

October 2013

Olga Pogarska, Edilberto L. Segura

- At the end of October, Ukrainian officials made several key decisions, which increase the chances of Ukraine to resume cooperation with the IMF.
- The Ukrainian economy showed signs of gradual recovery in July-August 2013 with agriculture and private consumption being the principal drivers of recovery.
- Ukraine is expected to collect a record high grain harvest in 2013.
- Intensified trade tensions with Russia since the end of July 2013 restrained the pace of recovery, hitting Ukraine's exports and export-dependent industries and sectors.
- Industrial production reported a 5.4% yoy decline in output.
- There is a good chance Ukraine will sign the free trade and cooperation agreement with the EU in November 2013. Ukraine is expected to benefit from the agreement in the medium-term, but may face short-term difficulties due to Russia's possible imposition of trade restrictions.
- With the state budget deficit twice as high as in January-August 2012 and delays in fiscal adjustment measures, Ukraine's fiscal position continued to raise concerns.
- Although Ukraine's public sector debt-to-GDP ratio compares favorably with other countries, the relatively short maturity of government debt obligations adds to short-term fiscal and foreign liquidity pressures.
- Ukraine continued to report deflation in July-August 2013.
- The National Bank of Ukraine lowered its discount rate by 50 basis points to 6.5% pa in mid-August. This move, the second in less than three months, is aimed at stimulating economic growth through bank lending activity.
- Due to high external financing needs, Ukraine's gross international reserves fell to \$21.7 billion at the end of August 2013, which is less than three months of imports.
- Ukrainian authorities confirmed their willingness to resume cooperation with the IMF, but want to avoid a painful increase in natural gas prices to population, which makes negotiations tough.

### Executive Summary

At the end of October, key Ukrainian officials made several principal decisions, which may facilitate negotiations on a new IMF loan. First, it was agreed to raise natural gas tariffs by 60% for households who consume more than 3.5 thousand m<sup>3</sup> of natural gas per year. Second, the government will develop a program to stabilize public finances (the program may include a delay in profit tax rate cut, a revision of tax privileges for business and social benefits for population, a reduction of expenditures on public administration, etc). This would allow reducing public sector deficit to around 4% of GDP in 2014. Third, Hryvnia will be allowed fluctuating up to UAH 8.5 per US Dollar. With the IMF program in place, Ukraine's external liquidity and fiscal challenges will be reduced, bringing the country onto a more sustainable path of growth.

Following four quarters of negative growth, real GDP may pick up in the third quarter of 2013 thanks to a significant grain crop and continuing gains in private consumption. Indeed, agricultural output rose by 13.3% yoy in January-August 2013 as Ukraine is forecast to collect a record high grain harvest this year. In addition, the sector's strong performance is supported by steady improvements in animal breeding and poultry. Real wage growth remained robust (up by 9.3% yoy over the first eight months of the year), supporting personal consumption expenditures. As a result, retail sales rose by 10.2% yoy over the period.

Modest but strengthening recovery of the global economy and low steel stock helped world steel prices begin recovering in July. However, the positive impact of these developments was outweighed by worsened trade relations with Russia. Imposition of trade restrictions had a notable impact on Ukraine's

machine building, metallurgy, manufacturing of food products, chemicals and plastics as well as performance of wholesale trade and cargo transportation. As a result, industrial production continued to decline, with output down by 5.4% yoy in August. As trade tensions with Russia have softened somewhat since late-August, Ukraine is forecast to continue recovery in 4Q 2013, although at a slow pace. Real GDP is projected to increase by 0.3% yoy in 2013.

Next year, the country is forecast to benefit from a stronger recovery of the world economy, particularly in the EU, Ukraine's largest trading partner. Moreover, there is now a good chance that Ukraine will sign the free trade and cooperation agreement with the EU in November 2013. In the short-term, the elimination of tariffs and other quantitative restrictions is likely to bring only modest economic benefits for Ukraine. Over the medium-term, the agreement is forecast to facilitate both exports and investment activity in the country. Although there is a risk of short-term losses due to imposition of trade restrictions by Russia, which highly opposes the agreement, we believe they will be softened by the EU's compensatory measures. Helped also by a favorable statistical base effect, real GDP growth is forecast to accelerate to 2% yoy in 2014.

