September 2015 *Oleg Ustenko, Djulia Segura, Valentyn Povroznyuk*
Edilberto L. Segura

Executive Summary

- The ceasefire in Eastern Ukraine has been holding for several weeks and pro-Russian rebels have declared their intention to cancel their own local elections originally planned for mid-October. These developments give the expectation that the conflict will be "frozen" at current positions. This may permit the rest of the country to move forward on economic and social matters.

- With the support of civil society and international institutions, Ukrainian authorities are accelerating implementation of its economic and social reform agenda. Numerous corruption cases by government officials were brought to public attention and criminal investigations were initiated. However, the pace of structural reforms is still below the expectations of Ukrainians and international observers. The reforms, particularly on corruption, are considered insufficient to weaken the influence of vested interests that wish to maintain the status quo.

- High-frequency monthly production data shows that the pace of output decline has slowed since May 2015. Industrial production declined by -5.8% yoy in August, a lower decline compared to previous months: -13.4% yoy in July, -18.0% yoy in June and 21% yoy in May. The August declines in industrial output were widespread affecting almost all subsectors, but with larger declines in consumer goods.

- The consolidated fiscal budget continued in surplus during January-August, due principally to large increases in budget revenues induced by inflation and the depreciation of the national currency.

- Inflation in August continued to decelerate, but at a slow pace. In fact, CPI growth decelerated from its peak of 61% yoy in April to 58% yoy in May, 57% yoy in June, 55% yoy in July, and 52.8% in August. It is expected to decline further to 45% by the end of the year.

- The NBU continued its soft monetary policy in August, lowering the policy interest rate by 5 percentage points to 22% starting on September 25th. It also introduced changes in the procedures for the provision of liquidity loans in order to facilitate migration to inflation targeting by the end of 2016. Furthermore, due to the relative stability of the FX market (with a FX rate of 21.5 UAH/USD at the end of September), the NBU started to remove administrative restrictions that it introduced last year. In order to speed up the replenishing of international reserves, the NBU returned to the practice of preannounced FX auctions.

- In August 2015, the current account of the balance of payments continued to show a surplus, though it was lower than in July. The August current account surplus amounted to USD 60 million. The NBU re-estimated the January-August current account deficit at USD 133 million. Along with a surplus in the financial account of USD 444 million, these surpluses allowed the National Bank of Ukraine to accumulate USD 2,163 million in gross international reserves, which reached USD 12.6 billion at the end of August.

- Following the August 24th agreement with Ukraine's main external creditors to restructure about USD 18 billion of its public external public debt, the government offered to exchange securities due in September and October 2015 with a note maturing in 2019. This new offer should meet the requirements of half of the remaining bondholders, who are now likely to approve the deal. The bondholders will be voting on the deal on October 15th.

- The issue regarding the USD 3 billion bond held by Russia is still outstanding with the Russian Ministry of Finance, reconfirming that Russia would not participate in the bond restructuring and is prepared to go to litigation if not paid by December 2015.

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Main Macroeconomic Indicators	2011	2012	2013	2014	2015f
GDP, $ billion	163.4	176.6	182.0	127.4	98.0
Real GDP Growth, % yoy	5.5	0.2	0.0	-6.8	-11.0
Private Consumption, real growth, % yoy	15.7	8.4	6.9	-9.6	-17.0
Fiscal Balance, incl. Naftogaz and Pension Fund, % of GDP	-4.3	-6.0	-6.5	-11.7	-8.0
Public Debt, External and Domestic, % of GDP	36.3	36.7	39.9	70.3	94.0
Consumer Inflation, eop, % yoy	4.6	-0.2	0.5	24.9	45.0
Hryvnia Exchange Rate per USD, eop	8.0	8.0	8.2	15.8	25.0
Current Account Balance, % of GDP	-6.3	-8.2	-9.2	-4.1	0.0
FDI ($ billion)	7.0	6.6	3.3	0.2	0.5
International Reserves ($ billion)	31.8	24.5	20.4	7.5	13.0
Total Public and Private External Debt ($ billion)	126.2	134.6	142.1	125.9	138.0

