

September 2017

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Executive Summary

- ❖ During the past month, there was a significant decrease in the number of artillery firings by Russian-backed separatist in Donetsk and Luhansk. Currently, the daily number of attacks does not exceed 20.
- ❖ On the reform agenda, the Ukrainian Parliament passed a law on Pension System reform. The law introduced a hike in the pension age by gradually increasing the minimum working age requirement from 15 years to 35 years by 2028. This measure should make the pension system more sustainable over time. Another important development was the agreement by President Poroshenko to form a working group to find a compromise about the creation of independent anti-corruption courts, a measure he had opposed earlier.
- ❖ In the second quarter of 2017, Ukraine's GDP grew by 2.3% year-over-year, compared to a 1.5% yoy in the second quarter of 2016. On the production side of GDP, in Q2 the largest increases took place in the construction sector, which grew by 28.8% yoy. On the expenditure side of GDP, gross fixed capital formation showed the highest growth rate (23.7% yoy), followed by household consumption (6.9% yoy). August data shows further recovery, with construction increasing by 23.6% yoy, retail trade by 9.8% yoy, transport by 7% yoy, and agriculture by 6.4% yoy.
- ❖ After one month of deficit, in August the state budget was again executed with a surplus. The cumulative consolidated budget surplus from the beginning of the year increased to UAH 68.6 billion (about 4% of period GDP).
- ❖ Consumer inflation increased slightly from 15.9% yoy in July to 16.2% in August. The main inflation drivers were faster growth in prices of food, footwear and wearing apparel, transportation, education, and restaurants and hotels.
- ❖ In the banking sector, deposits continued to expand in August. Growth of national currency deposits reached 12.5% yoy as both household and corporate deposits grew by 14.1% yoy and 7.0% yoy, respectively. At the same time, foreign currency deposits denominated in USD expanded by 4.3% yoy. On the banking assets side, national currency bank lending continued to grow. Household loans expanded by 18.8% yoy, whereas corporate loans increased by 20.6% yoy. The growth of the monetary base remained almost unchanged in August at 6.0% yoy.
- ❖ The UAH/USD exchange rate has been depreciating since the beginning of September, due to increased dollar demand by importers, following the summer vacation period, and dividend repatriation by banks with foreign capital.
- ❖ In August 2017, Ukraine's current account deficit of the balance of payments declined by 54% yoy to USD 226 million, compared to a deficit of USD 490 million in August 2016. In August, Ukrainian merchandise exports performed well, increasing by 12.8% yoy to USD 3,325 million, while imports of goods increased by 10.4% yoy, reaching USD 4,200 million. Since net financial inflows amounted to USD 775 million, they covered the current account deficit and allowed international reserves to increase to USD 18.0 billion by the end of August 2017 (3.6 month of the future imports.)

Main Macroeconomic Indicators	2011	2012	2013	2014	2015	2016	2017f
GDP, USD billion	163	173	180	130	87	93.4	101.0
Real GDP Growth, % yoy	5.5	0.2	0.0	-6.6	-9.9	2.3	2.5
Fiscal Balance (incl. Naftogaz/Pension Fund), % of GDP	-4.3	-5.5	-6.5	-11.7	-2.1	-2.3	-3.5
Public Debt, External and Domestic, % of GDP	36.4	36.6	40.4	69.4	79.1	81.2	78.0
Consumer Inflation, eop, % yoy	4.6	-0.2	0.5	24.9	43.3	12.4	12.0
Hryvnia Exchange Rate per USD, eop	8.0	8.1	8.2	15.8	24.0	27.0	27.0
Current Account Balance, % of GDP	-6.3	-8.3	-9.0	-4.1	-0.2	-4.1	-3.5
FDI, Net Annual Inflow, USD billion	7.0	7.2	4.1	0.3	2.3	3.4	3.0
International Reserves, USD billion	31.8	24.5	20.4	7.5	13.3	15.5	18.0
Public External Debt, USD billion	33.3	32.1	31.7	34.9	42.6	42.5	47.0
Private External Debt, USD billion	92.7	102.3	110.3	91.2	76.0	69.9	65.0

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Political and Reform Developments

During the past month, there was a significant decrease in the number of artillery firings by Russian-backed separatist in the Eastern regions of Donetsk and Luhansk. Currently, the daily number of attacks does not exceed 20.

