Executive Summary

- Since early January, Russian-backed separatists have intensified their military hostilities in Eastern Ukraine. The Avdiivka city in Donetsk oblast became a target for massive firings by the rebels. Almost all communal services were hit, including water and electricity. At this time, the resolution of the conflict is still uncertain.

- On a reform side, Ukraine continues to implement steps aiming at improving its business climate. The major efforts are concentrated in fighting corruption and reducing administrative barriers for businesses. Numerous cases of administrative corruption were detected, but due to cumbersome procedures, they were not submitted to the courts. These facts emphasize the necessity to speed up judicial system reform.

- Data from the State Statistical Service show that the economic performance of Ukraine has continued to improve. In fact, GDP in the fourth quarter of 2016 grew by 4.7% yoy, compared to 2.0% yoy in the third quarter. As a result, GDP for 2016 may have grown by about 1.8%, compared to an earlier estimate of 1.5%. High frequency data for December 2016 show that the best performance was in agricultural output, which increased by 66.4% yoy (93.5% mom).

- State budget revenues expanded at high rates in December, while expenditures remained almost flat. For the year as a whole, the overall consolidated budget deficit for 2016 reached UAH 54.7 billion (2.3% of GDP), excluding payments to Naftogaz and the pension fund. This deficit is within the limits agreed with the IMF.

- In 2016, the rate of inflation was 12.4% yoy, which was close to the target band of 12.0±0.3 set by the Monetary Policy Strategy for 2016-2020. This is a significant improvement over the 43.3% yoy inflation in 2015. Core inflation decelerated from 34.7% yoy in 2015 to 5.8% yoy in 2016.

- In December, a 5.2% yoy growth in household deposits and a 12.0% yoy growth in corporate deposits converted into an 8.7% yoy growth of total national currency deposits. The situation with foreign currency deposits denominated in USD also improved in December as their decline decelerated to its lowest level since the beginning of the year at 0.4% yoy.

- The UAH/USD exchange rate has fluctuated widely, but has remained at about 27.0 UAH/USD.

- During 2016, the current account deficit of the balance of payments reached 3.7% of GDP. Nevertheless, thanks to a surplus in the financial account, the current account deficit was fully covered, with international reserves increasing to USD 15.5 billion (about 3.7 months of future imports).

<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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<tbody>
<tr>
<td>GDP, USD billion</td>
<td>163</td>
<td>173</td>
<td>180</td>
<td>130</td>
<td>87</td>
<td>88</td>
<td>92</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>
<td>1.8</td>
<td>3.0</td>
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<tr>
<td>Fiscal Balance (incl. Naftogaz/Pension Fund), % of GDP</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>
</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>80.1</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>12.4</td>
<td>10.0</td>
</tr>
<tr>
<td>Hryvnia Exchange Rate per USD, eop</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>
</tr>
<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>-3.7</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>3.4</td>
<td>3.0</td>
</tr>
<tr>
<td>International Reserves, USD billion</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>
</tr>
<tr>
<td>Public External Debt, USD billion</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>
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<tr>
<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>
<td>62.0</td>
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</table>
Political and Reform Developments

Since the end of January, Russian-backed separatists have intensified their military hostilities in Eastern Ukraine. The Avdiivka city in Donetsk oblast became a target for massive firings by the rebels. Almost all communal services were hit, including water and electricity supply. Since Donetsk oblast has been experiencing extremely low temperature sometime reaching -20°C, a humanitarian catastrophe was inevitable. Ukrainian militants and civilians have become victims of such escalated aggression. More than 10 Ukrainians were killed just in the first two days of hostilities in Avdiivka.

All western diplomatic missions in Ukraine have reported this sudden increase in military activities in Ukraine to their national governments. President Poroshenko stopped his official visit to Germany and immediately returned to Ukraine. The Ministry of Foreign Affairs has called for a meeting in the Normand format to put more pressure on Russia to stop this aggression. The US State Department and EU partners of Ukraine have expressed deep concerns about the situation in the Eastern part of Ukraine. The U.S. representative in the United Nations has emphasized that the conflict in Ukraine and latest developments in Avdiivka are backed by the Russian Federation. At this time, the possibility of having an international meeting in the Normand format in the nearest future are unclear.

On a reform side, Ukraine continues to implement steps aiming at improving its business climate. The major efforts are concentrated in fighting corruption and reducing administrative barriers for businesses. During the month of January, the General Prosecutor Office (GPO) reported several dozens of cases in which government officials were caught while committing corruption acts. The list of captured corrupt officials includes local judges, prosecutors, MP’s assistants, fiscal service officers, employee of the National Bank, etc. On a negative side, due to cumbersome procedures for arresting government officials, most suspects were not detained and their cases were not even sent to courts for further legal actions. These facts emphasize the necessity to speed up the judicial system reform. This point along with the need to create a special anticorruption court were mentioned in the current resolution on Ukraine of the European Council.