Political and Reform Developments

With very few exceptions, the ceasefire in Eastern Ukraine, which was agreed upon on August 24th, has been holding for several weeks. Pro-Russian rebels have also declared their intention to cancel their own local elections planned for October. This ceasefire gives Ukraine extra time to provide new army recruits with necessary training supported by NATO instructors. NATO also provides Ukraine with a significant support in other areas, including management and communications. In September, NATO's Secretary General Jens Stoltenberg visited Ukraine, undertook a number of field visits and participated in a meeting of the Ukrainian National Security and Defense Council. In this meeting, three documents were signed: (i) the diplomatic status of NATO's representation in Ukraine, (ii) NATO's support of Ukraine in communications, and (iii) strengthening of NATO-Ukraine technical cooperation. After this visit, President Poroshenko signed a New Military Doctrine of Ukraine. The new Doctrine clearly identifies Russia as an aggressor. This message was reconfirmed by the President of Ukraine within the framework of the UN General Assembly at the end of September.

With the support of civil society, international institutions and donor-countries, Ukraine has accelerated the implementation of its reform agenda. The main efforts were concentrated on fighting corruption, simplification of doing business in the country, and EU integration. However, the pace of structural reforms is still below the expectations of Ukrainians and international observers. The reforms, particularly on corruption, are considered insufficient to weaken the influence of vested interests that wish to maintain the status quo.

Significant progress has been made in fighting corruption, though more efforts are still necessary. A large number of corruption cases by government officials are examined almost every week. In September, several corruption cases were documented and videotaped by the Ukrainian security service, including the head of the State Employment Service, several cities' prosecutors, top military officials, members of parliament, etc. There were several cases involving Ukrainian government officials, including the head of the State Fiscal Service, who did not report their multimillion real estate property overseas. However, the most recent statement of the

U.S. Ambassador to Ukraine Geoffrey R. Pyatt makes clear that the speed of the process is still slow and is being blocked by the General Prosecutor's office. One of the key factors to overcome corruption is still pending – openness and transparency in all public services. To assist in this area, USAID has initiated a $1.3 million project. The latest estimates by some government officials, including the governor of Odessa Oblast Mikheil Saakashvili, shows that the annual cost of corruption in the country might be as high as $5 billion, which is translated into around 6% of the country's GDP.

To simplify business regulation, the Ukrainian government introduced new simplified and streamlined procedures for the clearance of vessels and cargo in ports. There was a significant reduction in the number of inspections of vessels and cargo. Regular inspection on board vessels was cancelled and will be carried out only if there is a documented reason. Cargo operations in ports will be held without delay.

To increase the level of transparency in all public procurement, the Finance Ministry and the Ministry of Economic Development and Trade introduced public reporting of the State Treasury Service. The new system should provide citizens with access to information on the quantity of paid taxes and expenditures of state and local budgets. In a statement released by the Presidential Administration, thanks to amendments to the public procurements legislation, an annual savings of around $2 billion (i.e., equal to 2% of GDP) is forecast. However, the level of detailed information of all public procurements and expenditures is still insufficient and should be significantly improved.

Economic Growth

Updated data from the State Statistics Committee shows that GDP declined by 17.2% yoy in Q1 2015 and by 14.6% yoy in Q2 2015.

High-frequency monthly production data shows that the pace of output decline has ameliorated since May 2015, though from a low base. In fact, industrial production declined by -5.8% yoy in August, a lower decline compared to previous months: -13.4% yoy in July, -18.0% yoy in June and 21% yoy in May. The bulk of this yoy improvement is due to a low statistical base caused by the large 20% yoy output decline that took place in August 2014 when military hostilities resurged.