Weak economic growth, plentiful agricultural harvest, a virtually stable exchange rate and government reluctance to raise utility tariffs were the main reasons for continuing deflation in July-August 2013. Given price developments over the first eight months of the year and government efforts to avoid an increase in utility tariffs to the population, inflation is now forecast at around 1% yoy at the end of the year. Low inflation amid sluggish economic growth urged the Ukrainian monetary authorities to ease monetary policy. In mid-August 2013,

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the NBU reduced its discount rate by 50 basis points to 6.5% pa for the second time in less than three months. Improvements in banks' funding conditions have already started to gradually impact economic activity through revival of credit growth. The stock of commercial banks loans grew by almost 6% yoy as of August 2013.

Due to budget revenue shortfalls and delays in fiscal consolidation measures, Ukraine's fiscal position continued to raise concerns. The state budget deficit reached UAH 34.8 billion (\$4.4 billion) for January-August 2013, twice as high as in the corresponding period last year. As a result, the general public sector deficit may reach 6% of GDP. Although the public sector is not excessively indebted with total public debt standing at less than 37% of projected full-year GDP, a high fiscal deficit and relatively short maturity of government debt obligations add to short-term fiscal and foreign liquidity pressures.

Ukraine's export performance remained weak in July-August 2013 as benefits from the gradual strengthening of global growth and high agricultural harvest were offset by increased trade tensions with Russia. Moreover, robust domestic consumption led to only a moderate reduction in imports, despite government measures to cut the volume of energy imports. As a result, the current account deficit is forecast to narrow only slightly, to about 7.5% of GDP in 2013. In addition, Ukraine has significant short-term external debt obligations. Total external debt repayments due within one year amounted to over \$60 billion as of June, according to NBU data. As foreign investors grew increasingly risk averse towards emerging markets during summer, Ukraine's high external financing needs led to a reduction in gross international reserves to \$21.7 billion as of August. The current level of international reserves is below 3 months of imports, which increases the country's vulnerability to external shocks.

	2009	2010	2011	2012	2013f	2014f
GDP growth, % yoy	-14.8	4.1	5.2	0.2	0.3	2.0
GDP per capita, \$	2545	2974	3575	3864	4106	4389
Industrial production, % yoy	-21.9	11.2	7.6	-1.8	-3.0	2.0
Retail sales, % yoy	-17.4	9.8	14.8	15.9	—	—
Budget deficit, % GDP*	-8.5	-6.7	-4.3	-5.6	-6.0	-4.0
Government external debt, % GDP	20.5	23.8	20.4	18.3	16.5	17.0
Inflation, eop	12.3	9.1	4.6	-0.2	1.0	7.0
Gross international reserves, \$ billion	26.5	34.5	31.8	24.5	19.0	22.0
Current account balance, % GDP	-1.5	-1.9	-5.5	-8.4	-7.5	-7.8
Gross external debt, % GDP	88.2	86.0	77.2	76.6	72.0	71.0

\* Including Naftogaz and Pension fund deficits (not including bank recapitalization expenditures and VAT refund bonds in 2009 and 2010 respectively).  
 Source: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2013 Budget Law, The Bleyzer Foundation

### Economic Growth

Following four quarters of negative growth, real GDP may pick up in the third quarter of 2013 thanks to a significant grain crop and continuing gains in private consumption. Indeed, agricultural output rose by 13.3% yoy in January-August 2013, as Ukraine is forecast to collect a record high grain harvest this year. As of the beginning of September, Ukraine had harvested almost 33 million tons of grains, which was 27% higher than in the corresponding period last year. Thanks to favorable weather conditions and improved technology, the average yield reached 30.8 centners per ha. As only 65% of the crop area was harvested, Ukraine's grain output may reach a record high of about 58 million tons in 2013. This will be the third year of record high harvest over the last six years. In addition, abundant crops over the last few years drove fodder prices down, favoring animal breeding and poultry farming. As a result, output production in this sub-sector was up by 4.8% yoy for January-August 2013.

