June 2015 *Oleg Ustenko, Djulia Segura, Valentyn Povroznyuk*
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Executive Summary

- ❖ Military action in the temporarily occupied territories of Donetsk and Lugansk regions remains at high levels. International observers, including the OSCE, confirmed the use of illegal heavy artillery by Donbas rebels, with separatist leaders reconfirming their plans to control more territories of Lugansk and Donetsk.
- ❖ To avoid possible future military deterioration, the Normandy Four Group met in Paris at the end of June and concluded that there is no military solution for the existing conflict. This signals that the conflict may be "frozen".
- ❖ Ukraine continues to move forward with its reform agenda. In particular, there was progress in ensuring the country's financial stability, accelerating anticorruption efforts and implementing energy sector reform. Both Ukrainian authorities and IMF executives confirmed their willingness to continue co-operation within the framework of the Extended Fund Facility program (EFF).
- ❖ Revised statistics show that during the first quarter of 2015, GDP declined by 17.2% yoy, with deeper declines in private investments (-25.1% yoy), and private consumption (-20.7% yoy). On the supply side, major GDP declines took place in the east of the country and in the following sectors: construction, mining, manufacturing, and wholesale and retail trade.
- ❖ High-frequency monthly output data reveals some improvement in many sectors during May 2015, both on a month-to-month basis and year-to-year. This may signal that output may be stabilizing in many sectors, although at a low level. These output improvements took place in mining and manufacturing, food processing, metallurgy, and petroleum refining.
- ❖ The consolidated fiscal budget continued to improve in January-May 2015, with the fiscal budget showing a surplus of UAH 19.4 billion, which was almost 5% higher than in January-April. This improvement was due to temporary factors such as Hryvnia devaluation and inflation, which helped increase government revenues while expenditures were controlled by austerity measures. For 2015, a fiscal deficit of 7.5% of GDP is still expected.
- ❖ The previous upward trend of consumer inflation was reversed in May 2015, with consumer prices increasing by 58.4% yoy in May, compared to 60.9% yoy during April. In May, on a month-to-month basis, almost all price categories experienced a deceleration of inflation from 14.0% mom in April to 2.2% mom in May. Inflation by the end of 2015 is now expected to be 45%.
- ❖ After one month of improvement, banking deposits slightly deteriorated in May. National currency deposits posted just a minor increase of 0.1% mom, while foreign currency deposits denominated in dollars fell by 3% mom. Similarly, banking loans also observed negative developments in May. National currency loans saw a 2.8% mom decline, while foreign currency loans declined by 1.5% mom.
- ❖ The Hryvnia exchange rate stabilized at around 21 UAH/USD during May, despite some increased volatility mid-month. Through the rest of the year, the Hryvnia is expected to devalue to around 25 UAH/USD, provided that the IMF program is on track.
- ❖ Ukraine's balance of payments is relatively stable, with a small current account deficit of USD 10 million during May. During January-May 2015, the current account deficit was also small at USD 345 million, but the deficit in the financial/capital account was bigger at USD 1,444 million. This latter deficit was caused by heavy repayments of external debt by local commercial banks and corporations (USD 3,162 million). On the other hand, foreign direct investments compensated for part of this inflow with a net inflow of USD 774 million during January-May 2015. IMF net financing of USD 4,260 million covered these deficits and enabled international reserves to reach USD 9,900 million at the end of May. The IMF has approved in principle the disbursement of the next tranche of USD 1.7 billion once some pre-conditions are met.
- ❖ The Ukrainian government is currently negotiating the restructuring of about USD 23 billion of Eurobonds with its foreign creditors. But the negotiations are deadlocked on the government proposal to secure a "haircut" of principal of 40%. A more recent government proposal includes a provision to allow creditors to recover more value if future GDP performs better than anticipated. Formal negotiations are now expected to start on July 6th.