The need for a complete ceasefire in Ukraine continues to be discussed in international security meetings. It was a subject in the recent meeting of the U.S. State Secretary Rex Tillerson and Russian Minister for Foreign Affairs Lavrov, on September 18. The need to resolve the conflict was also discussed during the meeting of the representative of the US Administration Kurt Volker and the special advisor to the Russian President, Vladislav Surkov on October 7 in Belgrade. The Ukrainian issue is expected to be reflected in the United Nations Security Council resolution about the possible deploying of the UN peacekeeping mission to Donbas. The final draft of the resolution should be sent to the UN Council within the course of this year.

In September, key items in the reform agenda of the Ukrainian government remain the issues initially agreed with its international partners: (i) pension system reform and (ii) fighting corruption.

In October, the Ukrainian Parliament passed a law on Pension System reform. The law introduced a hike in the pension age by increasing the minimum working age requirement. It starts from 15 years and should be gradually increased to 35 years by 2028. This measure should make the pension system sustainable, as it would substantially decrease over time the fiscal deficit in the Ukrainian pension fund. The second pillar of the pension reform – a fully funded system - will be gradually introduced starting in 2019. On a negative side, the new law envisages a higher indexation of pension payments to the existing pensioners than what was initially agreed with the IMF. This norm might decrease the positive effect from the law in the short-run.

Fighting widespread corruption remains another key item in the agenda of both (i) international partners of Ukraine including the IMF and (ii) Ukrainian civil society. A key element of this fight was the creation of independent anticorruption courts, given that a good part of the existing judiciary is considered weak, politicized and corrupt. But this proposal was initially blocked by the government, which wished to create anticorruption courts within the existing court system. The European Union's Venice Commission, international institutions and opposition groups rejected this government's proposal and argued that the creation of independent anti-corruption courts was an essential step to improve justice in Ukraine. They noted that the absence of convictions in high-level corruption cases was evidence that independent courts were needed. President Poroshenko has now said he would create a working group to find a compromise about the creation of independent anti-corruption courts. It is expected that the new draft law will be submitted to Verhovna Rada by President Poroshenko in a few several weeks.

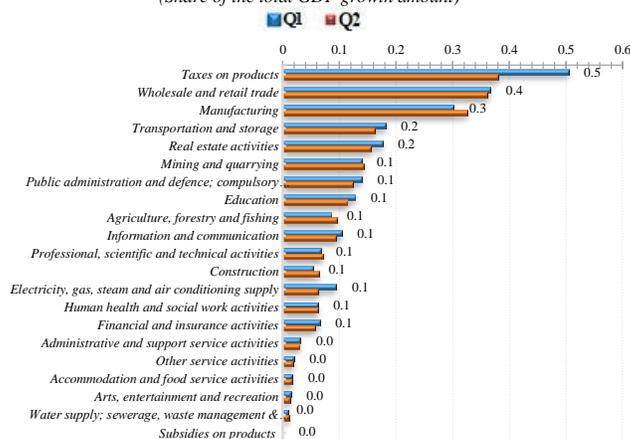
Economic Growth

In the second quarter of 2017, Ukraine's GDP grew by 2.3% year-over-year, compared to a 1.5% yoy increase in the second quarter of 2016.

On the production side of GDP, the largest increases in Q2 took place in the construction sector (28.8% yoy growth), real estate activities (5.7% yoy), communications (4.7% yoy), manufacturing (4.2%

Contributions to GDP by production, Q1-Q2 2017

(Share of the total GDP growth amount)