Real wage growth remained robust (up by 9.3% yoy over the first eight months of the year), sustaining personal consumption expenditures. As a result, retail sales rose by 10.2% yoy over the period. A gradual revival of banks' credit growth support-

### Real Sector Performance of Ukraine, % yoy

	2013				2012	2011	2010
	8m	7m	6m	5m			
Agriculture	13.3	14.8	15.4	5.1	-4.5	17.5	-1.5
Industry	-5.2	-5.3	-5.3	-5.2	-1.8	7.6	11.2
Construction works	-15.1	-15.7*	-17.8*	-17.3*	-14.0	11.1	-5.4
Domestic trade, turnover							
Wholesale trade	-4.7	-3.3	-6.0	-5.8	-4.4	0.6	0.4
Retail trade	10.2	10.6	11.2	11.6	15.9	14.7	9.8
Transportation, turnover							
Cargo	-7.1	-8.8	-10.1	-11.4	-7.6	5.7	6.4
Passenger	-3.3	-2.9	-4.2	-3.5	-1.2	3.3	-0.2
Communication services	-1.7	-1.2	-0.5	0.5	1.1	3.1	
Other Services, non-financial	-1.8	-1.9	-2.2	-1.6	0.8	18.6	2.9

\* Revised data  
 Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

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ed the construction sector. Output decline in the sector moderated to 15.1% yoy over January-August compared to 17.8% yoy in 1H 2013. The continuing rebuild of iron ore inventories in China underpinned growth in Ukraine's mining sector, where output production was up by 1.1% yoy in August.

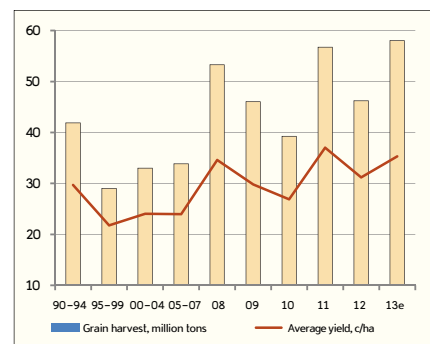
A modest recovery of the global economy, gradual revival of construction activity in China and the US in particular, and low steel stocks helped world steel prices begin recovery in July. As a result, Ukraine's metallurgy resumed growth in July, expanding by 1.6% yoy. However, as Russia canceled import quotas on Ukraine's pipes for 2H 2013 and foreign demand for processed and finished metal products remained subdued, the industry output fell by 2.4% yoy in August.

Further worsening of trade relations with Russia, however, had a notable impact on select export-dependent industries of Ukraine. Russia is Ukraine's main single country trading partner, accounting for about 1/4 of total exports of goods and services of Ukraine. Russia's imposition of trade restrictions and tightening of customs controls, which virtually stalled all Ukrainian exports to Russia for a couple of days in mid-August, were particularly painful for the machine-building industry and food processing industries, which reported a 14.5% yoy and an 8.5% yoy decline in output in August, respectively; production of rubber and plastics, and chemicals, whose output went down by 4.1% yoy and 25% yoy, respectively. Although worsened trade relations with Russia also hit Ukraine's wholesale and cargo transportation sectors, their impact was partially softened by higher grain exports and improvements in select industries. As a result, the sectors' performance was mixed with wholesale trade activity contracting further by 4.7% yoy, while cargo transportation improved slightly to -7.1% yoy over January-August 2013.

The Ukrainian economy is expected to continue recovering through the remainder of the year, although at a slow pace. The recovery will be in part thanks to good agricultural performance and solid private consumption growth, helped also by a favorable statistical base effect. However, trade tensions with Russia, although softened somewhat since late August, will continue to weigh on economic activity. As a result, real GDP is forecast to grow by about 0.3% yoy in 2013. Next year, the country is forecast to benefit from a stronger recovery of the world economy, particularly in the Euro area as there is a rather high chance that Ukraine will sign the FTA and cooperation agreement with the EU in November 2013. In the short-term, the elimination of tariffs and other quantitative restrictions is forecast to bring only modest economic benefits for Ukraine. Over the medium-term, however, the agreement will become an anchor for institutional development and economic reforms in Ukraine, which will bring improvement in the business climate. In addition, being in the supply chain for the large European market, Ukraine will attract large foreign direct investments. This should support both exports and investment activity in the country.

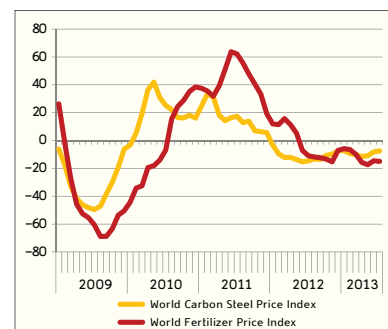
But these gains may be overshadowed by possible short-term losses due to imposition of strict trade restrictions by Russia, which highly opposes the agreement. Since Ukraine's import duties with the EU will be either removed or lowered compared to current duties between Russia and the EU, Russia is worried that its market will be flooded with European, Turkish and other goods through Ukrainian territory (so called re-exports) or lower quality Ukrainian goods, which would face tighter competition from EU products. These restrictions, if imposed, may have negative consequences for both Ukraine's fragile economic growth and its external liquidity position. Under the base-line scenario, however, we believe that, although Russia will apply some additional trade pressure on Ukraine, to a notable extent its impact will be softened by compensatory measures from the EU. As a result, real GDP growth is forecast at 2% yoy for 2014.