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Forecast of Main Macroeconomic Indicators for 2014-2015	2011	2012	2013	2014	2015f
GDP, $ billion	163.4	176.6	182.0	127.4	96.8
Real GDP Growth, % yoy	5.5	0.2	0.0	-6.8	-9.0
Private Consumption, real growth, % yoy	15.7	8.4	6.9	-9.6	-12.0
Fiscal Balance, incl. Naftogaz and Pension Fund, % of GDP	-4.3	-6.0	-6.5	-11.7	-7.5
Public Debt, % 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
External Debt ($ billion)	126.2	134.6	142.1	125.9	138.0

Political and Reform Developments

Military escalation in the temporarily occupied territories of Donetsk and Lugansk regions remains at a high level. International observers, including the OSCE, confirmed the use of heavy artillery by Donbas rebels. Separatist leaders reconfirmed their plans to control more territory in Lugansk and Donetsk. In particular, separatists undertook several unsuccessful attempts to increase their influence in the Donetsk region by attacking the small town of Mariyanivka, controlled by the central government. To avoid possible future deterioration, the Normandy Four Group met in Paris at the end of June and concluded that there is no military solution for the existing conflict. The outcome of the Minsk-2 working group meeting, which took place prior to the Normandy Four Group meeting in Belarus, provided indirect signals that the conflict might be "frozen".

Ukraine continues to move forward with its reform agenda. In particular, there was progress in ensuring the country's financial stability, accelerating anticorruption efforts and implementation of energy sector reform. Both Ukrainian authorities and IMF executives confirmed their willingness to continue co-operation within the framework of the Extended Fund Facility program (EFF). The IMF Board has made a positive decision on the next tranche disbursement of $1.7 billion, provided that some pending preconditions are met. According to IMF executives, the restructuring of Ukraine's outstanding Eurobond in the amount of around $23 billion is not a precondition for the Fund's decision. Debt restructuring negotiations between Ukraine and its private creditors are deadlocked on the question of the need for a "haircut" of 40% of bond principal amounts, as proposed by the Ukrainian government.

The Ukrainian government is continuing its efforts to fight corruption. The Prime Minister announced a reform of the State Tax Police to reshape it into a Financial Investigations agency similar to the U.S. Internal Revenue Service. It was also announced that the State Customs Service could be chaired and operated by an international company. This is fully in line with public policy recommendations made to Ukrainian authorities by The Bleyzer Foundation in the past. The government has also launched several investigations of top government officials, including the chairman of the Kiev Arbitrary Court. Some efforts were undertaken at the local level, including the current initiatives by the head of Odessa's Regional Administration, former President of Georgia Michael Saakashvili.

Prime Minister Yatsenyuk announced a broad audit of all state energy companies. This is partly due to substantial pressure on the Cabinet from some members of the Ukrainian Parliament who requested gas tariff rate justification to be publicly available.

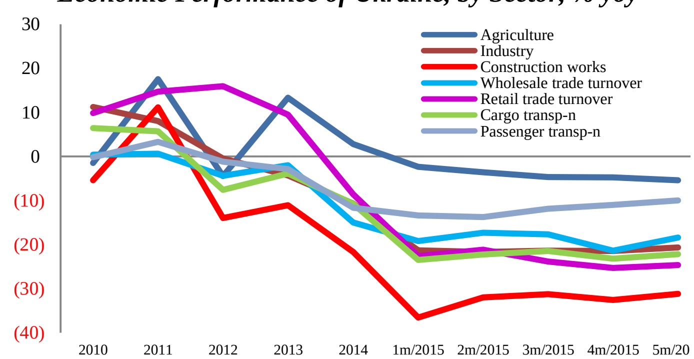
The Ukrainian government announced that the Venice Commission has confirmed the right of Ukraine to clean executive power from those who were involved in usurpation of power by former President Yanukovych. The final conclusion of the Venice Commission declares that the Law of Ukraine on lustration is not in contradiction with resolutions of the Council of Europe.

Economic Growth

GDP data recently released by the State Statistics Committee shows that in the first quarter of 2015, GDP declined by 17.2% yoy, rather than by 17.9% yoy as previously reported. This negative growth rate was caused mainly by the military conflict in the east of the country, which disrupted production capacities, reduced exports and affected confidence, all of which led to large currency depreciations, high inflation, and banking sector stress, and reduced bank credits.

