NATIONAL
BANK
OF UKRAINE

INFLATION REPORT

April 2016

PREFACE

The Inflation Report reflects the opinion of the National Bank of Ukraine (the NBU) as to the current and future economic state of Ukraine with a focus on inflationary developments that form the basis for monetary policy decision-making. The NBU publishes the Inflation Report quarterly in accordance with the forecast periodicity.

The publication of the macroeconomic forecast and its underlying assumptions aims at strengthening the transparency and predictability of the NBU monetary policy. This should enhance society's confidence, which is an important prerequisite for anchoring inflation expectations and achieving price stability.

The Monetary Policy and Economic Analysis Department developed forecasts of inflation and other macroeconomic variables. NBU Board (the Board) approved the forecasts during a meeting devoted to monetary policy issues on 21 April 2016.[1] Macroeconomic projections, including inflation, comprise the principal input, but not the only one, the Board considers in its decision-making. In addition to the projections of inflation and other macroeconomic variables, the Board takes into account any new information appearing after the forecast has been developed. The assessment of risks to the outlook or relations between macroeconomic parameters may vary between members of the Board.

The analysis in the Inflation Report is based on the macroeconomic data available at the date of its preparation; therefore, the time horizon of the analysis for some indicators may vary. This report used 15 April 2016 as the cut-off date for the data.

The Inflation Report is a translation of the original Report in Ukrainian. In case of any discrepancies between the original document and its translation to English, readers should consider the Ukrainian version of the Report as correct.

[1] NBU Board Resolution No. 279 as of 21 April 2016 *On the Approval of the Inflation Report*.

CONTENTS

ABBREVIATIONS AND ACRONYMS

ATO	**A**nti-**T**errorist **O**peration
BoP	**B**alance **o**f **P**ayments
BPM5 **BPM6**	IMF **B**alance of **P**ayments **M**anual (**5**th edition) IMF **B**alance of **P**ayments And International Investment Position **M**anual (**6**th edition)
CDs	**C**ertificate of **D**eposit(s)
CIS	**C**ommonwealth of **I**ndependent **S**tates
CMU	**C**abinet of **M**inisters of **U**kraine
Core CPI	**Core C**onsumer **P**rice **I**ndex
CPI	**C**onsumer **P**rice **I**ndex
CRUspi	The **CRU S**teel **P**rice **I**ndicators
DGF	**D**eposit **G**uarantee **F**und
DXY	**US D**ollar **I**ndex
ECB	**E**uropean **C**entral **B**ank
EFF	**E**xtended **F**und **F**acility
EU	**E**uropean **U**nion
FAO	**F**ood and **A**griculture **O**rganization
Fed	**F**ederal **R**eserve **S**ystem
FTA	**F**ree **T**rade **A**rea or **F**ree **T**rade **A**greement
GDP	**G**ross **D**omestic **P**roduct
GVA	**G**ross **V**alue **A**dded
IIF	**I**nstitute of **I**nternational **F**inance
IKSO	**I**ndex of **K**ey **S**ectors **O**utput
ILO	**I**nternational **L**abour **O**rganization
IMF	**I**nternational **M**onetary **F**und
Markit PMI	**M**arkit **P**urchasing **M**anagers' **I**ndex
MFU	**M**inistry of **F**inance of **U**kraine
MSCI	**M**organ **S**tanley **C**apital **I**nternational
MTP	**M**ain **T**rading **P**artner
NBU	**N**ational **B**ank of **U**kraine
NEER	**N**ominal **E**ffective **E**xchange **R**ate
OPEC	**O**rganization of the **P**etroleum **E**xporting **C**ountries
PFTS	**PFTS S**tock **E**xchange, **F**irst **S**tock **T**rade **S**ystem
PPI	**P**roducer **P**rice **I**ndex
REER	**R**eal **E**ffective **E**xchange **R**ate
RF	**R**ussian **F**ederation
SESU	**S**tate **E**mployment **S**ervice of **U**kraine
SFSU	**S**tate **F**iscal **S**ervice of **U**kraine
SSSU	**S**tate **S**tatistics **S**ervice of **U**kraine
Treasury	**S**tate **T**reasury **S**ervice of **U**kraine
UN	**U**nited **N**ations
USA	**U**nited **S**tates of **A**merica
VAT	**V**alue-**A**dded **T**ax
VRU	**V**erkhovna **R**ada of **U**kraine
WTO	**W**orld **T**rade **O**rganization
OECP	**O**rganisation for **E**conomic **C**o-operation and **D**evelopment
M	million
bn	billion
UAH	Ukrainian hryvnia
EUR	euro
USD	US dollar
RUB	Russian ruble
pp	percentage points
bp	basis points
M0	cash outside banks
M3	Broad money
USD/bbl	US dollars per barrel
USD/MT	US dollars per metric ton
USD per EUR	exchange rate of euro to US dollar
UAH per USD	exchange rate of Ukrainian hryvnia to US dollar
RUB per USD	exchange rate of Russian ruble to US dollar
y-o-y	year-over-year, compared to the same time period in the previous year
m-o-m	month-over-month, compared to the previous month
q-o-q	quarter-over-quarter, compared to the previous quarter
y-t-d	year to date, since the beginning of the year
LT	Long-term

1. SUMMARY

In Q4 of 2015 and in early 2016, the external conditions as a whole remained unfavorable for the development of the Ukrainian economy. These were associated with the continued sharp decline in global commodity prices and weak external demand in Ukraine's main trading partner countries. However, since mid-February 2016 global commodity prices have shown a strong rebound. In particular, oil prices have risen by 35% on average since mid-February. The rally reflected expectations that the current oversupply in the oil market would be addressed and high risks of oil supply disruptions from the Middle East countries due to infrastructure problems. In turn, **the rebound in oil prices supported also non-energy commodity prices.** Thus, in Q1, steel prices rose by almost 30% amid a gradual, yet steady decline in world production, statements by the Chinese government on measures aimed at reducing excess production capacities, as well as the introduction of anti-dumping duties by individual countries.

High volatility in global commodity and financial markets, as well as subdued global activity were reflected in monetary policy decisions of leading central banks. In particular, the Federal Reserve System recent decision implied a slower pace of monetary policy tightening, while the ECB easing was more significant than had been anticipated by market participants. These resulted in a marked weakening of the US dollar against major currencies, including against the euro. In turn, the US dollar depreciation and prevailing optimism in world commodity markets propelled **investors' appetite for riskier assets, including those of emerging market countries. These factors contributed to the appreciation of the currencies of emerging market economies in Q1 2016, despite significant depreciation pressures at the beginning of the year.** That led to weakening of hryvnia real effective exchange rate, accounting for steady disinflation in Ukraine and enhanced depreciation pressure on hryvnia nominal exchange rate in early 2016.

A gradual rebalancing in global commodity markets, which will result in a moderate increase in prices, **represents a major change in external assumptions to the baseline scenario of macroeconomic forecast of Ukraine**[2]. However, in 2016, on average commodity prices will remain lower than a year ago, and will grow moderately in 2017. Countries' further adjustment to low prices on the back of the accommodative monetary policy stance of leading central banks will contribute to a gradual pick up in global economic activity in the second half of 2016 and in 2017.

In contrast, **domestic assumptions have not changed** and primarily suggest that the situation in the east would not deteriorate, cooperation with the IMF will continue (although disbursements of official funds will be shifted by one quarter ahead compared with previous estimates), and lending activity will gradually recover in the second half of 2016.

In Q1 of 2016, as expected, consumer inflation in Ukraine continued to slow down thanks to tight monetary and fiscal policies, low world commodity prices, and stabilization of inflation expectations. However, a slowdown of inflation (to 20.9% y-o-y in March) **proceeded faster than projected.** This can be mainly attributed to higher supply of food products in the domestic market due to narrowed export opportunities for domestic producers and increased imports of fruits and vegetables. In addition, heightened competition between tobacco manufacturers resulted in a more moderate rise of the Administered prices and tariffs sub-index than it had been expected. Core inflation in Q1 was in line with our forecast.

Although actual inflation came in below the NBU forecast in Q1 2016, inflation projections remain unchanged and consistent with the targets – 12% at the end of 2016 and 8% at the end of 2017. The unaltered forecast primarily reflects the NBU opinion that most supply side factors are short-lived and their effect will unwind in the following periods. A return of inflation to the target will also be fostered by rising prices on world commodity markets. The forecast of **core inflation is in line with the previous prediction (9.1% at the end of 2016).** However, given the strong impact of supply side factors in Q1, risks to inflation forecast for 2016 year-end have tilted to the downside.

The implementation of a prudent fiscal policy will be a significant factor contributing to further disinflation. In January-February 2016, the consolidated budget generated a significant surplus (UAH 9.9 billion) in contrast to deficits reported for this period in previous years. The surplus was achieved thanks to an increase in budget revenues that outperformed expectations and a moderate rise in expenditures. Lower revenues to social funds due to a payroll tax rate reduction will result in a substantial increase in budget support of the Pension Fund of Ukraine in 2016. However, due to the retrenchment of other budget expenditures, further progress in tackling Naftogaz's deficit, and reduction

[2]Hereinafter assumptions and projections are compared with the previous NBU forecast published in the "Inflation Report" for January 2016.

of other quasi-fiscal needs, the public sector fiscal deficit will decline. **Moreover, unlike previous years, in 2016, fiscal dominance will not be a binding constraint for monetary policy.**

Ukraine's economy continued to recover in Q4 2015, confirming the NBU estimates the economy bottomed out in the first half of 2015. De-escalation of the military conflict in the east of Ukraine that allowed starting to restore economic links between the regions and improving business expectations were among crucial domestic factors underpinning the recovery in the second half of 2015. In addition, Ukraine's national accounts data reading were better than expected in Q4 2015 - real GDP increased by 1.4% compared with the previous quarter in seasonally adjusted terms; while in annual terms the decline slowed to 1.4%. Deviations from the forecast can be primarily attributed to the faster recovery of investments and a more substantial than expected increase in public consumption. **For 2015 as a whole, real GDP declined by 9.9%, which also exceeded our expectations.**

According to our estimates, **economic activity kept growing in Q1 2016 with real GDP reporting slight increase in annual terms,** as expected in the previous forecast. **The forecast for annual** real GDP growth remained unchanged - 1.1% in 2016 and 3.0% in 2017. Although the external assumptions, regarding global commodity prices, were improved, their impact can be leveled by worsened business expectations and investors' sentiment amid heightened political uncertainty and delays with unfreezing cooperation with the IMF. The risks to real GDP forecast are seen as balanced.

At the beginning of 2016, unfavorable external conditions, new trade and transit restrictions imposed by the Russian Federation, and a number of temporary factors hit Ukraine's exports. That led to worse export performance than expected. Moreover, imports rebounded following relaxation of import tariff restrictions, and the deffered demand for imported goods exceeded our estimates. Consequently, **in January-February 2016,** the **current account deficit (USD 543 million) was wider than projected.** At the same time, it was offset by a larger net inflows on the financial account (USD 662 million), mainly due to net borrowing from abroad by the private sector. Given delays with planned official financing, debt repayments were dominant within the public sector operations. As a result, the overall balance of payments recorded a small surplus of USD 46 million in January-February 2016. **International reserves declined by USD 0.5 billion in Q1 2016 to USD 12.7 billion as of the end of March,** sufficient to cover 3.6 months of future imports. The decrease reflected March's external debt repayments by the public sector as well as NBU interventions to mitigate excessive hryvnia exchange rate volatility.

In 2016, the current account deficit forecast remained virtually unchanged (UAH 2.3 billion or 2.7% of GDP), although its quarterly pattern and component breakdown were revised. Thus, wider than previously projected merchandise trade deficit will be compensated by larger private remittances from abroad. At the same time, natural gas imports were revised further downwards. **In 2017, the current account balance forecast also remained almost unchanged – the deficit will narrow to 1.8% of GDP.** Projections for financial account balance in 2016 and 2017 were maintained almost unchanged. **In 2016, the overall balance of payments is expected to show a surplus (USD 1.2 billion)**, which, along with the IMF disbursements, will allow reserves to increase up to USD 18.7 billion, or 4.7 months of future imports. **In 2017, the international reserves are expected to grow to USD 22.6 billion**, or 5.3 months of future imports, due to a balance of payments surplus (USD 1.6 billion) and loans from the IMF.

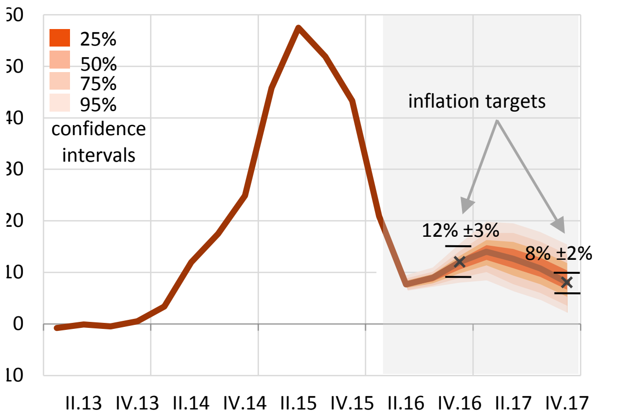
Considering the presence of a number of risks to price stability, in Q1 2016, **the NBU maintained monetary policy tight and kept its key policy rate unchanged at 22%.** Following heightened depreciation pressures due to external and internal shocks in January-February 2016, the situation on the foreign exchange market stabilized in March-April. The banking system continued to operate in an environment of a structural liquidity surplus. However, during Q1 2016, the amount of funds placed in NBU certificates of deposit slightly decreased amid higher liquidity absorption through other channels. In particular, it was facilitated by the Government returning to the domestic market of debt securities.

The banking system continued to benefit from domestic currency deposit inflows as well as a slowdown in foreign-currency deposit outflow. Also, notwithstanding overall weak lending activity, signs of its revival were observed in February 2016. However, due to lower demand for cash and given sizable base effects (caused by revaluation of FX deposits following a sharp hryvnia exchange rate depreciation at the beginning of last year), monetary aggregates demonstrated significant decreases in annual terms in Q1 2016. **Domestic currency deposits are forecast to remain on a growth track in 2016, and the inflow of FX deposits is also projected to resume this year.**

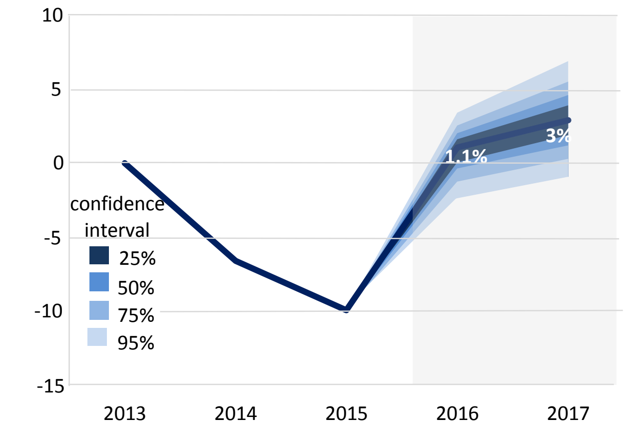
Apart from the outlined baseline forecast scenario, which is the most likely, the NBU also considered both optimistic and pessimistic scenarios.

On one hand, the **recovery of global commodity prices and stronger demand for Ukrainian exports may stimulate both higher investment and a more rapid economic recovery**. Successful privatization may also propel higher capital inflows.

Headline CPI Forecast and Targets, % y-o-y



Real GDP Forecast, % y-o-y



On the other hand, **the NBU considers that among the main downside risks to the forecast of economic development** may be a possible resumption of hostilities in the east of Ukraine, a further fall in global commodity prices, a decrease of external support in the event of hampered reforms, and a complete suppression of Ukrainian exports through the territory of the Russian Federation. **If these risks are realized, it will be the foreign exchange market and economic agents' inflation expectations that will put pressure on prices**.

Further alleviation of risks to price stability allowed the NBU to ease monetary policy. The key policy rate was cut to 19%, effective from 22 April 2016 (NBU Board Resolution No. 278, dated 21 April 2016, On Money Market Regulation). The main factors contributing to inflation risks weakening were easing political tentions (due to formation of a new government) and improved external conditions, such as the resumption of transit of Ukrainian goods through the territory of the Russian Federation and a gradual recovery in prices for key Ukrainian export commodities. It is expected that the NBU will continue to ease its monetary policy given that risks to price stability diminish further (including thanks to resumption of the IMF program). Also, **in line with the process of implementing inflation targeting regime, the NBU continued to improve its monetary policy tools, in particular, operational design of its interest rate policy.** The most significant change is that the interest rate on the main monetary operations of the NBU (currently - 2-weeks certificates of deposit) will be set at the level of the key policy rate. Also, a symmetric and fixed interest rate band (+/-2 pp around key policy rate) for standing facilities (overnight loans and deposits) was introduced, and auxiliary tools were optimized. **Transition to this system allows for enhancing transparency and predictability of monetary policy, and strengthens the impact of the NBU interest policy on prices of** other financial assets and retail **banking** interest rates**, thus raising monetary policy effectiveness in fulfilling the inflation targets.**

2. CURRENT ECONOMIC CONDITIONS

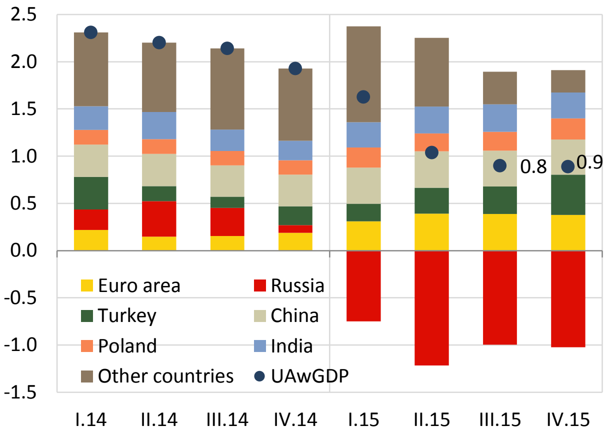
2.1. EXTERNAL ENVIRONMENT

In Q4 2015, the weighted average index of economic growth in Ukraine's main trading partner (MTP) countries remained low; however, it almost did not change compared to the previous quarter. This was due to loose monetary policies of leading central banks and countries adapting to the low level of prices on world commodity markets. At the same time, inflation in MTP countries gradually decreased.

Significant volatility characterized the situation in world commodity markets since the beginning of the year. In the first half of Q1, a further slump in prices was observed, which changed to significant growth in the second half of the quarter. In particular, against a background of decline in production volumes in China and a anti-dumping policies by the EU and the USA, steel prices increased by almost 30% in Q1. These price movements contributed to improving external conditions for Ukrainian manufacturers in the second half of the Q1 2016.

Stabilizing commodity markets against the backdrop of uneven economic recoveries in leading countries increased investors' demand for emerging market assets. This, in turn, provided support for currencies of those countries and allowed them to appreciate.

Ukraine's MTP Countries Contributions to the Annual Change of UAwGDP, %



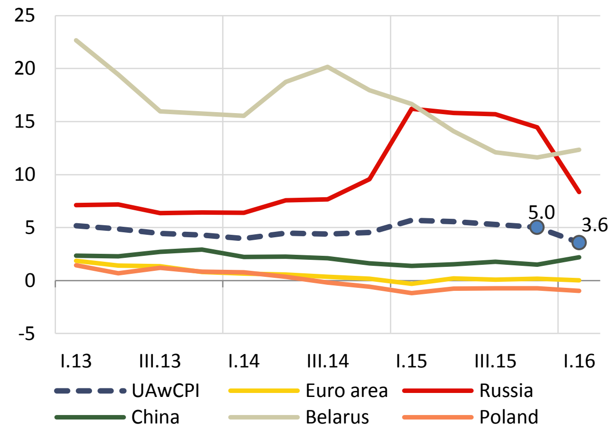
Source: NBU staff estimates (preliminary data)

In Q4 2015, external demand from trading partners of Ukraine (expressed with UAwGDP index dynamics) remained weak, however, it stabilized compared to the previous quarter. Relative factors included:

- the rapid economic growth of Turkey (by 5.7% y-o-y in Q4 2015) driven by domestic consumption, regardless of geopolitical tensions in the region and volatility in global financial markets;
- the stable pace of business activity growth in the euro area (by 1.6% y-o-y) against a backdrop of Euro depreciation and an ongoing ECB quantitative easing program;
- a slowdown of the GDP decline in Russia (to 3.8% y-o-y), first of all due to growth in mining industry.

It offset the impact of economic activity slowdown in two world's largest economies – China and the USA.[3]

Consumer Price Indices in Countries - Main-Trading Partners of Ukraine, % y-o-y



Source: NBU staff estimates (preliminary data)

The weighted average consumer inflation in MTP countries (UAwCPI index) gradually decreased in Q1 2016 due to:

- reduced depreciation pressure on emerging market currencies (in particular, CIS countries and Turkey), against a background of the Fed postponing interest rate hikes and marginal increases of commodity prices;
- the slowdown of inflation growth in Russia against a background of stabilization in the ruble to the US dollar exchange rate;
- deflationary pressure in the euro area, despite the ongoing quantitative easing program.

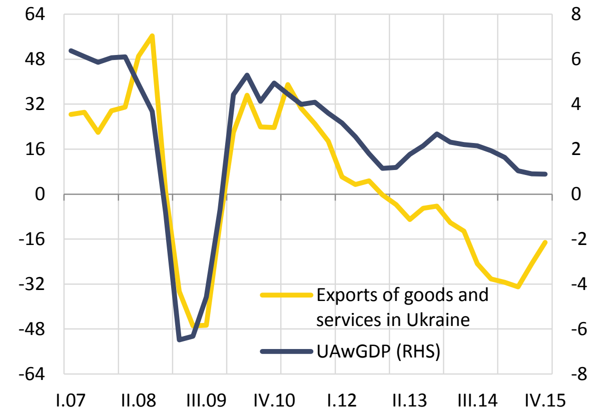
[3] Real GDP growth of China in Q4 2015 slowed down to 6.8% y-o-y against the background of a moderate economic reform process, accumulated financial imbalances, and capital outflow. Real GDP growth of the USA slowed down to 2% y-o-y due to the US dollar strengthening, a slowdown in investments, and weakening of consumption.

Indicators of External Demand and Inflationary Pressure from MTP Countries

Ukraine-weighted GDP Index (UAwGDP) is a weighted average of GDP growth rates of MTP countries. Increase in UAwGDP implies that external demand for Ukrainian producers from MTP countries rose, which may contribute to the growth of exports. According to NBU calculations, this index represents a leading indicator of the external environment's impact on the domestic economy with a time lag of one quarter.

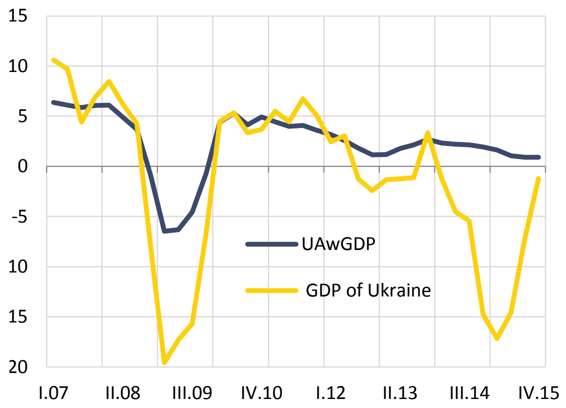
The annual real GDP growth rates of MTP countries in the corresponding quarter form the basis for UAwGDP calculation. The calculation uses weighting coefficients that reflect the relative share of MTP countries in percent of total goods and services for the previous year. A country's share of Ukraine's goods and services establishes the criterion for a country's inclusion to the MTP list. Currently, Ukraine set the criterion value at 0.3%. Accordingly, UAwGDP is estimated considering the Eurozone (19) and 21 other MTP countries. The total volume of exports of goods and services with MTP countries considered in UAwGDP calculation accounts for 75% of total Ukrainian exports.

UAwGDP and Exports of Goods and Services in Ukraine, % y-o-y



Source: NBU staff estimates (preliminary data)

UAwGDP and Real GDP of Ukraine, % y-o-y

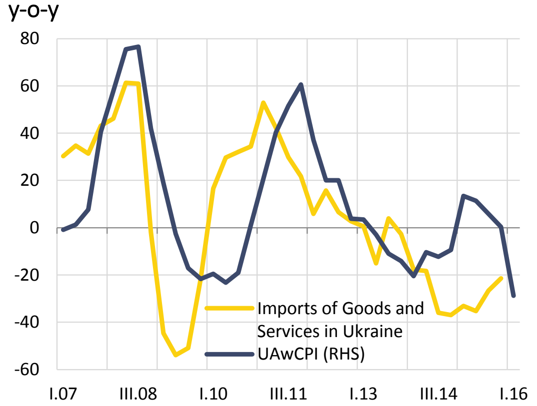


Source: NBU staff estimates (preliminary data)

Ukraine-weighted Inflation Index (UAwCPI) is a weighted average of consumer inflation rates in MTP countries. UAwCPI increase, other things equal, means, on one hand, higher contribution of imported inflation to consumer price developments in Ukraine, and, on the other hand, the increased competitiveness of domestically produced goods relative to foreign counterparts, which can help reduce the volume of imports.

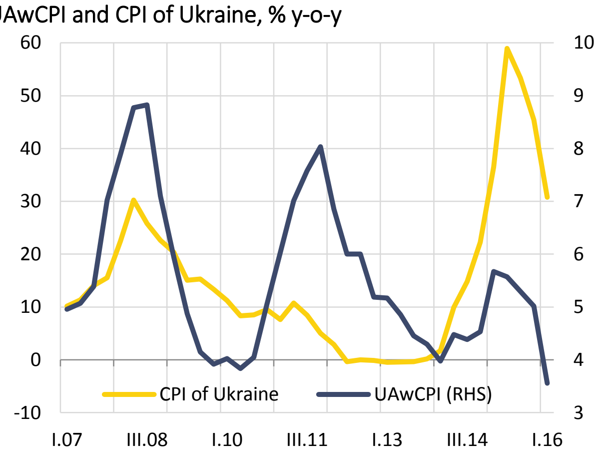
UAwCPI calculation uses the quarterly averages of Consumer Price Index (CPI) of MTP countries as a measure of inflation. The weighing coefficients, that reflect the share of MTP countries' total imports of goods and services for the previous year, are used in UAwCPI calculation. Currently, UAwCPI is calculated for 39 MTP countries. The total volume of imports of goods and services from these countries accounts for 88% of total imports to Ukraine.

UAwCPI and Imports of Goods and Services in Ukraine, % y-o-y



Source: NBU staff estimates (preliminary data)

UAwCPI and CPI of Ukraine, % y-o-y



Source: NBU staff estimates (preliminary data)

The sources of data regarding real GDP growth are the IMF, national statistics agencies, and Thomson Reuters agency.

The calculation of UAwGDP and UAwCPI are based on a methodology of international financial organizations (in particular, the IMF) and authorities of selected world countries (in particular, the central banks of England, Turkey, and Romania). The NBU updates this statistical data on a quarterly basis.

At the beginning of 2016, the economic activity of MTP countries demonstrated divergent dynamics. In particular, growth accelerated in China on the back of recovery in the manufacturing industry. The fall in industrial production in Russia slowed due to growth in the mining industry. However, the decline in US industrial production continued against a background of relatively low energy prices.[4]

Global oil prices experienced major fluctuations (from 25 USD/bbl up to 40 USD/bbl) during Q1 2016 as a result of the effects of both fundamental and temporary factors. Fundamental factors were associated with the persistent oil supply glut that continued to exert downward pressure on prices. These factors included: lifting the ban on US crude oil exports, lifting of sanctions against Iran's oil, US crude oil stocks growth (12.4% y-o-y - up to 529.9 million barrels as of 1 April 2016), etc.