### Evolution of Grain Harvests in Ukraine



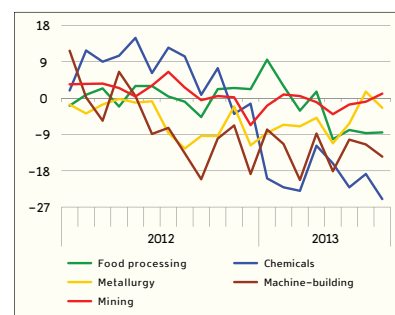
Source: State Statistics Service of Ukraine, The Bleyzer Foundation

### World Steel and Fertilizer Price Indices, % yoy



Source: MEPS, WB GEM Commodities database, The Bleyzer Foundation

### Industrial Production Index, select branches, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

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### Fiscal Policy

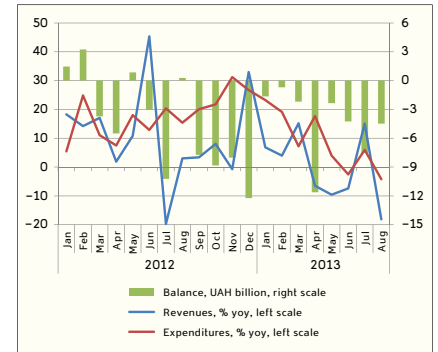
Ukraine's fiscal position continued to raise concerns. Due to budget revenue shortfalls and delays in fiscal consolidation measures, the state budget deficit reached UAH 34.8 billion (\$4.4 billion) for January-August 2013, twice as high as in the corresponding period last year. As a result, the general public sector deficit is now forecast to reach 6% of GDP. Although the public sector is not excessively indebted, with the total amount standing at UAH 546 billion (\$68 billion, or less than 37% of projected full-year GDP) as of the end of August, the high fiscal deficit adds to short-term fiscal pressures, which stem from a high level of maturing public debt.

Weaker than projected nominal GDP growth was the main reason for a 1.3% yoy decline in state budget revenues for the period. Considerable shortfalls in collections were reported for corporate profit tax (CPT) and value added tax (VAT), the two main sources of state budget revenues. Thus, receipts from VAT, which account for more than half of total state budget collections, fell by a nominal 2.5% yoy over January-August 2013. While retail sales remained buoyant over the period, a decline in VAT proceeds may be attributed to a decrease in wholesale commerce and lower imports. Corporate profit tax revenues, accounting for about 17% of total budget revenues, fell by 1.1% yoy as a result of declining profitability. According to the State Statistics Services of Ukraine, profits before taxation fell by a nominal 2.5% yoy in 1H 2013, while losses grew by more than 30% yoy over the period. Higher excise taxes and import duties, and the transfer of National Bank of Ukraine profits (the latter was up by almost 40% yoy over January-August 2013) only partly offset the shortfalls from VAT and CPT. Given that additional revenue-raising measures would be challenging to implement amid an already burdensome tax system in Ukraine, the reduction in fiscal pressures could have been achieved by expenditure adjusting measures.

Nevertheless, state budget expenditures rose by a nominal 7.7% yoy over January-August. Indeed, social benefits and age-related spending expanded by a nominal 20.4% yoy, while debt service expenditures were 9.5% yoy higher over the period. At the same time, the government seems to have been containing non-social and debt-related expenditures. Thus, transfers to local budgets and expenditures on public administration rose by only 3.4% yoy and 4.8% yoy respectively, while spending on economic activity and defense fell by 12.2% yoy and 4% yoy. However, as these expenditure savings were not legislatively approved, the government looks reluctant to revise the 2013 state budget law and is going to use Treasury notes to restructure budget accounts payables, the pace of expenditure growth is likely to pick up at the end of the year. Although some of the government programs may remain under-executed, faster growth in expenditures will lead to deeper fiscal deficits than initially expected.