New data on GDP's value-added composition shows that the major declines on the demand side of GDP took place in fixed investments (-25.1% yoy) and private consumption (-20.7% yoy). On the other hand, government expenditures increased by 5.0% yoy, led mainly by military expenditures and social payments. On the supply side of GDP, during the first quarter of the year, the major contractions in GDP took place in value-added in construction (-35.3% yoy), mining (-29.4% yoy), manufacturing (-25.6% yoy) and wholesale and retail trade (-24.8% yoy). The lowest declines in GDP were experienced in information and communications (-4.3% yoy), education and health (-4.6% yoy), agriculture (-4.8% yoy), and financial services (-10.5% yoy). Public administration showed positive growth again due to war-related expenditures (+1.3% yoy).

Economic Performance of Ukraine, by Sector, % yoy



Source: The Bleyzer Foundation

Higher-frequency monthly data on output showed some improvements in many sectors during May 2015, both on a month-to-month basis and year-to-year. This may signal that in many sectors, output may be stabilizing, although at a low level. On a month-to-month basis, output of mining and manufacturing increased by 1.2% mom, food processing increased by 3.0% mom, metallurgy by 7.6% mom, and petroleum refining by 15.1% mom. As a result, in these subsectors, there were some output improvements in May on a year-to-year basis as compared to April yoy, as follows: overall industry, -20.7% yoy in May, compared to 21.7% yoy in April; food processing, -15.2% yoy in May, compared to -15.7% yoy in April; metallurgy, -24.6% yoy in May, compared to -25.7% yoy in April, and petroleum refining, -40.6% yoy, compared to 43.6% yoy in April. But further declines took place in chemicals (-8.2% mom), machine building (-10.6% mom), and electricity (-9.0% mom).

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The chart at right shows the economic performance of Ukraine by sector, with the latest data covering a 5-month period from January to May 2015. Agriculture was the best performing sector during this 5-month period and has been since 2013, with construction works being the poorest performer since 2011.

From a regional point of view, in January-May 2015 compared to January-May 2014, industrial production indexes increased in the following oblasts: Vinnytsia (10.2% yoy), Volyn (4.9% yoy), Zhytomyr (6.4% yoy), Rivne (8.6% yoy), Ternopil (1.5% yoy), Khmelnytsky (5.6% yoy), and Chernivtsi (1.4% yoy). On the other hand, the largest output declines took place in the east, which used to be the industrial center of the country, with large declines in January-May in Lugansk (-88.0% yoy), Donetsk (-50.6% yoy), and Kharkiv (-18.9% yoy). Others regions that experienced declines, though at lower rates, included: Dnipropetrovsk (-10.6% yoy), Transcarpathia (-14.4% yoy), Zaporizhia (-6.7% yoy), Ivano-Frankivsk (-3.7% yoy), Kiev (-1.7% yoy), Kirovograd (-22.4% yoy), Lviv (-2.8% yoy), Nicholaiv (-13.0% yoy), Odessa (-8.5% yoy), Poltava (-6.2% yoy), Sumy (-0.6% yoy), , Herson (-7.2% yoy), Cherkasy (-5.4% yoy), and Chernihiv (-13.1% yoy).

Output Indicators of Ukraine, % yoy

	2015 5m*	2014	2013	2012	2011	2010
Agriculture	-5.4	2.8	13.3	-4.5	17.5	-1.5
Industry	-20.7	-10.7	-4.3	-1.8	7.6	11.2
Construction works	-31.2	-21.7	-11.1	-14	11.1	-5.4
Domestic trade, turnover						
Wholesale trade	-18.4	-15	-2	-4.4	0.6	0.4
Retail trade	-24.7	-8.6	9.5	15.9	14.7	9.8
Transportation, turnover						
Cargo	-22.2	-10.8	-3.9	-7.6	5.7	6.4
Passenger	-10	-11.7	-2.9	-1.2	3.3	-0.2

Source: State Statistical Service of Ukraine, The Bleyzer Foundation
** Excluding Crimea*

Assuming that the military conflict in the east of the country remains “frozen”, it is expected that, starting from a low base, the economy will continue to stabilize in the next months, with stronger recovery towards the end of the year. On this basis, GDP is expected to decline by 9.0% during 2015 (compared to -17.2% in the first quarter), with a positive rate of growth of about 2% in 2016. A medium-term stronger and sustainable recovery will require a durable resolution of the military conflict.

