INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING

Monthly Economic Monitor Ukraine

No.9 (167), September 2014

EXECUTIVE SUMMARY

HIGHLIGHT: NBU POLICY

Politics: Russian invasion of Ukraine was condemned by most developed nations. The conflict is expected to be long-lasting.

Real Sector: Military conflict in Donbas resulted in sharp contraction of industrial output in July by 12.1% yoy as many companies of the region had to stop operation.

Energy sector: Ukraine might have problems with energy supplies in autumn and winter as storages of natural gas and coal might be insufficient.

Agriculture: The Parliament approved several laws, which are likely to expand access for Ukrainian agricultural producers to the EU market.

External sector: Merchandise trade deficit in July narrowed to USD 0.2 bn. Services trade balance also turned negative at USD 0.1 bn due to lower foreign tourists inflow to Ukraine.

Fiscal policy: Legislative changes approved in March and July ensured increase in central fiscal revenues by 8.9% yoy in the first eight months of 2014. Still, revenues and deficit remained lower than targets, which resulted in under-execution of expenditures.

Social policy: The Government plans to continue pension reform in the nearest future to restrict growth in central fiscal transfer to the Pension Fund.

Labour market: In July, average wage grew by only 2.6% yoy in nominal terms and dropped by 8.9% in real terms.

Monetary policy: In August, consumer inflation reached 14.2% yoy due to increase in prices for transport, pharmaceuticals, housing, water, electricity, gas and other fuels.

Exchange rate: In August, hryvnia weakened sharply from UAH 12 per USD to UAH 14 per USD. As a result, the NBU introduced harsh administrative measures to support national currency.

State debt: State debt in 2014 is estimated to reach near 60% of GDP.

Highlight of the month: NBU policy

WHERE THE NBU IS GOING

Vitaliy Kravchuk

In August hryvnia weakened sharply from UAH 12 per USD to UAH 14 per USD after several months of relative stability. In response the NBU sold foreign currency in intervention on interbank market and then introduced harsh administrative measures to support national currency. These included among others mandatory sale of all export revenues and restrictions on foreign currency transfers abroad and deposit withdrawals in foreign currency. The NBU stated that during military conflict in the East these administrative measures were justified. It also pressured the commercial banks to stabilize hryvnia exchange rate. Such measures were moderately successful and hryvnia exchange rate returned to levels below UAH 13 per USD.

The NBU had little choice if it wanted to stabilize exchange rate and comply with the IMF program terms. In order to receive continued IMF funding, the Government and the NBU must fulfil a number of quantitative and structural performance targets. In particular, the NBU should effectively restrict interventions on the foreign currency market and limit provision of liquidity to agreed levels. There are exceptions as bank recapitalization and loans to Deposit Guarantee Fund do not count towards liquidity target. The NBU has some room for manoeuvre as after the first review the IMF agreed that some action of the NBU may be needed to stabilize economy and adjusted the reserve targets downward as well as increased monetary base target. Besides targets apply only on test dates of September 30 and December 31 and as long as sales of foreign currency are offset by purchases the NBU may intervene as much as it wishes between the test dates.

This will likely allow the NBU to stabilize the exchange rate in the short-term but the question of future exchange rate and monetary policy remains open. Since 2010 the NBU was mandated by the law to maintain price stability as its main goal. Until 2014 this resulted in repeated declarations of impending transition to inflation targeting and some technical preparations. Still, fixed exchange rate was the main anchor of the monetary policy until the Government and the NBU decided to allow hryvnia to depreciate in the beginning of 2014. This happened after the central bank lost large part of international reserves. Afterwards, exchange rate was allowed to move more or less freely without major interventions of the central bank. However, it was still propped up by administrative measures such as mandatory sale of foreign currency receipts.

After Ukraine signed the Stand-by arrangement, authorities committed to move to inflation targeting in 2015. This would mean no return to fixed exchange rate after the crisis ends. Inflation targeting means the central bank is responsible primarily for keeping inflation low and preferably stable. If the central bank is credible in its promise of price stability inflation target will be incorporated in medium and long-term planning by businesses and individuals. This in turn makes central bank's job much easier and shields economy from adverse effects of excessive price volatility. Inflation targeting also usually involves increased communication and more transparent decision-making. This means that the NBU must explain its actions clearly and convincingly and react more or less predictably to shocks.

However, the NBU faces a number of serious challenges in moving to inflation targeting. First, it must be able to do full-scale monetary policy and actually influence interest rates and through them inflation. However, currently the NBU has little control even over interbank interest rates. The NBU can already withdraw or inject large amounts of liquidity leading to swings in interest rates on the interbank market but this control is very loose. Connection between interbank interest rates and lending rates is also not very tight. Initial goal in this regard would be to expand monetary policy operations sufficiently to ensure that short-term interest rate is close to policy rate (e.g. by creating deposit and lending facilities with little restrictions on access of sound banks and with not very wide margin between interest rates).

Second, the NBU must formulate and communicate its policy on exchange rate. It clearly cannot afford to ignore exchange rate in pursuit of price stability in dollarized and open economy. Excessive exchange rate volatility and especially significant swings of the exchange rate are likely to have large impact on prices and on the stability of the financial sector. At the same time, too little volatility will hamper development of exchange rate hedging, support dollarization and make monetary policy more difficult. There will also be a risk of new external imbalances. Thus, the NBU must decide what interventions would be acceptable and what is more important explain its approach to the public. Transparent and predictable exchange rate policy is needed to form the right expectations (i.e. exchange rate will not be fixed but the NBU will move in to stem large depreciation or appreciation).

Third, the NBU must address its balance sheet structure. It holds too much domestic assets including over quarter of state debt and large loans outstanding to commercial banks and too little international reserves. If efforts to reduce domestic lending and increase reserves are not coordinated they may have unwelcome impact on monetary policy. Changes in interest rates may also lead to large paper losses or gains for the NBU.

Last but not least are fiscal issues. Coordination of fiscal and monetary policy is important especially on initial phases of inflation targeting. In more practical terms large fiscal deficits or unsustainable public debt make it hard to bring inflation down. Monetary financing of fiscal or quasi-fiscal deficits also has inflationary impact. This means that conservative fiscal policy may be critical for success of inflation targeting over the next few years.

The NBU has plenty of help in preparing for inflation targeting and this time declaration about changes in monetary policy may be more than just words. In this case we should expect serious changes in NBU policies over next several quarters. Many details of inflation targeting framework are not determined yet but likely exchange rate will remain flexible to a degree but still managed by the NBU. Successful inflation targeting should be able to bring down inflation and real interest rates. Lower interest rate may provide significant boost to Ukrainian economy. However, this will require institutional transformation of the NBU and carefully prepared monetary framework adapted to Ukrainian problems.

Monthly Economic Monitor Ukraine

Politics: Russia starts direct intervention into mainland Ukraine

War in the East. In the first three weeks of August, Ukrainian troops continued to gradually force back pro-Russian insurgents, which tried to separate Donetsk and Luhansk regions (Donbas) from Ukraine. However, on August 25-27, the situation dramatically changed. Russia, which earlier annexed Ukrainian peninsula of Crimea and heavily supported separatists in Donbas, advanced to a massive military intervention into mainland Ukraine. At least a few thousands of Russian regular troops crossed the border, stopped the offensive of Ukrainian government forces, and slightly extended the territory controlled by insurgents. Even though Russia did not recognize officially that it invaded Ukraine most developed nations condemned Russia's invasion.