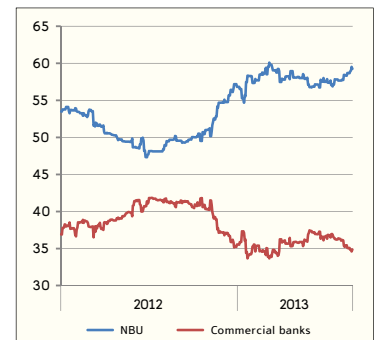
As foreign investors grew increasingly risk averse towards emerging markets during the summer, the Ukrainian government relied on domestic borrowings to finance the budget deficit over June-August. At the same time, demand for domestic government bonds was weak, despite improved banking sector liquidity and low inflation. As a result, the National Bank of Ukraine increased its purchases of domestic T-bonds, implicitly monetizing the budget deficit. Indeed, the amount of outstanding government bonds grew by 4.7% over June-August 2013, while the NBU holdings of domestic securities rose by 8.6% over the period. The share of bonds held by the National Bank of Ukraine increased from about 57% at the end of May to more than 59% at the end of August. The practice of the National Bank purchasing government securities has

### Monthly State Budget Execution, not seasonally adjusted



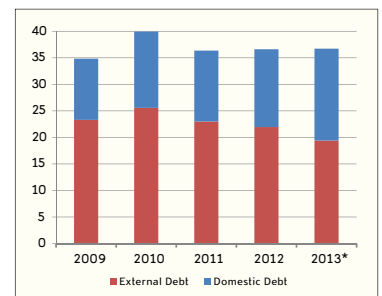
Source: Ministry of Finance, The Bleyzer Foundation

### Outstanding Amount of Domestic T-Bonds by Main Holders, 2012-end of August 2013, % of total



Source: NBU, The Bleyzer Foundation

### Ukraine's Public and Publicly Guaranteed Debt, % of GDP



\* as of end-August 2013  
Source: MinFin, The Bleyzer Foundation

<sup>1</sup>According to Ukrainian legislation, it is forbidden for the NBU to finance the state budget deficit. However, the National Bank of Ukraine implicitly monetizes the deficit through purchases of government T-bonds from commercial banks.

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its limits as it increases the monetary base and may trigger inflation. So far, the purchases of government securities have had little impact on inflation, to a notable extent due to an economic downturn. However, as soon as the economy starts recovering, the government will have to implement fiscal consolidation to avoid inflation overhang.

Despite high fiscal deficits, Ukraine's public-debt-to-GDP ratio seems stable at about 37% of GDP. This was achieved mainly on account of large repayments on external public debt. Over the first eight months of 2013, the government and the National Bank of Ukraine redeemed around \$4 billion to the IMF and \$1 billion of sovereign Eurobonds. As a result, there has been a visible shift towards the lesser share of public external debt (debt owed to non-residents), which fell from around 25.5% of GDP in 2010 to about 19.5% of projected full-year GDP at the end of August 2013. Despite this favorable trend and the fact that Ukraine's current debt level to GDP compares favorably with many developed countries and emerging markets, the debt structure makes the country vulnerable to adverse developments in international financial market conditions. Indeed, Ukraine has a large portion of its debt in foreign currency and at short maturities. The country has to repay about \$1.6 billion to the IMF in 4Q 2013 and an additional \$3.5 billion in 2014, while total repayments of public and publicly guaranteed debt are estimated at around \$7 billion in 2014 (including maturing domestic market foreign-currency bonds, sovereign Eurobonds and quasi-government (Naftogaz) Eurobonds). High external debt repayments put pressure on both the fiscal balance and local currency.

High external financing needs amid the ongoing capital outflow from emerging markets are urging the Ukrainian authorities to intensify negotiations on a new loan agreement with the IMF. Although the progress in the negotiations was modest so far due to the Ukrainian government's reluctance to raise natural gas to the population, the cooperation may be resumed at the end of 2013/the beginning of 2014. At the end of October, key Ukrainian officials made several principal decisions, which may facilitate negotiations on a new IMF loan. First, it was agreed to raise natural gas tariffs by 60% for households who consumer more than 3.5 thousand m3 of natural gas per year. Second, the government will develop a program to stabilize public finances (the program may include a delay in profit tax rate cut, a revision of tax privileges for business and social benefits for population, a reduction of expenditures on public administration, etc). This would allow reducing public sector deficit to around 4% of GDP in 2014. Third, Hryvnia will be allowed fluctuating up to UAH 8.5 per US Dollar. With the IMF program in place, Ukraine's external liquidity and fiscal challenges will be reduced, bringing the country onto a more sustainable path of growth.