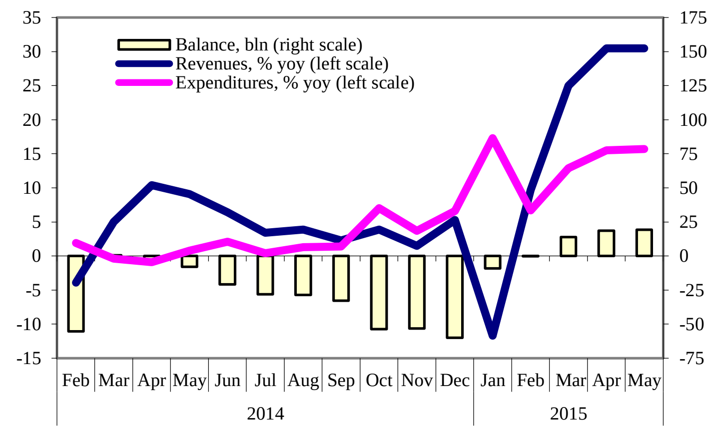
Fiscal Policy

During January-May, the growth of consolidated budget revenues remained high at 30.5% yoy, the same rate as in January-April. Some acceleration in the growth of state budget revenues from 45.9% yoy in January-April 2015 to 47.9% yoy in January-May was offset by slower growth in revenues at the local level.

The sources of the highest receipts to the general fund of the state budget remained the same; however, there were some changes in the composition of receipts. In particular, receipts from the VAT on both imported and domestic goods, excise tax on domestic goods, and corporate profit tax saw deceleration in growth. This deceleration, however, was offset by acceleration in growth of receipts from acreage rent and some other taxes and duties. Deceleration in growth of receipts from taxes on imported goods was expected because of stabilization on the foreign exchange market. For example, proceeds from the VAT on imported goods saw deceleration in growth by 11 percentage points to 43.2% yoy in January-May 2015. The deceleration in the growth of receipts from VAT and excise taxes on domestic goods is harder to explain. The deceleration of inflation was not sufficient to cause a 4 percentage point deceleration in growth of receipts from the VAT on domestic goods (to 22.5% yoy) and a 9.2 percentage point deceleration in growth of receipts from the excise tax on domestic goods (to 50.8% yoy), especially taking into account some improvements in the trends of domestic trade. The decline in proceeds from corporate taxes accelerated to 12.7% yoy in January-May, but was still much lower than one would expect considering the official data on losses of Ukrainian firms this year.

Consolidated budget expenditures continued to grow at slower pace compared to expenditures in May. Cash disbursement from the consolidated budget increased by 15.7% yoy in January-May, which is almost the same as in January-April. As before, expenditures of the state budget grew faster than those at the local level and the growth rate further accelerated to 22.5% yoy. As the conflict in Eastern Ukraine continued, the country further increased its defense expenditures. In January-May, these expenditures posted a 180% yoy growth reaching 8.3% of the total state budget expenditures. Expenditures on public debt servicing also saw high growth (100% yoy) over the period due to both an increase in the debt itself and depreciation of the national currency. Austerity measures continue to affect state expenditures, with social expenditures, expenditures on economic activity, general public functions, cultural and physical development, and education either declined or increased at much lower rates compared to other state budget expenditures.