Evidently, Russia's ultimate goal with respect to Ukraine is to return Ukraine into the Russian sphere of influence, but the strategy remains unclear. One option for Russia is to continue the offensive to take the Eastern and Southern part of Ukraine or even the whole country under direct control. Another option is to entrench in Donbas, not formally separating it from Ukraine, in order to get a tool to influence external and internal policy of Ukrainian government. The conflict is likely to be long-lasting. On the one hand, Ukraine does not have sufficient military power to defeat Russia, at least in the short-term. On the other hand, it is likely that Russia does not have enough military and economic resources to occupy Ukraine or even its significant part, especially taking into account western economic sanctions.

Parliament. On August 27, Ukraine's President Petro Porosehenko decided to dissolve the the Verkhovna Rada and scheduled the next parliamentary election on October 26. This decision was expected because the governing coalition in the Parliament collapsed on July 24, and no attempts to form a new coalition were taken. The current parliament will retain its power until the first sitting of the new one, and is expected to continue to pass laws, including the law on ratification of the EU-Ukraine Association Agreement. The Verkhovna Rada denied to modify election rules. Thus, a half of the new parliament will be elected through party lists, while the rest from single-member constituencies. It implies that the Parliament may lack about 25 members from the regions that are not controlled by the Government (the total number of MP's is 450). In late August, Petro Poroshenko's party led the polls leaving its opponents far behind.

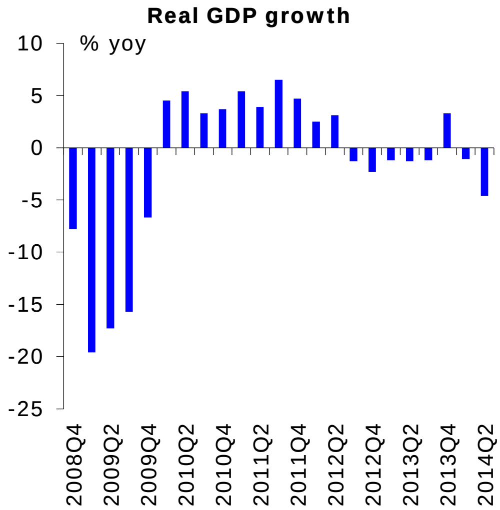
IMF. On August 29, the IMF Executive Board completed the first review under the Stand-By Arrangement (SBA), allowing for the second disbursement of the loan to the country at USD 1.4 bn (SDR 914.7m), which was received on September 4. About USD 1 bn from that disbursement were allocated to budget support, the rest was provided to the NBU. Given ongoing military conflict in Ukraine, the IMF approved waivers of applicability and nonobservance of performance criteria related to international reserves, general government deficit, net domestic assets of the central bank, and publicly guaranteed debt.

The IMF also decided to merge the remaining two reviews scheduled for 2014, which implied that Ukraine might receive next two tranches of the loan (each worth of USD 1.4 bn or SDR 914.7 m) in December. Previously it was planned that the third disbursement may be made in late September or early October.

Real sector: Industrial output dropped due to military conflict

GDP. Real GDP declined by 4.6% yoy in the second quarter of 2014. Real private consumption contracted by 2.3% yoy likely due to decline in disposable income. Financial constraints against the background of high economic and political uncertainty resulted in drop of real fixed capital accumulation by 18.5% yoy. Decline in real

Population: 45.5 m
Industry/GDP: 23%
Agriculture/GDP: 10%
Investment/GDP: 18%
Exports to: Russia 24%, EU 26%
Imports from: Russia 30%, EU 35%



Source: Ukrstat

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domestic demand resulted in contraction of real imports at 11.3% yoy. At the same time, real exports declined by 7.4% yoy due to weak external demand and unrest in the Eastern Ukraine. Real net exports likely positively contributed to real GDP growth.

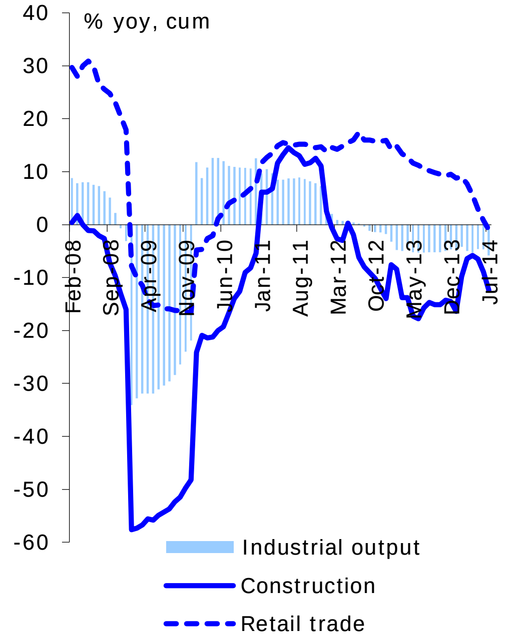
Sectoral trends. Military conflict in Donbas resulted in sharp contraction of industrial output in July by 12.1% yoy as many companies of the region had to stop operation. In particular, chemical production dropped by 22.2% yoy. Some metallurgical companies in other regions also were challenged by lack of sufficient coke supplies. As a result, output in metallurgy declined by 12.3% yoy. Trade tensions with Russia contributed largely to a decline in machine building by 23.8% yoy. Decline in manufacture of vehicles reached 79.9% yoy due to weak demand. Overall, manufacturing output dropped by 12.7% yoy. Output in mining industry decreased by 12.5% as several mines stopped working in Luhansk oblast due to military conflict.

In July retail trade by enterprises dropped by 10.0% yoy. This might reflect decline in real private consumption due to lower households' disposable income.

Rapid drop in construction (31.0% yoy in July) may be explained primarily by military actions in Eastern Ukraine. Construction in other regions also sharply declined due to financial constraints.

Agricultural production in July increased by 11.3% yoy due to higher yields of most crops.

Real sector trends



Note: Since April 2014 - data excludes Crimea
Source: Ukrstat

Energy: Ukraine lacks coal to produce electricity

Gas. On September 2, Slovakia gas operator Eustream started commercial supply of gas to Ukraine via Vojany-Uzhgorod pipeline. The guaranteed minimal traffic volume is 6.4 bcm of gas per year. This route will help Ukraine to fill its underground storage facilities and prepare for the winter. However, in fall and winter gas supplies from Slovakia might be restricted due to higher gas consumption in European countries.

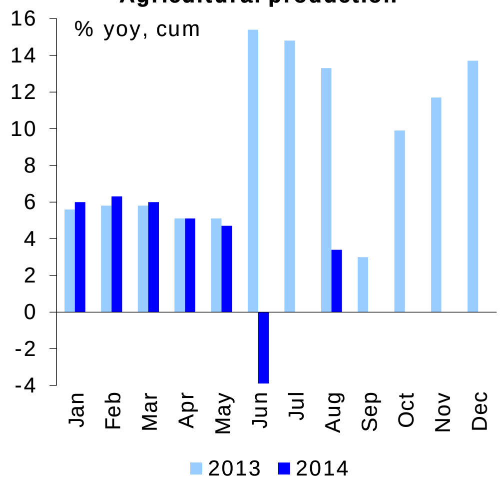
Electricity. Due to shortage of coal at Thermal Power Plants (TPP) Ukraine lacks loads shifting capacities in electricity networks. Therefore, Ukraine might face difficulties with supplying electricity at peak consumption periods. Moreover, at some cities electricity consumption in winter is expected to increase as the households will use electric heaters due to problems with hot water supply and district heating. As a result, the Energy Ministry warned of possible emergency power outages in the future.

Ukrainian Energoatom renewed the contract with American-Japanese company Westinghouse Electric on supplies of nuclear fuel. This agreement as well as the construction of the Centralized storage of spent nuclear fuel (which started on August 26) will help Ukraine diversify energy resources supplies and lessen its energy dependency on Russia.