At the same time, since mid-February, reporting on a suspected agreement between leading oil producers as early as mid-April to freeze oil production volumes significantly impacted the increase in oil prices. Additional factors were: reduced production of the biggest shale-oil producers in the United States for the first time in many years; further rapid decline in the number of drilling rigs in the world (within the current year – 1.7 times); and oil supply disruptions from Iraq and Nigeria because of problems with their old infrastructure.

As a result, Brent and WTI Crude Oil Prices at the end of Q1 2016 amounted to 38.9 USD/bbl and 36.9 USD/bbl, respectively, having increased from mid-February on average by 35%.

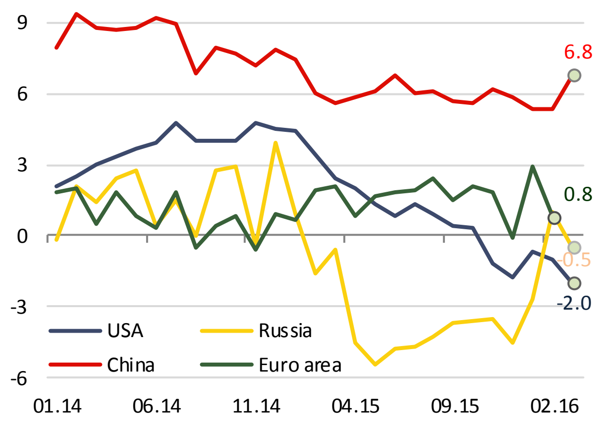
Early this year, steel prices showed a sharp drop in the global markets in line with oil prices and due to weak economic activity in China during the holidays. However, from mid-February, steel prices grew rapidly against a background of:

- implementation of anti-dumping duties in the EU and the USA on semi-finished steel from China, Russia, and other countries;
- price increases for iron ore as a result of the renewal of crude steel production by China after holidays in February;
- further decreases in the steel supply in the global market (by 3.3% y-o-y in February); and
- the approaching seasonal revival of business activity in northern hemisphere countries.

In addition, in early March, the Chinese government confirmed their intention to continue conducting a set of measures to reduce the volume of overproduction in the steel market.[5] As a result, prices of semi-finished Chinese steel products (in USD equivalent), despite a correction in March, increased on average by 30% during Q1.

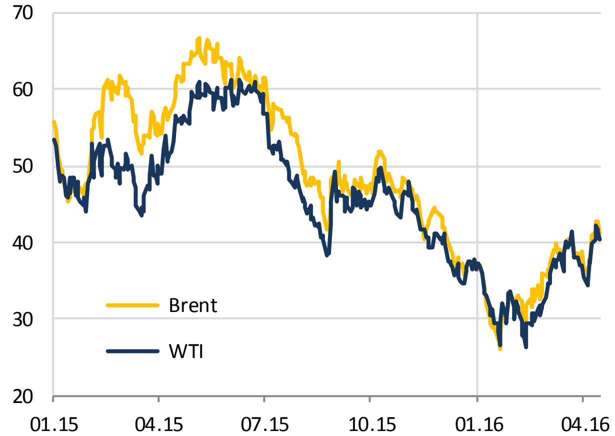
In general, the pricing environment for Ukrainian exporters improved in Q1 with external commodity price index tracking changes in world prices for Ukrainian exports (ECPI)[6] up by 5.7% since the beginning of the year. A sharp increase in prices for steel

Industrial Production in Selected Advanced and Emerging Economies, % y-o-y



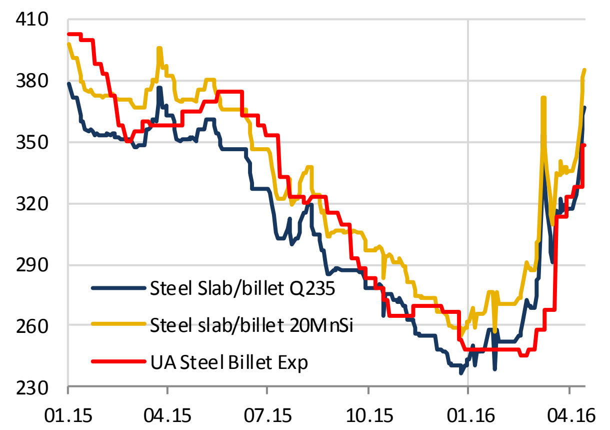
Source: National Statistical Offices

Brent and WTI Crude Oil Prices, USD/bbl, as of 15.04.2016



Source: *Thomson Reuters Datastream*

Semi-finished Steel Prices in China and Ukraine, USD/MT, as of 15.04.2016



Source: Thomson Reuters Datastream

[4] A drop in the US mining in March comprised 12.9% y-o-y and in the electric, gas, and water utilities – 7.7% y-o-y.
[5] Decline of steel production by China during 2015 was 2.3%, or 19 million tons. As per the statement of the Prime Minister of China on 5 March 2016, steel production will decrease by 100-150 million tons or 12-19% from the current production level up to 2020.
[6] ECPI is an indicator of world prices change on major Ukrainian export commodities. Weighting coefficients for ECPI calculation reflect the average share of Ukrainian export commodities in the total exports volume for the corresponding quarter of the previous year, which allows taking into account seasonal price fluctuations. Currently, ECPI is calculated using a basket of 14 world price indicators. In ECPI calculation, 10 Ukrainian export commodity groups are used, the total volume of which amounts to 67% of total Ukrainian exports.

products and iron ore made a significant positive contribution to the index's growth. Moreover, opportunities for sales volume increase have expanded for Ukrainian manufacturers, due to the imposition of anti-dumping duties by the EU and the USA.

Additional factors of ECPI growth included:

- wood and plastic products price increase due to the growth resumption in the construction industry of the northern hemisphere;
- world meat prices increases, particularly in beef prices, largely due to limited supplies from Australia and the USA.

These factors offset a further decline in cereals prices in world commodity markets due to large amounts of carryover stocks in the current marketing year.

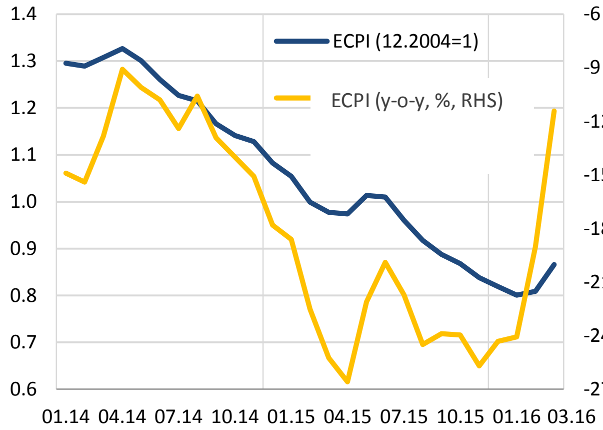
During Q1 2016 in the global financial markets, **major stock market indexes showed a significant correlation with global commodity prices**, which was supported by the effects of temporary factors. Thus, a significant slump of the S&P 500 and Eurostoxx 50 at the beginning of the year stemmed from, among other things, China's stock market decline resulting from panicked investor moods regarding the deepening of an economic slowdown in China; deterioration of global economic growth forecasts; fear regarding the UK leaving the EU; and investors' concern on the reduction of banks' profitability, particularly European in terms of central banks expanding use of negative interest rates, tighter banking regulation, and significant charges on restructuring by individual banks.

Simultaneously, **since mid-February growth in global stock markets resumed**. Against the background of a reversal in global commodity prices, contributing factors also included: the Fed management's statements on the possibility of a more gradual interest rate increase, which the Fed confirmed at the March meeting; the first signals and further easing of the ECB's monetary policy; and loosening of bank reserves requirements by the People's Bank of China.

Under these conditions, there took place a gradual renewal of investor's interest in emerging market financial assets, with the **MSCI EM index up by 17.4%** from 11 February to the end of March 2016**.** For the first time in eight months, in February 2016, **the outflow of portfolio investments from emerging markets ceased** (primarily due to inflows to bond funds in these countries), and in March, investors invested about USD 36.8 billion in emerging markets shares and bonds.[7] This represented the largest monthly volume of capital inflows for the last two years and much higher than the average level of the last four years.

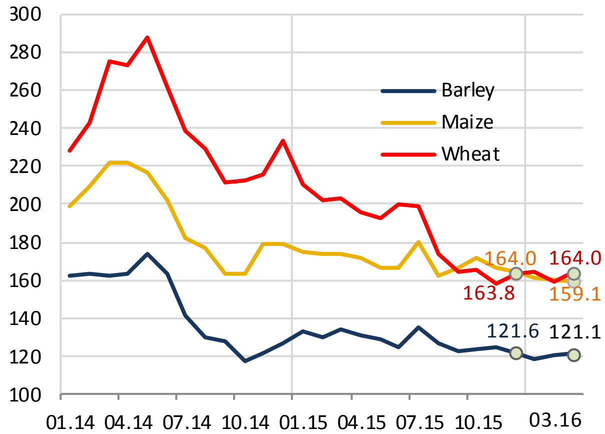
In March 2016 monetary policy decisions of major central banks reflected the presence of significant risks in global financial markets and the relative weakness of the world economy. Thus, the easing by the ECB was more significant than expected. In turn, the Fed confirmed the postponement of an interest rate increase. As a result, the **US dollar depreciated against the basket of major currencies (by 4.1%) as of Q1**, in particular, versus the euro (by 4.9% – up to 1.14 USD per EURO). Under the influence of US dollar dynamics, world prices on commodity markets and the renewal of

External Commodity Price Index (ECPI)



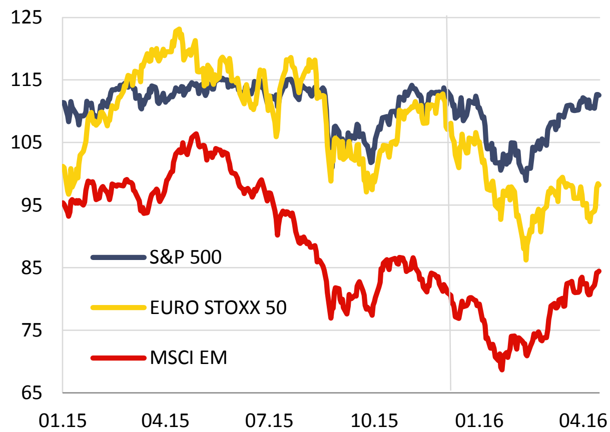
Source: NBU staff estimates

World Cereal Prices, USD/MT



Source: IMF

World Stock Indices, 01.01.2014=100, as of 15.04.2016

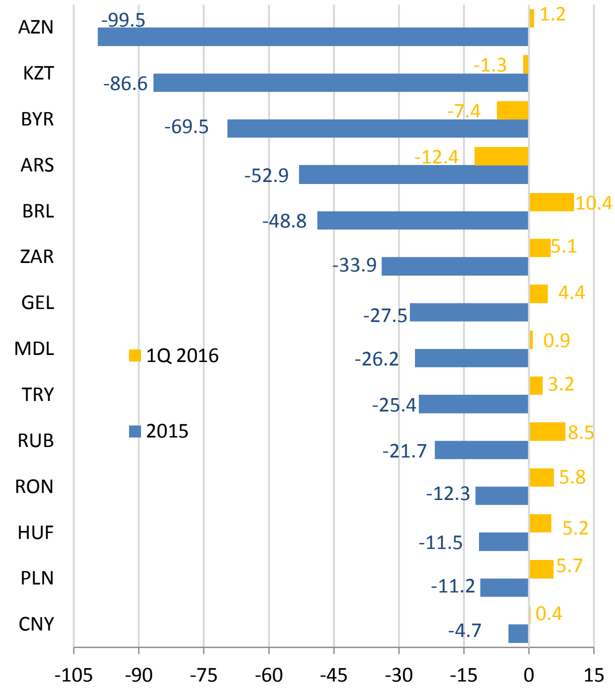


Source: Thomson Reuters Datastream

[7] According to data of The Institute of International Finance.

investors' interest in risky assets, emerging market currencies mostly strengthened as of Q1 2016, regardless of significant depreciation pressure at the beginning of the year.

Exchange Rates of Emerging Market Currencies versus US Dollar in 2015 and Q1 2016, % change, eop



Source: *Thomson Reuters Datastream*

2.2. DOMESTIC ECONOMY

2.2.1. INFLATION DEVELOPMENT

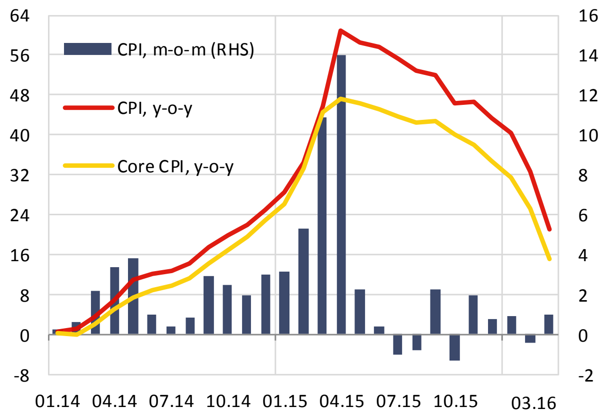
In Q1 2016, the rapid slowdown of consumer inflation in Ukraine continued (up to 20.9% y-o-y in March). During Q1, an increase in CPI amounted to 1.5%, which came in under the NBU forecast of 4.0%.

Mainly, deviations from projections occurred due to supply-side factors of raw foods, which are mostly short term in nature. Thus, the introduction of restrictions by the Russian Federation on trade and transit through its territory, as well as narrowing the possibilities to export certain products (including eggs), resulted in a significant expansion of the food supply in the domestic market. Also, the supply of imported fruits and vegetables increased, especially from Belarus and Turkey. The impact of supply-side factors was also supported with a downward trend in world food prices. As a result, prices of raw foods in Q1 increased by only 0.2% compared to the projected growth of 7.6%.

Competition among manufacturers of tobacco products led to a more moderate increase in administered prices and tariffs (2.1% in Q1) as compared to the NBU forecast (3.3%). Largely, the price increase for this component of the consumer basket occurred due to the planned increase in electricity tariffs for households.

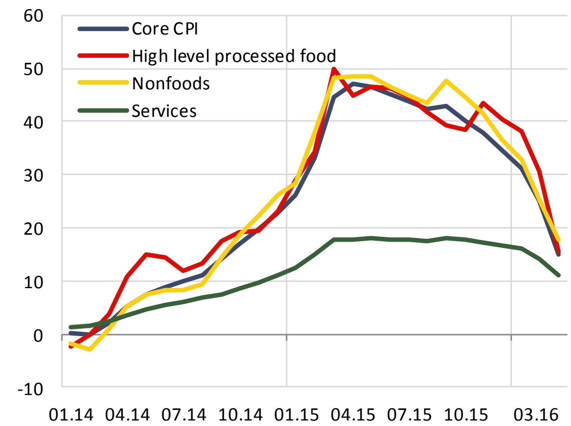
At the same time, core inflation (2.3% in Q1) and its slowdown in annual terms (to 15.0% y-o-y in March) complied with the NBU forecast.

Inflation Indicators, %



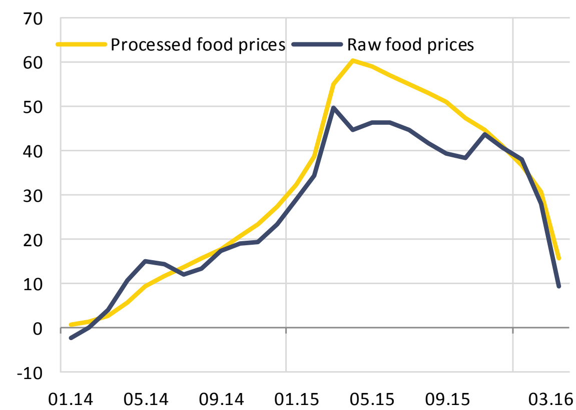
Source: State Statistics Service of Ukraine

Core CPI and its Components, % y-o-y



Source: State Statistics Service of Ukraine; NBU staff estimates

Processed and Raw Food Prices, % y-o-y



Source: State Statistics Service of Ukraine; NBU staff estimates

Core Inflation

Core inflation during Q1 2016 was slowing down, as expected, because of the modest consumer demand, a high basis of comparison, and improvement of inflation expectations.

Despite strengthening depreciation pressure on the hryvnia exchange rate in the first two months of 2016, growth of prices for non-food products, largely represented by imported goods (including clothing and footwear, household appliances, pharmaceutical products, audio equipment, photographic and information processing equipment), continued to slow down gradually - to 17.9% y-o-y in March.

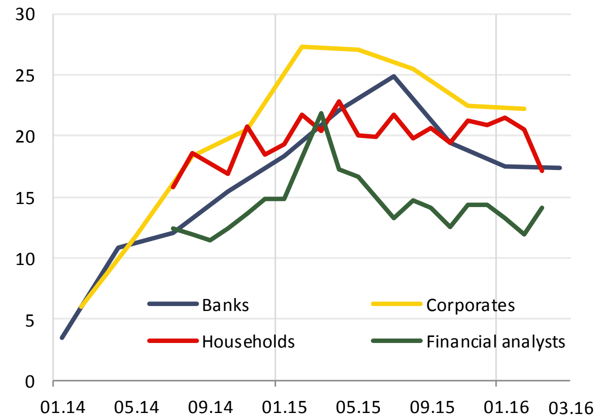
For these goods, and for other ones as well, the pass-through effect of the hryvnia exchange rate changes to prices was less evident than it was in 2014 and H1 2015. This can be explained by the depreciation pressure in late 2015 and early 2016, which occurred due to the influence of such factors as falling global commodity prices, the introduction of further restrictions by Russia, and the weakening of MTP countries' currencies against the US dollar. Meanwhile the same factors held back the rise of prices in Ukraine. However, in 2014 and H1 2015, depreciation was primarily due to a sharp increase in risk premiums for the Ukrainian economy and the need for adjustment of accumulated foreign imbalances. In addition, other factors played important roles determining the magnitude of pass-through effects – the speed and volume of the depreciation, the level of inflation, and exchange rate expectations.

In particular, stabilizing inflation expectations for the next 12 months across all groups of respondents became a significant factor of slowing core inflation. The lowest, although quite volatile, were expectations of financial analysts, while inflation expectations of households declined rapidly in late Q1 (to 17.1%), the lowest level since November 2014.

Food inflation included in the core CPI (especially highly-processed foods) also slowed down rapidly (to 15.6% y-o-y in March). This, among other things, reflected the impact of lower prices for components of non-core CPI (especially for fuel and selected raw foods), low prices on external food markets, and weak consumer demand.

Improving inflation expectations and low consumer demand restrained prices growth of services included in the core CPI basket, which slowed down to 11.2% y-o-y in March. The high comparison base also partly determined such dynamics.

Inflation Expectations for the Next 12 Months, %



Source: NBU; GfK Ukraine

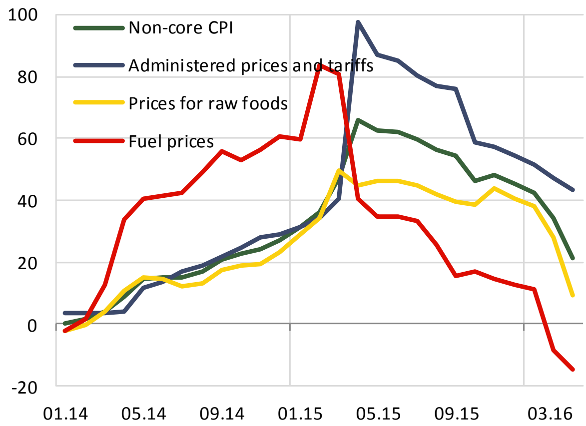
Non-core inflation

Non-core inflation during Q1 2016 slowed down sharply – to 21.3% y-o-y in March (as a whole for Q1 amounted to only 1%). A sharp slowdown in the raw food inflation (to 9.3% y-o-y in March) contributed primarily, which had a more significant impact than the NBU expected. In particular, the price of raw foods increased by only 0.2% in Q1 compared with projected growth of 7.6%. Such low rates of price change resulted primarily from an increased supply of raw foods, particularly through:

Narrowing of export opportunities for domestic producers. This is due to restrictions imposed by the Russian Federation on trade and transit through its territory, complicated supplies due to the military conflict in the Middle East and difficulties in obtaining permits for the supply of certain products. As a result, the price for eggs in the domestic market decreased by 39.6% in Q1, and by 5.3% y-o-y in March (after the 59.4% y-o-y growth in 2015);

Expansion of fruits and vegetables import, especially from Belarus and Turkey. In particular, the reorientation of Turkish exports from the Russian market to the Ukrainian one because of trade restrictions imposed by the Russian Federation, led to expansion of Turkish foods in the domestic market, including citrus fruits and greenhouse vegetables. As a result, prices for fruits and vegetables grew at a much slower rate compared to the seasonal growth in previous years.

Non-Core CPI and its Components, % y-o-y

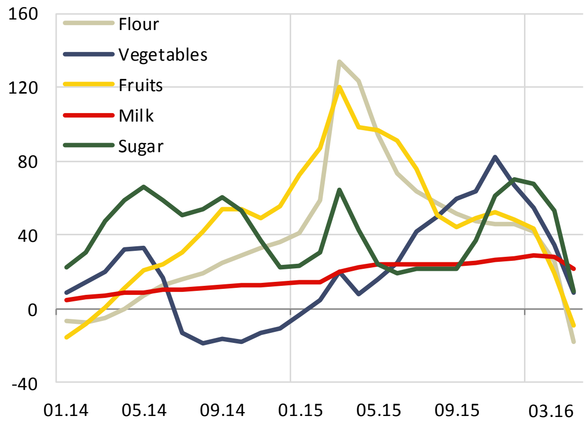


Source: State Statistics Service of Ukraine; NBU staff estimates

The high comparison base caused a slowdown of growth in milk prices, despite the increased demand from manufacturers for raw milk in terms of expanding their export opportunities.

Moreover, amid the restrained consumer demand and reduced number of livestock and poultry, the meat supply expanded, which contributed to the slowdown of growth in prices for meat and meat products.

Raw Food Prices, % y-o-y



Source: State Statistics Service of Ukraine

In Q1 2016, fuel prices in the domestic market decreased. This was due to a downward trend in world oil prices observed until mid-February this year, and regulatory initiatives of the government.[8] **Against a high comparison base, the rate of decline in fuel prices**

[8] In mid-January the Ministry of Energy and Coal Industry of Ukraine agreed on price decreases with oil traders and also started posting indicative distribution prices for gas (with their structure) on filling stations on its website.

accelerated to 14.7% y-o-y in March, which remained close to the NBU estimates.

Growth in **administered prices and tariffs** amounted to 2.1% **in Q1** being more moderate as compared to the NBU forecast (3.3%). The lower growth rate as compared to the estimated one was due, in particular, to the competitive struggle of manufacturers of tobacco products. This largely offset the impact of planned increases in excise taxes on alcoholic beverages, as well as tariffs for certain utility services. In particular, in January the tariff increases took effect for water and sewage, and since 1 March 2016 for electricity (by 25.2%). Growth rates for other utility services tariffs were more moderate.

In annual terms, the growth of administered prices and tariffs **slowed down to 43.4% y-o-y** in March and occurred for most components, including the price of bread and bakery products, and the cost of communication services and transport services. The latter, apart from the high comparison base, was due to a decrease in fuel prices. The annual increase in the cost of housing services during Q1 y-o-y was almost unchanged.

Producer Price Index

In Q1 2016, the sustainable slowdown of industrial inflation continued – to 10.5% y-o-y in March from 25.4% y-o-y in December last year. This slowdown is primarily due to the effect of a high base of comparison and it was characteristic both for mining and for the processing industry.

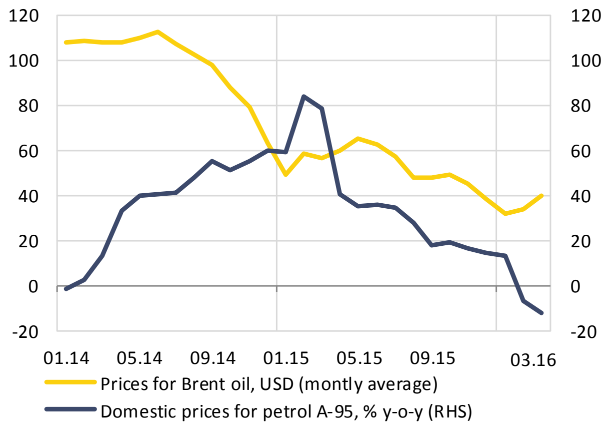
However, several factors restrained the slowdown of the growth in prices in the mining industry. In particular, in February and March, the price growth in coal mining (as compared to January) accelerated due to the pricing policy of individual producers. Moreover, the price dynamics in the industry were largely determined by the situation in foreign markets. Thus, because of rising world prices for oil and other commodities in the second half of February, prices in Ukraine for mining iron ores (February - March), crude oil, and natural gas (in March) increased in monthly terms.

Rising prices in the mining industry during Q1 led to price increases in the following branches of production: manufacture coke and refined petroleum products, and metallurgy industry. However, the impact of the high base of comparison from last year was rather substantial. As a result, prices in the metallurgy industry, after slowing in annual terms in January and February, resumed a decline in March (2.4% y-o-y). In the production of coke and refined petroleum products, the price decrease in March slowed to 10.1% y-o-y.

In Q1, the decline in prices in the chemical industry resumed, accelerating to 5.3% y-o-y in March. This was primarily due to the saturation of the domestic market of mineral fertilizers amid high competition and lower prices for fertilizers on world markets observed from October last year to February 2016.

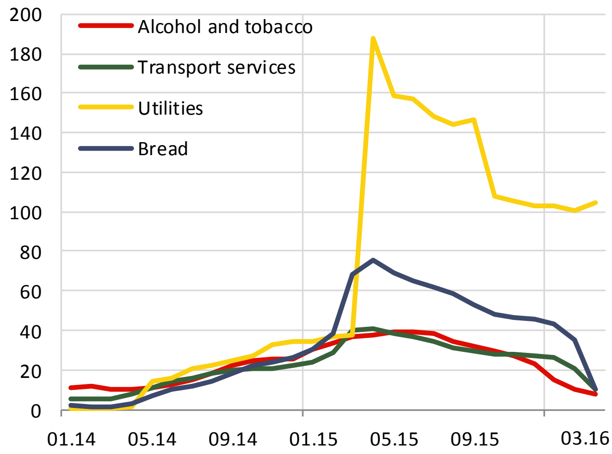
Price growth in the food industry in Q1 slowed down every month (to 14.7% y-o-y in March), including almost in all of its sub-sectors. This was primarily due to the effect of a high base of comparison, which outweighed the impact of expanding export opportunities for producers of milk and sunflower oil.

Prices for Petrol and Oil



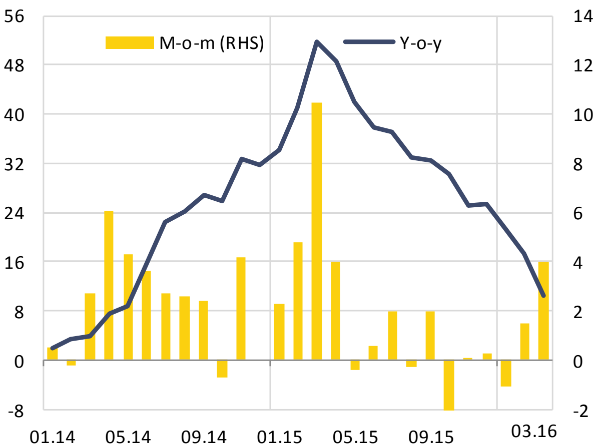
Source: State Statistics Service of Ukraine ;Thomson Reuters Datastream

Components of Administered Prices and Tariffs, % y-o-y



Source: State Statistics Service of Ukraine

Producer Price Index, %



Source: State Statistics Service of Ukraine

2.2.2. DEMAND AND OUTPUT

After hitting bottom in H1 2015, Ukraine's economy recovered faster than expected. In particular, real GDP in Q3 and Q4 grew by 1.1% and 1.4%, respectively (excluding seasonal factors). As a result, for Q4 and the whole of 2015, the decline in real GDP in annual terms (1.4% and 9.9%, respectively) was slightly lower than anticipated.

