, compared to 11.9% a year ago. On the other hand, Ukraine’s exports to Europe increased by 2.4% yoy, and now represent 32.7% of total exports, compared to 29.8%, in January–November 2015. At the same time, exports to Asia declined by 6.4% yoy and now take 34.8% of total Ukrainian exports.

Regarding Ukrainian merchandise imports, its growth in November of 17.8% yoy was due to increased purchases of machinery and equipment (with 39.3 % yoy growth), mineral products (15.8 % yoy) and chemicals ( 10.5% yoy). In addition, Ukraine imports also increased in agricultural products (13.8 % yoy), and industrial goods (18.7 % yoy).