Coal. According to coal miners' trade union, 50 out of 103 coal mines in Donbas are not acting due to military operation, which created shortage of coal of T and A types suitable for TPP. According to the Energy Ministry, as of September 1 there are 2.1 m tons of coal stored at TPPs, which will be used in 11-50 days depending on the station. To fight the coal shortages Ukrainian Government signed a contract on purchasing 1 bn tons of coal from the South Africa. Poland also received several offers from Ukrainian companies on coal supplies.

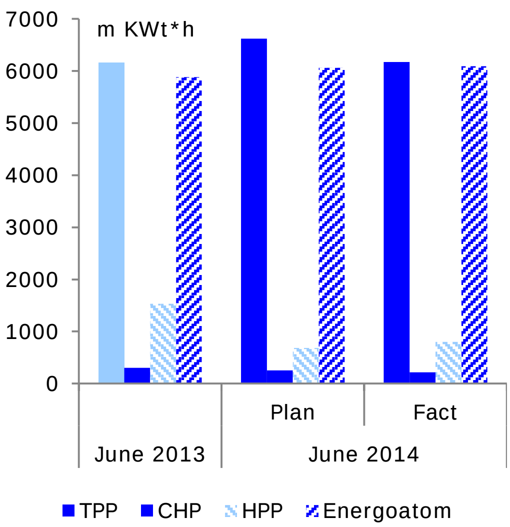
Regulation. On August 27, the President liquidated the National Energy Regulation Commission (NERC) and the National Commission of the State Public Utilities Regulation and instead created the National Commission of the State Energy and Public Utilities Regulation. This should result in higher efficiency as both Commissions regulated big natural monopolies in related sectors. However, there is a danger that the reorganization process might last till the end of 2014 and delay decisions on setting cost covering tariffs for district heating and hot water supply.

Agricultural output
Agricultural production



Source: Ukrstat

Electricity generation



Note: TPP - Thermal Power Plant, CHP - Combined Heating Plant, HPP - Hydro Power Plant
Source: Energobusiness

Agricultural sector: The need to reallocate exports

Exports. According to the Ministry of Agricultural Policy and Food, in the first half of the year exports of agricultural and food products to Russia decreased by 31% yoy to about USD 1 bn. However, it was compensated by about 75% by exports growth to other countries. Overall, total agricultural and food exports increased by about 4.5% yoy to USD 7.9 bn. Grains and fats/oils accounted for 37% and 25% of total agricultural exports, respectively.

At the same time, producers of confectionery, meat and dairy products, beer and soft drinks, liquor and wine are likely to suffer the most from trade barriers imposed by Russia for political reasons. There are possibilities for Ukrainian meat and dairy producers to partially reallocate their exports from Russian market to the EU market. However, they have to adapt to the EU food quality and safety standards.

The chances to reallocate to the EU market increased after the signature of the Association agreement, which establishes the DCFTA. It resulted in cancellation or reduction of export duties for a variety of products. However, currently these opportunities are not fully utilised. As of 8th of September, only tariff quotas (on the basis of first come, first served) for exports of natural honey, grape and apple juices were fully exhausted. Tariff quotas for cereals, malt and wheat gluten, preserved tomatoes and bran were used by about 40%, 28%, 18%, 9%, respectively, while exports of products in 17 categories have not even started. In addition, tariff quotas based on import licenses were fully used only for corn and by 77% and 45% for poultry and wheat, respectively.

Legislative initiatives. On 14th of August, the Parliament approved the Law on identification and registration of animals (still to be signed by the President). This Law is crucial for opening an access for Ukrainian meat produce to the EU market. It ensures harmonisation of Ukrainian legislation with the EU standards via clarification of terminology, rights and obligations of subjects in the animal sector, state support for identification of cattle and also responsibilities for violation of this law.

In addition, another important Law on food products is still to be signed by the President. It envisions implementation of the European model of food quality and safety system based on the HACCP (Hazard Analysis and Critical Control Points), establishment of a single government body on food safety, elimination of several permits and procedures not existing in the EU. Its implementation will also result in introduction of the EU principles on GMOs regulation.

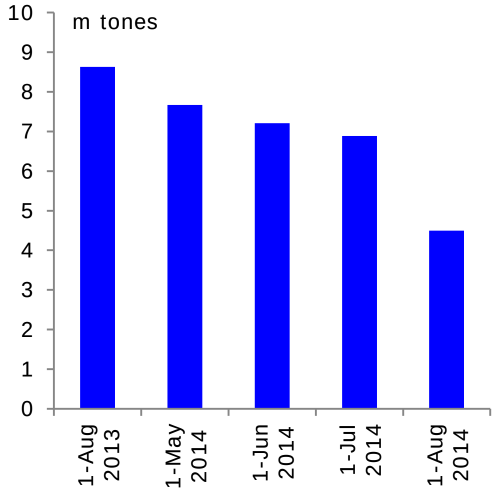
External sector: FDI inflow remained positive

Current account deficit in July was USD 0.3 bn. While merchandise trade deficit narrowed to USD 0.2 bn, services trade balance turned negative at USD 0.1 bn due to lower foreign tourists inflow to Ukraine.

Exports of goods declined by 7.4% yoy reflecting disruptions in production due to unrest in Donbas and further trade tensions with Russia. Exports of chemicals declined the most (by 34.5% yoy) as several enterprises in the East of Ukraine stopped operation due to military conflict. Sharp contraction of machinery exports (by 31.5% yoy) was explained by lower access of Ukrainian goods to Russian market as both countries imposed trade restrictions for these goods. Food products was the only group that demonstrated increase in exports (by 26.2%) due to larger shipments of wheat and positive effects of autonomous trade preferences by the EU.

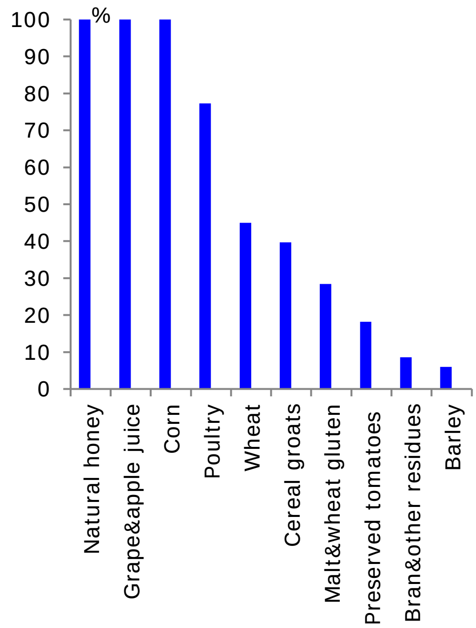
Imports of goods declined by 31.1% yoy. Consumption and investment demand for imported goods dropped due to decline in income and financial constraints of companies. Besides, sharp hryvnia depreciation resulted in imports substitution. As a result, imports of all product groups declined, however, the largest contraction was for energy imports (by 44.3% yoy) as Ukraine imported natural gas only from Europe.