Deviation of the actual trajectory of economic activity from the projected growth was primarily due to Gross Value Added (GVA) growth in most service sectors, the statistics of which are not observed on a monthly basis. Also, construction sector surprised on the upside, reporting high growth thanks to favorable weather conditions and significant capital expenditures from the budget. Other sectors performed as anticipated - the decline in industry and trade continued to slowdown, while the transport sector reported growth. This was due to the recovery of industrial linkages primarily in terms of de-escalation in the east and the corresponding improvement in business expectations. The deepening recession in financial and insurance activities was the main factor that hindered economic recovery.

By expenditure components, gross fixed capital formation (investment) and public sector consumption resumed growth (+1.4% y-o-y and +8.1% y-o-y, respectively). Although the fall in private consumption slowed down further (to 13.2% y-o-y), it retained a significant negative contribution to real GDP change.

The key sectors output data points to further economic recovery in Q1 2016, which, however, remains unstable. In particular, trade and transit restrictions imposed by Russia, a further decline in world commodity prices, and temporarily adverse weather conditions caused some deterioration of economic performance in January. However, further unlocking of transit flows through Russia, improving external conditions, and a low comparison base prompted the resumption of output growth in key sectors of the economy in February-March. Given this, it is expected that in Q1 2016, GDP resumed growth in annual terms (albeit modest).

Output

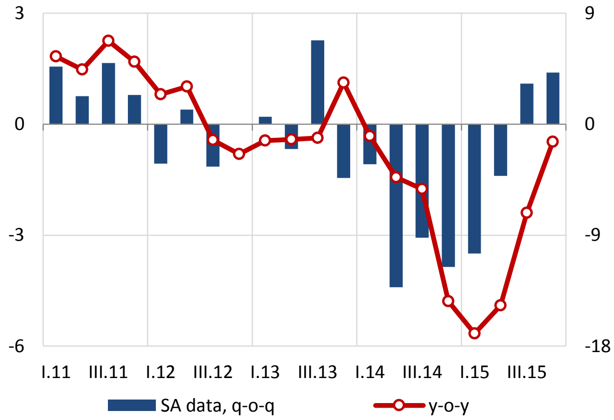
In Q3 and Q4 2015, Ukraine's real GDP showed growth as compared to the previous quarter, confirming preliminary NBU estimates regarding passing the bottom of the fall in H1 and the start of a weak recovery in H2**.**

In annual terms, real GDP decline slowed to 1.4% in Q4. GVA growth in annual terms was observed in most sectors, except financial and insurance activities. The dynamics of GVA of services improved the most significantly, determining the deviation of actual GDP growth from the projected path, as statistics on these sectors are almost not observed on a monthly basis.

In particular, the following tendencies were observed:

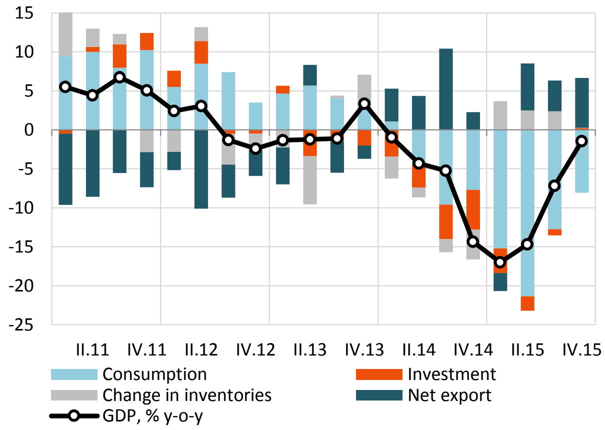
- GVA grew in such sectors as healthcare and social assistance (by 11.8% y-o-y), education (by 4.5% y-o-y), and public administration and defense (by 0.3% y-o-y). The growth was consistent with the increase in the "consumption of the general

Real GDP Growth, %



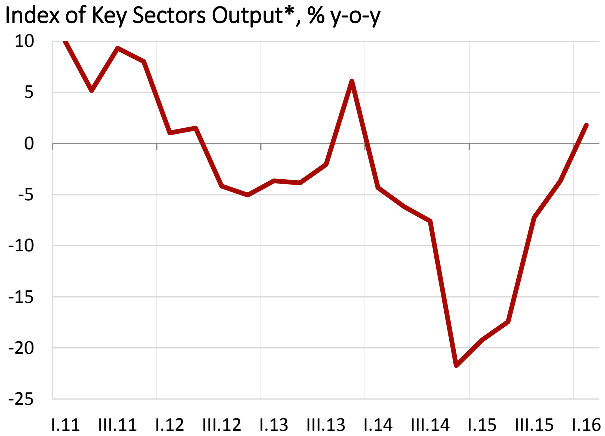
Source: SSSU

Contributions to Annual GDP Growth, pp



Source: SSSU; NBU staff estimates

Index of Key Sectors Output*, % y-o-y



For Q2-Q4, the average value of the index are given.

Source: SSSU; NBU staff estimates

government sector” (by 8.1% y-o-y) in the expenditure approach to calculating GDP and reflected a pick-up in budget expenditures;

- GVA rose in the real estate operations sector (by 5.8% y-o-y), underpinned by a slight recovery of demand in the primary real estate market and, consequently, the services to support its operations;
- the information and communication sector also reported GVA growth (by 6.5% y-o-y), supported by solid external demand for information technology services.

Significant increase of GVA in construction in Q4 (by 10.8% y-o-y) was unexpected, although its positive contribution to the change in GDP was relatively insignificant (0.2 percentage points). The increase of GVA in construction, especially its non-residential segment, was due to growth of consolidated budget capital expenditures in 2015 (infrastructure and social facilities, construction of which was financed from the budget, were put into operation mostly at the end of the year). In addition, after reaching a relative cease-fire, the gradual rebuilding of transport infrastructure began in the eastern regions. Also, favorable weather conditions had a significant impact on this sector.[9]

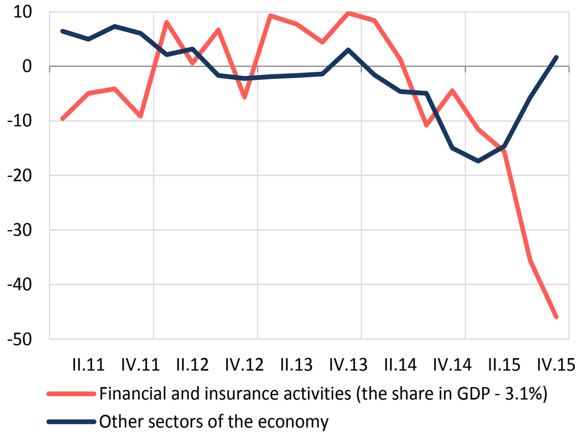
In other sectors, the dynamics of GVA was in line with expectations. In particular, the decline of GVA in industry, which is the largest component of the national GDP (over 20%[10]), slowed and was virtually flat (0.3% y-o-y[11]) in Q4. De-escalation in the east led to improvement in business expectations, gradual restoration of transport and production infrastructure in the affected regions. In addition to the low base effect, this contributed to the improved performance in the industrial sector.

In particular, the mining industry growth resumed (up by 1.9% y-o-y) after a recession that lasted since early 2014. Growth in coal production (by 7.9% y-o-y[12]) was mainly due to adjusting its delivery to processing plants. A slight increase in production volumes of metal ores lasted for the second consecutive quarter (by 1.2% y-o-y in Q4) and was primarily caused by an increase in their export volumes.

For the first time since mid-2012 in the processing industry, the decline in volumes of machine building halted (+0.2% y-o-y). In particular, production of vehicles[13] has significantly increased due to intensification of production of all types of products (cars, trucks, buses). However, capacity utilization of vehicle manufacturers remained low.

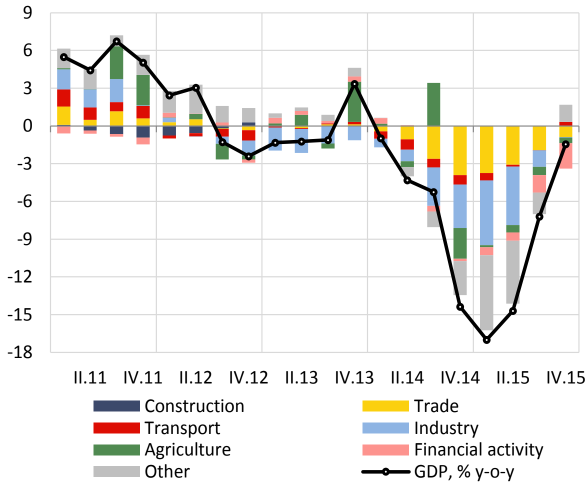
A further slowdown of metallurgical production decline continued (to 3.4% y-o-y), which, among other factors, was due to the stabilization of the supply of certain raw materials to the metallurgical enterprises. In particular, coke production increased further (by 23.0% y-o-y). At the same time, extremely low scrap supplies persisted in terms of their exports growth and low volume of collection.

GVA Change in the Financial and Other Sectors of the Economy, % y-o-y



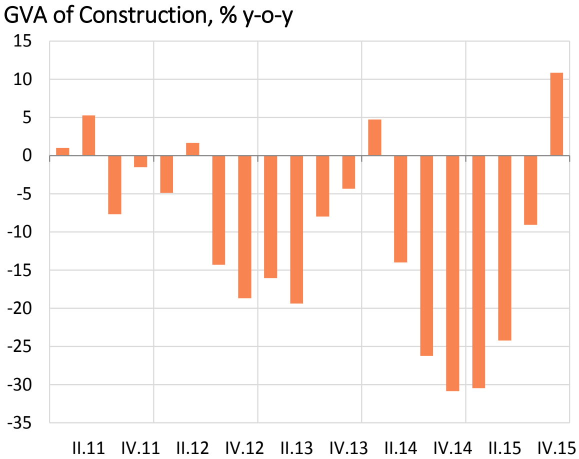
Source: SSSU; NBU staff estimates

Contributions of Certain Activities to Annual Growth of Real GDP, pp



Source: SSSU; NBU staff estimates

GVA of Construction, % y-o-y



Source: SSSU

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[9] In November and December 2015, the air temperature was 2.6ºC and 3.2ºC in excess of the norm, respectively, when in November-December 2014, the air temperature was close to the norm.
[10] Estimated on the basis of GVA by economic activities in 2015.
[11] According to estimates of the NBU on the basis of GVA of basic types of industrial activity.
[12] In terms of industries and commerce, mid-quarterly changes in output are provided.
[13] Data from the “Ukrautoprom” association.

The decline in production of chemicals and chemical products slowed significantly (by 3.9% y-o-y) due to the resumption of operation at two large chemical plants at the end of Q3 2015[14].

At the same time, the rate of decline in electricity supply remained almost unchanged (by 8.0% y-o-y) primarily due to the warm weather of the reporting quarter.

The decline of GVA in domestic trade significantly slowed down (to 6.1% y-o-y). First of all, the rate of decline in wholesale trade turnover decreased (to 5.2% y-o-y) due to some recovery of raw materials and finished products supply chains in industry and improved exports performance.

Despite the slowdown of real wage decline and the further gradual improvement of consumer sentiments[15], retail trade turnover continued to decline at a substantial rate in the reporting quarter (-16.8% y-o-y).

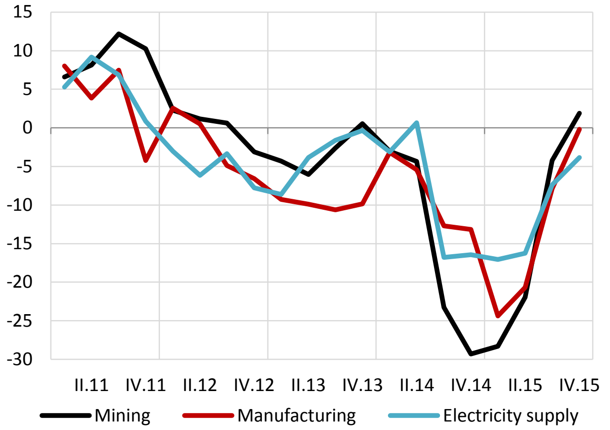
In Q4, the transport sector reported GVA growth (by 4.9% y-o-y), which was related to relevant dynamics of pipeline freight turnover under the conditions of high volumes of gas transit from the Russian Federation and exports recovery.

The decline rates of GVA in agriculture remained almost unchanged (3.6% y-o-y). Overall in 2015, there was a reduction of the acreage for most agricultural crops, and also a decrease of yields for late-planted grains and technical crops because of dry weather conditions during the active ripening period. As a result, the harvested volumes of some agricultural crops in Q4, as well as overall in 2015, were slightly lower than in 2014.

As to animal production, a certain worsening trends were observed in meat production: in Q4, the decrease accelerated to 2.2% y-o-y. Meanwhile, based on annual results, the reduction of the livestock slowed down (cattle, pigs and poultry).

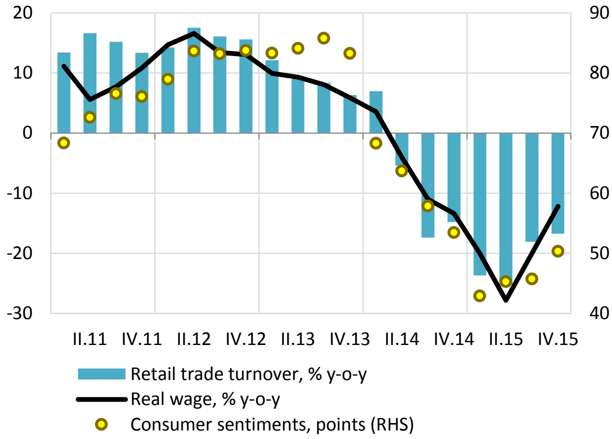
Output figures for major sectors of the economy highlight further gradual economic recovery in Q1 2016, which, however, remained unstable. From the beginning of 2016, transit through the territory of the Russian Federation was blocked and a further decline in world commodity prices was observed. Additionally, temporary weather deterioration persisted during January. These factors adversely affected the activity in some industrial and adjoining sectors of the economy and resulted in a deterioration of their performance. However, later on, mostly positive factors influencing economic activity prevailed. In particular, transit streams were mostly unblocked (since the end of February), and distinct signs of improvement of conditions in the global commodity markets were observed. Due to this, and also against the low comparison base, the growth of industrial production began, while the decline in construction, transport, and trade slowed down. Reduction of the production volumes in agriculture also continued to slow down (in Q1, only animal production dynamics were taken into account), first of all due to an

GVA by Industries, % y-o-y



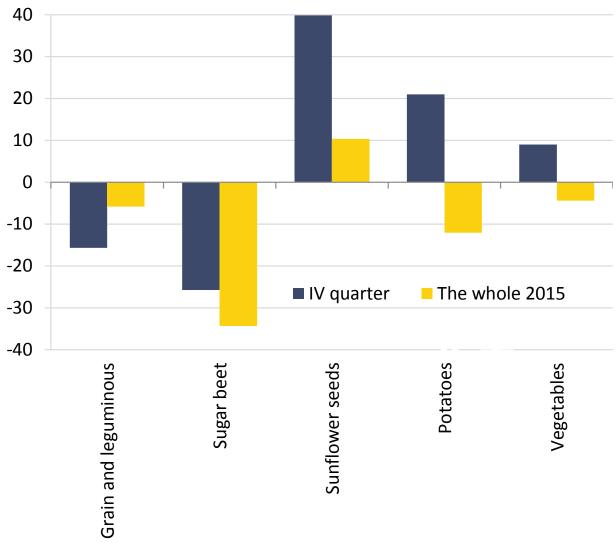
Source: SSSU

Retail Trade Turnover, Real Wages and Consumer Sentiments Index



Source: SSSU; GfK Ukraine; NBU staff estimates

The Total Harvest of Some Crops,% y-o-y



Source: SSSU; NBU staff estimates

[14] AZOT PJSC (Cherkassy) and Rivneazot PJSC, which are inherent to chemical holding Ostchem, renewed work at the end of September after four months of downtime.

[15] Consumer sentiments index of GfK Ukraine increased for the third quarter in a row, in particular from 45.7 points on average during Q3 up to 50.3 points on average during Q4.

improvement of dynamics in meat and milk production, in particular due to increased export capabilities.

It confirms the previous NBU estimates regarding the resumption of a slight growth of real GDP y-o-y in Q1 2016.

Domestic demand

A decrease in real GDP in Q4 continued to be determined by the contraction of domestic consumption (the negative contribution amounted to 7.8 pp). As opposed to previous periods, it was caused only by a decrease in consumption by households in the reported quarter, whereas investment demand and state sector demand, as expected, showed a slight recovery.

In spite of a further slowdown, the decrease in final private consumption expenditures remained substantial (13.0% y-o-y) and may be explained by the reduction in real incomes, credit contraction, and still restrained households' sentiments.

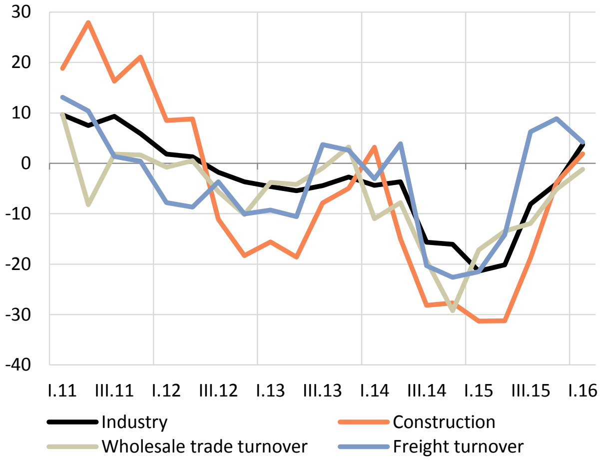
A reduction in consumption demand was observed across all items, however, the decrease in real final consumption expenditures for foods rapidly slowed down (to 4.6% y-o-y). At the same time, respective expenditures for utilities decreased substantially (by 37.4% y-o-y), which may be explained by relatively more thrifty consumption of such services by households under the conditions of rising costs, as well as increased volumes of subsidies provided. As a result, the share of households expenditures for utilities slightly decreased (to 12.6% from 15.4% in Q3), which was additionally caused by the rise in expenditures for foods in particular due to the seasonal price increases. Overall in 2015, the share of expenditures for utilities increased (to 14.8% from 12.3% in 2014).

Consumption expenditures in the general government sector in Q4 resumed growth in annual terms (by 8.1%), which is connected primarily with substantial budgetary expenditures at the end of the year.

In Q4, the downtrend in investment demand stalled: gross fixed capital formation in real terms increased by 1.4% y-o-y.

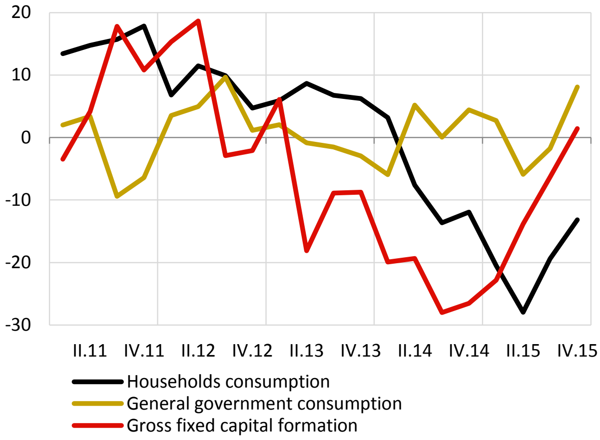
In particular, due to increased demand in the primary real estate market in Q4, a substantial growth of dwelling investments was observed (by 18.1% y-o-y). Slowdown of the decline of investments in non-residential buildings and constructions continued (up to 10.1% y-o-y), including due to a gradual recovery of social and transport infrastructure in the east of the country. Investments in machines and equipment were virtually unchanged (-0.9% y-o-y). At the same time, the decline of investments into intellectual property products resumed, possibly triggered by evolving negative expectations in response to signals about the complicated tax conditions in the information technologies industry[16]. At the same time, weak credit activity and limited access to external financial resources restrained investment activity further.

The Output in Certain Sectors of the Economy, % y-o-y



Source: SSSU; NBU staff estimates

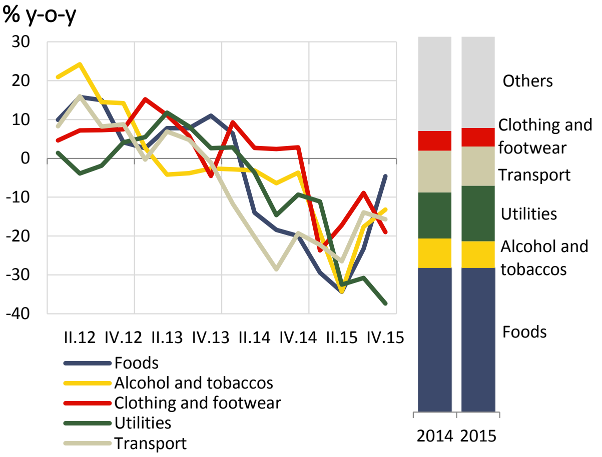
Domestic Consumption Categories, % y-o-y



Source: SSSU

Final Consumption Expenditures of Households by Purpose, % y-o-y

Expenditure structure, %



Source: SSSU

[16] In the process of preparation of the new Tax Code at the end of 2015, there was a debate regarding the strengthening of the tax burden for the information technology sector, however, resulting in no significant changes.

High volumes of crop exports in Q4 led to a reduction of inventories, which resulted in a zero contribution to GDP change (after a positive contribution of 2.4 pp in Q3).

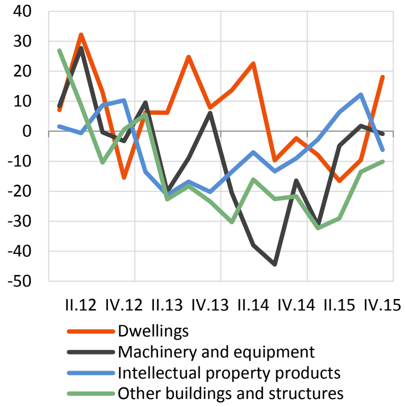
External demand[17]

In Q4, exports decrease slowed down considerably. Imports decline rates were notably higher and virtually unchanged in comparison to the previous quarter. As a result, the positive contribution of the net export to real GDP change increased substantially (up to 6.4 p.p.).

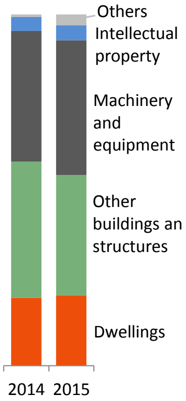
The slowdown of exports decline in Q4 (up to 5.8% y-o-y) was observed virtually across all commodity groups. This was due to low comparison base, as well as in view of development of new market outlets for food industry products.

A slight moderation of imports decline in Q4 (to 17.3% y-o-y) was prompted by a gradual recovery of economic activity. At the same time, it was suppressed by a decrease in natural gas imports volumes amid warm weather conditions. In addition, importers postponed purchases before tax changes at the beginning of 2016.

Gross Fixed Capital Formation by Types of Non-financial Assets, % y-o-y

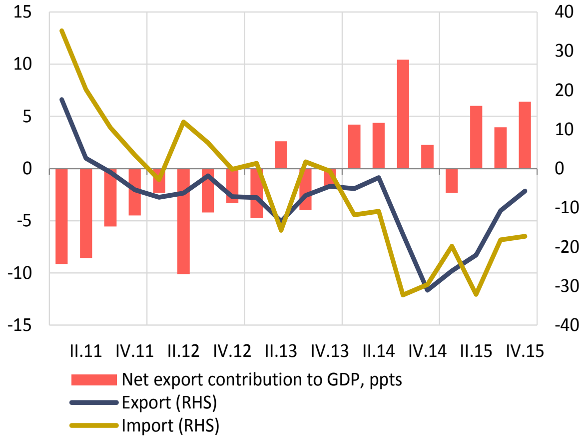


Structure of Gross Fixed Capital Formation, %



Source: SSSU

Export and Import of Goods and Services, % y-o-y



Source: SSSU; NBU staff estimates

[17] Changes of the actual group-wise volumes of export-import were calculated on the basis of data from the NBU.

2.2.3. LABOR MARKET AND HOUSEHOLD INCOME

The situation in the labor market remained tense despite the recovery of economic activity in the second half of 2015. However, at the end of 2015 and at the beginning of 2016, some signs of a gradual recovery of demand for labor force appeared. According to the methodology of the International Labor Organization (ILO), the seasonally adjusted unemployment rate in Q4 2015 slightly decreased, though in general in 2015 it remained at a fairly high level (9.1%).

In 2015, the nominal household income increased in comparison to the previous year by 15% mainly due to wages and social benefits. Thus, the average nominal wage (per permanent employee) increased by 30.4% for the year. However, its growth rate slowed down slightly in January-February 2016. At the same time, easing inflationary pressure, which started in May 2015, caused a substantial slowdown of decline in real wages, as well as real disposable household incomes.

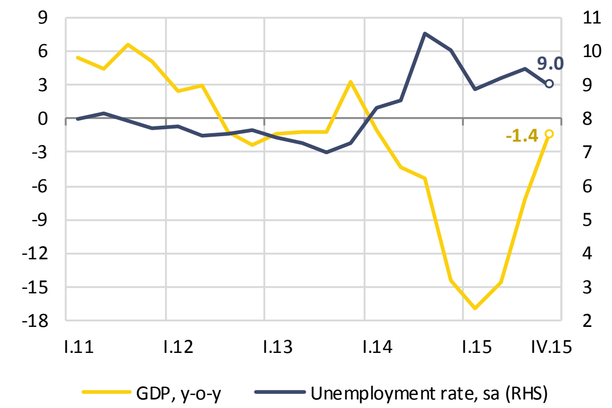
Labor market[18]

According to the ILO methodology, the unemployment rate (as a percent of economically active people aged 15 to 70) **remained at a high level of 9.1% in 2015** (in the previous year – 9.3%). In addition, **in Q4 2015, the seasonally adjusted unemployment rate decreased by** 9.0% (however, the official unemployment rate increased).

For reference: Registered unemployment at the end of 2015 and in January-February was 1.9%[19] in seasonally adjusted terms, implying virtually no change since the middle of 2011 (1.6% – 1.8%). The annualized quantity of unemployed people registered at the State Employment Service of Ukraine (SESU) tended to decrease since July 2015 to stand at 508,200 people as of the end of February 2016. This can be explained by the requirements people have to meet in order to get registered / retain the unemployment status, as well as the unwillingness of some people to contact public employment offices because they offer low-paid jobs and a low level of unemployment benefits.[20]

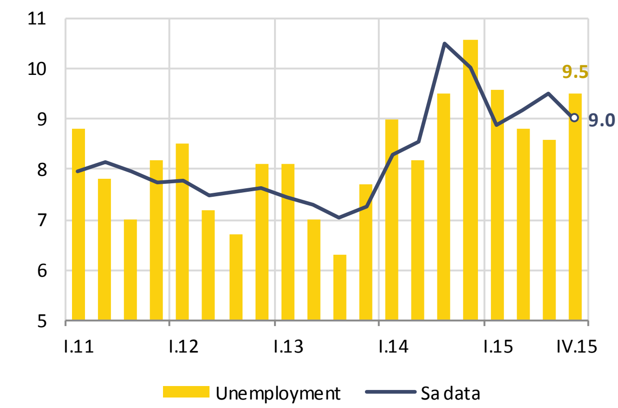
The number of permanent employees decreased in 2015 (by 3.5%). All types of economic activities posted a decrease (except agriculture), mostly in Industry, Finance and Insurance sector, Transport and Trade (total contribution to the annual decrease exceeded 50%). At the beginning of 2016, the decrease in the number of permanent employees continued (down to 7.8 million people[21] at the end of February), which may have been caused by a planned reduction. In particular, in January-February 2016, enterprises informed the SESU about plans to lay off 83,000 employees, which is 40% more than in the relevant period in the previous year.