The Ministry of Economy and Trade approved a plan to improve Ukraine’s position in the Doing Business Report of the World Bank. The plan aims to place Ukraine within the top-30 countries in the next 5 years. This might be a significant step forward for improving the quality of the investment climate in the country, which is currently rated as number 80 out of 190 countries. The major bottlenecks in this rating are (i) the position of Ukraine in dealing with construction permits (140/190) and (ii) getting electricity (130/190). However, other steps to improve the business environment are required. The implementation of the reform agenda should not be delayed due to the military hostilities in the East.
Economic Growth

Data from the State Statistical Service show that the economic performance of Ukraine continued to improve during the last months of 2016. In fact, GDP in the fourth quarter of 2016 grew by 4.7% yoy, compared to 2.0% yoy in the third quarter. As a result, GDP for 2016 may have grown by 1.8%, compared to an earlier estimate of 1.5% for 2016 and a decline of 9.9% in 2015.

In December 2016, the best output performance was in agricultural production, which increased by 66.4% yoy (93.5% mom). Other sectors also showed good results: industrial production grew by 4.5% yoy (1.9% mom); construction output rose by 5.8% yoy (41.4% mom); retail trade turnover improved by 3.9% yoy (12.4% mom); freight and passenger turnover increased by 2.7% yoy and 8.9% yoy, respectively. These positive results were supported by favorably developments in the level of nominal monthly wages and salaries, which increased by 20.2% yoy.

Concerning individual industrial production sectors, the largest increases in industrial output took place in the following areas: production of foodstuffs (15.1% yoy); computers and electronics (13.6% yoy); and electricity, gas, steam, air conditioning supply (10.4% yoy). On the other hand, the highest drop in industrial output was experienced in the production of wood, paper and printing (-6.1% yoy); chemicals (-6.1% yoy); and basic pharmaceutical products (-0.9% yoy).

Regarding regional industrial outputs, their percent increases in December 2016 were as follows: Ternopil (36.7 % yoy), Khmelnitsky (26.8 % yoy), Zhytomyr (25.1 % yoy), Kirovograd (23.6 % yoy), Odessa (23.5 % yoy), Vinnytsia (21.2 % yoy), Kharkiv (17.9 % yoy), Donetsk (12.2 % yoy), Mikolaiv (12.1 % yoy), Volyn (10.5 % yoy), Lugansk (90 % yoy), Chernivtsi (8.9 % yoy), Poltava (8.1 % yoy), Zakarpattia (7.2 % yoy), Ivano-Frankivsk (6.5 % yoy), Kyiv (2.0 %), and Lviv (0.4 % yoy).
Fiscal Policy

State budget revenues expanded at high rates in December, while expenditures remained almost flat. Nevertheless, the budget was executed with a deficit of UAH 24.6 billion, which was below the deficit in 2015. Regarding local budgets, December was the only month of the year in which local budgets were executed with a deficit (UAH 20.1 billion). For the year as a whole, the overall consolidated budget deficit for 2016 expanded by UAH 44.7 billion to UAH 54.7 billion (2.3% of GDP), excluding payments to Naftogaz and the pension fund. This deficit is almost 80% yoy higher compared to the previous year, but it still lies within the limits agreed with the IMF.

State budget revenues increased by 32.8% yoy in December, primarily due to higher non-tax revenues. Non-tax revenues grew thanks to another large transfer from the NBU and accelerated increase in receipts of non-tax revenues of budget institutions. As for tax revenues, they also expanded but at significantly lower pace (12.4% yoy) because of a record high reimbursements of the VAT (UAH 16 billion). Receipts from excise taxes on imported goods grew at an accelerated rate (45.8% yoy) thanks to activation of imports. Both receipts from personal income tax and corporate profit tax continued to grow at high rates, especially the latter (by almost 200% yoy). Growth of receipts from personal income tax was the result of increases in the nominal minimum wage, while receipts from corporate profit tax to a great extent increased because of advance payments by companies. From the beginning of the year, cumulative state budget revenues grew by 15.3% yoy.

Despite significant build up in the state budget expenditures, they posted almost zero growth in December. Expenditures on environment protection and public order/security posted the highest growth rates of 74.7% yoy and 39.8% yoy, respectively. At the same time, the largest decline was observed for general state governance functions at -15.2% yoy. Cumulative state budget expenditures for the year grew by 18.7% yoy, which is 3.7 percentage points slower than in January-November.

Monetary Policy

Inflation. Consumer inflation accelerated in December going slightly beyond the forecasted level of 12.0% yoy. The total-items CPI posted a 12.4% yoy increase, which is very close to the target band of 12.0%-0.3 set by the Monetary Policy Strategy for 2016-2020 and is a significant improvement over the 43.3% yoy in 2015. Core inflation decelerated from 34.7% yoy in 2015 to 5.8% yoy.