Coal in storage



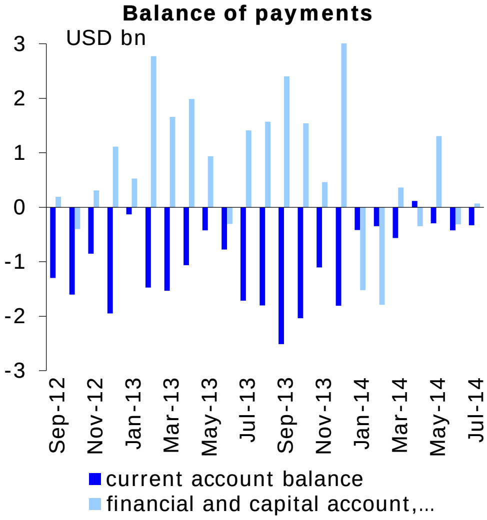
Source: Ukrstat

Share of the EU tariff qouta used by Ukrainian producers



Source: Taxation and Customs Union, Ministry of Economic Development and Trade of Ukraine, ProAgro

Balance of payments



Source: NBU preliminary estimates

Financial and capital account was balanced at USD 0.1 bn. Net FDI inflow reached USD 0.2 bn. Ukrainian banks and real sector were able to attract USD 0.3 bn of short term loans. As a result, net inflow of investments and short-term debt financing were sufficient to cover private and public repayments on medium- and long-term debt (USD 0.4 bn) as well as outflow of cash foreign currency outside banks (USD 0.1 bn).

Fiscal policy: Fiscal pressure increases

Note: *The State Treasury reported on-going settlement of VAT refund arrears with government bonds as cash refund of VAT. In our opinion this is incorrect (it is more properly accounted for as reduction in payables) and we adjusted data from Treasury reports to exclude the effect of VAT refund arrears settlement on budget revenues.*

Preliminary data. According to preliminary data of the State Treasury central fiscal revenues in the first eight months of the year increased by 8.9% yoy (excluding as noted above reduction of revenues due to repayment of previous year's VAT refund arrears by special issue of state domestic bonds at UAH 6.4 bn). This increase is partly explained by frontloading of NBU profit transfer to the budget. Tax increases introduced in March and August also had an effect on revenues. These include increase in rent payments and excise rates, changes in VAT exemptions as well as introduction of war surcharge on personal income tax and deposit interest taxation. VAT collections from imports also increased over the last months as imports subject to VAT increased in hryvnia terms.

However, central fiscal revenues were by 5.9% (or by UAH 16.8 bn) lower than a target over eight months of the year. As a result, the Government had to cut discretionary spending. At the same time, it reported that debt servicing payments, wages and pensions were financed in time and in full.

July. In July central fiscal revenues dropped by 5.4% yoy. In particular, EPT revenues dropped by 22.9% yoy. At the same time, VAT revenues surged by 19.5% yoy due to lower cash VAT refunds and higher collections of this tax on domestically produced as well as imported goods. It should be noted that nominal consumption likely grew in July.

Officially reported VAT refunds in July surged as the Treasury included there UAH 5.4 bn of refunds using special government bonds. These refunds reflected VAT arrears accumulated in previous years. The "one-time" VAT refunds with bonds were conducted several times with the stated goal to clear the slate and to do prompt refunds from now on. However, delayed VAT refunds remain interest-free and quickly available instrument of emergency financing.

Non-tax revenues in July dropped by 13.4% yoy as NBU profit was transferred to the budget in previous months.

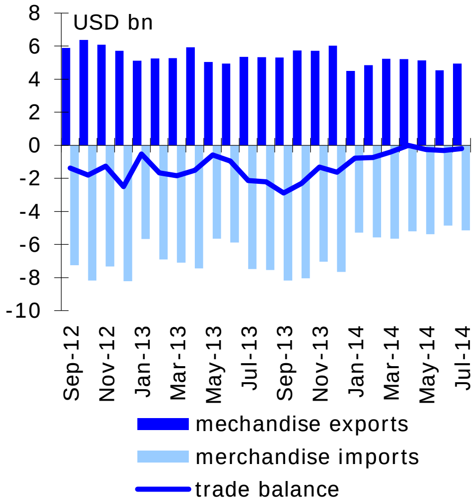
7 months. Central fiscal deficit reached UAH 32.8 bn and was predominantly financed by external borrowings. Privatisation receipts remained low (at 0.3% of annual target) as the State property fund did not initiate any big deals at time of high economic and political uncertainty.

Lower than planned deficit and revenues resulted in under-execution of central fiscal expenditures (general fund) by 7.7%. As usual, social protection items and intergovernmental transfers were financed close to plan (at 98.4% and 95.5% of target, respectively). However, surprisingly, defence spending was far below the target (at 68.8% of target). This was likely caused by delays in tenders. Government efforts to cut discretionary spending were most obvious in capital outlays, which reached only 12.3% of annual plan.

Social policy: Pension reform is expected

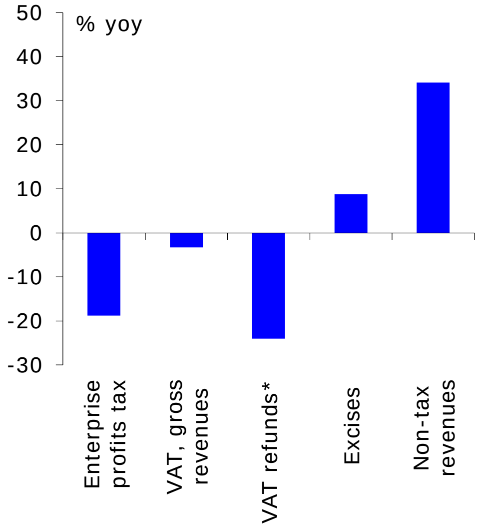
Pension reform. In the Letter of Intent to the IMF the Government revealed plans to continue pension reform and submit the respective draft law to the Parliament by end-September. Reform efforts will focus on privileged pensions, which are quite expensive at the moment. In particular, their nominal level will be frozen by the end of 2015. Besides, they will not be received by new entrants. This should

External merchandise trade



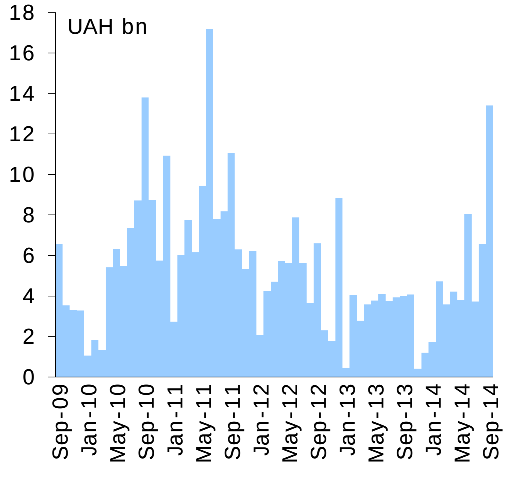
Source: NBU preliminary estimates

Growth of central fiscal revenues January-July 2014



* cash VAT refunds (without VAT-bonds)
Source: State Treasury reports

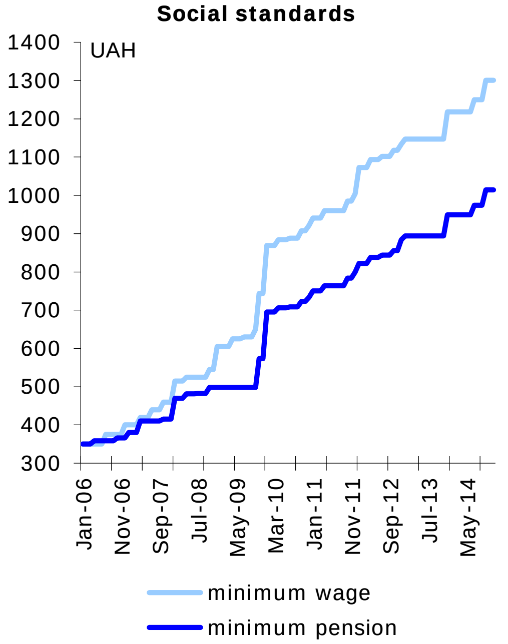
Balance of the Single Treasury Account



* in the beginning of month
Source: State Treasury

help to stem increases in central fiscal transfer to the Pension Fund. Besides, the Government plans to expand taxation of high-income pensioners. However, it should be also noted that originally when the pension reform was started in 2003 payment of privileged pensions was to be managed by non-state pension funds.