Seasonally Adjusted ILO Unemployment[1-2] and GDP, %



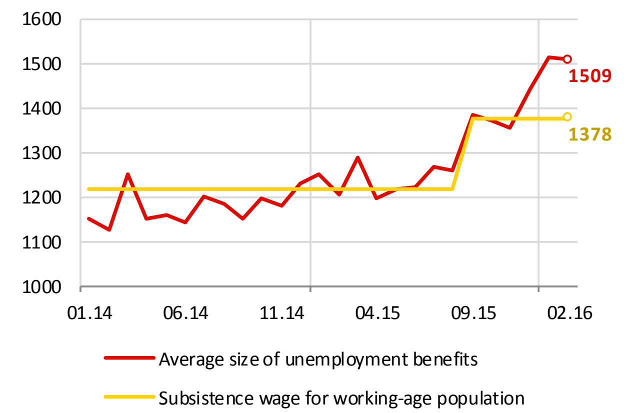
[1] % of economically active population aged 15-70
[2] Excluding Crimea and Sevastopol, since 2015 also part of ATO zone
[3] Excluding Crimea and Sevastopol, since 2014 also part of ATO zone
Source: SSSU; NBU staff estimates

ILO Unemployment*, % of the economically active population aged 15-70



** Excluding Crimea and Sevastopol, since 2015 also part of ATO zone*
Source: SSSU; NBU staff estimates

The Average Size of Unemployment Benefits and a Subsistence Wage for Working-age Population, for a month, UAH



Source: SSSU; The Law of Ukraine On the State Budget of Ukraine for 2015

[18] From the beginning of 2015, the SSSU publishes data excluding part of ATO zone; therefore, some labor market indexes may be underestimated.
[19] Estimation of the registered unemployment level is based on the number of people registered at employment centers.
[20] The SESU reported as of 1 January 2016 that one third of all vacancies had been for jobs paying less than UAH 1,500 per month, or less than 30% of the average wage for the end of 2015. Only 3.6% of vacancies were for jobs paying over UAH 5,000. Apart from that, during 2015 the average level of unemployment benefits almost equaled the subsistence wage for working-age persons. However, starting in 2016, the difference between these indexes slightly increased.
[21] In January 2015, the number of permanent employees was 8.1 million people.

For reference: According to the SESU, the level of compulsory underemployment was quite high in 2015. Thus, the number of employees moved to a part-time workday (week) due to economic reasons amounted to 9.2% of the average number of staff (2014 saw the highest level for the last five years), and the number of people who were on unpaid leave of absences amounted to 0.8% of the average number of staff (in 2014 – 1%). This employment status appeared most commonly in Dnipropetrovsk, Kharkiv, Poltava, Sumy, Zaporizhia, Donetsk, and Luhansk regions, where 11% to 21% of employees worked part-time. Part-time working hours were mostly observed in Industrial and Transport sectors.

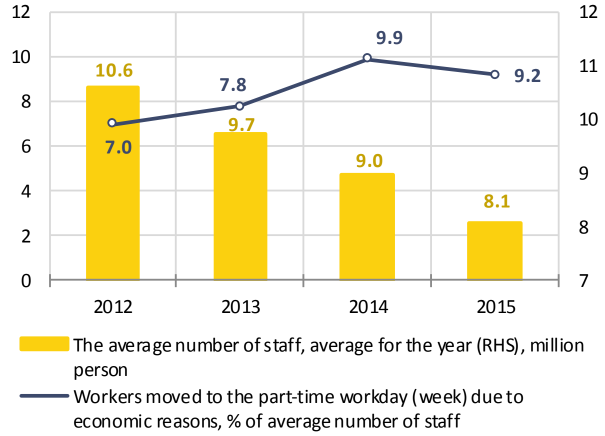
Due to the economic crisis in 2015, employers' demand for employees declined in virtually all areas of economic activity and in all occupational categories. This led to an **increase in the load of registered unemployed per 10 vacant work places** (on average in 2015 it exceeded the 2014 level by 20%). However, at the end of 2015 and the beginning of 2016, the situation slightly improved – the load level for February 2016 decreased in seasonally adjusted terms (down from 134 people per 10 vacancies in November 2015), revealing a gradual increase of demand for labor.

Household income and savings[22]

In 2015, the nominal household income increased in comparison to the previous year by 15%, which was mainly caused by an increase of wages and social benefits, as well as other current transfers (total contribution to annual growth amounted to 10.5 pp). **In Q4 2015, the increase of nominal household income substantially accelerated** primarily due to social benefits and other current transfers, which increased by 39.1% y-o-y. The wages in the nominal income structure in Q4 2015 increased only by 18.2% y-o-y.[23] Consequently, the share of social benefits in nominal household income exceeded the share of wages for the first time since Q2 2009 (40% and 36%, respectively).

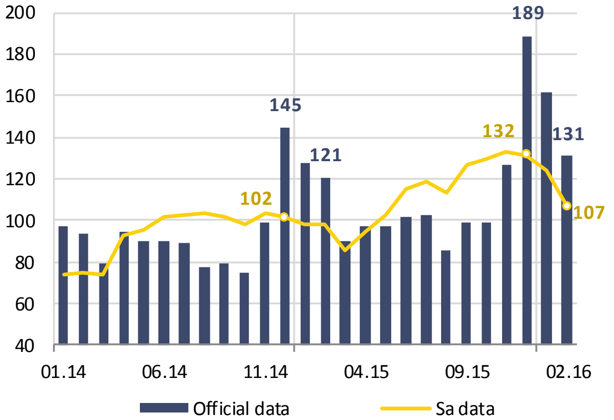
The average nominal wages (per permanent employee) **during 2015 grew more rapidly.** In Q4 2015, the growth rate of nominal average wages accelerated (the quarterly average amounted to UAH 4,753). The major reason behind this growth in Q4 2015 was a rise in minimum wages (by 13% – up to UAH 1,378 from 1 September 2015) and pre-new year payments in December, which were higher than in previous years. In Q4 2015, wage increased predominantly in such types of economic activities as Air Transportation (by 54.9% y-o-y), Trade (by 40.7% y-o-y) and Health care (by 37.7% y-o-y). **At the beginning of 2016, the growth of nominal wages slowed down** (by 26.2% y-o-y in February), which may be caused by smaller amounts of wage indexation due to a weakening of inflation pressure, as well as to methodological approaches to calculating the index.[24]

The Average Number of Staff and Level of Forced Part-time Employment*



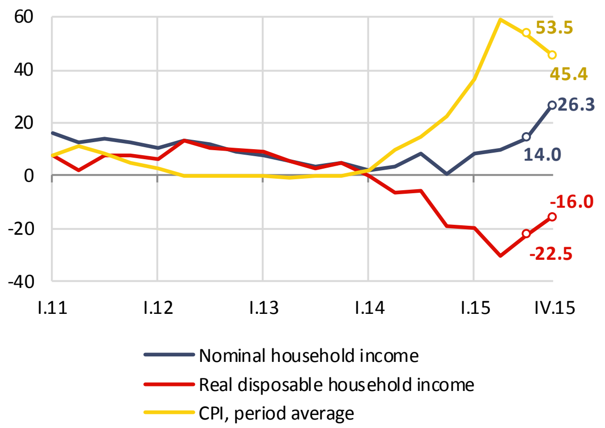
** Excluding Crimea and Sevastopol since 2013 and also part of ATO zone since 2015*
Source: SSSU

Load of Registered Unemployed per 10 Vacant Work Places (Vacancies)*, end of month, person



** Excluding Crimea and Sevastopol since 2014 and also part of ATO zone since 2015*
Source: SSSU; NBU staff estimates

Household Income and CPI*, % y-o-y



** Excluding Crimea, Sevastopol and part of ATO zone since 2014*
Source: SSSU

[22] The SSSU published data at the end of the year on household income and expenditures in Q4 and for the year, which took into consideration data published earlier for Q1–Q3 of the year. Therefore, data presented in previous Inflation Reports may be slightly different from revised ones.

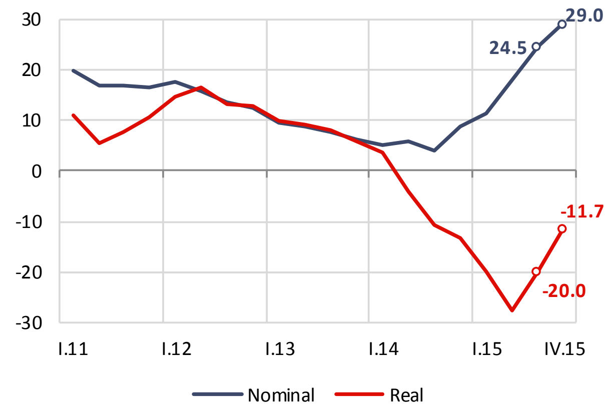
[23] The growth rate of wages within the structure of incomes and nominal average wages (per permanent employee) are different as a result of methodological peculiarities in the course of corresponding calculations. Thus, calculation of wages as a part of household incomes was performed on the basis of a wider sample of information. In particular, cash coverage of career military staff and freelance staff, payments for temporary disability, wages of individual entrepreneurs, and other payments, which are not considered when calculating average nominal wages (per permanent employee) are taken into account.

[24] Indexation is conducted starting from a base month. A base month is determined individually for each employee. It is deemed to be a month in which the employee received a raise in salary, a permanent salary increment, extra payment, etc., which, with a high probability, occurred after an increase in the minimum wage from 1 September of 2015. Additionally, the indexation threshold (a CPI change within the month) increased from 1% to 3% from January 2016.

The easing of inflation pressure and rising of average nominal wages contributed to the further reduction in the rate of decline in real wages **(in Q4 2015 and February 2016 – down to 8.3% y-o-y) and real households disposable income.**

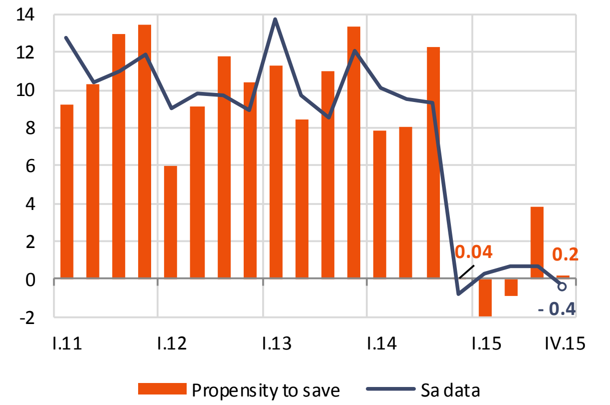
Household propensity to save[25] (both adjusted and unadjusted for seasonal effects) during 2015 remained at a low level after decreasing virtually to zero in Q4 2014. Only in Q3 did a higher growth in savings occur driven by growth of non-financial assets, in particular, on account of agricultural households. In Q4 2015, the low level of propensity to save resulted primarily from growth of expenditures before the New Year holidays and partly by expenditures shifting to payments for heating services after the beginning of the heating season. Particularly, growth of savings in Q4 2015 amounted only to UAH 0.7 billion (UAH 0.1 billion last year).

Wages*, average for the period, % y-o-y



** Excluding Crimea and Sevastopol since 2014 and also part of ATO since 2015*
Source: SSSU; NBU staff estimates

Propensity to Save[1-2], %



[1] Savings to disposable household income ratio
[2] Excluding Crimea, Sevastopol and part of ATO zone since 2014
Source: SSSU; NBU staff estimates

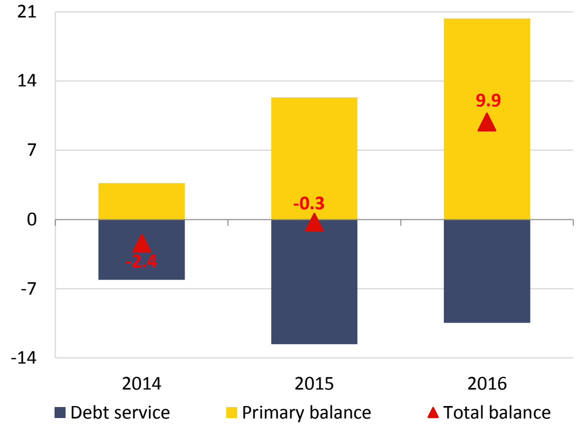
[25] Savings to disposable household income ratio.

2.2.4. FISCAL SECTOR

The Ukrainian government maintained a restrained fiscal policy at the beginning of the year. This was particularly evidenced by the gradual growth in expenditures, which is rather typical for the first months of the year, especially in a period of important tax changes. Modest growth resulted from lower social expenditures in January, as the Government transferred a significant part of January's pensions in advance during December 2015. At the same time, revenues growth exceeded expectations, which, however, may be partially explained by the effect of temporary factors. As a result, in January - February 2016, a sizable consolidated budget surplus emerged compared with the deficit during this period in previous years.

Public and publicly guaranteed debt increased to UAH 1.741 trillion, in particular due to renewed issuance of Domestic Government Bonds ("government bonds").

Consolidated Budget Balance in January - February, UAH bn



Source: Treasury; NBU staff estimates

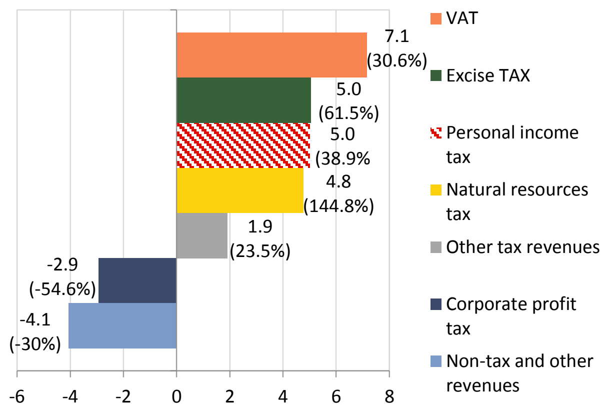
Revenues

In January-February of the current year, consolidated budget revenues grew by 22.6% y-o-y, mostly due to tax revenues.

Changes in legislation and economic factors improved the revenues history of almost all major taxes, although some of them may be short-term in nature.[26] In particular, the growth in receipts from personal income tax accelerated due to the standardization of the basic rate[27] at the level of 18% (instead of 15% and 20%) against an increase in nominal wages. The growth in receipts from excise taxes also continued to accelerate at a fast pace in the first two months of the year. This is due to improved imports and hryvnia depreciation, as well as the increase in production of excisable goods subject to labeling (including wine and vodka) before the increase of tax rates. The statistical base was also an important factor behind the growth rate acceleration, as in the first months of last year the procedures for settlement of additional excise tax on sales in retail trade of excisable goods had not yet been fully established.[28] Receipts from taxes on international trade grew by 20.2% y-o-y, which is also due to improved imports and hryvnia depreciation (the share of import duties in these receipts is 99%). These factors, along with a pick-up in retail trade turnover, led to an increase in VAT receipts despite its sizable refund volumes (almost UAH 16 billion for the first two months of 2016), this allowed for a reduction in corresponding arrears to UAH 10.5 billion as of 1 March 2016.

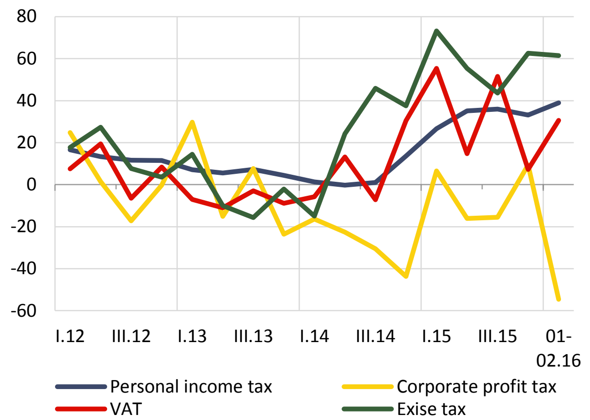
Instead, other parts of consolidated budget revenues in January-February of the current year were lower than last year. This primarily refers to receipts from corporate income tax, which significantly declined due to cancellation of advance monthly payments in 2016. **There was also a reduction in non-tax revenues** by 31.8% y-o-y due to the absence of NBU transfers in January-February 2016 compared to UAH 5.5 billion in the same period last year.

Consolidated Budget Revenues Changes, UAH bn and % y-o-y



Source: Treasury; NBU staff estimates

Main Consolidated Budget Taxes, % y-o-y



Source: Treasury; NBU staff estimates

[26] In particular, regarding the dynamics of imports (effects of deferred imports due to expectations of canceling the additional import duty since 1 January 2016), exchange rate, and production of excisable goods.

[27] The Law of Ukraine *On Amendments to the Tax Code of Ukraine and Certain Other Legislative Acts of Ukraine in Respect of Ensuring Balanced Fiscal Revenue in 2016,* dated 24 December 2015, introduced a single basic tax rate of 18% for personal income tax instead of 15% for income that is up to 10 minimum wages and 20% for income that is over 10 minimum wages. This standardization led to an increase in receipts from this tax to the budget (as according to the SSSU in December 2015, employees receiving wages up to 10 minimum wages accounted to about 92% of all employed people).

[28] A tax (below 5%) was introduced on 1 January 2015 to strengthen the resource base of local budgets. January-February 2015 was the adaptation period of the tax introduction, therefore, revenues were relatively low in this period.

Expenditures

In January-February 2016 consolidated budget expenditures enlarged moderately by 8.3% y-o-y due to the increase in current expenditures. The growth of the latter (by 8.9% y-o-y) resulted primarily from **increased expenditures on social programs**.

First of all, growth of expenditures on social care accelerated to 22.4% y-o-y despite the absence of transfers to the Pension Fund in January, which was due to the fact that a significant part of January's pensions was transferred in advance in December 2015. The reason for this acceleration lied in significant amounts of subsidies to households for payment of utility services compared to last year, as the new procedure for granting them began in April 2015. Additionally, expenditures on salaries in general grew by 24.6% y-o-y, while charges on it declined by 16.2% y-o-y due to payroll tax rate decreases. Expenditures on subsidies and current transfers to enterprises also increased significantly by 35.5% y-o-y.

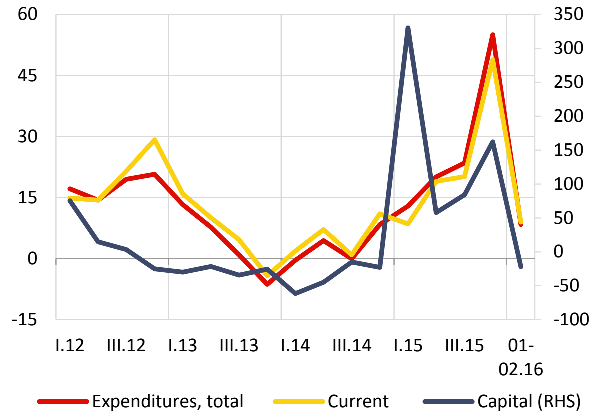
In contrast, a significant increase in expenditures on social programs was compensated by a decrease in other current and capital expenditures. Thus, expenditures on the use of goods and services were lower than in the last year by 4.4% y-o-y due to a marked reduction in expenditures on such items as research and development, payment services, and more. Another sphere of expenditures that suffered a reduction was debt servicing. This was due to a significant reduction in the expenditures on the external debt service (by 74.7% y-o-y) under conditions of government debt restructuring (payments on the new securities' principal started on 1 March 2016). However, the reduction of expenditures on debt servicing was generally less significant (17.1% y-o-y), as large volumes of government bonds for quasi-fiscal needs issued over the past year led to an increase in expenditures on servicing domestic debt (by 11.1% y-o-y). **Following the rapid growth of capital expenditures during 2015, a 22% y-o-y decrease was recorded in January-February 2016.** In particular, it may be due to some saving of funds in the beginning of the year, as the Pension Fund has a significant need for additional resources after the decrease in the payroll tax.

Balance

The consolidated budget in January-February 2016 performed with a substantial positive balance of UAH 9.9 billion. The surplus was provided by local budgets (UAH 12.3 billion), while the State Budget had a moderate deficit (UAH 2.4 billion).

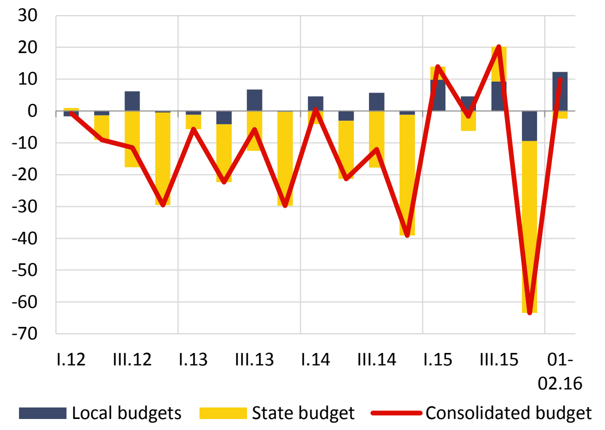
In the beginning of 2016, the Government renewed placement of short- and medium-term government bonds with maturities of six and three months. This, among other things, will contribute to the formation of the yield curve,[29] which is an essential tool for implementing the NBU's monetary policy in terms of preparation for the transition to an inflation targeting regime. In addition, the process to issue government bonds for quasi-fiscal purposes already began (UAH 14.3 billion in order to support banks).

Consolidated Budget Expenditures, % y-o-y



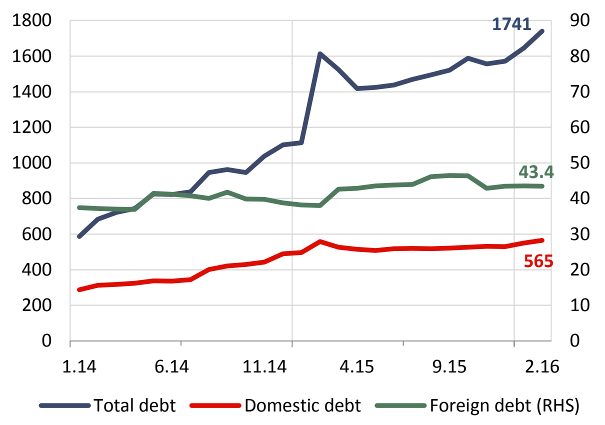
Source: Treasury; NBU staff estimates

Consolidated Budget Balance Indicators, UAH bn



Source: Treasury; NBU staff estimates

Public and Publicly Guaranteed Debt, UAH bn (Foreign Debt – USD bn)



Source: MFU; NBU staff estimates

[29] The yield curve for state securities serves as a benchmark for determining the market value of other financial instruments.

This debt policy, together with the effects of revaluation in the context of hryvnia depreciation, led to the growth of public and publicly guaranteed debt since the beginning of the year by 10.7%.

Public Sector Balance

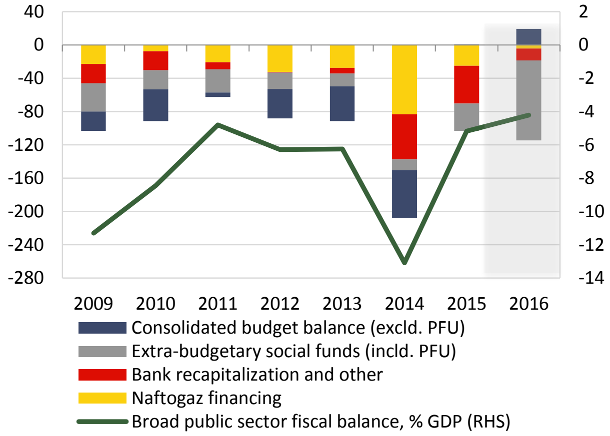
The consolidated budget balance is not a sufficient indicator that can adequately assess the sustainability of public finances. According to the IMF methodology, public quasi-fiscal operations are also subject to analysis. In the case of Ukraine, they include support for the banking system, NAK "Naftogaz," extra-budgetary social funds, etc. In Ukraine, these transactions are only partially carried in the consolidated budget, although they have acquired a massive character in recent years. Therefore, for a more complete analysis, **an indicator of the broad public sector balance** that takes into account all transactions of the sector is used.

The fiscal consolidation policy in 2015 led to a marked reduction of the broad public sector deficit to 5.2%[30] of GDP, which was the lowest since 2009 (excluding 2011).

This level was reached due to a reduction of both the budget deficit and a quasi-fiscal component:

- the NAK "Naftogaz" deficit was the most significantly reduced (to 1.3%[31] of GDP), particularly due to an increase in the utility tariffs for households and reformation of the company's activity;
- the issuance of government bonds to support the banking system diminished, despite the fact that cleaning up the banking system was in its most active phase (in this context, DGF support increased to 2.1% of GDP);
- the overall public sector[32] deficit amounted to 1.6% of GDP. This was reduced primarily due to the substantial reduction of the negative consolidated budget balance,[33] which would have acquired a marginally positive value but for funds provided to cover the Pension Fund's deficit.

Broad Public Sector Fiscal Balance, UAH bn



Source: MFU; Treasury; IMF; NBU staff estimates

By contrast, the pace of fiscal consolidation was restrained by the increase in the scope of budget support to the Pension Fund of Ukraine. Funds directed to cover its deficit rose to 1.6% of GDP in 2015.

A decrease in quasi-fiscal expenditures pressure is expected to take place in 2016. In particular, bringing utility tariffs closer to the cost-recovery level will reduce the unprofitability of NAK "Naftogaz." Quasi-fiscal needs in the banking sector will also continue to decline since the peak of the banking system's clean-up occurred in 2014-2015. At the same time, the reduction in revenues by extra-budgetary social funds due to the payroll tax rate decrease, which is a key source of their revenues, will cause a significant increase in budgetary support to cover the expenditures of the Pension Fund. The increase of the Pension Fund's deficit will be partially offset by a decrease in consolidated budget expenditures on other items, resulting in a projected surplus of the consolidated budget (excluding the funds allocated to cover the Pension Fund's deficit).

As a result, **in 2016, a further reduction of the negative broad public sector balance will be in progress, though at a slower pace – down to 4.2% of GDP**. Instead, a substantial increase in budget support to the Pension Fund, which will be of a systemic nature given demographic trends, will require accelerated efforts regarding social reformations.

[30] Preliminary estimates.
[31] Figures taken from separate financial statements of NAK "Naftogaz" are used.
[32] Includes indicators of the consolidated budget balance and extra-budgetary social funds.
[33] Regarding the balance of the consolidated budget for 2015, see the Inflation Report for January 2016.