Source: The Bleyzer Foundation

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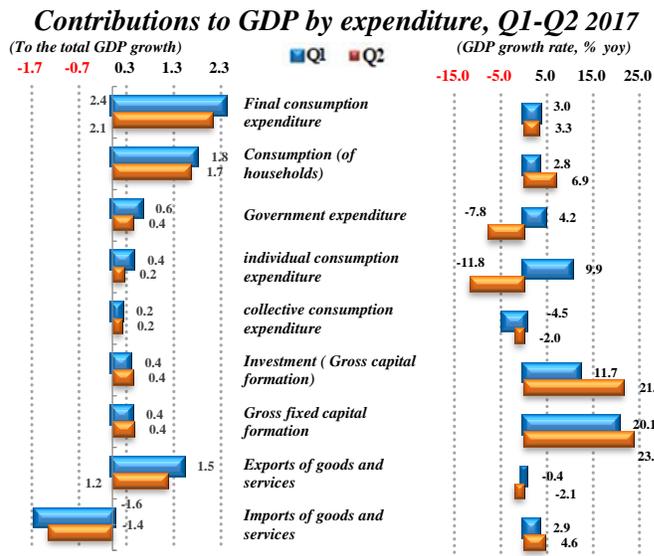
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yoy), transportation and storage (4.1% yoy), accommodation and food service activities (4.1% yoy), and wholesale and retail trade (3.8% yoy). In terms of sectoral contributions to the 2.3% GDP growth, about one-half of it was generated by the wholesale and retail trade, manufacturing, transportation, and real estate activities. However, the poorest production performance continued to be in the same sectors as in the first quarter of 2017, in particular electricity, gas and steam supply sector, which fell by -8,8% yoy; water supply and waste management which went down by -6,9% yoy; and mining & quarrying (-5,7% yoy). These poor performances were due to the hostilities in the East and the trade embargo there.

Concerning the expenditure side of GDP, in the second quarter of the year gross, fixed capital formation showed the highest growth rate (23.7% yoy). However, its contribution to GPG growth was only 0.4% due to its small base. Household consumption also grew at a fast pace of 6.9% yoy, contributing 1.7% to the 2.5% GDP growth. International trade made negative contributions to GDP growth.

Recent monthly data shows that, in August 2017, the highest growth of the real sector of Ukraine took place in construction output, which increased by 23.6% year-over-year (17.3% yoy in July 2017). This is due to the fact that real estate is considered a "safe" investment in today's investment climate. Construction was followed by retail trade turnover, which increased by 9.8% yoy. Ukrainian transportation system showed similar results with freight and passenger turnover increasing by 7.2% yoy and 6.6% yoy, respectively. Despite bad weather conditions, agricultural production also increased significantly by 6.4% yoy, compared to the previous month decline of -1.9% yoy. In addition, Ukrainian industrial production recovered to a positive sign growing by 1.2% yoy, supported by growth in the manufacture of chemicals & chemical products (33.0% yoy), machinery and equipment (10.4% yoy), manufacture of furniture (7.1% yoy), and production of foodstuffs (6.0% yoy). On the other hand, the main output reductions during the month were in coal mining, coke & refined petroleum, gas & electricity production, due to the problems in the East.

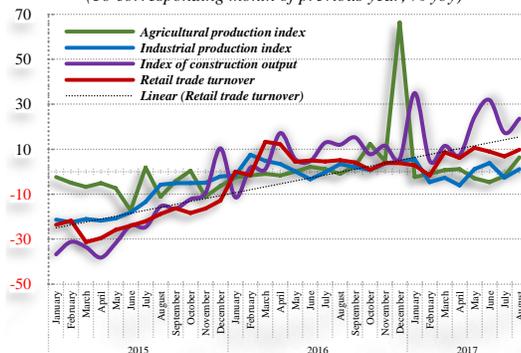
As to the regional distribution of industrial production, in August 2017 the highest output growth took place the following regions: Chernivtsi (23.6% yoy), Ivano-Frankivsk (21.9% yoy), Khmelnytskyi (14.2% yoy), Sumy (12.8% yoy), Zaporizhzhya (8% yoy), Ternopil (7.9% yoy), Lviv (7.8% yoy), Odesa (7.3% yoy), Dnipropetrovsk (6.5% yoy), Rivne (6.4% yoy), and Kherson (5.7% yoy). The worst output performance continued to be Lugansk (-37% yoy), Donetsk (-13.6% yoy), Kyiv City (-10.1% yoy), Kirovograd (-5.4% yoy), Nicholaev (-3.6% yoy), Chernihiv (-1.9% yoy), Poltava (-0.9% yoy), and Cherkasy (-0.4% yoy).