Dynamics of Consolidated Budget Components



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

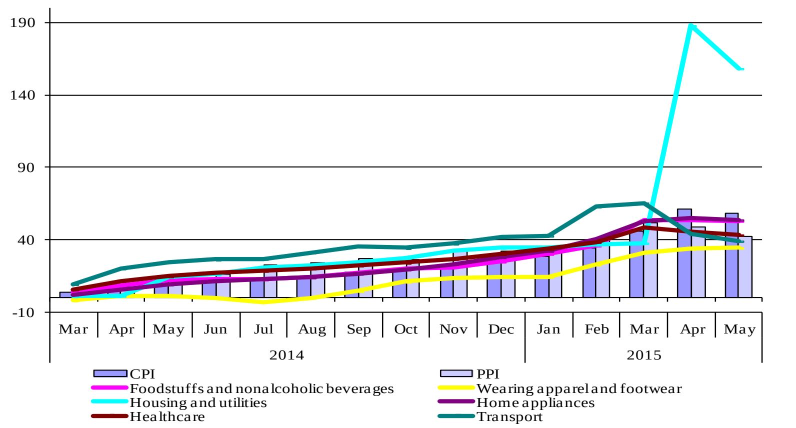
Due to higher revenues than expenditures, the consolidated budget surplus further increased in May. The budget surplus totaled UAH 19.4 billion in January-May, which was almost 5% higher than in January-April. At the same time, the mentioned increase was the result of budget surplus expansion at the local level. The state budget was executed with a deficit in May, as the 5-month surplus of the state budget was lower than that observed in January-April by 31.6%. The Minister of Finance forecasts further decline in surplus, as positive imbalances between state revenues and expenditures were the result of unplanned depreciation of the national currency in Q1 2015 and boosted inflation. The impact of depreciation has already started to diminish. The same is expected also in relation to the impact of inflation. Furthermore, the government expects a significant increase in subsidies to the population in Q4 2015 because of recent increases in utility tariffs. Therefore, there is a good probability that the current consolidated budget surplus will turn into a deficit by the end of the year. As of the end of May, the government took UAH 105.6 billion in loans to finance the execution of the state budget. Domestic loans amounted to UAH 16.5 billion of the mentioned amount.

Monetary Policy

Inflation. On a month-to month basis, in May, almost all price categories experienced a deceleration of inflation from 14.0% mom in April to 2.2% mom in May. On a year-over-year basis, inflation in May stood at 58.4%, compared to 60.9% yoy in April. Deceleration in inflation was observed on all major consumer price indices except for alcoholic beverages and tobacco products, transport, and communication services. On the contrary, for year-over-year price indices, just about half of them saw deceleration in growth, while another half saw acceleration. In particular, deceleration in growth of prices was observed for foodstuffs and non-alcoholic beverages (by 7 percentage points to 53.0% yoy), housing and utilities (by 30 percentage points to 158.8% yoy), home appliances (by 1 percentage point to 53.8% yoy), healthcare (by 1.4 percentage points to 43.4% yoy), and transport (by 4.7 percentage points to 39.1% yoy). Acceleration of growth in prices in other major indices was not very sharp, ranging from 0.3 percentage points for recreation and culture services (to 46.8% yoy) to 2.5 percentage points for other goods and services (to 47.2% yoy).

The results of the latest meeting of the NBU's Committee for Monetary Policy indicate that the regulator continues using tight monetary policy to lower inflation. In particular, the Committee decided to leave the policy rate unchanged at 30% and to continue its operations on liquidity sterilization.

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



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

The latter operation involves selling government securities from the NBU's portfolio and placing deposit certificates with maturity from 1 to 3 months, with the placing price to be determined through interest tenders with limited issue size. These measures, together with the softening impact of currency depreciation, lowering world market prices, economic activity below its potential and tight fiscal policy, should decelerate inflation to 12% by the end of 2016. Recent data shows that the NBU was quite successful in limiting growth of money supply in the market. In May, money supply decreased by 1.3% mom to UAH 967.6 billion, limiting growth from the beginning of the year to 1.1%. A decline in the monetary base continued during the reporting month. The monetary base inched down by 0.2% mom (to UAH 329.6 billion), accelerating the decline from the beginning of the year to 1.1%. Cash outside banks also declined to UAH 2934 billion (by 0.9% mom) in May, remaining almost unchanged from the beginning of the year.

Based on the latest data, many institutions already revised their forecasts for inflation in 2015. Overall, inflation expectations worsened for the year and all the forecasts were revised upwards. The latest forecast was published by the NBU, according to which inflation is expected at 48% in 2015. For now, we have decided to maintain our inflation forecast for 2015 at 45%.