Increase in social standards. The Government plans to limit increases in social standards (minimum wage and minimum pension) in 2015 to expected inflation. This is aimed at preserving purchasing power of Ukrainians from further decline but small real increases previously planned for 2015 will not be provided. This means that private sector will likely also increase wages, but nominal wage increases may be lower than inflation.



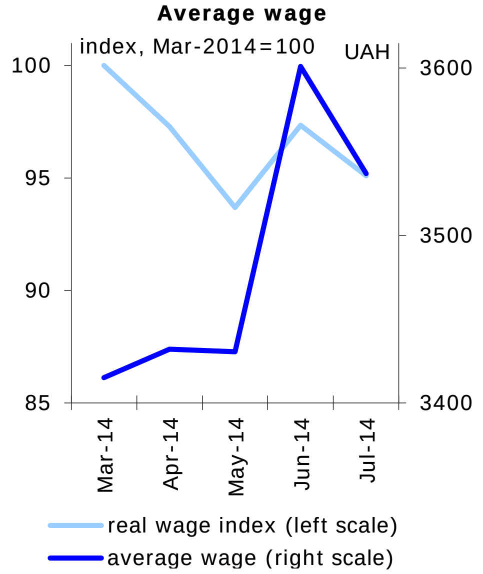
Source: State Budget Laws for 2006-2014

Labour market: Hard times for wage growth

Wages. In July average wage grew by only 2.6% yoy in nominal terms and dropped by 8.9% in real terms. Such trends are explained by industrial output decline, closure of many enterprises in Donbas region and high fiscal pressure.

Growth of average wage in industry by mere 1.7% yoy turned to be lower than minimum wage increase (at 6.2%). Armed conflict in Eastern Ukraine had a particularly hard impact on coal industry as many mines are situated in war zone and are unable to operate. As a result, average nominal wage in coal industry decreased by 16.6% yoy. Sectors that do not depend on coal or metal supplies increased wages more than minimum wage increase.

Good harvests of grain and other crops resulted in increase of nominal wages in agriculture by 10.4% yoy. Still, wages in the sector remained the lowest among all sectors of economy. Fiscal consolidation measures resulted in zero growth in public administration and defence, decline of wages in education (by 2.0% yoy) and minor increase in health care wages (by 0.9% yoy).



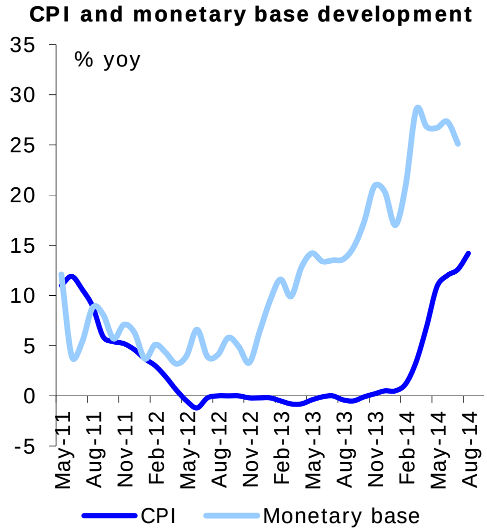
*not including AR Crimea
Source: Ukrstat

Employment. Number of employees that were shifted to shortened hours of work in the first half of 2014 increased by 24% yoy to 717 thousand individuals. The sharpest increase occurred in several oblasts of Eastern Ukraine, where many companies were forced to reduce their working day because of a life-threatening working environment and severance of supply chains and client relationships. In particular, in Donetsk oblast number of employees with reduced working day increased by 51.8% yoy to 104 thousand individuals. Number of employees working shortened working schedule in Kharkiv oblast doubled.

At the same time, the highest share of employees working less hours was in Zaporizhia oblast (12.7%). Though, it is not much different from previous year. This might be explained by weak demand for goods, produced in the oblast (e.g. steel and heavy machinery) already last year. At the same time, companies do not dismiss employees hoping for increase in demand in the nearest future.

Monetary policy: Inflation accelerated to 14.2% yoy in August

In August consumer inflation reached 14.2% yoy as prices for goods and services exhibited divergent dynamics. On one end of spectrum, prices for transport (fuel, cars and transport services), pharmaceuticals, “housing, water, electricity, gas and other fuels” jumped by 22-31% yoy. This reflected impact of hryvnia depreciation and related increase in regulated prices magnified by large weight of imports and inelastic demand. On the other hand, prices for vegetables reportedly dropped by 18.6% yoy, while prices for clothing and footwear declined by 3.3% yoy. Prices for communications were almost constant and prices for recreation and culture services increased only slightly (by 3.9% yoy). Here effects of low consumer demand were more pronounced due to higher demand elasticity and low import component (with the exception of clothing). Competitive environment in internet and mobile markets and good harvest of vegetables also helped contain prices.



Source: Ukrstat, NBU

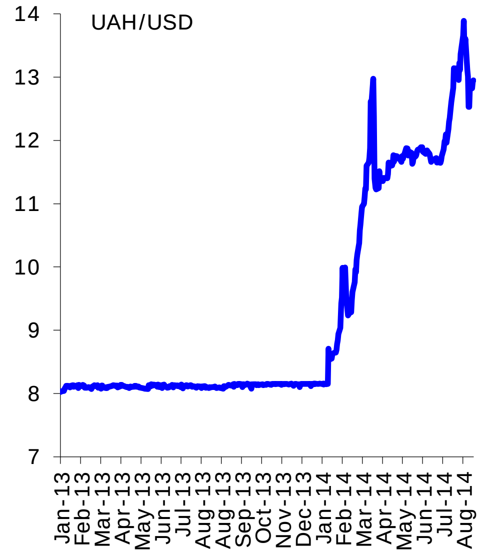
Overall, month-to-month core inflation (that excludes raw food products, energy, and administratively set prices) increased to 1.2% mom. It remained below monthly increases in core CPI between March and June.

The NBU in August increased interest rate on overnight deposit facility to 7.5% p.a and offered 85-day deposits at 12% p.a. At the same time, interbank interest rates crossed 10% mark despite increase in bank liquidity in August. This fact may point to increasing effectiveness of monetary policy operations.

Exchange rate: Sharp depreciation in August

Between May and July interbank exchange rate remained relatively stable at 11.5-12 UAH per USD. In August exchange rate stability was lost after political situation destabilised in late July. Exchange rate passed UAH 12 per USD mark and then exceeded UAH 13 per USD. Initially, the NBU tried the "verbal interventions" and then actual interventions on the interbank market.

Weighted average exchange rate at interbank



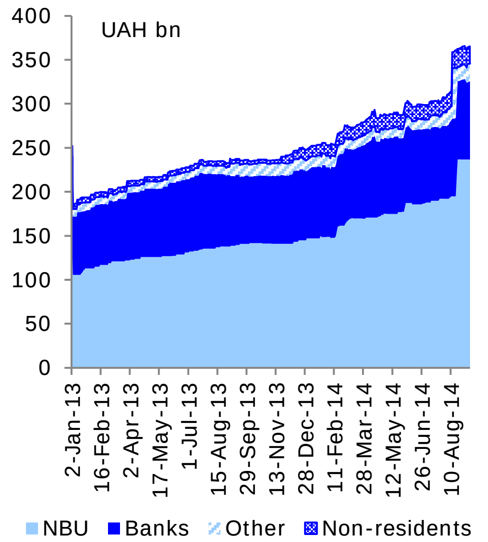
Source: NBU

As the NBU capacity to intervene on interbank market was limited by conditions of the IMF program the central bank turned to increasingly extreme administrative action. On August 20 the NBU decided to introduce 100% mandatory sale of foreign currency receipts by exporters and other recipients of foreign currency transfers. It also introduced monitoring of "propriety" of foreign currency operations. Still, hryvnia continued weakening.