Source: The Bleyzer Foundation

Real Sector of Ukraine

(To corresponding month of previous year, % yoy)



Source: The Bleyzer Foundation

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Fiscal Policy

After one month of deficit, the state budget was again executed with a surplus in August. Faster growth in revenues than in expenditures ensured a UAH 11.5 billion surplus in the reporting month. Cumulative balance of the local budgets also remained positive and expanded to UAH 4.4 billion. Thus, the cumulative consolidated budget surplus from the beginning of the year increased to UAH 68.6 billion (about 4% of period GDP).

Growth of state budget revenues remained high in August. The 33.4% yoy increase was fueled mainly by tax revenues thanks to economic factors, as improvements in economic activities of companies led to a 47.7% yoy growth in corporate profit tax and increases in nominal wages caused a 27.7% yoy growth in personal income tax. Receipts from the VAT continued to grow at high rates, although significantly decelerated (to 20% yoy). Lower growth of imports and relatively stable foreign exchange markets led to a slower growth of revenues from taxes on international trade and from the excise tax. Growth of nontax revenues somewhat slowed but remained high thanks to transfer of last year's profits from the NBU. Growth of cumulative consolidated budget revenues in January-August 2017 amounted to 46.1% yoy.

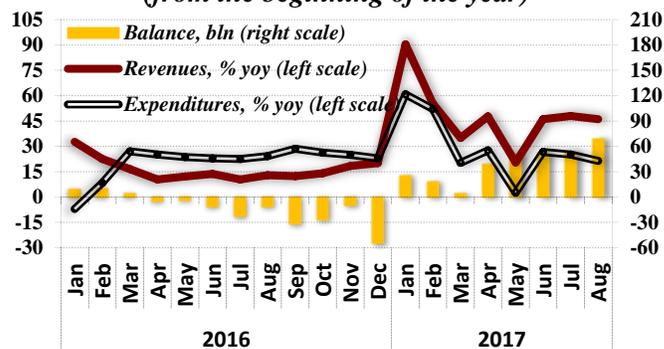
The state budget expenditures grew at accelerated pace in August. Increased current transfers and social expenditures were the main source of a 29% yoy increase in total expenditures. In particular, subsidies to the population on utilities payments saw significant increases. Also, expenditures on state debt servicing and capital expenditures saw accelerated growth. On the contrary, expenditures on goods and services posted significant deceleration in growth. Similarly to the situation with revenues, the increase in the cumulative consolidated budget expenditures decelerated to 21.3% yoy in January-August.

Monetary Policy

Inflation. Consumer inflation remained slightly above its forecasted path in August. The all items index reached 16.2% yoy, while core inflation expanded to 7.8% yoy due to faster growth in prices of whole foods and higher pressure on prices by raising production costs.

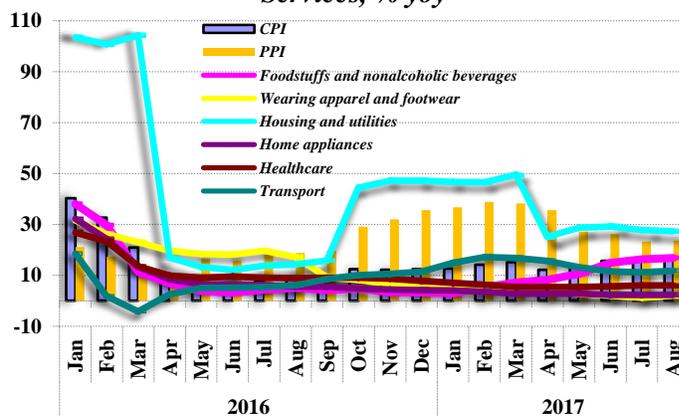
Consumer prices of the major groups of goods and services saw minor increases in August. Acceleration in the overall consumer inflation was the result of faster growth in prices of foods, footwear and wearing apparel, transport, education, and restaurants and hotels, which more than offset deceleration in growth of prices of alcoholic and tobacco products, recreation and culture, and housing and utilities tariffs. The fastest acceleration in price growth

Dynamics of Consolidated Budget Components (from the beginning of the year)



Source: Ministry of Finance of Ukraine, The Bleyzer Foundation

CPI, PPI, and Growth of Prices for Select Goods and Services, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

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was reported for footwear and wearing apparel of 0.9 percentage points to 2.1% yoy, while the most significant deceleration in growth of prices was observed for alcoholic and tobacco products at 1.2 percentage points to 25.1% yoy. Given the persistence of inflationary trends, we forecast inflation to be at 12% for 2017.