### Monetary Policy

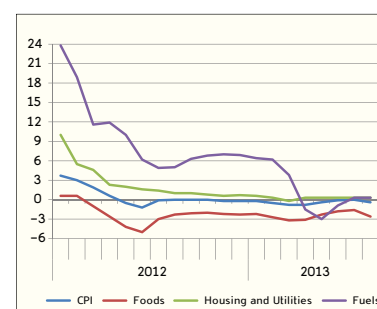
Ukraine continued to report deflation in July-August 2013. Moreover, deflation deepened to 0.4% yoy in August after close to zero inflation in the previous month. Weak economic growth, a plentiful agricultural harvest, a virtually stable exchange rate, and the government's reluctance to raise utility tariffs were the principal reasons for price deflation. Indeed, food prices, the weightiest component in the consumer basket, fell by 1.8% yoy and 2.8% yoy in July and August respectively, reflecting high grain, fruit and vegetables harvests. An almost 1.5-year food deflation trend should be mainly attributed to steady gains in the agricultural sector (both grain production and animal breeding). Thus, prices for meat and meat products, vegetables, and sugar were 2.4% yoy, 15.2% yoy and 7.2% yoy lower in August 2013, respectively. Although the authorities allowed raising the costs of select administratively regulated services, such as railway and city transportation, education and health care, their impact was offset by a continuing de-

### Key External Debt Repayments in 2013-2014, \$ billion

	2013		2014
	Jan-Sep	4Q	
IMF	4.0	1.6	3.7
Sovereign Eurobonds	1.0		1.0
Foreign currency			
domestic bonds	1.4	0.5	0.8
Quasi-government			
bonds (Naftogaz)			1.6
<b>Total</b>	<b>6.4</b>	<b>2.1</b>	<b>7.1</b>
	8.5	8.5	7.1

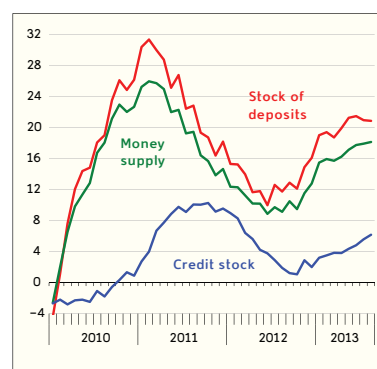
Source: IMF, MinFin, The Bleyzer Foundation

### Consumer Price Index by Select Components, % yoy



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

### Select Monetary Indicators, % yoy



Source: NBU, The Bleyzer Foundation

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crease in prices on clothing and footwear, household appliances and computer equipment. Moreover, due to unchanged natural gas, electricity and water tariffs, the increase in the cost of utility services was subdued at 0.3% yoy. Looking ahead, less benign weather conditions during August-September may interrupt the deflationary trend of food prices in the coming months. However, given the high grain harvest and the fact that the Ukrainian officials have been seeking ways to avoid an increase in utility tariffs to the population, inflation is forecast to remain subdued through the rest of the year. Taking into account price developments for the first eight months of the year, we have revised our 2013 end-year inflation forecast downwards to 1%.

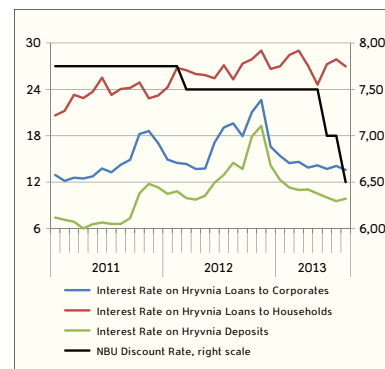
Low inflation amid sluggish economic growth led the Ukrainian monetary authorities to further ease monetary policy. In mid-August, for the second time in three months, the National Bank of Ukraine lowered its discount rate by 50 basis points to 6.5% pa. As the NBU discount rate is the base rate for other NBU interest rates, including refinancing transactions, the rate reduction will boost banking sector liquidity. While abundant liquidity may inspire commercial banks to soften their lending requirements and reduce lending rates for industry and consumers, monetary policy measures alone may not be sufficient to stimulate bank lending and to encourage private sector investment. To be effective, this move should be accompanied by more pronounced reform efforts to improve the business environment in the country. Otherwise, the change in the NBU discount rate will take a relatively long time to have its impact on the economy.