Banking Sector. After one month of improvement, banking deposits slightly deteriorated in May. National currency deposits posted just a minor increase of 0.1% mom, while foreign currency deposits denominated in dollars fell by 3% mom. Unlike April, private persons were the main factor negatively influencing dynamics of deposits in May. Both national currency deposits and foreign currency deposits denominated in dollars of private persons posted declines during the reporting month. The latter declined sharper (by 3.9% mom against 1.2% mom decline in the national currency deposits). Deposits of business entities performed better in May. National currency deposits posted a 1.5% mom increase, while foreign currency deposits denominated in dollars dropped 1% mom. Despite the mentioned developments, the year-over-year trends of deceleration in declines of both national currency deposits and foreign currency deposits denominated in dollars continued.

Similarly to deposits, banking loans observed negative developments in May. However, unlike in case of deposits, negative developments were more pronounced in the corporate sector. National currency loans saw a 2.8% mom decline due to a 3.3% mom decline in the corporate sector. National currency loans to private persons decreased by 0.9% mom.

Total foreign currency loans also declined, but at a slower pace compared to national currency loans (by 1.5% mom). The decline in corporate sector foreign currency loans denominated in dollars was almost two times larger than in private persons' foreign currency loans (1.7% mom against 0.9% mom). Both national currency

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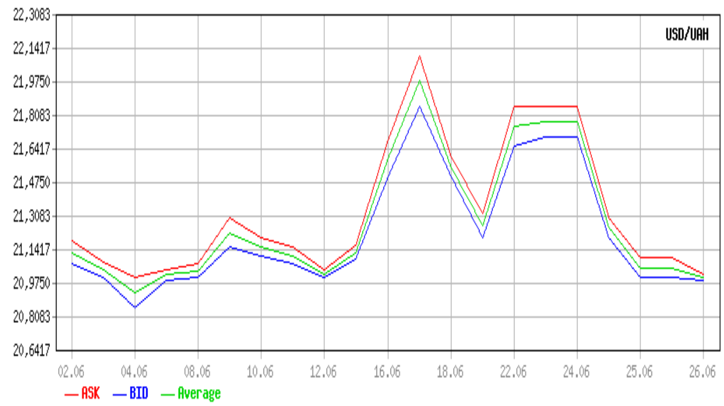
and foreign currency loans (denominated in dollars) observed decreases through all the term groups and acceleration in decline in year-over-year terms in May.

These developments caused additional challenges to the banks' financial stance. On the other hand, the stress of the banking system also helped address the banks' liquidity and solvency problems, which were threatening the stability of the whole banking system. The process of getting insolvent banks out of the banking system continued in May-June 2015, when 4 banks were declared insolvent. The last one was Commercial Bank Financial Initiative, which was declared insolvent on June 24th, 2015. The NBU provided 180 days to bring its activities into compliance with national banking legislation in February 2015. In particularly, the bank was supposed to increase capitalization, stabilize liquidity, and recover solvency, but failed. However, according to the NBU, 92% of bank depositors will receive their deposits in the full amount from the Deposit Insurance Fund though authorized banks.

Overall, the NBU revoked licenses and liquidated 41 banks in 2014-2015. Moreover, more than half of these (24 banks) were liquidated in the first half of 2015. Ten more banks are under temporary administration (temporary administrations were imposed in 18 solely in 2015 and 51 overall from the beginning of 2014). As of June 25th, 2015, 128 banks operated in Ukraine (excluding those under temporary administration), 40 of which are banks with foreign capital. This means that in 1.5 years, the NBU liquidated one-fourth of the banks that operated in the country. The regulator plans to conduct stress tests of 20 largest banks with new methodology by October 2015. As of the end of the first half of the year, 35 banks had successfully passed the stress tests.

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



Source: Ukrdealing, The Bleyzer Foundation

There are signs that the process of eliminating problem banks is approaching its end. In particular, the amount of funds provided to banks to support their liquidity reduced almost ten-fold. In total, the NBU provided UAH 1.4 billion to 6 banks in May. Four banks received overnight loans for the amount of UAH 1.2 billion. Loans with maturity of up to 90/360 days amounted to UAH 190 million and were provided to 3 banks. There were neither loans under the financial rehabilitation programs, nor direct repo transactions in May.