On August 28 and August 29 the NBU prohibited clearing of foreign currency liabilities, required next-day settlement for mandatory sales of foreign currency and demanded from banks to send detailed information on sellers of foreign currency. The NBU also reintroduced limits on foreign transfers as well as cash withdrawals of foreign currency from bank deposits at equivalent of UAH 15000 per day. Other measures include three-day freeze on funds to buy foreign currency on interbank measures and cut in allowed open foreign currency position by banks (in effect requiring them to sell some of the foreign currency holdings). The NBU also held closed-door talks with heads of largest banks and later announced that actions of the NBU and commercial banks will allow them to return hryvnia to levels below UAH 13 per USD.

The weakening of the exchange rate may reflect decrease in export revenues due to stoppage in export-oriented plants and disruptions in supply. Low market liquidity likely exacerbated the problem. Radical action by the NBU essentially amounts to administrative setting of the exchange rate and the NBU or state banks have to act as market-makers to balance demand and supply. This is obviously a short-term solution and the NBU options will be limited if supply-demand imbalances continue. Still, if the NBU takes steps to make market deeper and psychological demand for foreign currency subsides, volatility on foreign exchange market may remain low.

Domestic government bond holdings



Source: NBU

State debt: Second IMF loan tranche was received

Domestic debt. Total amount of domestic bonds issued in August reached UAH 52.2 bn with only small share of them placed at the open market. In particular, The Ministry of Finance placed only UAH 4.5 bn of hryvnia denominated bonds with increased weighted average yield (by 2.1 p.p.) to 17.5% p.a. against the background of low demand. Two- and three-year bonds accounted for 88.9% of the total placement. At the same time, the Government was not able to refinance previously issued USD-denominated bonds due to lack of demand.

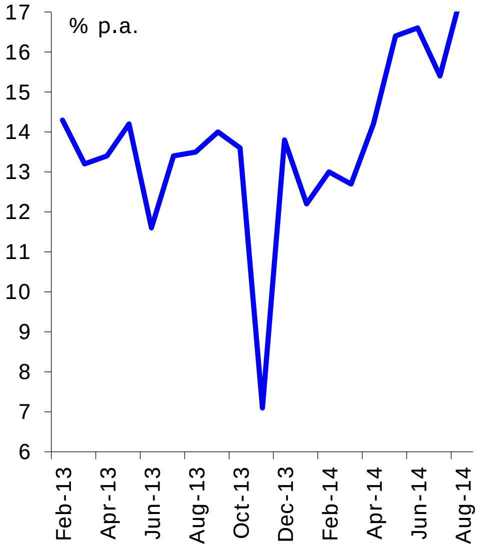
At the same time, the Government issued near UAH 42 bn of domestic bonds (out of planned UAH 96.6 bn) to increase Naftogaz's statutory capital. Bods have ten-year maturity at 14.3% p.a. The received funds will likely be spent on redemption of the company's Eurobonds scheduled by the end of September.

The Ministry of Finance also issued the third tranche of special government bonds at UAH 955 m to cover VAT refund arrears. They were provided to near 50 taxpayers.

External debt. On September 4, Ukraine received a second tranche of the IMF loan under the Stand-By Arrangement at USD 1.4 bn, including USD 1 bn for budget purposes. Besides, in the end of August Japan International Cooperation Agency in cooperation with the World Bank granted a USD 100 m loan to Ukrainian Government under the framework of the Intergovernmental Agreement Loan on development policy for economic reforms (for twenty years with a 6-year grace period at 0.95% p.a.).

Debt sustainability. State debt in 2014 is estimated to reach near 60% of GDP. The state debt growth raises concerns on fiscal vulnerability. According to the IMF Report on the First Review under the SBA, the Government did not reimburse the NBU for repaying budget support received from the IMF under previous SBA arrangement (near USD 1.3 bn).This resulted in accumulation of government debt to the NBU. It likely explains why the debt repayments target was under-executed in January-August (by UAH 12.9 bn or 16.4%).

Weighted average yield for domestic state bonds



Source: NBU

Economic Trends		Q3 12	Q4 12	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14	Oct	Nov	Dec	Jan	Feb	Mar	Apr[c]	May[c]	Jun[c]	Jul[c]	Aug[c]
Industrial production (real)	% yoy cum.	-1.2	-1.8	-5.0	-5.3	-5.2	-4.7	-5.0	-4.7	-5.2	-5.0	-4.7	-5.0	-4.2	-5.0	-5.3	-4.6	-4.7	-5.8	...
Construction (real)	% yoy cum.	-9.1	-14	-13.8	-17.8	-15.1	-14.5	-6.4	-8.9	-15.1	-14.3	-14.5	-16.4	-9.8	-6.4	-5.8	-6.5	-8.9	-12.4	...
Agricultural production (real)	% yoy cum.	-4.6	-4.5	5.8	15.4	3.0	13.7	6.0	-3.9	9.9	11.7	13.7	6.0	6.3	6.0	5.0	4.7	-3.9	3.4	...
Retail trade turnover (real)	% yoy cum.	16.0	15.9	13.4	11.2	9.8	9.5	7.7	0.8	9.5	9.2	9.5	8.8	9.0	7.7	5.6	2.9	0.8	-1.0	...
Average wage	UAH	3064	3195	3085	3289	3331	3390	3245	3488	3283	3268	3619	3148	3189	3398	3432	3430	3601	3537	...
CPI	% yoy eop	0.0	-0.2	-0.8	-0.1	-0.5	0.5	3.4	12.0	-0.1	0.2	0.5	0.5	1.2	3.4	6.9	10.9	12.0	12.6	14.2
PPI	% yoy eop	0.3	0.3	0.2	-1.6	-0.9	1.7	3.9	15.9	0.8	-0.5	1.7	1.9	3.3	3.9	6.1	8.8	15.9	22.5	24.2
Exports (USD)*	% yoy cum.	2.6	1.0	-4.7	-7.1	-6.2	-5.2	-7.7	-6.5	-9.0	-8.8	-7.6	-12.2	-10.0	-6.8	-8.3	-6.4	-6.7	-6.8	...
Imports (USD)*	% yoy cum.	7.6	5.6	-0.8	-8.3	-4.1	-3.4	-14.7	-19	-6.0	-5.7	-5.8	-6.7	-13.6	-16.1	-19.9	-17.3	-17.3	-19.5	...
Merchandise trade balance	USD bn cum.	-14.8	-20.5	-4.0	-7.1	-14.2	-19.6	-1.9	-0.6	-16.6	-18.0	-19.6	-0.8	-1.5	-1.9	-2.0	-2.2	-2.5	-2.7	...
Current account**	USD bn cum.	-10.0	-14.4	-3.1	-5.5	-11.4	-16.4	-1.3	-0.6	-13.4	-14.5	-16.1	-0.4	-0.8	-1.3	-1.2	-1.5	-1.9	-2.3	...
Gross international reserves	USD bn eop	29.3	24.5	24.7	23.2	21.6	20.4	14.2	16.1	20.6	18.8	20.4	17.8	15.5	15.1	14.2	17.9	17.1	16.1	15.8
Monetary Base	% yoy eop	5.8	6.4	9.9	13.4	14.8	20.3	28.5	25.1	17.3	20.9	20.3	17.0	21.0	28.5	26.8	26.7	27.3	25.1	...
Lending rate on UAH credits	% pa, aop	19.6	20.8	16.2	15.4	15.3	16.5	18.5	17.5	15.4	16.7	17.4	15.1	20.3	20.0	17.5	17.9	17.2	16.1	...
Exchange rate (interbank)	USD aop	8.10	8.15	8.12	8.14	8.15	8.21	9.1	11.71	8.18	8.20	8.24	8.37	9.08	9.98	11.61	11.78	11.79	11.74	12.98
Exchange rate (official)	USD aop	7.99	7.99	7.99	7.99	7.99	7.99	8.9	12.71	7.99	7.99	7.99	7.99	8.65	9.92	11.64	11.64	11.81	11.76	12.95
Exchange rate (official)	EUR aop	9.99	10.37	10.55	10.44	10.58	10.87	12.14	13.71	10.90	10.79	10.94	10.92	11.80	13.69	16.08	16.00	16.04	16.04	17.25