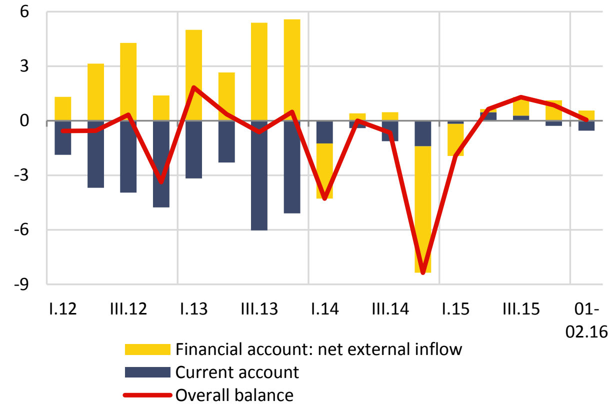
2.2.5. BALANCE OF PAYMENTS

In January-February 2016, the current account recorded a deficit amounting to USD 543 million. Export performance at the beginning of the year was determined by unfavorable external economic conditions and new trade restrictions imposed by Russia. Moreover, certain temporary factors caused a more significant decline in exports than expected. Instead, the decline of imports slowed against a background of weakening import tariff barriers, and the impact of deferred domestic demand for imported goods was somewhat underestimated. As a result, the current account deficit was higher than expected.

Net inflows to the financial account in January and February 2016 amounted to USD 562 million and were attributed to borrowings of the private sector. Under suspension of funding from international financial institutions, the public sector merely repaid its external liabilities. Net inflows of the private sector were somewhat higher compared with NBU expectations due to the significant inflows of trade credits. FX cash outside banks also decreased to a higher extent than expected. In January and February 2016, the overall balance of payments surplus amounted to USD 46 million.

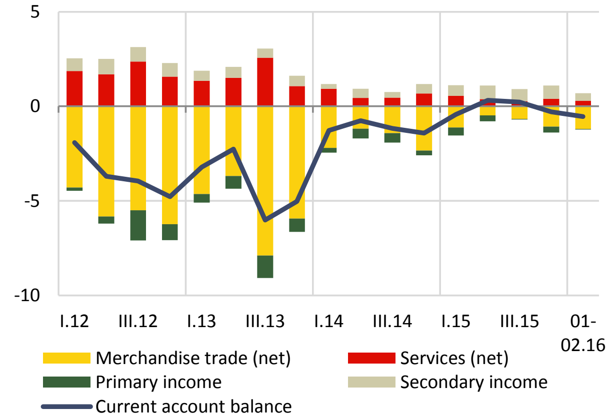
In Q1, international reserves decreased by USD 0.6 billion (down to USD 12.7 billion or 3.3 months of future imports). Payments on external public sector liabilities in March and NBU interventions aimed at reducing excessive fluctuations in the FX market caused the reduction in reserves.

Overall Balance of Payments, USD bn



Source: NBU

Current Account Balance, USD bn



Source: NBU

Current account

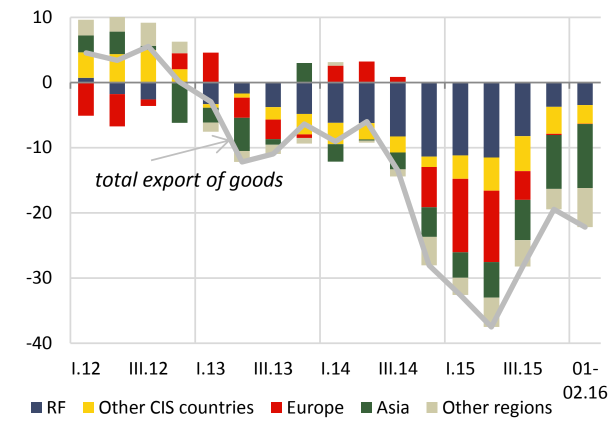
In January-February, the current account deficit widened due to a significantly negative trade balance.

Unfavorable external economic conditions and a number of trade restrictions imposed by the Russian Federation determined export performance at the beginning of the year. Moreover, in January, unexpected temporary factors (adverse weather conditions,[34] difficulties in obtaining permits, etc.) caused significant acceleration of the decline in export of goods – to 32.6% y-o-y. Though, in February, due to elimination of short-term factors, the decline slowed down to 12% y-o-y.

Factors affecting the performance of exports of goods varied significantly by region.

Low external demand, decreases in commodity prices, and increased tension in the Middle East resulted in a steep decline in exports to Asia – by 27% y-o-y (or USD 543 million) in January-February 2016. The most dramatic decrease occurred in groups of agricultural products, ferrous metals, and ores. In particular, export to China fell sharply since September 2015 after the shutdown of Ukrainian maize supplies due to a large crop in China. At the same time, China's government allocated about 2.8 million tons of import quotas for maize in 2016 in January, and, in late February, maize export to China recovered. Furthermore, a lower value of exports to China contributed to falling prices for iron ore. Meanwhile, the escalation of the Syrian conflict and increased

Contributions to y-o-y Exports Change by Regions, pp



Source: NBU staff estimates

[34]Adverse weather conditions complicated ports' performance. According to the Ukrainian Sea Ports Authority, volumes of grain export through ports declined by 17.7% y-o-y in January 2016.

tension in Turkey prevented the full supply of goods to the Middle East countries.

Exports of goods to the CIS countries except Russia fell 1.5 times (or USD 158 million) due to the de facto transit ban through the territory of the Russian Federation. Russia denied transit of any goods originating in Ukraine regardless of the country of final destination, although, from 1 January 2016, the Russian Federation de jure prohibited the transit of goods from Ukraine through its territory only to Kazakhstan. Transportation had to be carried out through the territory of Belarus. However, transit through Russian territory recovered after 26 February (to third countries other than Kazakhstan), which will improve export performance to CIS countries in March. Regarding the commodity structure of exports to those countries, the transit ban mostly affected exports of agricultural products, ferrous metals, and machinery.

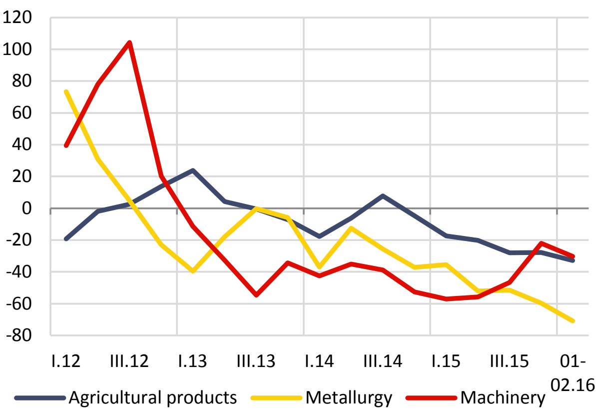
Despite the low base of comparison last year, exports to the Russian Federation continued to decline at a high rate (1.6 times y-o-y or USD 191 million). This happened due to the suspension of the agreement on a free trade zone with Ukraine since 1 January 2016, resulting in the average customs duty rate to the Russian Federation increasing from 0% to 9.1%, according to NBU estimates. Russia published a list of agricultural products prohibited for import from 1 January, which included meat, fish, milk and dairy products, vegetables, fruits, and nuts.

At the same time, exports to the EU in January-February did not change compared with the corresponding period of the previous year. The fact that a large number of Ukrainian enterprises received export permissions[35] to the EU contributed to a boost in export of agricultural products. In particular, a desire to take advantage of autonomous trade preferences[36] as of 10 March 2016, Ukraine exhausted annual quotas[37] for the supply of numerous agricultural products to the EU. However, Ukrainian export to the EU is not totally limited by quotas: current EU customs duties are not a serious obstacle for export from Ukraine by most product groups. Meanwhile, low metal prices determined a further drop in the value of ferrous metals' export.

In terms of goods structure, the largest decline in January-February was recorded in export of ferrous metals and minerals (by 33.5% and 39.7% y-o-y, respectively, solely due to price decreases) and machinery (22.1%). However, export prices for Ukrainian metals in March increased significantly, which, among other reasons, was due to the imposition of EU import duties for ferrous metals originating in certain countries. Export of agricultural products in January-February dropped by 11.1% y-o-y, and, excluding grain – merely by 8.4%.

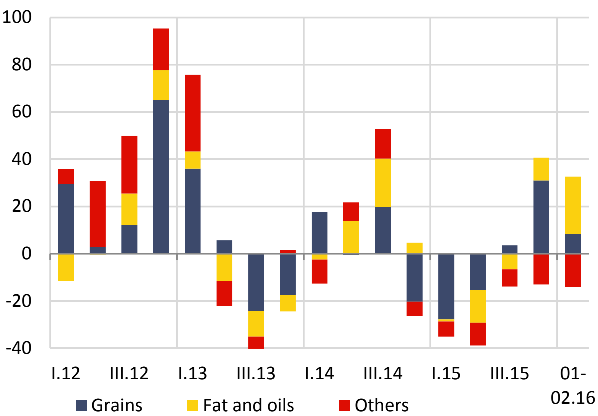
The decline in imports of goods in January-February slowed more than expected (15.9% y-o-y), including underestimating deferred demand on the background of weakening import tariff barriers (abolition of import surcharges and reduction of import duties

Export to CIS Countries (excl. RF), % y-o-y



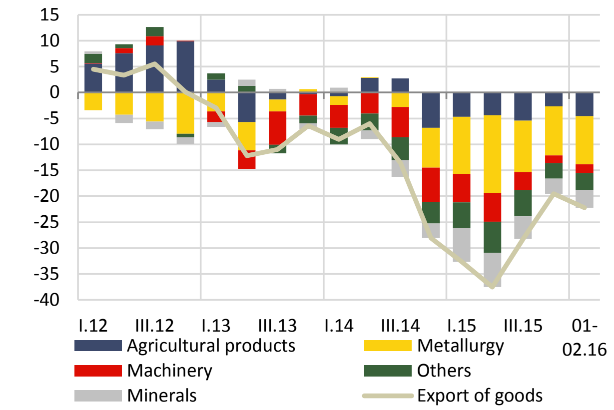
Source: NBU

Contributions to Agricultural Products Exports to EU Countries Annual Growth, pp



Source: NBU

Contributions to Merchandise Exports Annual Growth, pp



Source: NBU staff estimates

[35]According to the press service of the public association "Ukrainian Agrarian Confederation," for the first two weeks the Agreement on Free Trade with the EU countries was in force, more than 1,000 companies received an export permit to the EU.
[36]Under EU legislation, administering tariff quotas shall be carried out subject to two principles: "First come – first served" and by a system of import licenses.
[37]According to MEDT materials entitled "The use of tariff quotas under the DCFTA" available here: http://www.me.gov.ua/Documents/Detail?lang=uk-UA&id=1550d05a-f18d-459b-86d2-eb1fb9525dd5&title=VikoristanniaTarifnikhKvotVRamkakhPvzvt.

after the Free Trade Agreement with the EU became effective since the beginning of 2016).

In particular, non-energy imports in January-February increased by 1.6% y-o-y, primarily due to a boost in machinery imports. Growth under this category (by 23.4% y-o-y), amid other factors, was caused by upgrading the National Police's fleet of vehicles.[38] According to NBU estimates, increased volumes of VAT refunds to exporters[39] at the end of 2015 influenced the increase in imports of machinery and mechanical appliances, which they converted into investments in tangible assets.

The increase in imports of chemicals in January-February (8.4%) resulted from increased domestic demand for pharmaceutical products, in particular due to a sharp increase in the incidence of influenza and SARS at the beginning of the year. In addition, the NBU partially attributes this increase to a high demand for fertilizers before the sowing season due to a decline in external prices.

Depreciation of the currencies of MTP countries, the abolition of import surcharges, and reorientation of a part of Turkish exports after the deterioration of relations with Russia significantly slowed down the import of consumer goods, namely agricultural products (by 1.7% y-o-y) and industrial products (by 2.6% y-o-y).

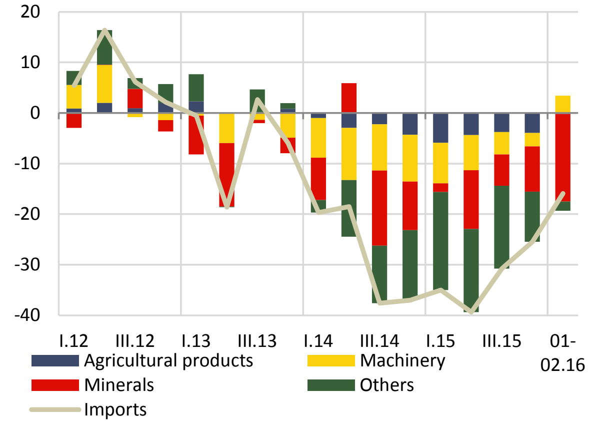
Energy imports continued to decline at a high rate (50.7% y-o-y) in January-February. In particular, the value of natural gas imports decreased threefold. Since November 2015, Ukraine imported gas only from Europe. As a result, imports from the Russian Federation in January-February dropped 2.3 times compared with the corresponding period of the previous year, and the share of the Russian Federation in total imports of goods decreased to 10% (from 19.6% in January-February 2015).

In January-February, the services trade balance surplus (USD 284 million) remained almost unchanged compared with the corresponding period of the previous year, and stayed in line with NBU expectations.

Exports of services reduced by 8% y-o-y, but some items showed opposite trends. In January, adverse weather conditions affected the exports via maritime and river transport, which declined by 6.3% y-o-y in January-February. A drop in the number of visitors and a relative reduction of their costs in dollar terms resulted in a decline of exports under the "travel" item (by 28.2% in January-February y-o-y). At the same time, export of pipeline transportation services was 1.6 times higher, mostly due to the low base of comparison, since before March 2015 Ukraine imposed limits on transporting gas from the Russian Federation to Europe. Export of IT services also continued to rise (6.1% y-o-y), its share in exports of services reached 17.9%. For more on service exports, see the content box entitled *Analysis of Services Exports in Ukraine*.

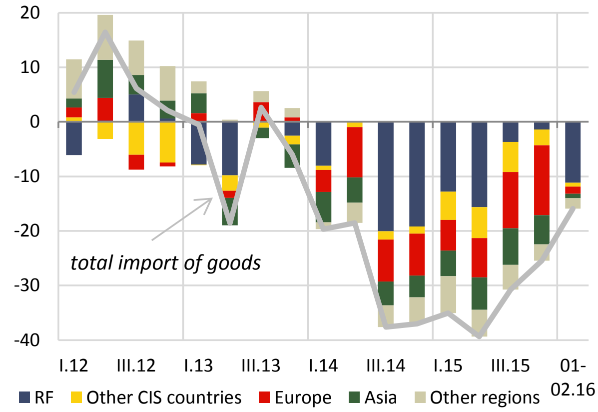
A reduction in economic activity and a drop in real disposable income caused a decrease in imports of services in January-February (6.1% y-o-y). In particular, import under the "travel" item

Contributions to Merchandise Imports Annual Growth, pp



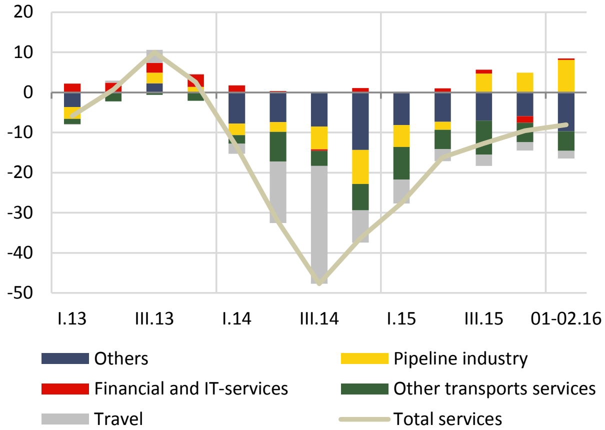
Source: NBU staff estimates

Contributions to Imports Annual Growth by Regions, pp



Source: NBU

Contributions to Export of Services Annual Growth, pp



Source: NBU staff estimates

[38]In January-February 2016, the new Ukrainian police force launched in the following cities: Zhytomyr, Dnipropetrovsk, Kharkiv and Kharkiv region, Ivano-Frankivsk, L'viv, Kherson, Chernihiv, Vinnitsa, and Kremenchuk. The National Police vehicle fleets in regions were replenished by "Renault" cars, sales of which occupied the top rank in October 2015 according to "Ukravtoprom" (http://ukrautoprom.com.ua/wp-content/uploads/ 2016/03 / 2016-02-market.pdf).

[39]The increase in import of machinery attributed to machinery used for preprocessing that is inherent for export-oriented sectors of industry.

dropped by 6.6% y-o-y and import of transportation services did so by 6% y-o-y due to a reduction of external trade turnover.

In January-February, an unexpected increase in private remittances to Ukraine took place (by 4.2% y-o-y) – up to USD 747 million. This was primarily due to growth in remittances from European countries, while remittances from CIS countries reduced as expected due to the deterioration of financial and economic situations in most of these countries.

Remittances in Jan-Feb, USD bn

Source: NBU

Financial Account

In January-February 2016, net inflows to the financial account amounted to USD 562 million amid private sector borrowings. Simultaneously, the public sector repaid its external liabilities.

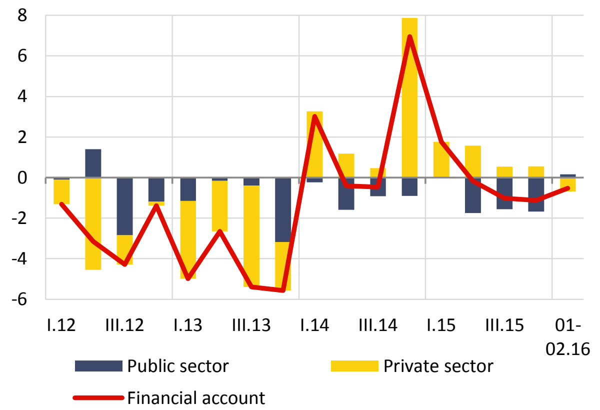
Net debt inflows of the real sector amounted to USD 536 million owing to net revenues from trade credits amounting to USD 561 million. However, short- and long-term loans registered net repayments (USD 133 million). FX cash outside banks continued to decrease (by USD 485 million), which was partially attributed to a reduction of real disposable income.

Net foreign direct investment inflows (USD 914 million) were mostly directed to the banking sector, the bulk of it being bank recapitalization through debt-to-equity swaps. Taking into account repayments for interbank loans, the net disbursements of the banking sector totaled only USD 85 million.

In January-February 2016, the rollover of long-term private external debt amounted to 37%. It was lower than expected because of low banks' disbursements. In addition to this, the low banking sector rollover reflects significant repayment of loans by Ukrainian banks to their parent institutions. At the same time, actual payments were somewhat lower, since a certain amount of repayments were restructured into equity.

In the beginning of the year, corporate sector arrears continued to grow (by USD 0.5 billion during the first two months of 2016). According to NBU estimates, stock of arrears by the end of February stood at USD 12.6 billion.

Financial Account: Net External Assets, USD bn

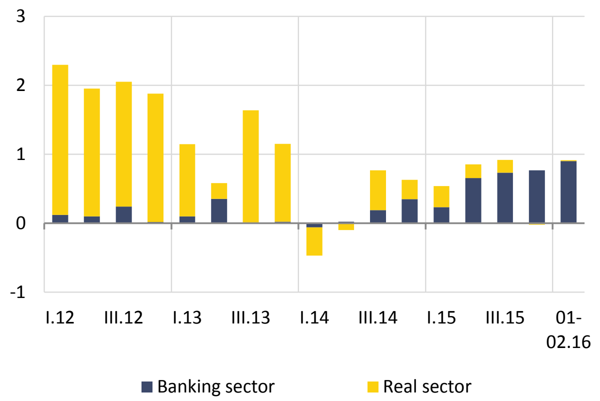


Source: NBU

Rollover of Long-Term Private External Debt

	2014	Q1.15	Q2.15	Q3.15	Q4.15	01-02.16
Banks	54%	35%	79%	18%	22%	11%
Corporates	57%	49%	31%	26%	57%	78%
Aggregate	56%	42%	54%	22%	35%	37%

Foreign Direct Investment, USD bn



Source: NBU.

Reserve assets

International reserves in Q1 declined by USD 0.6 billion to USD 12.7 billion (or 3.3 months of future imports). Payments on external liabilities of the public sector in March and NBU interventions aimed at reducing excessive fluctuations in the FX market caused the reduction in reserves.

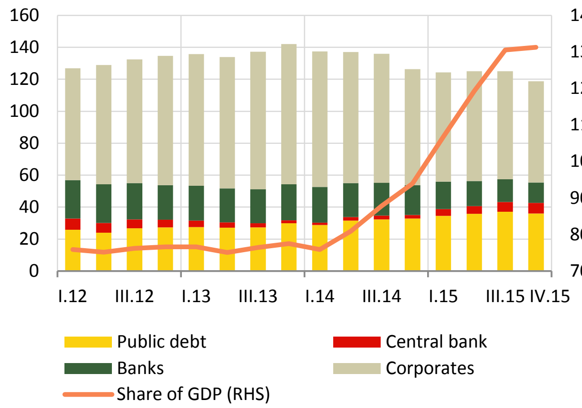
External sustainability

Despite reduction of the outstanding gross external debt in Q4, external sustainability indicators hardly changed because of the decline of nominal GDP in US dollar terms[40] and exports of goods and services. However, adequacy criteria for international reserves continued to improve in Q4.

In Q4, the gross external debt of Ukraine declined by USD 6.4 billion and totaled USD 118.7 billion. In particular, the following factors caused this reduction:

- reduction of indebtedness of the public sector as a result of successful Eurobonds restructuring;
- reduction of Ukrainian banks' debt to their parent institutions; and
- reduction of companies' indebtedness accompanied by growth of arrears.

Gross External Debt, USD bn



Source: NBU

External Sustainability Indicators

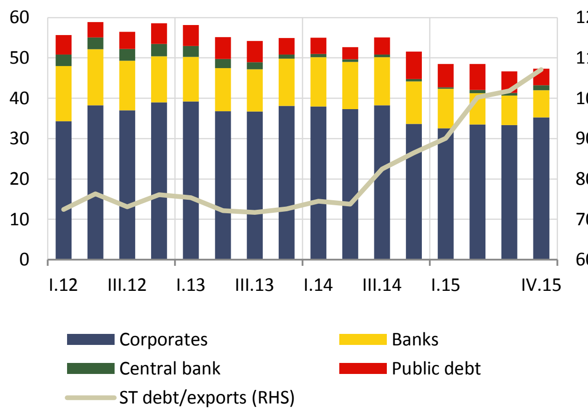
%	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015
External debt/GDP	75.9	80.9	87.9	93.9	106.7	119.3	130.5	131.3
External debt/exports of goods and services	172.2	177.6	189.3	193.0	207.0	230.1	248.6	248.4
Short-term debt/gross debt	43.2	41.5	43.6	44.8	43.5	43.5	41.0	43.1
Short-term debt / GDP	32.8	33.6	38.3	42.1	46.4	52.0	53.5	56.6
Short-term debt / exports of goods and services	74.5	73.7	82.5	86.5	90.0	100.2	101.9	107.1
Trade openness[41]	95.6	98.3	97.9	100.7	106.5	106.8	107.8	107.5
Reserves/ short-term debt	25.4	30.0	27.7	13.3	18.4	18.8	24.9	26.0
Reserves, composite IMF measure	41.0	47.5	44.8	22.8	31.9	32.9	41.9	45.2
Reserves in months of future imports (3 months)	90.7	115.3	121.8	60.9	83.3	86.9	109.7	115.8
Reserves as a share of broad money	17.5	21.3	21.3	12.4	22.8	22.1	29.4	32.1

In the Q4 2015, the short-term external debt by remaining maturity hardly changed and stood at USD 51.2 billion. The reduction of public sector indebtedness (by USD 1.3 billion) and indebtedness of banks (by 0.6 billion USD) were accompanied by an increase in real sector short-term debt (by USD 1.9 billion).

While the ratio of external debt to GDP and to exports of goods and services remained virtually unchanged, the respective short-term debt indicators grew. First of all, this reflects an accumulation of arrears, especially compared to its stocks with the scale of the economy in US dollar terms.

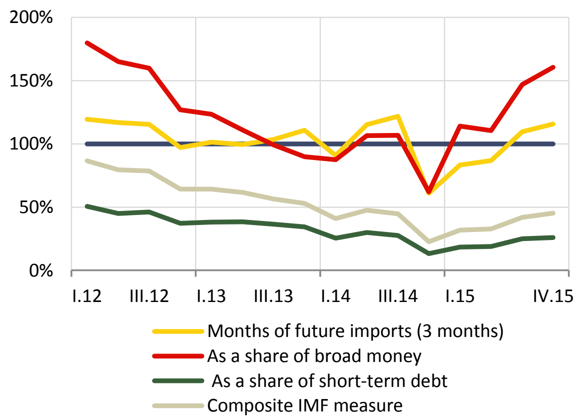
Reserves to the short-term debt ratio picked up to 26% (by 12.7 pp since the beginning of the year). But this value remains much lower than the threshold in accordance with Guidotti-Greenspan criterion. According to the composite IMF measure (ARA metrics), the situation is slowly improving. The reserves have grown 45.2% of the minimum sufficient level (by 22.4 pp since the beginning of the year).

Short-Term External Debt by Residual Maturity, USD bn



Source: NBU

Adequacy Criteria of International Reserves, %



Source: NBU staff calculation

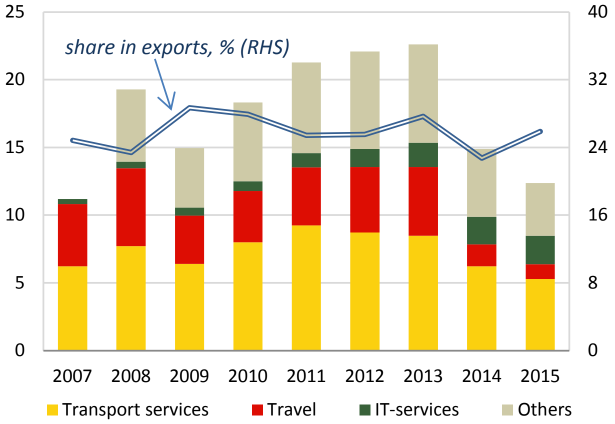
[40]Data with respect to changes in GDP over the year are recalculated into USD at average quarterly exchange rates.
[41]Openness calculated as an index of the 12-months sum of changing exports and imports to GDP.

Analysis of services exports in Ukraine

Exports of services comprise an important Balance of Payments component. Ukraine recorded the biggest value of service exports in 2013 (USD 22.6 billion or 12% of the GDP). During recent years, a decrease in service exports has occurred against a background of a general decrease in economic activity, the annexation of Crimea, the military conflict in the east of Ukraine, and worsening relations with the Russian Federation. So, exports of services decreased by 34.2% in 2014 (down to USD 14.9 billion), and by 16.9% in 2015 (down to 12.4 billion USD). However, the share of service exports in total exports changed insignificantly. It fluctuated from a maximum of 29% (2009) to a minimum of 23% (2014), and in 2015 it amounted to 25.9%.

The structure of services is traditionally divided into three spheres: transportation services, travel services, and other commercial services.