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this impact was supported by favorable developments in the supply of wholefoods. On the other hand, increases in regulated tariffs and prices, and some increases in crude oil prices, were the factors imposing additional pressure on consumer prices. We expect that inflation in 2017 will be around 10% yoy.

**Banking Sector.** Despite some positive developments in national currency deposits, their over-year growth decelerated in December because of statistical base effect (since large increases in inflows of deposits started at the end of 2015). A 5.2% yoy growth in household deposits and a 12.0% yoy growth in corporate deposits converted into an 8.7% yoy growth of total national currency deposits. The situation with foreign currency deposits denominated in USD slightly improved in December as their decline decelerated to its lowest level since the beginning of the year at 0.4% yoy.

On the lending side, growth of national currency loans further accelerated in December reaching 16.9% yoy. This growth was fully attributed to expansion of the corporate sector loans at 22.3% yoy, which more than offset the 4.0% yoy decline in household loans. At the same time, fast growth of the corporate sector national currency loans was the result of restructuring of the foreign currency loan arrears. This, on its turn, led to faster decline in the later. In particular, total foreign currency loans denominated in USD dropped 20.2% yoy in December.

Expansion of cash resources more than compensated for declines in balances at the correspondent accounts of commercial banks in the NBU. This led to growth of the monetary base by 6.7% mom in December accelerating its year-over-year growth to 13.6%. Positive monthly dynamics of deposits and growth in cash outside of banks ensured a further expansion of money supply in both monthly and over-year terms in December (by 5.4% and 10.8% respectively).

**Hryvnia Exchange Rate.** The UAH/USD exchange rate sustained significant fluctuations during December 2016, within a depreciating trend that brought the exchange rate from 26.0 UAH/USD in early December to about 27.2 UAH/USD by early January. Although with fluctuations, it has remained around 27.0 UAH/USD since then. There were two major reasons for the Hryvnia depreciation in December. First, the supply of dollar was rather low due to low business activities of exporters. And second, banks with foreign capital activated purchases of dollar for dividends repatriation purposes.
International Trade and Capital

In 2016, Ukraine’s current account deficit amounted to USD 3,364 mln (3.7% of GDP), compared to USD 186 mln (0.2% of GDP) in 2015. The increase in the current account deficit during 2016 was due both, to a decline in exports of goods and services of 4.1% and an increase in imports of 3.9%.

During the year, exports of goods fell by 5.2% to USD 33,571 mln, while goods import increase by 3.8% yoy to USD 40,364 mln. During 2016, agricultural products became the only merchandise export that showed a positive sign, with a 5.4% yoy increase and 45.4% share of the total export amount in the year. On the other hand, the main reductions of merchandise export in 2016 were caused by chemicals products (-24.8%), machinery and equipment (-17.8%), ferrous and nonferrous metals (-11.6%), mineral products (10.5%), industrial goods (-7.9%), and timber and wood products (-2% yoy).

During 2016, Ukraine merchandise imports showed a reduction only in mineral products (including gas and energy), by -27.9% yoy. Imports of other products increased, including machinery and equipment (37.9% yoy), ferrous and nonferrous metals (15.5% yoy), agricultural products (13.4% yoy), industrial goods (11.9% yoy), timber and wood products (10.4% yoy) and chemicals products (10.1% yoy).

Regarding merchandise trade by country, in 2016 Ukraine reduced export to the Russian Federation by -25.8% yoy causing a fall in its share of -2.6% to 9.3%. Similarly Ukrainian export to Asia fell down by -4.4% yoy (35% share), and to America by -5.6% yoy (2.1% share), including to USA by 9.8% yoy (1.2% share). On the other hand, during 2016, Ukraine increased exports to Europe by 3.1% (32.6% of the total export share), Africa by 2.5% yoy (11.5%), and Australia by 30.3% yoy (0.1%), respectively.

Regarding Ukrainian merchandise imports from Russia and CIS countries, in 2016 they declined by -31.2% yoy (12.6% of total share amount) and -15.7% yoy (24.8%), respectively. In addition, import from Australia and Africa, also fell down by -28.7% yoy (0.29%) and -4.5% yoy (1.05%). However, Ukraine merchandise import increased from Asia by 23.2% yoy (20.2%), Europe by 10.8% yoy (39.8%) and America by 13.4% yoy (5.7%), including USA by 14.3% yoy (3.9%), respectively, in 2016.

Ukraine’s current account deficit of USD 3.4 billion in 2016 was fully covered by net inflows in the financial account, which amounted to USD 4.6 billion. These financial inflows resulted mainly from private sector transactions, which amounted to USD 5.5 billion, including about USD 3.4 billion in foreign direct investments. As a result, the overall surplus in the balance of payments amounted to USD 1.3 billion, which increased international reserves to USD 15.5 billion (sufficient for 3.4 months of imports).