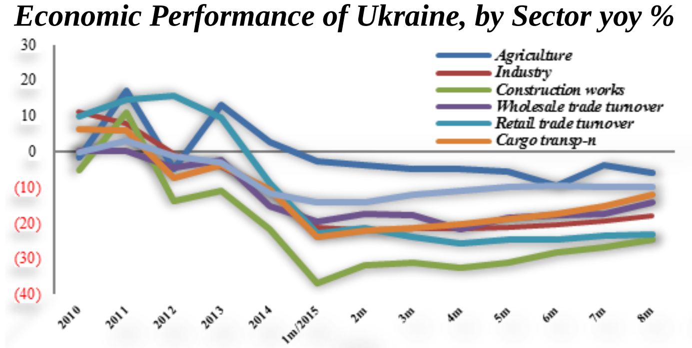
The August declines in industrial output were widespread affecting almost all subsectors, but with larger declines in consumer goods. Better year-on-year performances in August of the metallurgical and extracting industries (as well as in Luhansk and Donetsk) were due principally to the collapse of these industries in August 2014, due to the surge of military hostilities at that time.

Real Sector Indicators of Ukraine, % yoy

	2015 8m*	2014	2013	2012	2011	2010
Agriculture	-5.8	2.8	13.3	-4.5	17.5	-1.5
Industry	-18.0	-10.7	-4.3	-1.8	7.6	11.2
Construction works	-24.6	-21.7	-11.1	-14	11.1	-5.4
Domestic trade, turnover						
Wholesale trade	-14.1	-15	-2	-4.4	0.6	0.4
Retail trade	-23.1	-8.6	9.5	15.9	14.7	9.8
Transportation, turnover						
Cargo	-12.2	-10.8	-3.9	-7.6	5.7	6.4
Passenger	-9.8	-11.7	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service, the Bleyzer Foundation Excluding Crimea*

Economic Performance of Ukraine, by Sector yoy %



Other economic sectors showed mixed results in August 2015. The index of agricultural output for August declined by -11.1% yoy (-5.8 yoy in January-August), due principally to declines in agricultural output by

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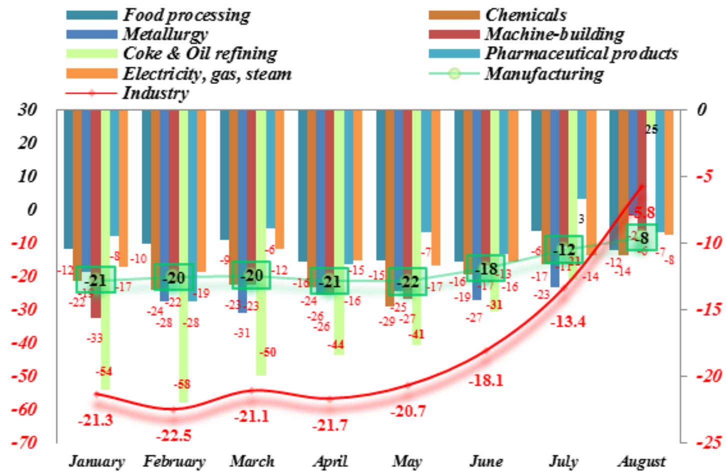
households, lower crop yields, a reduction of fields to be sowed with crops, lower cattle breeding in the East, and a high statistical base in 2014. The government now expects that the grain harvest will total 59 million tons in 2015, compared to 64 million tons in 2014.

The construction sector, however, showed some recovery, with residential construction increasing by 8.5% yoy. But non-residential construction declined by -25.7% yoy.

With a decline of -23.6% yoy during January-August, the retail turnover situation also worsened, principally in non-food products, due to declines in real wages, large increases in utility tariffs, and currency devaluation effects. In fact, real wages declined by -23.9% yoy during the first half of 2015. Similarly, transportation services continued to show declines, with cargo transportation falling by -12.2% yoy in January-August, and passenger transportation declining by -9.8% yoy during the period.