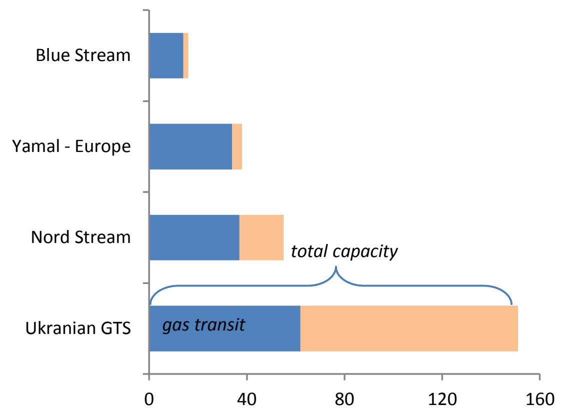
Services Exports, USD bn



Source: NBU

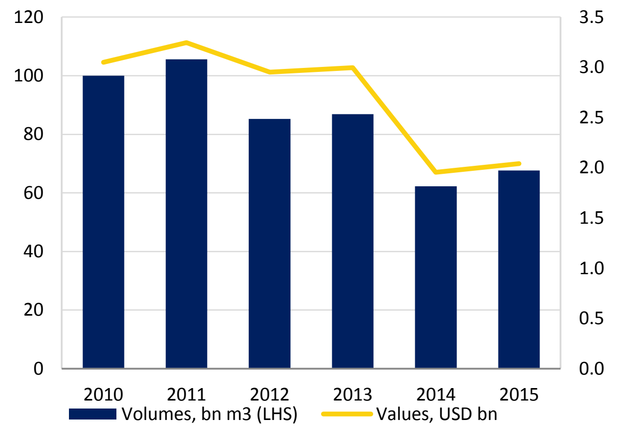
Thanks to its geographical location, Ukrainian transportation services prevail in the overall structure of service exports (about 40%). In turn, the pipeline transportation takes the biggest share (about 38%) of total transportation services; it consists of two parts (gas pipeline transport and oil pipeline transport). Up until now, Ukraine is the biggest natural gas transit country. By means of the main gas pipelines used by National Joint Stock Company "Naftogaz of Ukraine," Russian natural gas is transported to European countries. The capacity of the domestic gas-transport system is 290 billion m^3 (at the inlet) and 180 billion m^3 (at the outlet) per year.

Gas Supplies to Europe in 2014, bn m^3 (excl. Baltic States)



Source: Naftogaz

Gas Transit



Source: Naftogaz

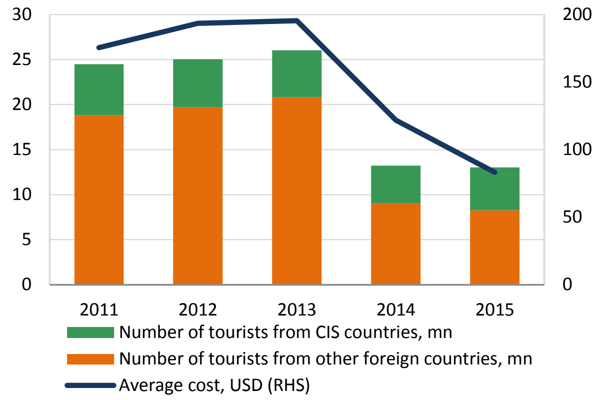
Gas transit limits through the territory of Ukraine set by Gazprom PJSC from August 2014 until March 2015 caused a decrease of gas transit volumes in 2014-2015, down to 62-68 billion m^3. At the same time, since 2014, gas transit fees decreased from USD 3 to 2.7 per 1,000 m^3/100km. The receipts for transit have decreased by one third (down to USD 2 billion per year). But amid other transportation service exports falling, the share of pipeline transport during 2014-2015 remained the largest.

Until 2014, provision of travel services was the second largest item of exported services (more than 20%). As a result of tourists' visits to the Autonomous Republic of Crimea, the travel revenues had a strong seasonal pattern: almost half of the annual exports accrued in the 3rd quarter. About 75% of visitors coming into Ukraine were citizens of CIS countries, in particular, from the Russian Federation (about 40%).

After annexation of Crimea in 2014 and the onset of the armed aggression by Russia in the east of Ukraine, the export of travel services item has significantly decreased as a result of the reduction in the number of tourists, as well as decreasing tourists' expenditures because of the hryvnia depreciation. While the number of visitors from the Russian Federation in 2014 decreased by 4.4 times, and in 2015 it decreased further by 1.9 times, the number of visitors from other foreign countries (excluding CIS countries) in 2014 decreased by only 20%, and in 2015 it increased by 14%. Overall during 2014, travel services exports decreased 3.2 times, and in 2015 it decreased by an additional 33% down to USD 1.1 billion. Respectively, in 2015 the travel services' share of total exports decreased to 8.7%.

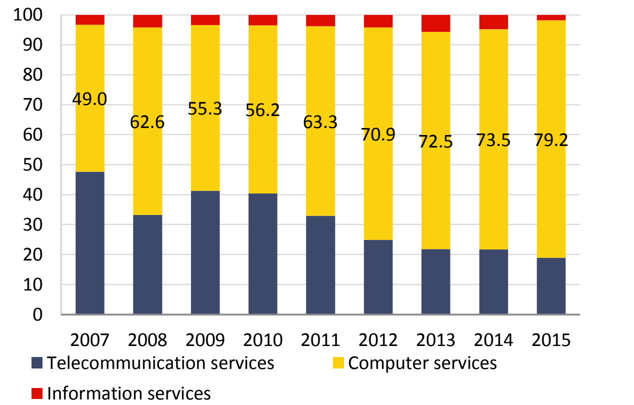
Growth of IT-services exports stood out as one of the features in recent years (telecommunication services, computer services, and information services). The share of these services in service exports during 2015 increased to 17% and their value grew by USD 2.1 billion. It is the only item of exports that has been growing during recent years. The biggest share of these exports belongs to computer services (79% in 2015), the dominant share of these services belongs to software development outsourcing. A notable reason for computer services' rapid development includes the low cost of labor services in Ukraine. According to data presented by Ukraine Digital News, the biggest number of IT-specialists worked in Ukraine (among all countries of Europe). This number accounted for 90,000 specialists and more than a thousand companies working in the IT-services sphere. Such international giants as Aricent, Boeing, Ericsson, Huawei, Oracle, Siemens, and Teleperformance chose Ukraine as a location for their scientific research. In 2014, six IT Clusters were formed in Ukraine in such cities as L'viv, Odesa, Kyiv, Kharkiv, Dnipropetrovsk, and Lutsk. These are communities of leading companies in the IT sector. Jointly with universities and local authorities, these communities improve and develop IT in the mentioned cities. At the same time, there are a number of factors limiting development of the IT sphere Ukraine's case. In particular, these factors include Ukrainian legislative shortcomings, "soft spots" in some spheres of the education system, and a low level of the English language proficiency.

Number of Tourists and Cost



Source: NBU

Structure of IT Services, %



Source: NBU

2.2.6. MONETARY SECTOR AND FINANCIAL MARKETS

In January-February 2016, the exchange rate dynamics were marked with heightened volatility and a tendency towards depreciation owing to external and internal shocks: a decrease in export receipts, a delay in external financing, political uncertainty, etc. Yet, in March 2016, in light of improving export conditions and the respective growth of FX receipts, the official hryvnia exchange rate moderately appreciated.

The banking system was functioning under conditions of a structural liquidity surplus. At the same time, the volume of NBU CDs slightly decreased due to increased absorption of liquidity through other channels in Q1 2016 (Government operations, repayment of previously-granted refinancing, and NBU operations on the FX market).

In January-February 2016, the growth of the domestic currency deposits accelerated on a y-o-y basis, while FX deposits outflow slowed down. In addition to that, despite the general weakness of lending activity, signs of its recovery were marked in February.

A significant decrease of monetary aggregates on a y-o-y basis was recorded in Q1 2016. This was caused by low demand for cash and significant comparison base effects against the background of considerable revaluation of deposits from the past year.

Taking into account the persistent risks to price stability, the NBU implemented a tight monetary policy in Q1 2016, maintaining the key policy rate at the level of 22% per annum.

FX market

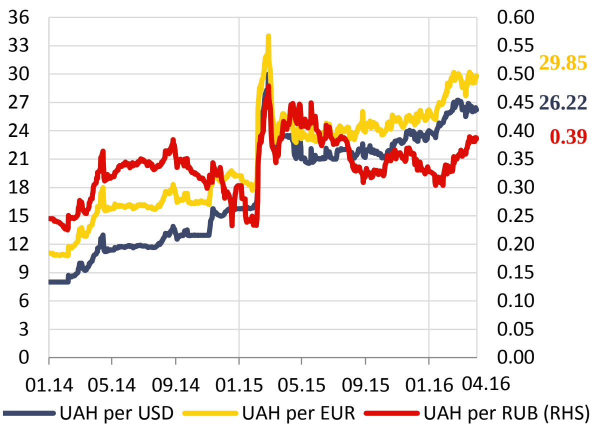
In the beginning of 2016, the hryvnia exchange rate was under depreciation pressure given a reduction in export receipts against a background of trading and transit limitations introduced by the Russian Federation, a further decline in world commodity prices as well as rising political instability. At the same time, already in March 2016 and predominantly in light of improving export conditions along with the associated growth of FX revenues, the hryvnia exchange rate with respect to the USD appreciated by 3.1%. Overall, according to the results of Q1 2016, it depreciated by 9.2%.

Under conditions of high exchange market volatility, the NBU took measures aimed at smoothing excessive exchange rate fluctuations. Both sale and purchase FX auctions were carried out. In particular, during March and against a background of weakening depreciation pressure, the volumes of FX purchases for replenishment of international reserves increased. Overall in Q1 2016, the net volume of currency sales performed by the NBU on the FX market amounted to USD 235 million.

In January-February 2016, amid further easing of inflationary pressure in Ukraine, the NEER depreciation led to a decline of the hryvnia REER by 8.5% since the beginning of the year (on a y-o-y basis the REER has appreciated by 33.8%, largely due to comparison base effects).

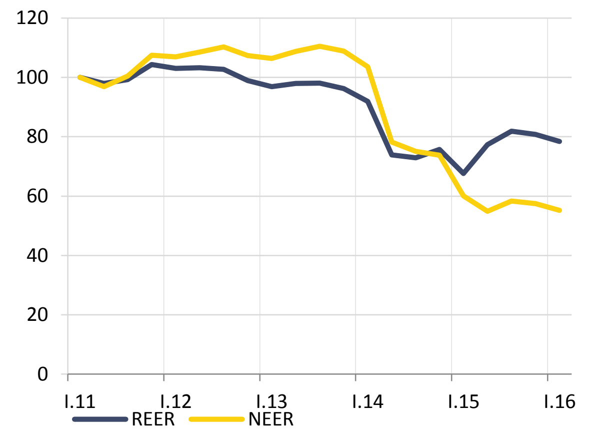
During Q1 2016, the cash segment of the FX market was marked by dominance of supply over demand. Thus, in March, the average daily volumes of cash sold by households reached a maximum and,

The Official Hryvnia Exchange Rate, as of 01 April 2016



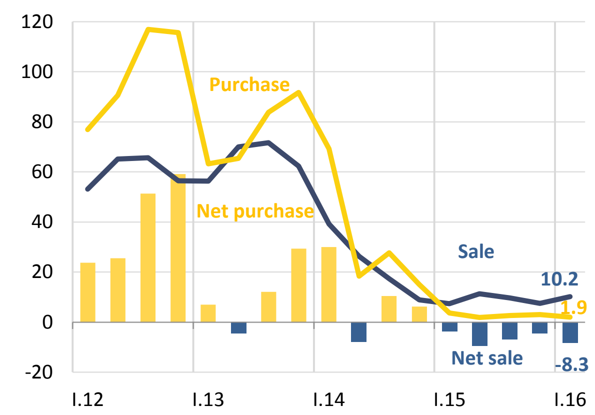
Source: NBU

Hryvnia REER and NEER (Based on Interbank Exchange Rate, I.2011=100, average)



** preliminary data*
Source: IFS, staff estimates

Daily Average Amount of Cash FX Purchased/Sold by Individuals, USD M



Source: NBU

according to Q1 2016 statistics, stood at USD 10.2 million (USD 7.4 million in the respective period of the previous year). The average daily volumes of cash purchases decreased to USD 1.9 million (from USD 3.6 million in Q1 2015). This can be a result of a decline in people's real income, which reduced their demand for currency.

Reduced risks in financial market gave the NBU an opportunity to continue gradual liberalization of administrative restrictions on the money supply and FX markets, providing preservation of standards preventing capital outflow.[42]

Base Money and Liquidity

In Q1 2016, the banking system functioned under conditions of a liquidity surplus – the average daily balances of banks' correspondent accounts as well as the stock of NBU CDs were significantly higher than in the respective period of the previous year (by 26.3% and 3.6 fold, respectively).

A sizable decrease of cash volumes (by UAH 20.5 billion during Q1 2016) was the main contributor to banks' correspondent accounts' growth. This was caused by the general tendency for development of cashless payments, a decrease of cash withdrawals from deposit accounts of households in conditions of simultaneous cash inflow, and increases of trading revenues and revenues from all kinds of services.

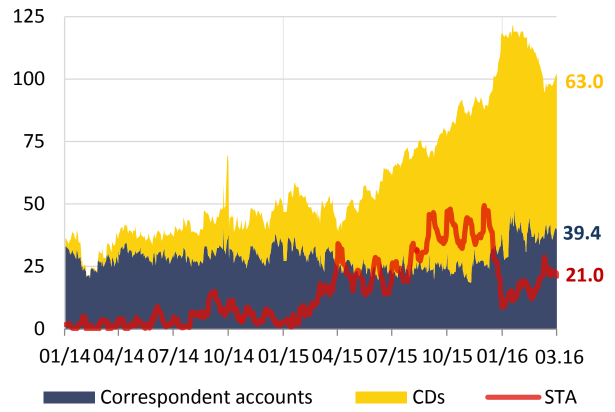
The increase of correspondent accounts also resulted from changing conditions of the reserves requirements framework[43] and DGF operations.[44]

In Q1 2016, excess liquidity was partially absorbed by Government operations (the net impact of which was estimated at UAH 26.0 billion[45]), repayment of previously-granted refinancing (the volume decreased by UAH 85 billion), and net FX sales performed by the NBU (in the amount of UAH 6.2 billion). This in turn led to a subdued demand for NBU CDs during Q1 2016.

The decline of cash volumes in Q1 2016 resulted in a decrease of the monetary base by 2.6%.[46] On a y-o-y basis, it contracted by 1.4%.

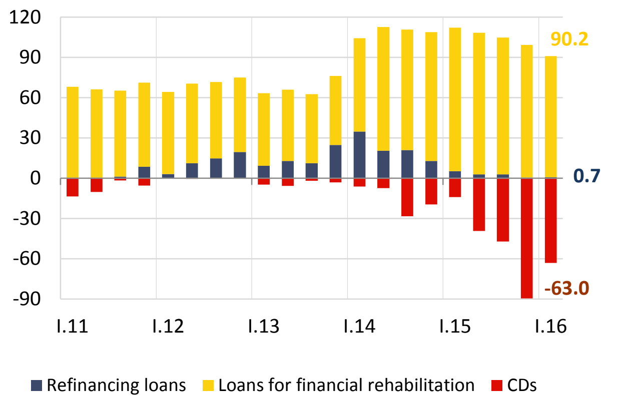
For NBU purposes, to effectively perform its function as a lender of last resort, as well as enable greater flexibility of the central bank's liquidity management operations, regulatory conditions for bank access to liquidity support instruments have been streamlined and optimized. In particular, banks' opportunities for receiving refinancing loans have been extended,[47] a rollover mechanism and a list of securities to be accepted as a collateral for overnight loans and direct repo operations have been extended , and banks are also permitted to change collateral for refinancing loans.[48] In addition to that, the short-term refinancing instrument has been

Select Indicators of Banking System Liquidity, UAH bn, as of 01 April 2016



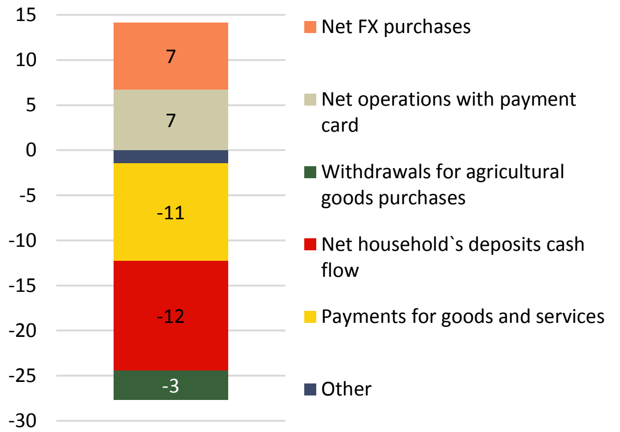
Source: NBU

Changes in Banking System Liquidity by Type of Operation, Stock, at the end of a period, UAH bn



Source: NBU

Channels of M0 Issuance/Withdrawal, Comparison IQ 2016 vs IQ 2015, UAH bn



Source: NBU

[42] More detailed information is available at: http://www.bank.gov.ua/doccatalog/document?id=28222435.
[43] More detailed information is available at: http://www.bank.gov.ua/doccatalog/document?id=25135755.
[44] In Q1 2016, the DGF transferred UAH 5.8 billion to banks' counterparties for further payments to depositors of banks in liquidation.
[45] Calculations of the impact of fiscal factors on liquidity of the banking system in Q1 2016 are based on changes in fund balances on the Single Treasury Account at the NBU (up by UAH 12.0 billion), as well as including Government debt service payments for bonds in the NBU portfolio (UAH 14.0 billion).
[46] Preliminary data.
[47] More detailed information is available at: http://www.bank.gov.ua/doccatalog/document?id=27525398.
[48] More detailed information is available at: http://www.bank.gov.ua/doccatalog/document?id=27809129.

optimized to allow FX purchase and sale operations under "swap" conditions, which will give banks an additional opportunity to satisfy their needs in short-term liquidity.[49]

Money Supply and Its Components

In January-February 2016, the money supply increased by 2.2% mainly due to revaluation of FX deposits. Taking into account the high comparison base of the previous year (in February of 2015, against the background of peak exchange rate values, the UAH equivalent of FX deposits increased), the decrease of the money supply on a y-o-y basis accelerated up to 10.6%.

During the first two months of the current year, stock of domestic currency deposits decreased by 1.6%. It resulted from a high comparison base (the stock grew by a record-breaking UAH 27.5 billion or by 7.6% m-o-m in December 2015). At the same time, the increase in the volume of domestic currency deposits accelerated on a y-o-y basis. The outflow of FX deposits (denominated in USD) slowed down.

The main contributor to growth of the volume of domestic currency deposits on a y-o-y basis (up to 9.6% in February) was a prolonged inflow of funds from non-financial corporations. In particular, during January-February of 2016 they increased by 1.6%, while the y-o-y increase was 24%. In addition to that, in February 2016, for the first time after almost two years, an insignificant increase of the volume of household domestic currency deposits was recorded (by 1% y-o-y).

A positive dynamic was also observed for FX deposits (denominated in the USD), where the outflows virtually stopped. This contributed to their deceleration on a y-o-y basis (down to 25.9% in February 2016 compared to 31.5% in December 2015).

Loans

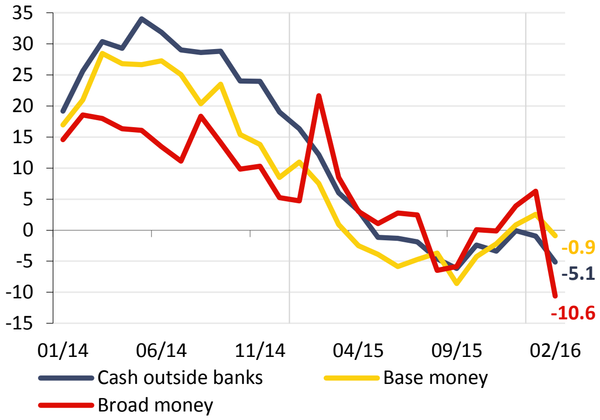
Amid significant credit risks, lending activity remained weak in January-February 2016. Lending conditions became somewhat more restrained,[50] and interest rates remained high.

At the same time, certain signs of recovery of banking lending activity appeared in February 2016. The volume of domestic currency loans increased by 0.8% m-o-m (the y-o-y decrease slowed down to 18.6%). Demand for domestic currency loans was mainly driven by non-financial corporations. Since the beginning of the year, their volume increased by almost UAH 3 billion (or by 0.9%).

In the first two months of 2016, the volume of domestic currency loans to households decreased by 0.1%, and that was mainly due to low creditworthiness of households and high costs of loans.

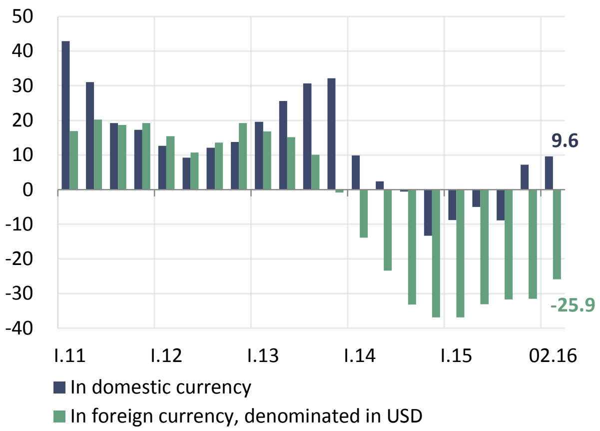
Also, there was a tendency towards reduction of the volume of FX loans **(denominated in the USD)** – overall by 1.3% as compared to December 2015 (by 21.5% y-o-y).

Monetary Indicators, y-o-y change, %



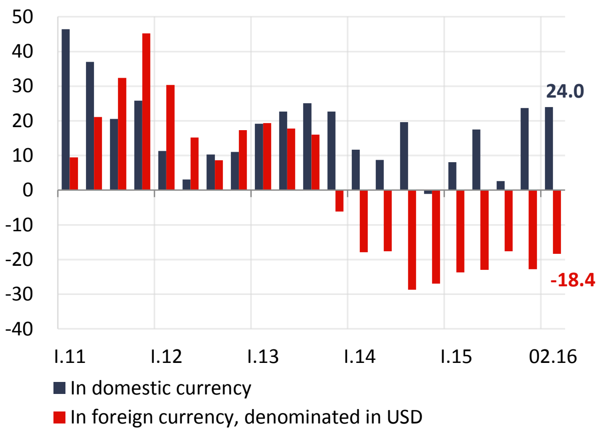
Source: NBU

Deposits *,
as of the end of the period, y-o-y change, %



** Including insolvent banks*
Source: NBU

Households Deposits *,
as of the end of the period, y-o-y change, %



** Including insolvent banks*
Source: NBU

[49] More detailed information is available at: http://www.bank.gov.ua/control/en/publish/article?art_id=29489860&cat_id=76291.
[50] In accordance with results of surveys of Ukrainian enterprises regarding their business expectations, the balance of their estimates concerning difficulty in lending conditions increased from 41.4% in Q4 2015 to 48.5% in Q1 2016.

Interest Rates

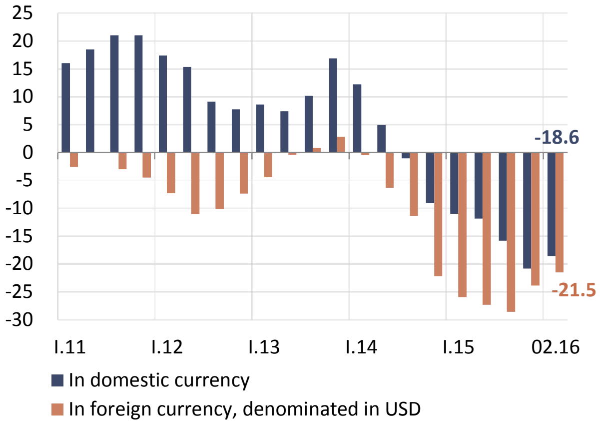
Under conditions of high internal and external risks, and in order to achieve the goal of reducing consumer inflation to 12% by the end of 2016 and to 8% by the end of 2017, the NBU maintained a tight monetary policy and left the key policy rate unchanged at the level of 22% during Q1 2016.

A slight reduction in the banking system liquidity during February-March 2016 against the background of turbulence in the FX market led to a marginal growth of the average cost of domestic currency resources in the interbank credit market (on average up to 19.8% during Q1 2016). However, the interbank interest rates remained within the NBU's overnight rates band.

Macroeconomic stabilization and completion of the main stage of the banking system's clean-up contributed to a decrease of the average weighted rates on domestic currency loans (excluding overdrafts) and deposits of non-financial corporations, which decreased to 19.4% and 11.0%, respectively, as well as on deposits of households (to 16.7%). Average weighted interest rates on loans to households (excluding overdrafts) grew to 29.6%, which was due to the increase of the short-term share in the structure of loans.

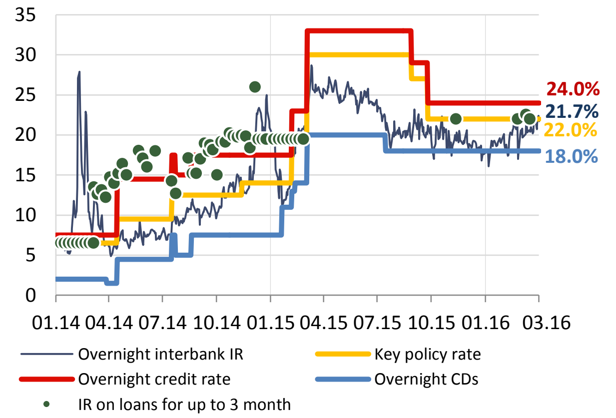
Further alleviation of risks to price stability enabled the NBU to ease its monetary policy stance. On 22 April 2016, the NBU cut the key policy rate to 19%.[51] The main factors that determined the reduction of inflation risks included decreased political tension and improved external conditions. To strengthen the NBU's capacity to implement inflation targeting, the NBU continued to improve its set of monetary policy instruments. In particular, the interest rate policy's operational framework was streamlined (more detailed information is presented in the box "The New NBU Interest Rate Policy Framework").

Loans *,
as of the end of the period, y-o-y change, %



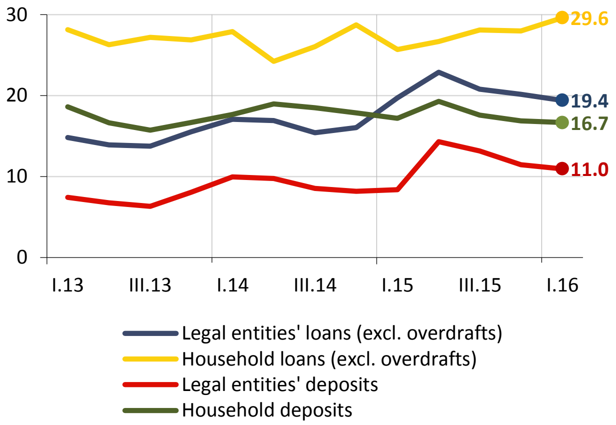
** Including insolvent banks*
Source: NBU

Overnight Interbank IR and NBU Key Policy Rate,
% pa, as of 1 April 2016



Source: CredInfo, NBU

Average Weighted IR on Hryvnia Loans and Deposits, % pa



Source: NBU

[51] NBU Board Resolution No. 278, dated 21 April 2016, *On Monetary Market Regulations*.

The New NBU Interest Rate Policy Framework

The NBU continued to improve its monetary policy instruments with a view towards implementing an inflation targeting regime.