To a notable extent, the speed of the NBU rate cut transmission into the economy will depend on commercial banks' expectations and confidence about how the NBU will react to intensified Hryvnia depreciation pressures in autumn this year. At the end of 2012 and the beginning of 2013, the National Bank of Ukraine severely tightened banking sector liquidity to curb Hryvnia exchange rate fluctuations. This move went against the reduction in the NBU discount rate by 25 basis points earlier in 2012. A severe liquidity squeeze drove commercial banks' lending rates to as high as 23% pa for corporate enterprises and almost 30% pa for households at the end of 2012.

Since then, banking sector liquidity has notably improved, which was evident from high daily cash balances on commercial banks' correspondent accounts (almost UAH 1 billion higher on average during July-August than in the previous two months) and the low overnight rate on Hryvnia resources on the interbank money market. In addition to NBU measures to stimulate credit activity, the increase in commercial banks liquidity should be attributed to solid deposit inflow and NBU monetization of public debt. In particular, the stock of deposits at commercial banks rose by 21% yoy in July-August, while NBU purchases of domestic T-bonds made a significant contribution to a 13.6% yoy increase in the monetary base as of August 2013.

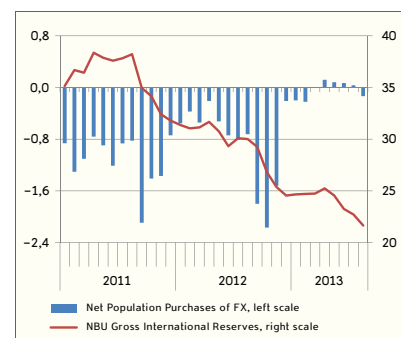
In the meantime, improvements in banks' funding conditions have already started to gradually drive economic activity through revival of credit growth. Interest rates on Hryvnia loans to corporate enterprises fell to around 14% pa on average over April-August 2013, while the stock of commercial banks loans grew by 5.8% yoy as of August 2013, up from around 2% yoy at the end of 2012. Looking at a breakdown by currency, the stock of commercial banks loans to corporate enterprises issued in foreign currency started to increase in July, for the first time in about 3.5 years. In August, it was 1% higher than in the corresponding period last year. It is worth noting that demand for foreign currency loans rose despite low domestic inflation and a virtually stable national currency. This signals that the cost of Hryvnia funds still remains high, outweighing foreign exchange risk. On a positive note, this may reflect both corporate enterprises and commercial banks' expectations that Hryvnia exchange rate pressures will be contained.

### Select Interest Rate Trends in Ukraine in 2012-2013



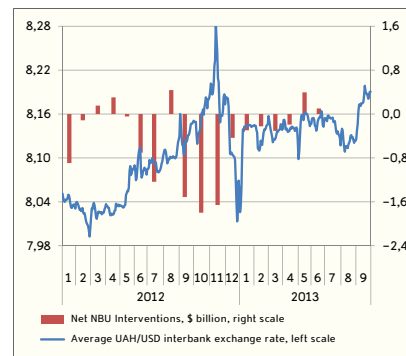
Source: NBU, The Bleyzer Foundation

### Population Demand for Foreign Currency, net purchases\*, and NBU Gross International Reserves, \$ billion



Negative number means that purchases of foreign currency exceeded sales of foreign exchange  
Source: NBU, The Bleyzer Foundation

### Inter-bank Foreign Currency Market in 2012-2013



Source: Finance.ua, NBU, The Bleyzer Foundation

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During the summer months, the foreign exchange market remained calm. Moreover, as the National Bank of Ukraine did not intervene on the market during July-August, the Hryvnia even appreciated slightly with respect to US Dollar amid seasonally lower demand for foreign exchange during the vacation period. As anticipated, however, Hryvnia exchange rate pressures intensified in mid-August amid high external debt repayments, a worsening foreign trade balance and increased business and population demand for foreign currency with the end of vacation season. In September, the National Bank of Ukraine resumed sale interventions on the forex market to maintain the Hryvnia. However, thanks to a \$750 million 2-year syndicated loan, the NBU likely avoided further reduction in gross international reserves in September following a \$1.1 billion drop in August to \$21.7 billion. The current level of international reserves is below 3 months of imports, which increases the country's vulnerability to external shocks. At the same time, the Ukrainian authorities confirmed their willingness to resume cooperation with the IMF, which would reduce this vulnerability. Until the deal is reached, Ukraine will muddle through thanks to the issuance of foreign currency domestic bonds and bilateral borrowing (e.g., from China). As a result, we maintain our 2013 end-year Hryvnia exchange rate forecast at UAH 8.3 per USD.