Industrial Production by Sectors, % yoy



Source: the Bleyzer Foundation

Nevertheless, despite the mixed economic performance in August 2015, given the deceleration in output declines during recent months, the economy is turning around, though at a slow pace. During the second half of 2015, GDP is expected to decline at a slower pace than in the first half of the year, with GDP for the entire year 2015 expected to fall by about 11%.

The medium term outlook for Ukraine's economy will depend on a number of factors including, first, the continuation of international financial support by the EU, the US, and international agencies, particularly the IMF; second, the cessation of military hostilities in the East of Ukraine; and third, the pace of economic reforms to improve Ukraine's business environment. Ukraine has already made significant progress in macro-economic stabilization and is accelerating the pace of reforms as noted earlier. With favorable developments in these areas, GDP is expected to have a growth rate of 1% to 2% in 2016, increasing to about 4% pa by 2018. Depending on the success of the FTA with the EU and with major improvements in the business environment, Ukraine's GDP growth could increase to around 6%-8% pa by 2020.

Fiscal Policy

As expected, in July 2015, local fiscal budgets were executed with surpluses, which more than offset the deficit of the state fiscal budget. According to data of the Ministry of Finance, the overall surplus of the local budgets was about UAH 3.3 billion in July. This surplus compensated for a UAH 158.5 million deficit of the state budget and expanded the total consolidated fiscal surplus from the beginning of the year to UAH 15.4 billion. This consolidated budget surplus is continuing to grow, as most of the trends in both revenues and expenditures remained favorable. In particular, inflation and national currency depreciation were still the major drivers of growth in revenues. In fact, VAT on domestic goods in January-July increased by 21.6% yoy (only slightly less than the growth of 23.3% experienced in January-June.) The growth of excise taxes on domestic goods also accelerated. A similar situation was also observed with the receipts of the VAT and excise taxes on imported goods.

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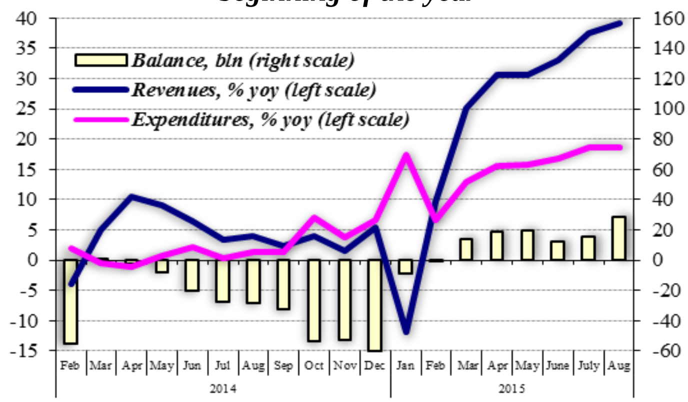
Overall, despite some deceleration in the growth of receipts for some major tax and nontax state revenues, total consolidated budget revenues continued to grow at an accelerated rate in January-July (37.5% yoy).

As for consolidated budget expenditures, their growth at 18.7% yoy was caused principally by the increase in spending on public debt service (by 90% yoy to UAH 48.9 billion), on public order and security (by 22.1% to UAH 25.2 billion), and by defense expenditures (by 150% yoy to UAH 24.4 billion).

The fiscal budget results for August 2015 are not yet available. But preliminary data of the NBU shows that growth of state revenues accelerated by 1.9 percentage points to 46.5% yoy in January-August, while growth of state expenditures decelerated by 0.8 percentage points to 24.7% yoy for the period. Therefore, the balance of the state budget turned positive and reached UAH 7.7 billon. At the local level, local budgets were also executed with surpluses in August. But these surpluses were lower than in previous months because expenditures grew faster than revenues. Overall, consolidated budget revenues grew by 39.2% yoy to UAH 411.7 billion in January-August, which is 1.8 percentage points higher than in January-July. At the same time, consolidated budget expenditures expanded by 18.6% yoy to UAH 382.8 billion during the reporting period. As a result, the consolidated fiscal budget surplus reached UAH 28.3 billion, the highest observed this year.