Sources: Ukrstat, NBU, ICAP, own calculations

* Monthly figures are only for merchandise exports and imports (source: NBU, preliminary data)
Quarterly figures are for trade in goods and services (source: NBU)

** Monthly data are according to the preliminary estimates provided by the NBU

[c] Data excludes Crimea

Key Economic Indicators		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Nominal GDP	UAH bn	170.1	204.2	225.8	267.3	345.1	441.5	544.2	720.7	948.1	913.3	1082.6	1302.1	1408.9	1454.9
Nominal GDP	USD bn	31.3	38.0	42.4	50.1	64.9	86.2	107.8	142.7	179.9	117.2	136.4	163.4	176.3	182.0
GDP growth (real)	% yoy	5.9	9.2	5.2	9.6	12.1	2.7	7.3	7.9	2.3	-14.8	4.1	5.2	0.3	0.0
Industrial production	% yoy	13.2	14.2	7.0	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	11.2	7.3	-0.5	-4.7
Agricultural production	% yoy	9.8	10.2	1.2	-11.0	19.7	-0.1	0.4	-5.2	17.5	0.1	-1.0	17.5	-4.5	13.7
CPI	% yoy aop	28.2	12.0	0.8	5.2	9.0	13.5	9.1	12.8	25.2	15.9	9.4	8.0	0.6	-0.3
CPI	% yoy eop	25.8	6.1	-0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5
PPI	% yoy aop	20.9	8.6	3.1	7.6	20.5	16.7	9.6	19.5	35.5	6.5	20.9	19.0	3.7	-0.1
PPI	% yoy eop	20.8	0.9	5.7	11.1	24.1	9.5	14.1	23.3	23.0	14.3	18.7	14.2	0.3	1.7
Exports (gs, USD)	% yoy	17.9	9.5	10.7	24.0	42.6	7.5	13.2	27.5	33.8	-36.7	27.1	28.2	1.0	-5.2
Imports (gs, USD)	% yoy	18.9	14.1	4.9	28.7	31.3	20.4	22.0	35.5	38.6	-43.1	29.3	33.8	5.6	-3.4
Current account	USD bn	1.5	1.4	3.1	2.9	6.9	2.5	-1.6	-5.3	-12.9	-1.9	-2.9	-9.3	-14.3	-16.4
Current account	% GDP	4.7	3.7	7.6	5.9	10.6	2.9	-1.5	-3.7	-7.2	-1.7	-1.7	-5.7	-8.1	-9.0
FDI (net)	USD bn	0.6	0.8	0.7	1.4	1.7	6.5	5.3	9.2	9.9	4.5	5.7	6.6	6.6	3.4
International reserves	USD bn	1.5	3.1	4.4	6.9	9.7	19.4	22.4	32.5	31.5	26.5	36.7	31.8	31.4	20.4
Fiscal balance'''	% GDP	-0.7	-1.9	0.8	-0.2	-3.0	-1.9	-0.7	-1.1	-1.5	-2.4	-6.0	-1.8	-3.6	-4.4
Total state debt	% GDP eop	45.3	36.5	33.5	29.0	24.7	17.7	14.8	12.5	19.9	33.0	39.9	36.0	37.4	40.1
External state debt (total)	% GDP eop	33.0	26.3	24.1	21.4	18.6	13.4	11.7	9.8	15.0	21.5	25.6	22.8	22.0	20.6
Monetary base	% yoy eop	39.9	37.4	33.6	30.1	34.1	53.9	17.5	46.0	31.5	4.4	15.8	6.3	6.4	20.3
Exchange rate	USD aop	5.44	5.37	5.33	5.33	5.32	5.12	5.05	5.05	5.27	7.79	7.94	7.97	7.99	7.99
Exchange rate	USD eop	5.44	5.30	5.33	5.33	5.31	5.05	5.05	5.05	7.70	7.98	7.96	7.99	7.99	7.99
Exchange rate	EUR aop	5.03	4.81	5.03	6.02	6.61	6.39	6.34	6.92	7.71	10.87	10.53	11.09	10.27	10.61
Exchange rate	EUR eop	5.10	4.67	5.53	6.66	7.22	5.97	6.65	7.42	10.86	11.68	10.57	10.54	10.30	11.04

Sources: Ukrstat, NBU, Ministry of Finance, own calculations

''' "Minus" denotes a consolidated fiscal deficit; without recapitalisation

Notes:

avg average

cum cumulative

mom month on month change

qoq quarter on quarter change

yoy year-on-year change

ytd year-to-date

p.a. per annum

eop end of the period

aop average of the period

gs goods and services

NBU National Bank of Ukraine

EPT Enterprise profit tax

VAT Value added tax

Ukrstat State Statistics Service of Ukraine

Quarterly trends

National accounts		Q4 09	Q1 10	Q2 10	Q1 11	Q2 11	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14[c]
GDP	UAH bn	259.9	217.3	256.8	257.7	311.0	369.8	363.6	293.5	349.2	387.6	378.6	302.9	353.0	394.7	404.3	313.0	372.7
GDP (real)	% yoy	-6.7	4.5	5.4	5.1	3.9	6.5	5.0	2.5	3.1	–1.3	-2.3	-1.2	-1.3	-1.2	3.3	-1.1	-4.6
Household consumption (real)	% yoy	-16.2	0.2	6.8	13.2	14.2	16.1	18.5	7.8	12.3	11.0	5.5	6.5	9.5	8.4	6.8	5.7	-2.3
State consumption (real)	% yoy	-3.7	3.8	-4.0	2.0	2.9	-9.4	-6.6	3.3	4.8	9.9	1.5	1.1	-2.3	-3.3	-2.5	-9.1	6.9
Gross fixed capital formation (real)	% yoy	-33.7	-5.7	-3.2	-1.8	3.7	9.7	12.0	13.8	17.5	-5.2	-4.9	7.0	-17.4	-7.7	-5.1	-19.1	-18.5
Exports of goods and services (real)	% yoy	6.9	0.4	13.2	19.4	4.9	0.3	-4.1	-7.3	-8.1	-3.8	-9.6	-9.0	-14.3	-7.9	-4.1	-2.0	-7.4
Imports of goods and services (real)	% yoy	-11.1	-6.2	17.2	38.1	23.3	12.5	5.2	-3.0	9.0	4.3	-2.6	-2.4	-18.4	-0.7	-1.8	-7.0	-11.3
Agriculture, hunting, forestry (real)*	% yoy	-11.6	5.4	0.5	4.9	1.3	16.7	38.1	0.5	11.5	-8.3	-4.0	5.7	20.8	-2.0	38.2	6.0	-8.8
Manufacturing industry (real)*	% yoy	6.5	10.9	10.1	7.8	3.4	4.6	-2.9	1.1	1.8	-4.8	-5.5	-9.5	-9.2	-9.8	-8.9	-6.8	-8.4
Construction (real)*	% yoy	-32.8	-7.7	-5.8	1.7	10.9	0.1	2.0	1.2	3.4	-15.3	-20.8	-14.9	-20.8	-11.1	-7.7	-3.9	-16.9
Trade, repair services (real)*	% yoy	-16.4	6.1	9.6	9.8	2.8	6.1	3.0	3.2	4.6	0.4	-1.2	1.6	-0.2	1.9	4.7	3.1	-9.1
Transport (real)*	% yoy	-0.4	1.3	1.8	10.2	7.9	5.7	11.1	-2.3	-3.3	-8.4	-9.5	-2.7	-0.6	2.8	2.8	-5.8	-6.1
Balance of payments																		
Current account balance	USD bn	-0.9	0.0	0.5	-1.6	-1.7	-2.6	-4.4	-2.1	-3.8	-4.0	-4.9	-3.1	-2.3	-6.0	-4.9	-1.3	-0.6
Current account balance	% of GDP	-2.7	-0.1	1.6	-4.9	-4.4	-5.6	-9.5	-5.6	-8.7	-8.3	-10.3	-8.3	-5.1	-12.2	-9.8	-3.8	-2.1
Trade balance in goods	USD m	-1407	-1236	-697	-3597	-2851	-4580	-5224	-3867	-5577	-5215	-5833	-4045	-3053	-7232	-5268	-1949	-567
Trade balance in services	USD m	550	930	1115	1262	1514	2007	1312	1299	1362	1975	1084	822	893	1919	480	589	142
Current transfers	USD m	722	608	728	1039	878	988	803	683	805	777	711	533	589	480	547	232	472
Direct investment (FDI)	USD m	1282	923	1196	880	2422	2090	1623	1663	1091	2002	1871	821	472	1199	859	-713	-292
Portfolio investments (equity)	USD m	41	-20	-18	149	113	42	207	-3	74	83	339	705	579	664	-757	-239	-53
Gross international reserves	USD bn	26.5	25.1	29.5	36.4	37.6	35.0	31.8	31.1	29.3	29.3	24.5	24.7	23.2	21.6	20.4	14.2	16.1
Exchange rate (interbank), UAH/USD	aop	8.06	8.00	7.91	7.95	7.98	7.99	8.01	8.03	8.04	8.09	8.11	8.11	8.14	8.15	8.21	9.14	11.71
Exchange rate (official), UAH/USD	aop	7.99	7.99	7.91	7.94	7.97	7.97	7.98	7.99	7.99	7.99	7.99	7.99	7.99	7.99	7.99	8.86	12.71
Fiscal indicators																		
Consolidated fiscal revenues	% of GDP	36.0	30.9	30.4	32.8	30.0	29.5	30.7	33.6	31.6	28.2	33.7	35.3	29.5	29.1	28.9	35.8	30.1
Personal income tax	% of GDP	4.7	4.9	4.8	5.0	4.8	4.2	4.7	5.1	4.9	4.4	5.0	5.3	5.1	4.7	4.9	5.2	4.8
Enterprise profits tax	% of GDP	3.6	4.3	3.0	4.5	4.5	3.6	4.4	4.9	4.1	2.9	4.2	6.2	3.4	3.0	3.0	5.0	2.5
Value-added tax	% of GDP	11.0	9.8	9.8	7.6	12.9	9.6	9.6	10.8	10.3	8.6	10.0	9.7	9.1	8.2	8.5	8.8	9.7
Excise tax	% of GDP	2.6	2.4	3.0	2.1	3.0	2.7	2.4	2.8	2.9	2.8	2.4	3.1	2.6	2.3	2.2	2.5	3.0
Consolidated fiscal expenditures	% of GDP	34.5	33.0	38.7	32.8	33.1	26.9	35.6	33.7	33.8	30.7	41.4	37.0	36.0	30.4	36.3	35.7	35.6
Current expenditures	% of GDP	31.4	32.4	37.4	31.5	30.8	23.9	30.1	31.8	31.3	27.7	37.4	35.7	34.1	28.5	33.5	35.2	34.6
Capital expenditures	% of GDP	3.1	0.6	1.4	1.3	2.4	3.0	5.5	1.9	2.4	2.9	4.0	1.3	1.9	1.9	2.8	0.5	1.0
Consolidated fiscal balance	% of GDP	1.1	-2.0	-8.0	-0.3	-3.4	-3.9	-5.5	-0.2	-2.6	-3.0	-7.8	-1.9	-6.3	-1.5	-7.4	0.1	-5.5
Privatisation receipts	% of GDP	0.0	0.1	0.0	0.4	3.2	0.0	0.1	1.4	0.3	0.1	0.4	0.0	0.0	0.2	0.1	0.0	0.0
Labour market																		
Average wage (real)	% yoy	-5.7	3.3	8.7	11.1	5.5	7.7	10.8	14.7	16.5	13.3	12.9	9.9	9.3	8.1	5.9	3.5	-10.6
Household income (real)	% yoy	-7.6	3.7	11.8	7.8	1.9	7.3	7.7	6.0	13.0	10.4	9.4	8.9	5.7	2.5	4.7	1.9	...
Unemployment rate (ILO methodology)	% cum	9.4	9.0	7.9	8.7	7.7	6.9	8.2	8.4	7.1	6.6	8.0	8.0	7.5	7.0	7.6	8.8	...
Banking system																		
Monetary aggregate M0	% yoy cum	1.5	5.4	9.9	15.7	11.5	8.6	6.3	4.7	6.7	5.2	5.5	9.7	9.8	12.3	17.0	19.2	31.9
Monetary aggregate M2	% yoy cum	-5.4	6.9	13.2	25.5	22.0	16.0	14.4	11.2	9.0	10.7	13.1	16.0	17.9	19.2	17.5	17.7	13.4
Household deposits in national currency	% yoy cum	-8.5	7.1	20.1	43.3	26.0	16.7	12.3	14.4	16.4	16.3	16.3	19.1	26.5	33.4	38.0	7.9	-2.3
Household deposits in foreign currency	% yoy cum	4.7	22.8	21.5	19.7	21.0	15.7	13.4	12.4	10.8	17.0	21.8	17.0	14.7	8.4	0.9	19.8	10.2
Com. bank credits in national currency	% yoy cum	16.9	13.6	8.3	16.0	18.5	21.1	21.0	17.4	15.3	9.1	7.7	8.6	7.4	10.2	16.9	12.3	4.9
Com. bank credits in foreign currency	% yoy cum	-15.2	-13.7	-10.5	-2.1	0.9	-2.3	-4.2	-7.0	-10.8	-9.9	-7.3	-4.4	-0.4	0.8	2.8	36.4	38.5
Long-term com. bank credits	% yoy cum	-3.8	-3.9	-2.8	5.0	6.3	5.3	2.9	-2.9	-7.0	-8.0	-6.6	-5.6	-2.7	-0.5	2.9	26.3	24.4
Long-term com. bank credits	% of total	68.1	68.5	68.9	67.2	66.6	64.4	62.9	61.5	59.8	59.1	57.8	55.9	55.7	55.1	53.2	58.5	59.1
Average lending rate on national currency credits	% p.a.	19.8	17.3	15.0	13.1	13.5	14.1	18.4	15.5	15.6	19.5	20.8	16.2	15.3	15.3	16.5	18.4	17.5
Average lending rate on foreign currency credits	% p.a.	10.1	10.9	11.1	10.2	9.8	8.8	8.4	8.2	8.2	8.5	8.8	9.4	9.7	9.6	8.8	8.7	9.4

Sources: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, Reuters, IER estimates

* change in value added

[c] Data excludes Crimea, preliminary NBU estimates for balance of paymer

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