### International Trade and Capital

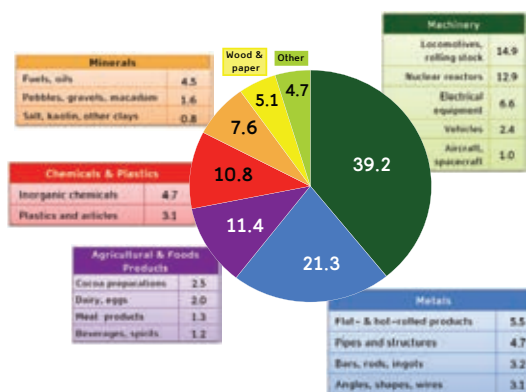
Ukraine's export performance remained weak in July-August 2013 as benefits from a gradual strengthening of global growth and high agricultural harvest were offset by increased trade tensions with Russia. Indeed, exports, which showed signs of improvement in July, reported a deeper decline in August, bringing the cumulative eight-month decrease to 8.6% yoy. As Ukraine's exports to Russia are dominated by machinery and equipment, metallurgical products, agricultural products and foods, chemicals and plastics, export performance of these commodity groups worsened in August compared to the previous month. In particular, export of metallurgical products declined by 14.8% yoy in August after a 7.6% yoy growth in July. Overseas trade with machinery and transport vehicles fell by 33.2% yoy in August, while export of chemicals and related products went down by 11.5% yoy. At the same time, high export of grains offset the impact of Russia's ban on Ukraine's confectionary. As a result, exports of agricultural and food products continued to increase and were 1% yoy higher in August.

On the import side, robust domestic consumption led to only a moderate reduction in imports, despite government measures to cut the volume of energy imports. In particular, import of foreign transport vehicles was almost twice as high as in August 2012, which may be attributed to higher car sales to the population prior to enforcement of the recycling fee since September 1st, 2013. Moreover, Ukraine increased purchases of natural gas in order to refill underground natural gas storage ahead of the new heating season. Though both commodity groups still reported declines in import values (by 3.8% yoy and 14.6% yoy respectively in August), their pace of decline notably slowed in July and further in August.

As a result, the current account deficit widened to about \$1.5 billion both in July and August, which is rather high for the summer months. At the same time, the cumulative eight-month deficit at \$8.2 billion was still 2.6% lower than a year ago. Moreover, as import growth of fossil fuels and machinery and equipment is likely to ease in the coming months, while exports should rebound following somewhat softened trade relations with Russia and thanks to high grain shipments abroad, we forecast Ukraine's current account deficit to narrow slightly to about 7.5% of GDP in 2013.

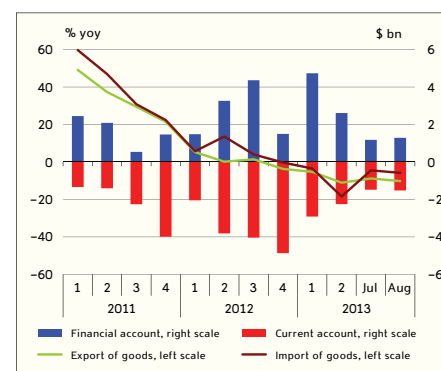
Despite some improvement in current account balance, Ukraine's external position remains fragile due to high foreign debt obligations. According to NBU data, total external debt repayments due within one year amounted to over \$60 billion as of June 2013. Even excluding trade credits, which account for around a third of total short-term debt repayments and are likely to be fully rolled

**Structure of Ukraine's Exports of Goods to Russia, 2012, % of total**



Source: UN Comtrade database, State Statistics Service of Ukraine, The Bleyzer Foundation

**Ukraine's Balance of Payments Performance, analytic presentation**



Source: NBU, The Bleyzer Foundation

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over, external financing needs still notably exceed the current level of international reserves. Amid turbulent international financial markets and existing vulnerabilities of the Ukrainian economy, which has already led to a downward reprising of Ukraine's sovereign debt and an increase in Ukrainian bond insurance cost (credit default swaps), Ukraine may face difficulties in securing sufficient external finances. A new loan from the IMF will not only reduce debt refinancing needs (particularly taking into account that \$3.6 billion of Ukraine's debt principal payments is due to IMF in 2014) but will also increase other foreign creditors' confidence in Ukraine. Although alternative sources of funds do exist, they may bear a higher interest rate as well as have political costs.

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