Dynamics of consolidated budget components from the beginning of the year



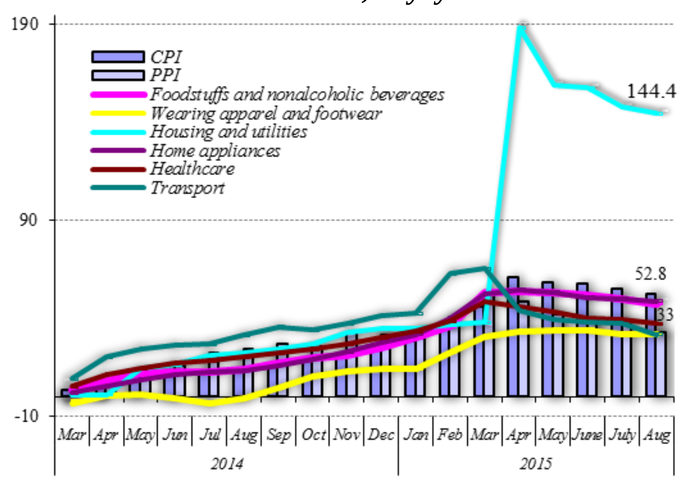
Source: The Ministry of Finance of Ukraine, the Bleyzer Foundation

Monetary Policy

Inflation. As noted in previous reports, inflation in 2015 peaked in April 2015 at 61% yoy, due principally to the one-off effect of the currency depreciation. Most of the deflationary trends observed since then continued in August, when the CPI reached 52.8% yoy. The overall price index posted a 0.8% mom decline in August, which is slightly below the 1.0% mom decline a month ago.

Both food prices and prices of apparel and footwear caused this small deceleration in price growth. Prices of foods and non-alcoholic beverages saw a 1.7% mom decline in August compared to the 2.0% mom decline in July. Deceleration in the monthly decline of prices for apparel and footwear was more significant (from 4.7% in July to 1.2% in August). The rest of the price indexes saw little or no monthly changes. Despite a slower monthly decline in consumer prices, the deceleration in inflation continued in year-over-year terms in August. The all items price index was equal to 52.8% yoy. This is a 2.5 percentage point deceleration yoy compared to a 2.2 percentage point deceleration in July. Deceleration was observed in all the major price indexes except for the communications price index and the education price index, which remained unchanged. Growth of transportation

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



Source: State Statistical Service of Ukraine, the Bleyzer Foundation prices decelerated most (from 37.3% yoy to 31.8% yoy). Inflation slowed by more than 2% yoy also in the foodstuffs sector (by 2.4 percentage points to 47.5% yoy) and in housing and utilities tariffs (by 3.4% yoy to 144.4% yoy.)

Taking into consideration these dynamics of prices, the NBU decided to continue the monetary policy softening initiated in August. The policy interest rate was lowered from 27% to 22% starting on September 25th. According to the statement published on the official site of the NBU, the joint actions of the NBU and the government ensured monthly deflation for two consecutive months, while core inflation remained close to zero. Furthermore, the NBU stated that factors promoting further disinflation will prevail both inside the country and abroad in the nearest future. In particular, monetary policy is balanced, prices of primary goods are low on world markets, and there is further softening of inflationary expectations. The latter will be supported by the sovereign debt restructuring recently agreed upon with major creditors and the continued cooperation with the IMF and other international partners. At the same time, NBU analysts believe that the planned increase of administrative prices and tariffs, as well as the long-term increase of wages and social benefits initiated by the government, will have no significant influence on inflation, which will continue decelerating. We expect that inflation will decelerate to 45% by the end of the year.

