NATIONAL
BANK
OF UKRAINE

INFLATION REPORT

JULY 2016

PREFACE

The **Inflation Report** reflects the opinion of the National Bank of Ukraine (NBU) regarding 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 forecast frequency.

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

The Monetary Policy and Economic Analysis Department developed forecasts of inflation and other macroeconomic variables. The NBU Board approved the forecasts during a meeting devoted to monetary policy issues on 28 July 2016.[1] Macroeconomic projections, including inflation, comprise the principal input, but not the only one, the NBU Board considers in its decision-making. In addition to the projections of inflation and other macroeconomic variables, the NBU 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 NBU 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 27 July 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 Decision No. 173-рш of 28 July 2016 *On the Approval of the Inflation Report.*

CONTENTS

ABBREVIATIONS AND ACRONYMS

ATO	Anti-Terrorist Operation
BoP	Balance of Payments
BPM5 **BPM6**	IMF Balance of Payments Manual (5th edition) IMF Balance of Payments And International Investment Position Manual (6th edition)
CDs	Certificate of Deposit(s)
CIS	Commonwealth of Independent States
Core CPI	Core Consumer Price Index
CPI	Consumer Price Index
DGF	Deposit Guarantee Fund
ECB	European Central Bank
EFF	Extended Fund Facility
EU	European Union
FAO	Food and Agriculture Organization
Fed	Federal Reserve System
GDP	Gross Domestic Product
GVA	Gross Value Added
IIF	Institute of International Finance
IKSO	Index of Key Sectors Output
ILO	International Labour Organization
IOM	International Organization for Migration
IMF	International Monetary Fund
MFU	Ministry of Finance of Ukraine
MSCI	Morgan Stanley Capital International
MTP	Main Trading Partner
NBU	National Bank of Ukraine
NEER	Nominal Effective Exchange Rate
OPEC	Organization of the Petroleum Exporting Countries
PPI	Producer Price Index
REER	Real Effective Exchange Rate
RF	Russian Federation
SESU	State Employment Service of Ukraine
SFSU	State Fiscal Service of Ukraine
SSSU	State Statistics Service of Ukraine
SSC	Social Security Contribution
Treasury	State Treasury Service of Ukraine
USA	United States of America
VAT	Value-Added Tax
VRU	Verkhovna Rada of Ukraine
WTO	World Trade Organization
OECD	Organisation for Economic Co-operation and Development
bn	billion
UAH	Ukrainian hryvnia
EUR	euro
USD	US dollar
RUB	Russian ruble
ppts	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
pa	per annum
sa	Seasonally adjusted
LT	Long-term

1. SUMMARY

Inflationary pressure continues to ease

Consumer inflation slowed to 6.9% y-o-y, faster than projected in the previous Inflation Report. Subdued aggregate demand, a gradual strengthening of the hryvnia exchange rate, and a high supply of food products have contributed to the rapid slowdown.

Due to these factors, both core and raw food inflation registered below the NBU forecast, offsetting somewhat higher contributions from administered prices and fuel prices. Also, slower actual inflation and the strengthening of the hryvnia paved the way for a further improvement in inflation expectations.

The appreciation of **the hryvnia exchange rate** to the US dollar largely reflected the supply of foreign currency exceeding its demand. In recent months, global economic conditions have been more favorable for Ukrainian producers than foreseen by the underlying assumptions for the previous forecast. Indeed, global steel and iron ore prices increased significantly in Q2 2016, fully offsetting their deep declines in Q1 2016; grain prices were also higher than expected. The commodity and financial markets reacted sharply to the UK's Brexit vote; however, the slump was short-lived.

There were signs of a gradual improvement in the labor market. However, it was insufficiently strong to boost consumption. **The unemployment rate** remained high. At the same time, since March 2016, for the first time in the last two years, **real wages** have risen due to a steady easing of inflationary pressures. However, as before, consumer demand put no additional pressure on inflation.