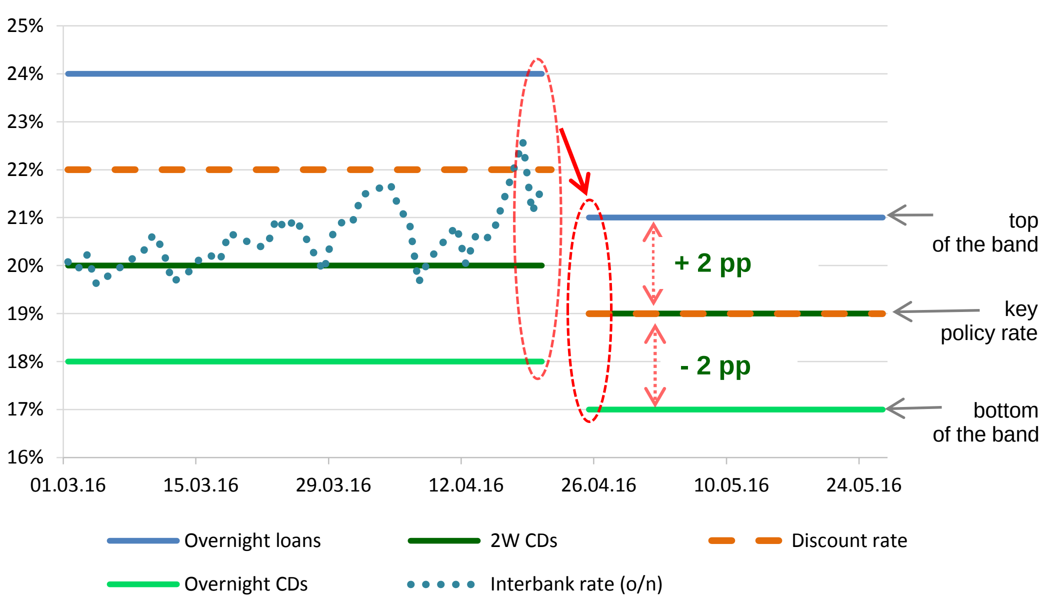
Pursuant to the Monetary Policy Strategy for the period of 2016–2020, the NBU's Board took the following decisions on 21 April 2016 in order to improve the interest rate policy.

Defining the discount rate as the de facto key interest rate of the monetary policy. From now on, the NBU will set the discount rate and the interest rate of the main monetary policy instrument at the same level. During a period of more than a year, structural liquidity surplus remained in the banking system. Therefore, it is quite natural that market conditions are influenced to a great extent by liquidity absorbing operations, and namely operations of CD placement for a two-week period. A large share of all placed CDs accrued to these operations over the long-term. Accordingly, the interest rates in the interbank credit market tend towards rates on these operations. Therefore, the Ukrainian Index of Interbank Rates (UIIR) fluctuates at about the level of rates on these operations.

From now on, changes in the discount rate (and correspondingly changes of the interest rate on CD placement) will trigger a prompt response of short-term interest rates in the interbank money market.

It should be noted that in the future, the banking system's structural position may change to a deficit. In this case, the NBU's main monetary policy instrument will take the form of liquidity providing operations conducted at the discount rate. This will ensure the effectiveness of the discount rate as the key rate of the monetary policy.

The NBU introduced a symmetric and fixed corridor of interest rates on standing facilities for the purpose of limiting fluctuations of short-term interest rates in the interbank market occurring around the key rate of the monetary policy. The top of the band is formed by the rate on overnight credits and the bottom is formed by the rate on overnight CDs. The corridor width (+/-2% from the discount rate) on one hand gives an opportunity to limit volatility of interest rates in the interbank credit market, and, on the other hand, it maintains incentives for redistribution of monetary resources (see the figure).



Optimization of the liquidity management procedure and instruments. In particular:

- The NBU does not plan to hold regular tenders on CD placement for periods other than two weeks. In particular, regular CDs were placed for periods of a week and a month earlier. On one hand, cancellation of their regular placement will contribute to a more active redistribution of monetary resources in the interbank market. On the other hand, it will increase the impact of the main liquidity operations (placement of CDs for a two-week period) on money market conditions;
- The NBU CDs may not be repaid early, since liquidity absorbing operations will be conducted exclusively for short periods of time and there is no need for this option anymore;
- From now on, all liquidity providing operations by the NBU will be conducted at a single interest rate, which will be equal to the overnight lending rate. Since the introduction of the rollover possibility for NBU overnight credits, they have in fact become identical to liquidity providing tenders.

The NBU's operational framework of the interest rate policy is common among leading central banks with an inflation targeting regime. Transition to this framework will provide the NBU an opportunity to increase transparency and predictability of its monetary policy. It will also contribute to the influence of the NBU’s interest rate policy on interest rates on bank operations and, finally, it will contribute to achieving the inflation target.

Transition to the new interest rate policy operational framework has occurred as a result of:

- The reduced impact of fiscal policy on monetary policy in the current year, i.e., the NBU does not have an obligation to finance fiscal and quasi-fiscal requirements. In particular, monetization of domestic government bonds by the NBU for financing the National Joint Stock Company "Naftogaz of Ukraine," the DGF, and state banks is not planned this year; and
- The decreased demand for refinancing loans as a consequence of the banking system clean-up. Within a period of more than a year, the banking system of Ukraine is functioning with a structural liquidity surplus. In such conditions, central banks usually refuse to conduct refinancing operations and implement liquidity management through operations to absorb liquidity. However, the significant level of segmentation in the Ukrainian banking system significantly impeded the redistribution of liquidity, which shaped how the NBU conducted operations for both providing and absorbing liquidity. Taking into account the completion of the main stage of the banking system clean-up and reduction of the interbank market’s segmentation level, the demand for refinancing loans became sporadic and negligible, and will remain so in the near future. At the same time, if banks need short-term liquidity, they may apply to the NBU, which will continue to perform as a lender of last resort.

3. PROSPECTS FOR DEVELOPMENT OF THE UKRAINIAN ECONOMIC SITUATION

3.1. EXTERNAL ASSUMPTIONS

Because of sizable fluctuations on the world's commodities and financial markets, global economic growth in 2016 will slow down to approximately 3% with a gradual recovery in 2017 to 3.4%.[52]

Notwithstanding moderate global economic growth, external demand from Ukraine's MTP countries is projected to improve gradually and in relation to:

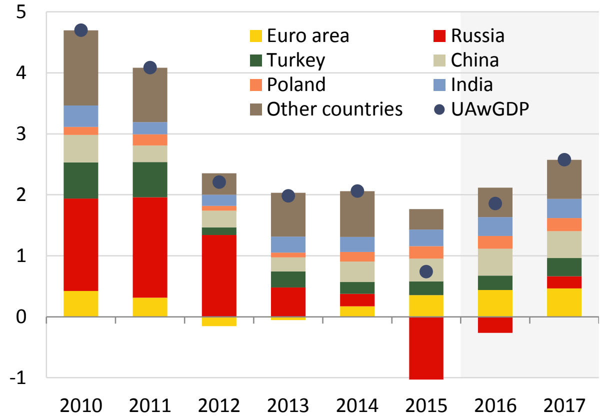
- the sustainable economic growth of the euro area against the background of the positive influence on exports and industrial production of the previous depreciation of the euro in relation to major currencies, as well as by expansion of the European Central Bank`s quantitative easing program and by increasing the volumes of business loans under the program of long-term refinancing for banks;
- the expected deceleration of GDP decline in Russia with further pick-up in economic activity related to recovery of the oil price and corresponding stabilization of the exchange rate of the Russian ruble to the US dollar;
- the sustainable economic growth of India and Turkey[53] due to increases in internal consumption; and
- notwithstanding the deceleration, by the high rates of economic activity of China against a background of governmental measures for easing credit directed at realignment of employees under the conditions of reducing the volumes of surplus production in metallurgy and coal mining,[54] further Government support for infrastructure projects,[55] and tax exemptions towards companies that will invest in hi-tech manufacturing.

At the same time, the US economic growth rates will be at a lower level than previously expected because of instability in the global financial markets, which is due to the "expensive" dollar leading to stricter financial conditions in the country, a decline in industrial production, and a slower recovery in the global economy than expected earlier.

Under such macroeconomic conditions, and taking into account a more gradual interest rate growth by the US Federal Reserve System than previously expected, an insignificant weakening of the US dollar against the currency basket is expected on the global foreign exchange markets in 2016–2017, in particular against the euro. Such US dollar weakening against a background of some stabilization in the situation in the global commodity markets will influence the strengthening of emerging market currencies.

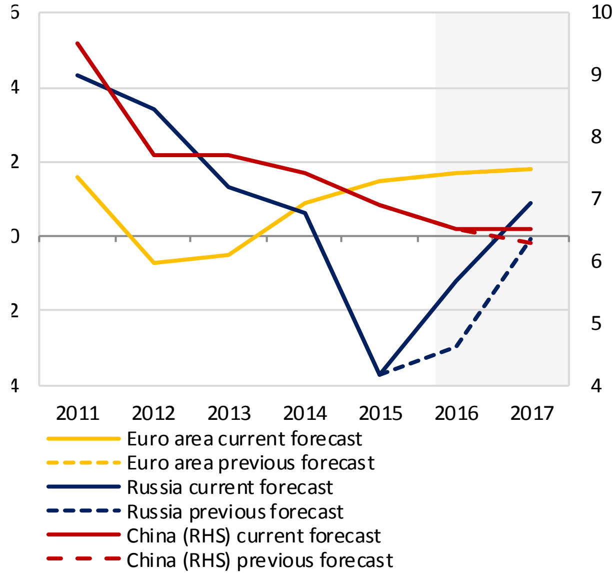
A REER depreciation by almost 5% in Q1 of the current year was caused by the hryvnia depreciation against a rapid decline in inflation in Ukraine. At the same time, the REER deviation from the potential level increased, which will encourage economic activity.

Contributions of Countries - Main Trading Partners of Ukraine to the Annual Change of UAwGDP, % y-o-y



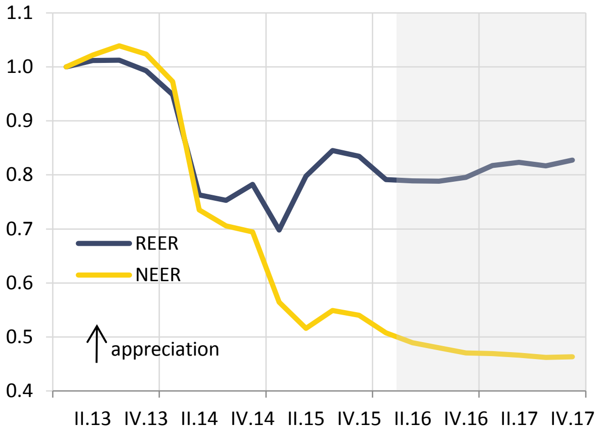
Source: NBU staff estimates (preliminary data)

Real GDP of Euro Area, Russia and China, % y-o-y



Source: NBU estimation, based on Fed, Economy Ministry of Russia, Consensus Economics

REER and NEER, I.2013=1



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52 Economic growth forecasts for particular countries and world territories are NBU estimations based on forecasts of the IMF, World Bank, European Central Bank, BofA Merrill Lynch, Scotiabank, Commerzbank, OECD, Fitch Ratings, Morgan Stanley, and JP Morgan.

53 The share of Ukrainian exports to India and Turkey in 2015 consists of 3.1% and 6.1%, respectively.

54 According to the Prime Minister of China, they are going to allocate Yuan 100 billion (USD 15 billion) for the professional realignment of dismissed employees.

55 According to the Prime Minister of China, they are going to assign more than USD 120 billion in state funds for development of railways and green infrastructure.

The expected strengthening of currencies of MTP countries will determine the hryvnia NEER depreciation. This, however, will be offset by a positive inflation differential (inflation in Ukraine is higher than in MTP countries). As a result, according to NBU estimations, the REER will remain at the level of Q1 in 2016.

In 2017, the REER will appreciate by an average of 4% against a background of high inflation in Ukraine so far, which resulted in the REER returning to its potential level, reducing the positive effect of the weak hryvnia on economic activity.

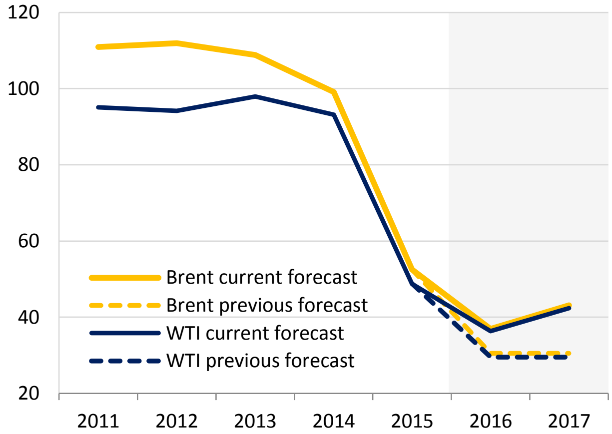
On global commodity markets, due to maintaining imbalances between supply and demand, prices in 2016 on average will remain lower than a year ago, and will moderately increase in 2017.

By the end of 2016, the imbalances between supply and demand in the global oil market are expected to remain, but they will decrease because of an upturn in demand. The global oil demand will grow by 1.3% y-o-y to 94.23 million barrels per day due to countries from North America, Asia, and Europe.[56] At the same time, demand will be reduced on the part of countries from Latin America and the CIS. The volumes of the world's supply will depend on stabilization agreements between the main oil producers. It is expected consequently that the average price for Brent crude oil in 2016 will be about 37 USD/bbl, and in 2017 prices for oil will grow by 15.8% on average.

First, the dynamics of steel prices in 2016 will depend on the situation in China's metallurgy sector. If China successfully realizes its program for economic reorientation towards domestic market, it will substantially influence steel prices.[57] In addition, the initiation of active anti-dumping duties, in particular by EU and the US, against some countries, mainly against China and Russia, will also enable prevention of further price reductions. As a result, the crude steel prices in 2016 will stabilize at a higher level compared to the previous forecast and will grow by 5% on average in 2017.

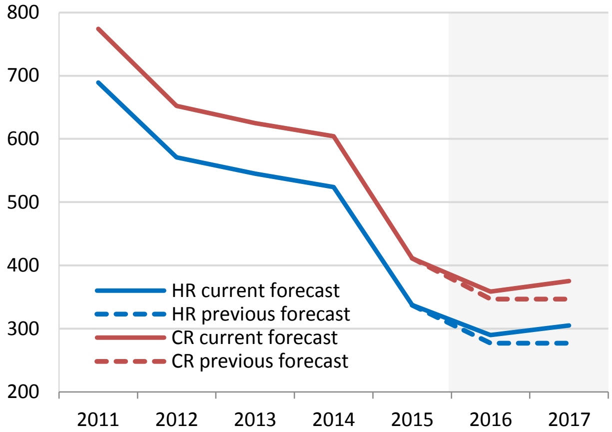
In the 2016/2017 marketing year, world cereal prices are expected to grow insignificantly. It will be stipulated by a less than expected harvest compared to the previous periods (mainly through reduction of the wheat yield), the risks of supply disruption (as a result of the possible increased tensions in the Middle East and in the Black Sea region), and increases in demand from China for sorghum and barley (due to changes in a domestic policy).

Brent and WTI Crude Oil Prices, USD/bbl, annual average



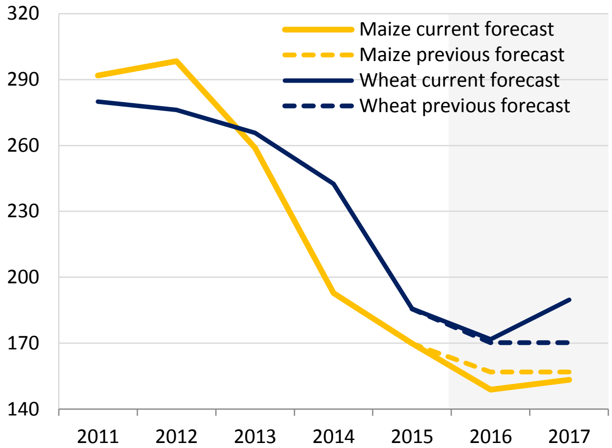
Source: NBU estimation, based on Consensus Economics, IMF, U.S. *Energy Information Administration, futures contracts*

Average Emerging Markets Steel Prices, USD/MT



Source: NBU estimation, based on Steel Insight

World Cereal Prices, USD/MT, annual average



Source: NBU estimation, based on IMF

[56] According to the OPEC *Monthly Oil Market Report*, since 14 March 2016, oil demand in the US is expected to increase to 20 million barrels, in China – to 11.1 million barrels, in Europe – to 13.8 million barrels, and in India – to 4.2 million barrels.

[57] According to the announcement of the Prime Minister of China, steel production is expected to reduce by 100–50 million tons by 2020. In other words, by 12–19% of production capacity (or 6–9% of world production).

	CPI, change as of the end of period, %			GDP, annual change, %			Exchange rates *		Commodity Prices*, USD			
	Euro area	Russia	USA	Euro area	Russi a	USA	USD per EUR	RUB per USD	Imported gas, per 1m³	Brent crude oil, per bbl	Ferrous metals export, per ton	Grain export, per ton
2014	-0.2	11.4	0.8	0.9	0.6	2.4	1.33	38.3	292.5	99.1	518.1	200.9
2015	0.2	12.9	0.7	1.5	-3.7	2.4	1.11	60.9	274.0	52.5	368.5	161.8
2016	0.1	8.5	1.6	1.7	-1.2	2.2	1.11	73.0	201.8	37.2	300.2	151.3
2017	1.3	6.8	1.9	1.8	0.9	2.1	1.13	74.0	229.2	43.1	326.1	156.3
annual change, %												
2015							*-16.6*	*59.1*	*-6.3*	*-47.1*	*-28.9*	*-19.4*
2016							*0.3*	*19.7*	*-26.4*	*-29.1*	*-18.5*	*-6.5*
2017							*1.5*	*1.4*	*13.6*	*15.9*	*8.6*	*3.3*

annual average

3.2. PRICES

Despite the fact that due to temporary factors the consumer price index increased less than expected in Q1, the inflation forecast remained unchanged - at 12% by the end of 2016, and at 8% by the end of 2017. It is related to the fact that the influence of short-term factors should be neutralized during the next periods. In addition, the return of inflation to the target level will be supported by world price increases.

A decline in world prices for food commodities and growth in supply on the domestic market led to price increases in raw food commodities by merely 0.2% during Q1 (28% of the consumer basket), which is considerably less than the inherent seasonality at the beginning of the year.

The NBU assumed that most factors are temporary. Thus, renewal of transit through the Russian Federation and export of separate food commodities to Middle Eastern countries will determine the upward adjustment of prices.

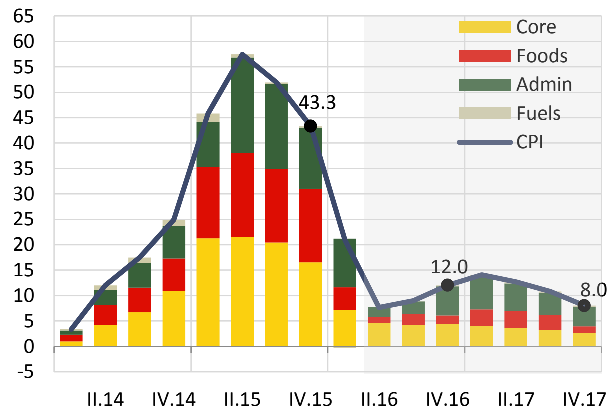
Supply of food commodities is substantially affected by the flow of commodities from Turkey because of a ban on imports of Turkish commodities by the Russian Federation. The possible release of tension between these countries will cause a price increase for the domestic food market.

The influence of the harvest on inflation development will be neutral, taking to account that the projected assumptions in terms of volumes remain unchanged compared to previous forecasts.

Recovery of food prices in global markets, together with neutralization of temporary factors, will return food inflation to the level of the previous forecast - 6.5% in 2016 and 4.6% in 2017.

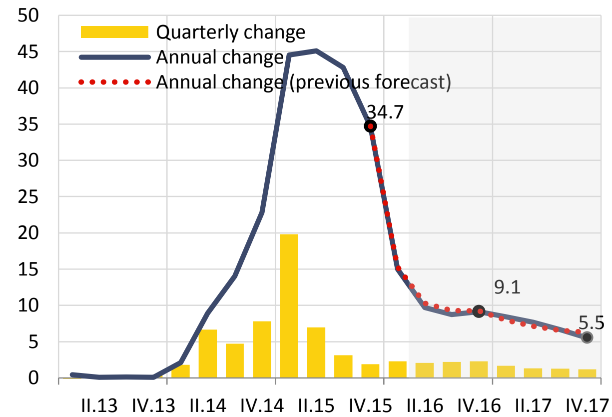
The probability of a sharper decline in core inflation (47% of the consumer basket) increases as a result the influence of secondary effects from raw food commodity prices. However, the dynamics

Contribution to Annual Growth of CPI, p.p.



Source: State Statistic Service of Ukraine; NBU staff estimates

Core Inflation, %



Source: State Statistic Service of Ukraine; NBU staff estimates of world prices for food commodities, starting from Q3 of the current year, as well as lack of evidence of a sustainable influence from temporary factors, determine the maintaining of the core inflation forecast of 9.1% at the end of 2016.

The weakening of the effects of exchange rate depreciation and improved inflation expectations, reinforced by a decline in imported inflation based on a deceleration of inflation in Ukraine's MTP countries, will have a positive impact on the further decline in core inflation to 5.5% in 2017.

Rising fuel prices should be comparable to the rate of overall inflation and will not create additional substantial pressure on prices.

The estimated increases in administered prices (23% of the consumer basket) remain unchanged in 2016: a 26% increase and should be mainly predetermined by increases in tariffs on gas, electricity, and heating. By our estimates, the competition between tobacco producers (which resulted in price-cutting for tobacco products at the end of 2015 and at the beginning of the current year) is ending. Thus, we expect a reversal in the trend for these products with the expected price increase of 20% in 2016, and 15% in 2017. In 2017, administered prices and tariffs will grow substantially (by 17.3%) in comparison to the previous forecast (15.3%), mainly resulting from a considerable increase in tariffs on gas due to increases in imported gas prices (for detailed information - see the paragraph 3.5 "Balance of Payments").

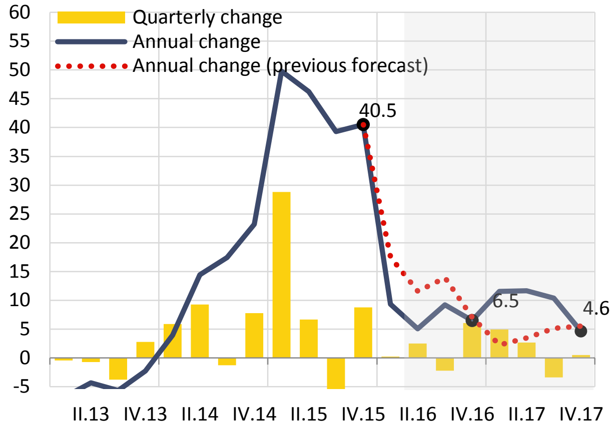
3.3. REAL ECONOMY

The estimation of the economic development for the forecast horizon remains unchanged (real GDP growth will recover gradually and will be 1.1% in 2016 and 3.0% in 2017). Despite improved external conditions and weakening of the REER, the forecast remains valid given the worsening of business expectations and moods of investors as a consequence of increased political uncertainty during Q1 and the delay in resumption of cooperation with the IMF.

By our estimates, a rapid decline in inflation and depreciation pressure, along with export price growth and recovery of external demand, will provide businesses and the population an opportunity to realize deferred investments and consumer decisions. So, private consumption is expected to start to recover (1% in 2016 and 4.1% in 2017), primarily due to realization of deferred demand as is already confirmed by the growing dynamics of non-energy imports in Q1 of the current year. Furthermore, demand is expected to be stimulated by increases in salaries in connection with the decrease of the unified social tax (UST). In addition, we expect that lower interest rates in the economy, among other factors, will lead to a gradual revival of credit activity. At the same time, the slow recovery of consumption growth in 2016 will be determined by a restrained fiscal policy.

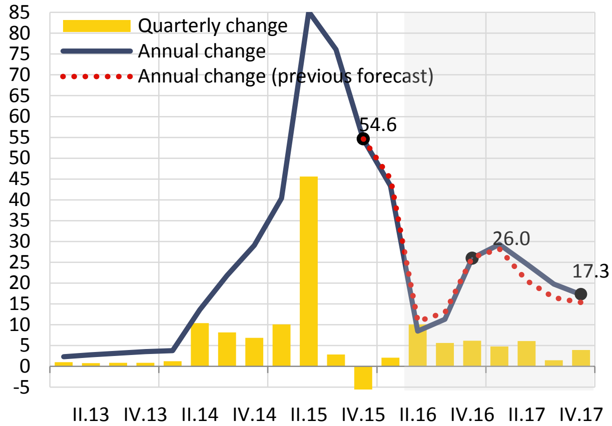
Investment demand will grow more robustly than consumer demand. Higher recovery rates of investment (5.1% in 2016 and 6% in 2017) compared to the previous forecast are related to the resumption of export price growth. At the same time, the assumptions of the previous forecast remain the same. Namely, that the investment climate will improve mainly because of

RAW Food Inflation, %



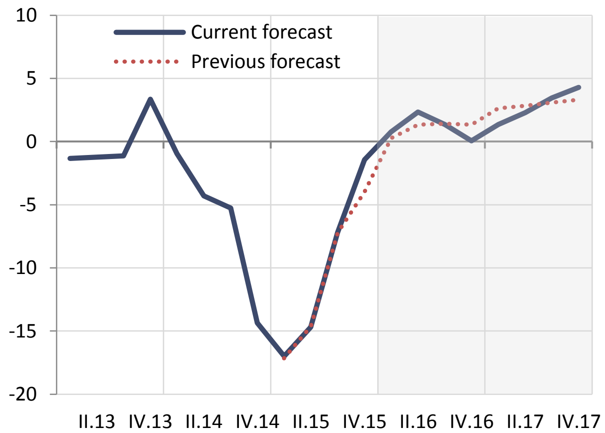
Source: State Statistic Service of Ukraine; NBU staff estimates

Administered Prices, %



Source: State Statistic Service of Ukraine; NBU staff estimates

Real GDP, % y-o-y



Source: State Statistic Service of Ukraine; NBU staff estimates stabilization of the situation in the east, lending resumption in the banking system starting from the second half of 2016, restructuring of external debt, and the effect of the Free Trade Agreement between Ukraine and the EU. The latter will provide an impetus for reorientation of domestic producers to the European markets and raising capital in order to strengthen the competitiveness of Ukrainian products. The decrease in the UST will release additional funds for business and boost investment activity, which would be relevant if external demand improves as expected. At the same time, world market prices for fuels and further increases in tariffs on heating will foster the implementation of energy efficient technologies.

Exports of goods and services, as estimated by NBU, will grow during the forecasting period due to the partial renewal of transit through the Russian Federation since the end of February 2016 and recovery of external demand among Ukraine's MTP countries. World market prices increase for basic export commodities and the forecasted increase in the yield of the oil crop will also contribute towards increases in physical export volumes. Though it is expected that the physical export volumes will grow starting from Q2 2016, the overall yearly volume will decrease (by 3.7% compared to the previous year) due to statistical effects. In 2017, the physical volumes of exports will grow by 3.8%, reflecting increased demand from MTP countries.

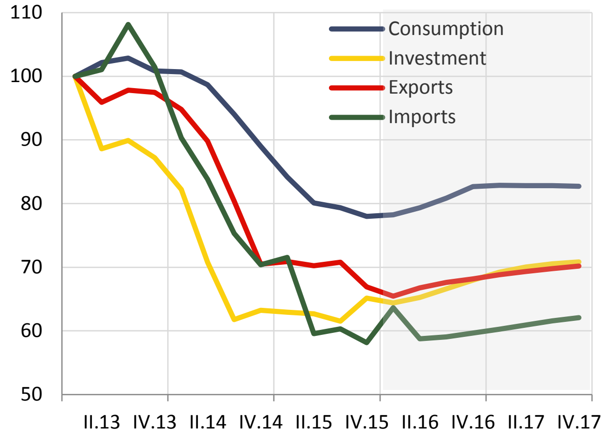
By our estimates, energy imports will decline during the forecast horizon both due to an increase in the price of imported energy resources and a decline in the volumes of gas purchases. The latter became possible thanks to favorable weather conditions that allowed accumulation of considerable gas reserves in depositories at the end of the 2015/2016 heating season. Gas demand from the population will also decrease due to increased gas tariffs. The increase in non-energy imports will be sustained by a recovery in consumer demand, so that the total physical imports will grow at a quarterly rate of 1% (compared with the previous quarter in seasonally adjusted terms) in 2016-2017. However, even given such an increase, the high base of comparison from last year will lead to a negative yearly index for 2016 (-2.3%). Increases in physical volumes of imports will amount to 1.9% in 2017.