Banking Sector

Banking deposits in national currency remained almost unchanged in August. A 0.8% mom increase in deposits of legal entities fully compensated for a 0.7% decline in deposits of private persons. Overall, from the beginning of the year, national currency banking deposits lost 2.6% as the 7.3% increase in deposits of legal entities was not enough to overcome an 11.3% decline in private persons' deposits. As for foreign currency deposits, they continued to decline in dollar equivalent. However, unlike in the case of national currency deposits, legal entities were responsible for most of the negative developments. Foreign deposits of legal entities saw a 4.2% mom decline in August, while deposits of private persons decreased by 0.9% mom. From the beginning of the year, however, deposits of legal entities saw slower decline (-23.4% versus -26.2% for private persons' deposits).

Bank loans in national currency saw a 1.1% mom increase in August on the back of a 1.4% mom increase in loans of legal entities. Loans of private persons remained almost unchanged. The monthly increase in loans slightly slowed their decline from the beginning of the year to 9.7%. At the same time, foreign currency loans decreased by 0.9% mom due to similar declines in both corporate and household loans (1.0% mom and 0.8% mom respectively). From the beginning of the year, total foreign currency loans declined by 14.7%. The NBU hopes that the above-mentioned softening of monetary policy will stimulate crediting in the economy, but this is unlikely to happen as interest rates on loans remain too high for many companies.

In September the banking system continued clearing out its problem banks. In particular, three banks were declared insolvent, while other four banks initiated liquidation procedures. Among those declared insolvent was Finance and Credit Bank, which was ranked 10th in total assets among 127 operating banks as of July 1st. In addition, thanks to amendments in legislation, the NBU also liquidated two Crimean banks, which had lost their banking licenses in May 2014. The total funds provided to support the liquidity of banks was equal to UAH 310 million. UAH 240 million were provided in overnight loans to one bank, while the rest of the financing was provided in the form of liquidity loan to another bank for terms from 90 to 360 days. From December 1st, liquidity loans will be provided for a term of up to 90 days. According to the NBU, the shortening of liquidity loan terms is a necessary condition for transferring to an inflation-targeting regimen, which is supposed to be completed by the end of 2016. In addition to shortening of the liquidity loan maturity, the NBU also optimized liquidity management instruments. In particular, the regulator allowed banks to place more than one bid during auctions of deposit certificates and of refinancing loans. Furthermore, the National Bank shortened the list of financial instruments that can be used as mortgage on refinancing loans. Changes were introduced also in other procedures related to mortgages. Among those are the introduction of a partial release of security (previously only partial repayment was allowed but mortgaged security was releases only after full repayment of loans), basing mortgage valuation on the fair market

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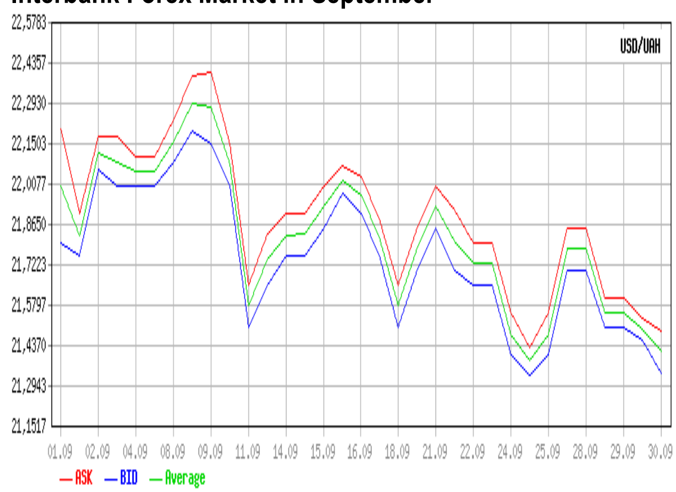
value, and lifting of the requirement of signing separate agreements for each loan received on specialized auctions (from now on only a single general agreement between a bank and the NBU is required).