Hryvnia Exchange Rate. The exchange rate was stable at 21 UAH/USD in the first half of June, but saw greater volatility in the second half of the month to a high of about 22 UAH/USD. The stability of the exchange rate during the first two weeks intensified talks on further liberalization of the foreign exchange market through lifting of administrative measures introduced by the NBU at the end of 2014 and at the beginning of 2015. The regulator stopped not only actual interventions on the interbank forex market but also 'verbal' interventions (announcements of interventions at some exchange rate without actual participation in the trading session) and significantly moderated cutting of the requests for dollar purchases submitted by banks. However, subsequent depreciation pressures led the NBU to intervene in the market, which led the exchange rate to the level of 21 UAH/USD observed at the beginning of the month.

Furthermore, the Governor of the National Bank claimed that the regulator together with the government developed a package of measures to liberalize the foreign exchange market, but the IMF suggested that liberalization was premature.

Additional depreciation pressures on the exchange rate were due to default fears. In particular, arduous negotiations with private creditors and principal differences in positions of the parties concerning the restructuring mechanisms raised concerns about achieving a positive conclusion to the negotiations. Since it was initially announced by the IMF that provision of the second tranche of the EFF program for Ukraine depended on agreement with creditors on external debt restructuring, failure of negotiations would mean at least postponement of the tranche and default of Ukraine with subsequent negative consequences to the foreign exchange market. Adoption of the law imposing a moratorium on external debt payments at the end of May was considered more proof that the government was prepared to default. However, more recent statements from the IMF that it will provide the second tranche even in case the negotiations between Ukraine and its creditors on external debt restructuring fail and Ukraine's payment of the coupon on Eurobonds held by Russia signaled that Ukraine will not default in June. This significantly lowered the depreciation pressure on hryvnia from default expectations.

As mentioned above, many institutions revised the economic forecasts for Ukraine. Expectations concerning the exchange rate dynamics worsened just as expectations related to other major economic development indicators. Fitch was the most pessimistic about the Ukrainian currency. In its revised forecast, the institution expects a depreciation of the Hryvnia to around 30 UAH/USD by the end of 2015. We agree that depreciation pressure on the Hryvnia will increase in the second half of the year, but expect the exchange rate to depreciate to around 25 UAH/USD.

International Trade and Capital

Ukraine's balance-of-payment has remained relatively stable, with a small current account deficit of USD 10 million during May 2015, compared to a small surplus of USD 138 million in April 2015. The deficit was caused by a 5.7% drop in exports of goods and services from April to May, compared to a smaller 3.1% drop in imports. The major declines in exports between April and May took place in foodstuffs (-USD 96 million), machinery and equipment (-USD 22 million), and metals (-USD 15 million).

For the entire period from January to May 2015, the current account deficit was USD 345 million, a manageable amount compared to a deficit of USD 1,942 million in the same period of 2014. This improvement was achieved thanks to a reduction in exports (-36.4% yoy) that was less pronounced than the reduction in imports (-39.3% yoy).

During January-May 2015, exports of goods declined by 36.4% yoy, with major drops in mineral products (-57.0% yoy), machinery and equipment (-52.8% yoy), metals (-40.4% yoy), chemical products (-39.3% yoy) and industrial products (-33.8% yoy). However, the agricultural sector has been performing well. In fact, according to the Ministry of Agriculture, since the beginning of the current 2014/2015 marketing year, Ukraine has exported 33.5 million tons of grain, which is higher than the historic record of 32.3 million tons achieved last year. Furthermore, ending stocks were almost 3.5 million tons larger than in the previous year.

During the January-May period, the major drop in exports took place in exports to Russia (-61.6% yoy), Europe (-38.8% yoy), the USA (-30.9% yoy), Africa (-24.4% yoy), and Asia excluding the CIS (-20.0% yoy). The drop of exports to Russia was caused not only by damage of productive capacity and infrastructure, but also by the trade sanctions imposed by Russia.