Fiscal sector

Fiscal policy in 2016 should remain restrained. The need to allocate 4.6% of GDP of budgetary resources for debt management in case of limitations in relation to the size of the full fiscal deficit will determine the need for implementation of the consolidated budget with a positive primary balance in the amount of over 1% of GDP. The current NBU estimate for 2016 is 1.6% of GDP.

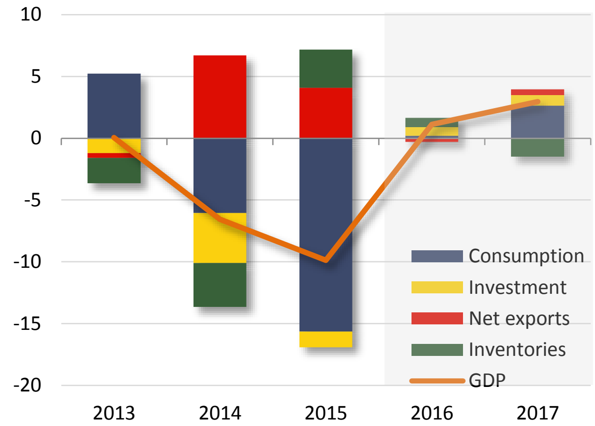
A substantial reduction in profit transfers by the NBU (38 billion hryvnia, or 1.7% of GDP, as compared to 3.1% of GDP during the last year), as well as an almost two-fold reduction of tax proceeds from international trade resulting from the abolition of the additional import surcharge reduce the funding base of the budget by 2% of GDP. However, the increase in other tax receivables (by an average of 16%) will provide an opportunity to compensate these losses and keep the deficit of the consolidated budget within the limits of 3% of GDP.

Real GDP, I.2013=100



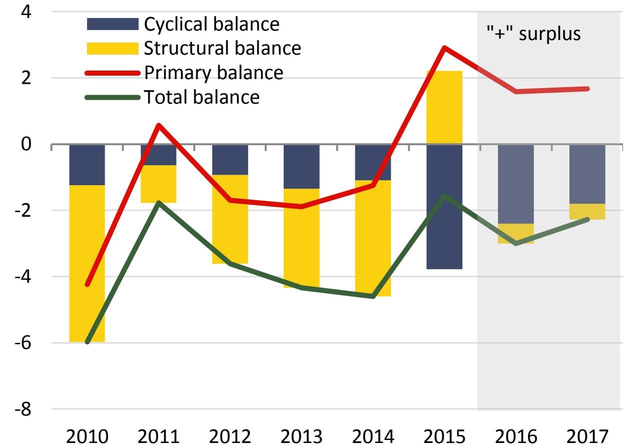
Source: NBU staff estimates

Contributions to Real GDP Growth, p. p.



Source: NBU staff estimates

Consolidated Budget, % of GDP



Source: NBU staff estimates

It is expected that the deficit of the general government (excluding Naftogaz and the needs to recapitalize banks) approximately constitutes 3.4% of GDP in 2016, and public debt and government-backed debt will not exceed 84% of GDP in 2016.

3.4. BALANCE OF PAYMENTS

Despite the change in the quarterly dynamics, the projected current account deficit for 2016 and 2017 has not changed substantially. The widening of the trade balance deficit in 2016 will be offset by increased remittances into Ukraine. The forecast of the financial account for 2016 and 2017 has remained almost unchanged. The public sector's borrowings were delayed for one quarter due to the postponement of the IMF program. The forecast of the private sector financing since Q2 2016 has also remained unchanged.

The forecast of the current account in 2016 remained almost unchanged – the expected deficit is estimated at USD 2.3 billion (USD 2.5 billion in previous forecast) or 2.7% of GDP.

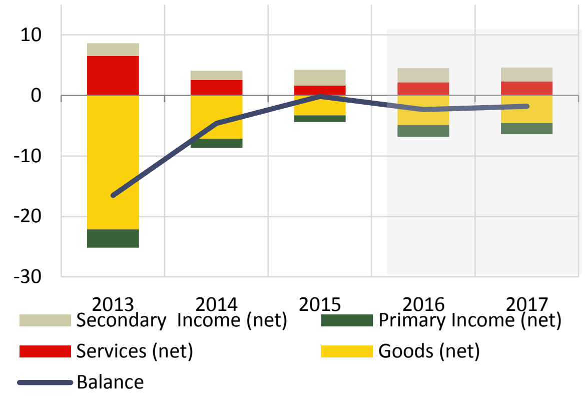
A deeper than expected decline in exports of commodities in Q1 is partially related to temporary factors in January, and should be offset in Q2. Thus, the rates of decline of merchandise exports in 2016 remained almost unchanged (12.0% y-o-y) compared with the previous forecast. However, the NBU expects opposite trends for certain groups of exports. Owing to the recovery of the ferrous metal prices in March, the ferrous metal exports rate of decline should decelerate to 19.1% (as compared to 22.4% in the previous forecast). Additionally, a 16.6% increase in the export of sunflower oil is expected as a result of yield growth and gradual price increases. At the same time, record high world carry-over stocks of grain should lead to gradual price decline in the first half of the year. Subsequently, the export of grain will decline to 14.8%. Also, the NBU expects low prices for ores to maintain, which will accelerate a decline in ore exports to 19.1%. It is associated with a reduction of Chinese demand and formation of excess supply of ore.

A deceleration of the decline in imports of goods to 6.9% (compared with 7.3% in the previous forecast) is caused by the recovery of non-energy imports by 3.3% (compared with 2.0%). The increase is determined by higher deferred demand than expected. Demand materialized after abolition of import surcharge and reduction of the customs tariffs from the EU. Furthermore, the acceleration of growth of domestic demand (both of consumption and investment) is expected. Imports of agricultural products will increase by 6.6%, and machinery by 1.5%. The increase in imports of the chemical products (by 5.5%) is connected with the decrease in world prices for fertilizers, and with corresponding increases in the volumes of their purchases by producers.

Imports of natural gas is expected to fall considerably to 11.5 billion cubic meters (compared with 13.8 billion cubic meters in the previous forecast). However, its average price should be higher – USD 202,400 cubic meters (compared with USD 189,600 cubic meters). It resulted in gas' import bill declining to USD 2.3 billion (compared with USD 2.6 billion).

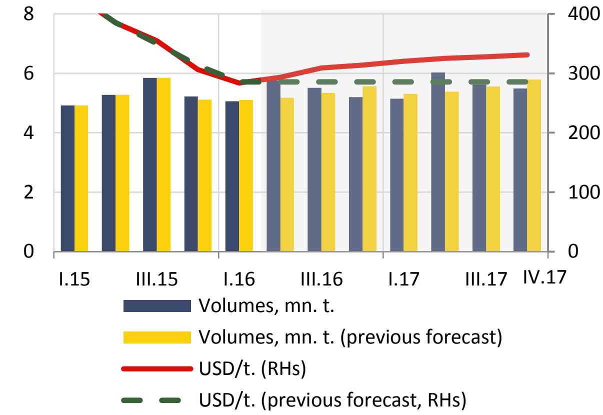
The estimated primary and secondary income increased by USD 0.3 and 0.2 billion, respectively. First, it represents an increase in remittances after improved forecasts of economic recovery in Russia.

Current Account, USD bn



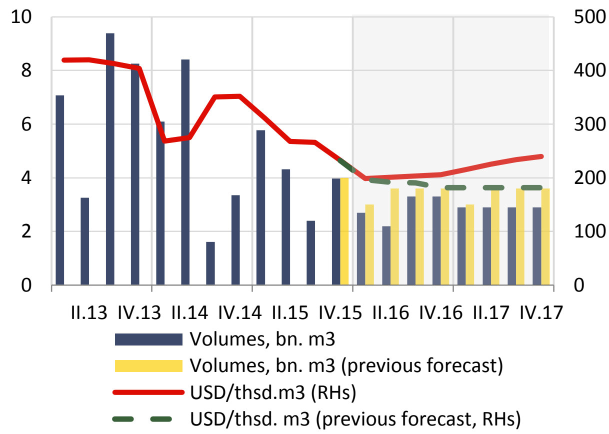
Source: NBU

Ferrous Metals Exports



Source: NBU

Natural Gas Imports



Source: NBU

The forecast for service exports and imports has not changed. The surplus of service trade will total USD 2.2 billion in 2016.

The forecast of the current account also remains unchanged in 2017. The deficit is about to decline to USD 1.8 billion (compared with USD 2.0 billion in the previous forecast) or 1.9% of GDP. The growth in exports of goods and services (by 5.7%) exceeded the recovery in imports of goods and services (by 4.2%). An increase of exports is expected for all commodity groups. The most rapid growth is expected in ferrous metal exports (by 14.9% compared with 4.0% in the previous forecast) caused by increasing prices for ferrous metals. Increases in non-energy imports is expected in all groups owing to growth of real disposable income, improvement of the financial results of enterprises, and lending recovery.

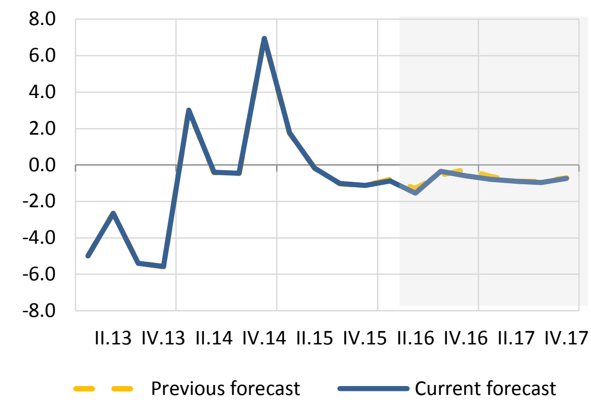
The forecast of the financial account remained almost unchanged in 2016 (net borrowings amount to USD 3.3 billion). The net inflow of foreign direct investments will stand at USD 2.7 billion, most of which will be directed towards capitalization of the banking sector. The private sector will continue to repay its liabilities and the rollover rate for long-term external debt remains at the level of 67%[58] without any changes. The delay of official financing for one quarter was offset by higher than expected reduction of FX cash outside banks thanks to stabilization of the FX market and higher inflows in the trade credits. In Q2, the recovery of external financing in the public sector is expected after easing in political uncertainty. The official borrowings are going to amount to USD 8 billion in 2016.

The net borrowings under the financial account remain unchanged in 2017. The inflow of the foreign direct investments will amount to USD 2.5 billion, and rollover of the private sector will increase to 100%. The borrowings of the public sector will be provided mostly by the IMF.

In 2016, the overall balance of payments is expected to show a surplus of USD 1.2 billion, which, along with the IMF injection will drive reserves accumulation to 18.7 billion, sufficient to cover 4.7 months of future imports.

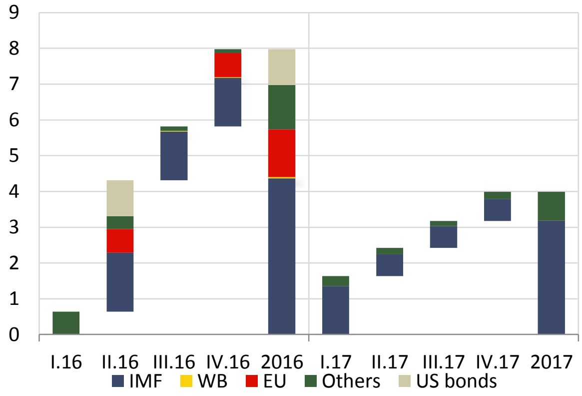
In 2017, the international reserves are expected to continue growing to USD 22.6 billion, or 5.3 months of future imports, due to a surplus of the overall balance of payments (USD 1.6 billion) and loans from the IMF.

Financial Account: Net External Assets, USD bn



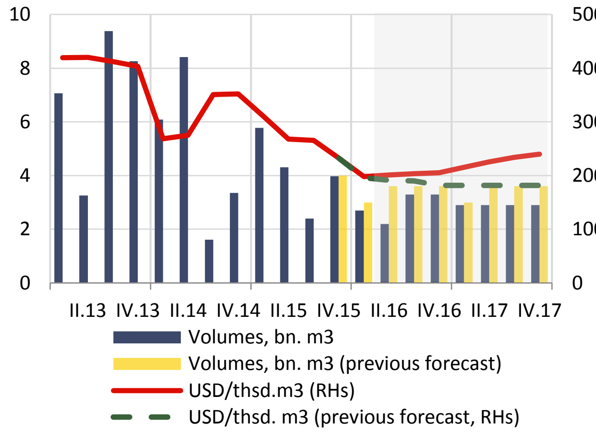
Source: NBU

Official Financing in 2016 - 2017, USD bn



Source: NBU, IMF

International Reserves



Source: NBU

58 Including the arrears.

3.5. MONETARY SECTOR AND FINANCIAL MARKETS

The monetary sector forecast is based on the assumption of the gradual recovery of money demand on the forecast horizon. Taking into account the unfavorable impact of internal and external factors on the macroeconomic situation and expectations of the economic agents in Q1 2016, compared to previous forecasts, lower deposits and cash growth is expected overall in 2016.

The banking system will continue functioning under conditions of a liquidity surplus, mainly driven by the NBU's purchase of FX on the interbank market.

The demand for hryvnia at the beginning of the year was weaker compared to NBU estimates. This resulted from negative external and internal factors: depreciation pressure resulting from a decrease of FX receipts, a decline in world commodity prices, political uncertainty, and a delay in external financing.

With the gradual mitigation of these factors, a further inflow of deposits in banks is expected.

In view of development of cashless payments, the rise of cash volumes is estimated at a lower level, compared to the previous forecast.

The money supply is projected to grow by 8% as a whole in 2016. Base money is expected to rise by 5% in 2016. With weak hryvnia demand, the base money growth will be mainly driven by increasing banks' correspondent accounts. The need for banks to increase balances on correspondent accounts is defined by a decision taken in December 2015 to exclude cash desk balances in domestic currency from the calculation of reserve requirements starting from 10 January 2016.

The banking system will continue to function under conditions of a structural liquidity surplus. Considering the above-mentioned, the NBU will use CDs to absorb excess liquidity.

The NBU's FX purchase auctions to replenish international reserves will largely ensure the liquidity of the banking system. In 2016, fiscal factors will not impact monetary policy implementation. It is assumed that, unlike in previous years, the DGF will not apply for NBU support to conduct payments to depositors of banks in liquidation.

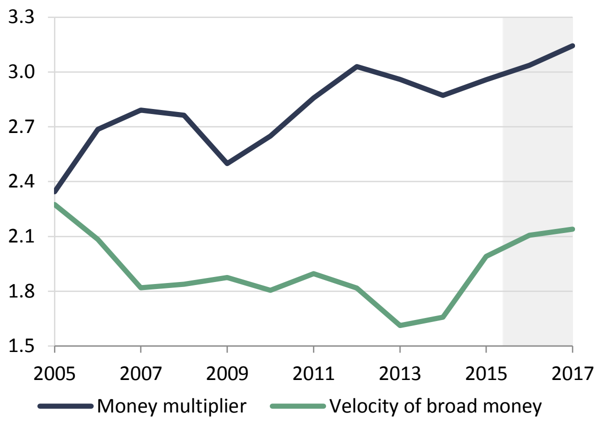
Government debt service payments for bonds in the NBU portfolio will be a major contributor to liquidity absorption.

Reflecting the liquidity surplus in the banking system, banks will conduct repayments for previously-granted refinancing.

Given further alleviation of risks to the macroeconomic environment and, as well to price stability, the NBU will continue easing its monetary policy. Hence, it will cause a gradual decline of the costs of market financial instruments alongside the interest rates on banks' operations.

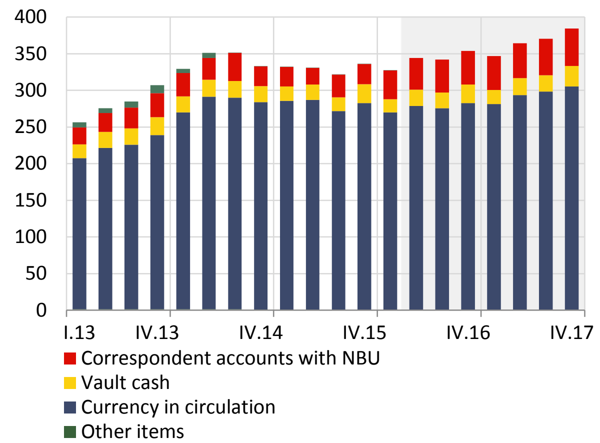
In 2017, the monetary policy is expected to normalize. Further disinflation and acceleration of economic growth will boost hryvnia demand with a simultaneous decline in the cost of resources.

Money Multiplier and Velocity of Broad Money



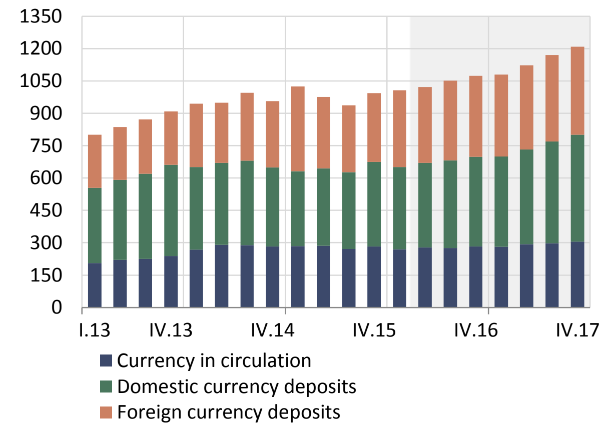
Source: NBU

Base Money by Components, UAH bn



Source: NBU

Broad Money by Components, UAH bn



Source: NBU

The money supply will grow mainly due to its deposit component. The development of the banking system and the subsequent replacement of cash payments with cashless will determine, in particular, the further upward trend of money multiplication. Under such conditions, base money is projected to grow at a somewhat slower pace (by 9%) compared to the money supply (13%).

3.6. RISKS OF FORECAST

The NBU considers the possible renewal of hostilities in the east of Ukraine, a slight decline in world prices for raw materials, a decrease of external support in case of deceleration of reforms, and complete blocking of Ukrainian exports through the territory of the Russian Federation **to be the key negative risks to the forecast for economic development.**

At the same time, **recovery in world commodity prices and growth of demand for Ukrainian goods exports can provide an impetus both for investment flows and for acceleration of economic recovery.** The successful realization of privatization is an additional factor for rapid cash inflows to the country compared to the base scenario.

Exposure to these risks during the forecast horizon determines the deviation of the actual inflation from the target trajectory and the corresponding response on the part of the NBU.

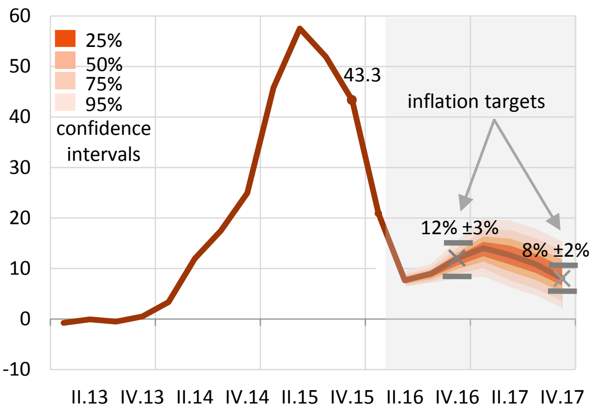
Risks to further inflationary development are tilted downside in the current year and upside for the next year. Such a course of events can be implemented in the case of a more protracted action of restrictions in relation to the export of products to CIS markets and other trade partners. It will create a surplus supply in the domestic market with corresponding pressure on prices in 2016, forming a low base of comparison for 2017. At the same time, the corresponding reduction in export profits may result in the downward pressure on the exchange rate - that is the effects of an excessive supply of commodities will level off.

The dynamics of commodity prices will have a similar effect. Being lower than assumed in the base scenario, the prices from one side will decrease an export surplus and increase pressure on the hryvnia exchange rate. The other side - deceleration of economic activity and inflation in Ukraine's MTP countries, together with lower costs for raw materials, should ease the pressure on inflation in Ukraine. Therefore, as a result, acceleration performs insignificantly. The response of the central bank implies a realization of a more restrained monetary policy as compared to the base scenario with a slower lowering of the key rate in 2016-2017.

The other possible reason for lower inflation remains a possible delay in administratively regulated price increases as compared to the terms stipulated in the IMF's EFF program. However, in this case, the response of monetary policy is going to be minimal (because one of the reasons as to why inflation runs below estimates is of a non-monetary nature) and should be concentrated mainly on secondary effects.

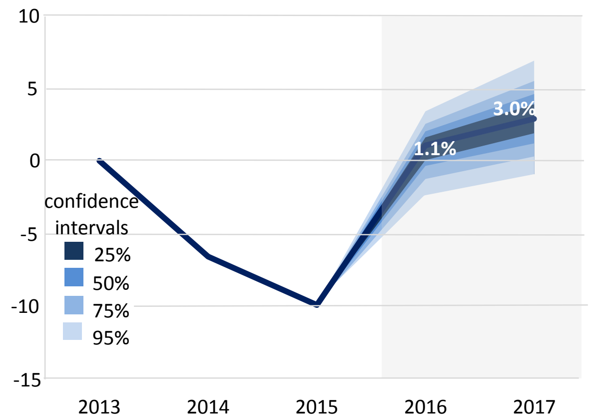
At the same time, in case of the slow realization of reforms by the new government, the NBU expects the situation of political

Headline CPI Forecast and Targets, % y-o-y



Source: NBU staff estimates

Real GDP Forecast, % y-o-y



Source: NBU staff estimates

The forecast is given as a FanChart. This chart type depicts the probability of various outcomes for the projected indicator. For instance, the probability that the inflation rate will be in the range of the darkest shading area on the chart (around the central line) stands at 25%. The same applies to other chart areas, meaning that the probability that the inflation rate will be in the range of the lightest area is 95%.

instability and corresponding increase of the risk premium that will cause depreciation of the hryvnia, thereby increasing pressure on inflation. Additional price advantages obtained by exporters will accelerate exports and overall economic activity, increasing pressure on inflation. In this case, a return of inflation to the special target level will require the realization of a tight monetary policy (considering the slow decline of the key rate compared to the base scenario).

As a positive shock, the NBU considers a scenario of additional increase in demand for Ukrainian products and acceleration of reforms. Based on this assumption, the rapid growth of economic activity will cause strengthening of the hryvnia given export surplus increase and cash inflows to the financial account. It will urge a slowdown in inflation (compared to the base scenario) that will enable the policy rate cut.

Macroeconomic forecast (April 2016)

Indicators	2013	2014	2015	2016						2017					
				I	II	III	IV	current forecast	forecast 01.2016	I	II	III	IV	current forecast	forecast 1.2016
REAL ECONOMY, % y-o-y, unless otherwise stated															
Nominal GDP (SNA'2008), UAH bn	**1465**	**1587**	**1979**	433	516	641	671	**2262**	2216	492	588	736	769	**2585**	2493
Real GDP	**0.0**	**-6.6**	**-9.9**	0.8	2.3	1.3	0.1	**1.1**	1.1	1.3	2.3	3.4	4.3	**3.0**	3.0
GDP Deflator	**4.2**	**15.9**	**38.4**	16.9	12.2	12.3	10.5	**13.0**	13.2	12.1	11.3	10.5	9.8	**11.0**	9.2
Consumer prices (period average)	-0.3	12.1	48.7					12.1	13.9					11.3	8.9
Producer prices (period average)	-0.1	17.1	36.0					10.9	6.8					10.0	6.9
Consumer prices (end of period)	**0.5**	**24.9**	**43.3**	1.5	4.1	1.7	4.2	**12.0**	12.0	3.3	2.8	0.0	1.6	**8.0**	8.0
Core inflation (end of period)	0.1	22.8	34.7	2.3	2.1	2.2	2.3	9.1	9.2	1.6	1.3	1.3	1.2	5.5	6.3
Non-core inflation (end of period)	0.9	26.8	50.9	0.8	5.9	1.3	5.9	14.6	14.4	4.8	4.2	-1.0	2.0	10.2	9.6
Administrative prices (end of period)	3.7	30.4	54.6	2.1	10.1	5.6	6.1	26.0	26.2	4.8	6.1	1.5	3.9	17.3	15.3
Producer prices (end of period)	**1.7**	**31.8**	**25.4**	4.4	3.9	2.5	2.1	**13.6**	6.9	2.3	3.3	1.6	1.0	**8.4**	7.3
FISCAL SECTOR															
Consolidated budget, balance	**-63.6**	**-72.0**	**-30.9**	-	-	-	-	**-68.1**	-70.1	-	-	-	-	**-59.3**	-65.6
% of GDP	-4.3	-4.5	-1.6	-	-	-	-	-3.0	-3.2	-	-	-	-	-2.3	-2.6
Public finance overall balance (IMF method)	**-57.5**	**-70.3**	**-31.9**	-	-	-	-	**-76.8**	-97.6	-	-	-	-	**-65.8**	-90.7
% of GDP	-3.9	-4.4	-1.6	-	-	-	-	-3.4	-4.4	-	-	-	-	-2.5	-3.6
General government and Naftogaz financing, % of GDP	-5.8	-9.9	-2.9	-	-	-	-	-3.6	-4.6	-	-	-	-	-2.5	-3.6
BALANCE OF PAYMENTS (NBU methodology)															
Current account balance, USD bn	-16.5	-4.6	-0.2	-1.3	0.0	-1.0	-0.1	-2.3	-2.5	-0.6	-0.3	-0.9	-0.1	-1.8	-2.0
Financial account, USD bn	-18.6	9.1	-0.6	-0.9	-1.5	-0.3	-0.6	-3.3	-2.9	-0.8	-0.9	-1.0	-0.7	-3.4	-3.2
BOP overall balance, USD bn	**2.0**	**-13.3**	**0.8**	-0.4	1.5	-0.5	0.5	**1.2**	0.6	0.2	0.6	0.1	0.6	**1.6**	1.1
Gross reserves, USD bn	**20.4**	**7.5**	**13.3**	12.7	15.9	16.8	18.7	**18.7**	19.6	20.3	21.5	21.8	22.6	**22.6**	22.3
Months of future imports	**3.5**	**1.9**	**3.5**	3.3	4.1	4.3	4.7	**4.7**	5.0	5.0	5.2	5.2	5.3	**5.3**	5.3
Export of goods, % y-o-y	-7.5	-15.0	-29.9	-23.0	-12.4	-11.6	-1.2	-12.0	-11.8	10.4	6.0	5.1	5.3	6.5	3.6
Import of goods, % y-o-y	-5.3	-27.8	-32.8	-14.4	-6.2	-3.5	-3.4	-6.9	-7.3	0.0	8.6	4.0	6.1	4.7	2.8
MONETARY ACCOUNTS (year-to-date)															
Base money, %	**20.3**	**8.5**	**0.8**	-2.6	2.4	1.7	5.3	**5.3**	8.3	-2.0	3.0	4.7	8.7	**8.7**	8.3
Broad money, %	**17.6**	**5.3**	**3.9**	1.3	2.7	5.7	8.1	**8.1**	10.5	0.5	4.6	8.9	12.5	**12.5**	11.5
Velocity of broad money (end of year)	**1.59**	**1.64**	**2.0**	-	-	-	-	**2.1**	2.0	-	-	-	-	**2.1**	2.0