Hryvnia Exchange Rate. The UAH/USD exchange rate fluctuated within an appreciation band in September, reaching 21.5 UAH/USD by September 30. Most of the FX rate fluctuations were caused by currency demand/supply forces. But this UAH appreciation was not enough to allow the NBU to buy FX to build up its international reserves. As a result, the NBU is behind the schedule for building up its international reserves. The NBU was relying on requests to players of the interbank forex market to cut their demand for foreign exchange. But these cut requests were ineffective. Therefore, in September the NBU returned to the practice of foreign exchange auctions, which will guarantee regular inflows of dollar into international reserves. In order to ensure the exchange rate's relative stability, the NBU decided that the amount purchased during the auction should not exceed USD 10 million but this threshold was increased twofold later on. Furthermore, bids of banks are being satisfied from that one with the lowest price and upwards until the NBU purchases the planned amount for the day, which is not disclosed. Participants of the auction are allowed to submit several bids at different prices. Taking into account the fact that under current regulations banks have to close their foreign currency positions the same day, the mentioned rules mean that those banks whose bids are not satisfied have to sell the amounts they bid in the interbank forex market the same day. This increases dollar supply in the market and support the Hryvnia exchange rate.

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



Source: Ukrdealing, The Bleyzer Foundation

Due to the relative stability of the exchange rate, the NBU decided to further soften administrative restrictions introduced in the foreign exchange market. In particular, the regulator increased the volume of foreign currency cash to be provided to banks' clients from UAH 15,000 equivalent to UAH 20,000 equivalent per day in order to restore population's trust to the banking system. Furthermore, the National Bank lifted the restriction banning purchases of foreign currency by banks' clients having more than USD 10,000 at their accounts. Clients of banks are now allowed to discharge export operations in case they provide the documents proving termination of obligations through counter claims in foreign currencies, which are not subject to obligatory sale. The volume of the mentioned claims is not allowed to exceed USD 0.5 million under one contract. Funds received as foreign currency revenues abroad and returned by an exporter within two days on a request of a foreign bank are not subject to obligatory sale in the interbank forex market anymore. In addition, the regulator lifted a requirement concerning the obligatory provision of a document stating that a client has no arrears on taxes and duties within the package of documents for foreign exchange purchases. Finally, the National Bank lifted the ban on registering changes to agreements on loans by residents from non-residents in foreign currencies in case those changes foresee substitution of a borrower, if a substitution is related to liquidation and/or merge.

On the other hand, the NBU also introduced one new restriction in the foreign exchange market. In particular, the regulator introduced a ban on foreign exchange purchases for the purposes of payments on imports of goods and services whose custom clearance took place before January 1st, 2014. The mentioned ban does not cover deals involving vital products. Nevertheless, the regulator plans to continue foreign exchange market liberalization. According to the NBU Governor, all the administrative restrictions in the foreign market will be lifted by mid-2016.

Given the likely FX needs to serve foreign debt and import energy in the rest of the year, we expect that the UAH/USD exchange rate will depreciate gradually to the level of 25 UAH/USD by December 2015.

International Trade and Capital

In August 2015, the current account of the balance of payments continued to show a surplus, though it was lower than in July. The August current account surplus amounted to USD 60 million. The NBU re-estimated the January-August current account deficit at USD 133 million.