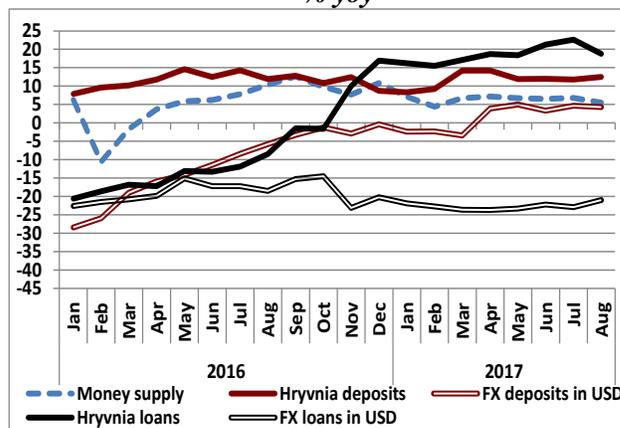
Banking Sector. Growth of national currency deposits in the banking system continued to accelerate in August. Household deposits grew at a rate of 14.1% yoy, which more than compensated for the deceleration in growth of corporate deposits to 7% yoy. Thus, the overall growth of the national currency deposits reached 12.5% yoy. Foreign currency deposits denominated in USD saw their growth marginally decreasing to 4.3% yoy. This happened despite further acceleration of growth in corporate deposits to 2.4% yoy.

Following the recovery of the banking sector, lending activities continue to growth, though at a lower pace. In August, national currency loans to households increased by 18.8% yoy, whereas corporate loans increased by 20.6% yoy.

The monetary base remained almost unchanged in monthly terms in August but its growth decelerated to 6.0% in over-year terms. At the same time, the decline in the national currency deposits and foreign currency deposits denominated in hryvnia, accompanied by shrinking cash resources outside banks, led to a monthly decline in money supply of 0.9% causing further deceleration of the over-year growth (to 5.5% from 6.8%).

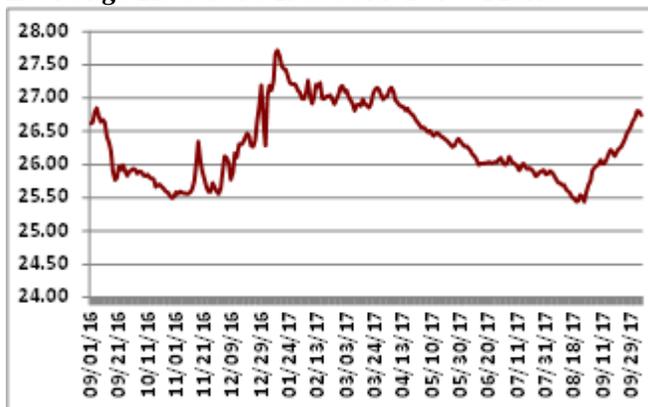
Hryvnia Exchange Rate. The UAH/USD exchange rate has been depreciating since the beginning of September. Traditionally, business activities activate in September after the summer vacation period. This leads to increased demand for dollar on the side of importers. This year this mechanism was accompanied by dividend repatriation by banks with foreign capital and VAT reimbursements to exporters. The former caused additional increase in dollar demand, while the later caused some decline in dollar supply as exporters received enough hryvnia resources to fulfill their tax obligations and refused to sell their foreign exchange revenues. Furthermore, after an initial increase in the dollar price, demand for dollar grew at the cash market as people decided to purchase dollar at local minimum of prices. Thus, the UAH/USD exchange rate at the cash market started to depreciate faster as compared to the interbank forex market. This created opportunities for speculators, who started to pump dollars from the interbank to cash forex market. As a result, depreciation slightly accelerated during the last part of the month. Overall, the UAH/USD exchange rate depreciated by 3.5% in September.

Dynamics of Money Supply, Deposits, and Loans, % yoy



Source: The NBU, The Bleyzer Foundation

Dynamics of the Average Weighted UAH/USD Exchange Rate in the Interbank Forex Market



Source: The NBU, The Bleyzer Foundation

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International Trade and Capital

In August 2017, Ukraine's current account deficit of the balance of payments declined by 54% yoy to USD 226 million, compared to a deficit of USD 490 million in August 2016. This deficit improvement was reached thanks to a 27% reduction in the merchandise and service deficit. Nevertheless, this deficit was still significant at USD 565 million; but it was partly offset by a surplus of USD 302 million in workers transfers from abroad.