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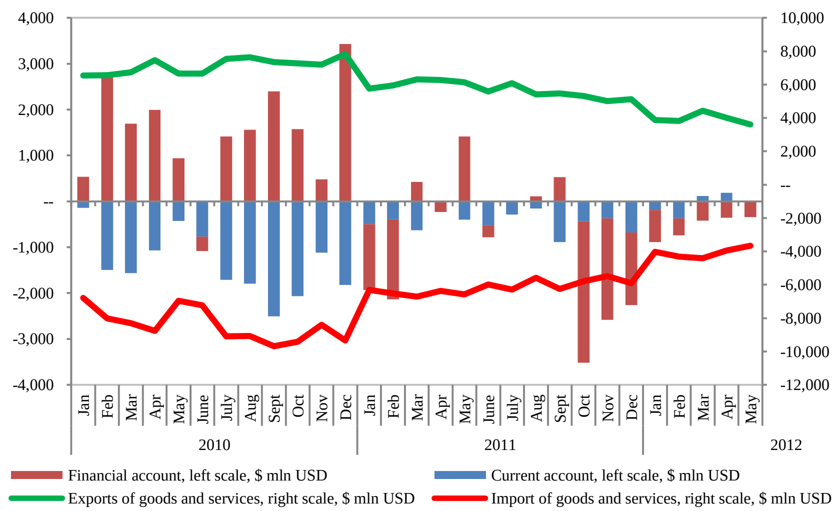
From January to May 2015, imports declined by 39.3% yoy, with major declines in the categories of metals (-48.3% yoy), foodstuffs (-47.9% yoy), machinery and equipment (-45.0% yoy), industrial products (-38.3% yoy) and chemicals (-31.4% yoy). Again, the major drop in imports was from Russia (-55.7% yoy), while the smaller reduction was in imports from Europe (-22.1% yoy). One of the causes of the drop in imports from Russia was that Ukraine imported most of its natural gas requirements from Europe, rather than from Russia. In fact, during January-April, Ukraine imported 4.8 billion cubic meters of gas from Europe compared to 2.4 bcm from Russia.

The deficit in the financial account of the balance-of-payments amounted to USD 1,692 million during January-May 2015, while the capital account showed a surplus of USD 248 million during this period. The major causes of the deficit in the financial account were heavy foreign debt repayments that were made by commercial banks (USD 1,478 million) and the corporate sector (USD 1,684 million) during January-May. On the other hand, positive contributions were made by net foreign direct investments (USD 774 million) and portfolio investments (USD 176 million).

Ukraine's External Balance of Payments Performance, ***$ mln USD***



Source: NBU, The Bleyzer Foundation

Including the current, capital and financial accounts, the overall deficit in Ukraine's balance of payments reached USD 1,789 million during January-May. This deficit was more than covered by net disbursements of USD 4,260 million made by the IMF under its Extended Fund Facility during this period. The excess IMF funds allowed the NBU to increase its international reserves by USD 2,471 million during the period. As of the beginning of June, international reserves amounted to USD 9,900 million, which are equivalent to about 2.7 months of current imports of goods and services. The IMF has recently announced that it has approved the disbursement of the next tranche of USD 1.7 billion as soon as some pending conditions are met, probably during July 2015.

In order to alleviate future heavy repayments of external debt, the government is negotiating with its creditors a public debt restructuring on USD 23 billion of bonds and loans. The government objective in the debt restructuring is to comply with the IMF requirements of saving USD 15 billion in public external debt service over the next four years, lower public debt to 71% of GDP by 2020, and reduce the fiscal budget's gross financing costs to an average of 10% of GDP from 2019 to 2025. As noted earlier, the debt restructuring negotiations are deadlocked on the question of the need for a "haircut" of 40% of bond principal amounts, as proposed by the Ukrainian government. More recently, the government has presented a revised proposal that includes a provision that would allow creditors to recover more value if future GDP performs better than anticipated. The creditors, on the other hand, have proposed longer extension of maturities and grace periods to alleviate debt service over the next few years. During "technical" discussions in Washington on June 30th with IMF participation, there was agreement on confidentiality arrangements that will allow starting formal negotiations on July 6th on possible restructuring options.