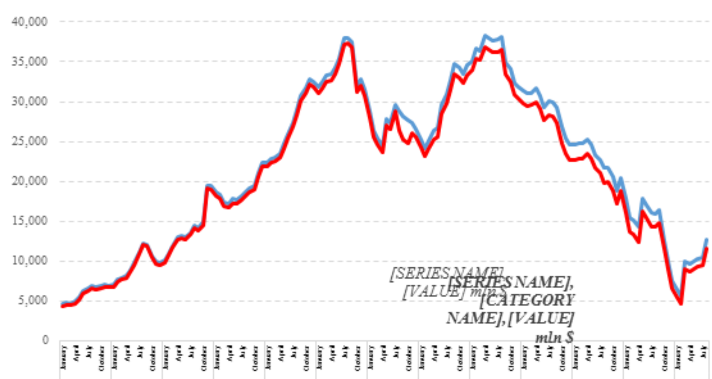
In the month of August, exports of goods amounted to USD 2891 million, a decline of 1.0% over July exports. With a contrary trend, imports of goods in August increased by 2.0% over July, reaching USD 3120. Therefore, the balance of goods showed a deficit of USD 229 million in August. But this goods deficit was overcompensated by the balance of services, which remained positive at USD 160 million in August. Also, net transfers from abroad reached USD 167 million in August.

The major decline in goods exports in August took place in mineral products (-51.9% yoy), metallurgy (-36.0% yoy), and chemicals (-34.5% yoy). These declines were somewhat compensated for principally by increases in agricultural products, which reached USD 1,213 million in August or 42% of total goods exports.

From a geographic perspective, in January-August 2015 exports of goods to the Russian Federation declined by -58.8% yoy and represented only 11.8% of total Ukrainian exports (compared to 30% in 2012). Exports to Europe declined by -34.8% yoy during the January-August period and represented 28.7% of total Ukrainian exports. Exports to the US remained at a negligible 1.3% of the total. Although exports to Asia, principally China, declined by -18.2% yoy during January-August, its share of the total increased to 35.7%, becoming the most important export market for Ukraine.

Ukrainian imports of goods from Russia also declined significantly by 49.4% yoy in January-August. Russia now supplies 19.3% of Ukrainian import needs, principally in energy products. Europe has become the most important supplier of goods to Ukraine, with 37.7% of total imports.

Ukraine International Reserves in August 2015, mln $



Source: the NBU, the Bleyzer Foundation

Regarding the financial account of the balance of payments, in August 2015 it showed a surplus of USD 444 million, following a surplus of USD 317 million in July. These surpluses were the result of net foreign direct investments of USD 642 million, almost wholly to the banking sector to comply with NBU capital requirements. These FDI inflows were offset in part by net debt repayments of USD 232 million, also by banks. Portfolio flows were negligible.

Improved current and financial account balances allowed the NBU to accumulate gross international reserves of USD 2163 million in August, which led to international reserves of USD 12.6 billion as of the end of August.

As noted earlier, on August 27th, Ukraine and its principal Eurobond creditors (holding about USD 9 billion of public external bonds) reached an agreement regarding Ukraine's external debt restructuring. The main elements of the restructuring agreement are: (i) an immediate 20% face value write-down on about USD 18 billion of its foreign public debt; (ii) this write off of around USD 3.6 billion could be offset by securities that will pay holders a percentage of Ukraine's economic growth from 2021 if GDP growth were to exceed 3% pa; (iii) the interest rate on the new securities will be 7.75%, or 0.5 percentage higher than the old securities; (iv) the new securities will have a four-year grace period, with principal payments repaid in eight equal amounts each year from 2019 to 2027.

The deal still needs to be approved by about half of the remaining bondholders to meet the criteria that the deal must be approved by holders of more than 75% of the bonds. The likelihood of this happening was enhanced by the recent decision of the government to change the terms of the exchange for about 25% of the bonds of short maturity. The government will exchange a $500 million bond maturing on September 30th, 2015 and a $660 million euro-denominated note due in October 13th into a new security that will mature in 2019. This offer should meet the requirements of half of the remaining bondholders who are now likely to approve the deal. The bondholders will be voting on the deal on October 15th.

The issue regarding the USD 3 billion bond held by Russia is still outstanding. The Russian Ministry of Finance has reconfirmed that Russia would not participate in the bond restructuring and is prepared to go to litigation if not paid by December 2015.