In August, Ukrainian merchandise exports performed well, increasing by 12.8% yoy to USD 3,325 million, while imports of goods increased by 10.4% yoy, reaching USD 4,200 million.

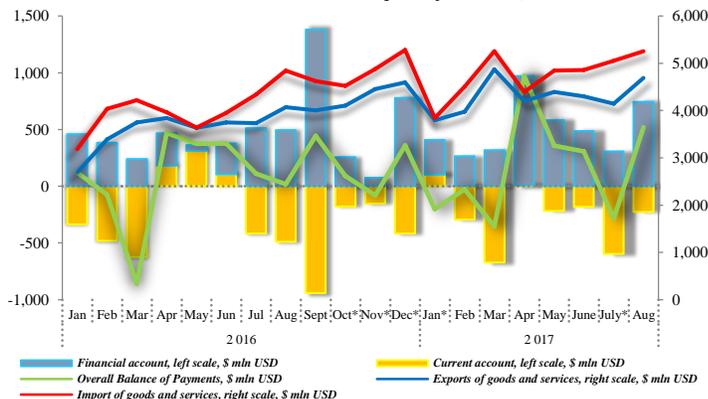
The major increases in exports during August took place in mineral products (25.3% yoy), followed by chemicals (24.6% yoy), industrial goods (23.7% yoy), agricultural products (17.5% yoy), timber & wood products (14.8% yoy), ferrous and nonferrous metals (8.1% yoy), and machinery and equipment (5.4% yoy). On the import side, the largest increases in imports took place in mineral products (32.7% yoy), ferrous and nonferrous metals (17.6% yoy), machinery and equipment (13.6% yoy), agricultural products (11.1% yoy), chemicals (10.6% yoy), and wood products (9.0% yoy).

Regarding the regional distribution of Ukrainian exports, the share of Europe increased from 33.3% of the total in January-August 2016 to 35.9% in 2017, thanks principally to the FTA with Europe. On the other hand, the share of Asia declined from 34.8% in the first eight months of 2016 to 31.8% in 2017. The share of Russia in Ukrainian exports declined slightly from 9.0% in 2016 to 8.9% in 2017.

On the import side, the main supplier of Ukraine continues to be Europe, which increased its share in Ukrainian imports from 39.1% in January-August 2016 to 41.6% in 2017. Russia also managed to increase its share in imports from 12.2% in 2016 to 13.7% in 2017. As a result, the trade imbalance with Russia reached almost USD 2,000 million in January-August 2017, compared to USD 1,166 million a year earlier. The share of Asia remained at about 20% on Ukrainian imports.

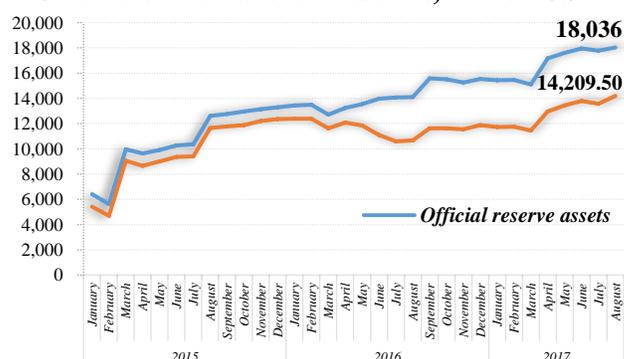
The current account deficit in August 2017 was fully covered by net financial inflows of USD 743 million (compared with net inflows of USD 493 million in August 2016). The main two sources of these inflows were USD 496 million of foreign exchange sold by the population to the banking system, and net foreign direct investments of USD 194 million directed to the real sector. After repaying USD 363 million to the IMF, international reserves increased slightly to USD 18,000 million in September of 2017, covering 3.6 months of future imports.

Ukraine's External Balance of Payments, million USD



Source: NBU, The Bleyzer Foundation

Ukraine's International Reserves, million USD



Source: NBU, The Bleyzer Foundation

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