Inflation forecast remains unchanged

The projection for year-end headline inflation remains unchanged and in line with **inflation targets** -- 12% for 2016, 8% for 2017, and 6% for 2018.

In H2 2016, headline inflation will return to the target, mainly on account of the reflection of further utility tariffs adjustments in price statistics. At the same time, core and raw food inflation will slow down at a faster pace than previously forecast. These price developments will be affected by a combination of strong supply effects, decelerating import prices amid lower hryvnia exchange rate volatility, and improving inflation expectations. As a result, we expect that core inflation, a measure of fundamental price trends, will decline to 5.5%. In the medium-term, core inflation is expected to reach 5%.

Rising **global commodity prices**, mainly for oil, will also support a return of inflation to the target. At the same time, this year's world grain crop may become the second highest in history, restraining an increase in grain prices.

Investments and net exports are the main drivers of economic growth

In Q1 2016, for the first time since the beginning of 2013, **real GDP** grew in annual terms, expanding by 0.1%. However, growth was weaker than expected predominately due to worse performance in select service sectors, while industrial sectors' output increased.

Foreign trade was the main driver of economic growth, despite restrictions on the transit of Ukrainian goods through the territory of the Russian Federation, imposed at the beginning of 2016. Likewise, domestic investment demand grew while private consumption remained subdued.

In Q2 2016, the external environment was more favorable than we expected in the previous forecast. At the same time, unforeseen internal risks materialized at the end of Q2 2016 that resulted in difficulties in the mining and steel industries. This led to a temporary but substantial drop in industrial output in June. Thus, according to NBU estimates, economic recovery was slower than expected in Q2 2016.

Nevertheless, in Q2 2016, a positive contribution of net exports to the economic growth remained in place. The **current account** balance for this period improved noticeably. First, Russia's transit restrictions were relaxed. Second, prices for commodities were higher than expected. Third, volumes of grain exports were larger than projected. At the same time, imports were in line with the forecast, with an unexpectedly stronger increase in imports of investment goods being offset by lower volumes of gas imports. As a result, the current account returned to surplus in Q2 2016 of USD 0.9 billion.

Net financial inflows totalled USD 0.3 billion in Q2 2016 owing to a substantial decline in cash outside banks (by USD 1.6 billion). The public sector repaid its outstanding external debts, while official financing was delayed again. As a result, thanks to a positive **overall balance of payments** (USD 1.2 billion), **international reserves** increased to USD 14.0 billion as of the end of June.

The Ukrainian economy will continue recovering

Real GDP growth forecast remained unchanged at 1.1% in 2016 and 3.0% in 2017. The growth will accelerate to 4.0% in 2018. The unaltered forecast for 2016-2017 reflects the mutually offsetting effects of divergent factors.

Thus, the **global economic** growth outlook has worsened mainly due to heightened downside risks to euro-area growth after the Brexit vote. Moreover, an increase in Brexit-related uncertainties will also weigh on medium-term prospects. Overall, however, the external environment will be more favorable for Ukraine over the forecast horizon, mainly on account of higher than previously projected global prices for its main export commodities.

In H2 2016, **private consumption** is expected to pick up slightly, supported by a rapid slowdown of inflation and easing depreciation expectations. However, its growth is projected to remain moderate, being held back by significant increases in utility tariffs and prudent fiscal policy. Over the next few years, private consumption will increase at a faster pace, fuelled by deferred demand, household income growth, and a projected revival in **lending**.

This year, the structural balance of the consolidated budget will be close to zero; however, **fiscal policy** is expected to gradually ease over the forecast horizon. But, given the still high debt service expenditures, primary Consolidated Budget surpluses must be maintained. At the same time, the pressure of quasi-fiscal needs will ease significantly. First, a rise in utility tariffs to the cost covering levels for primary energy will terminate the practice of using budget funds to compensate for Naftogaz losses. Second, the completion of the banking sector clean-up will decrease the quasi-fiscal needs of the banking sector and the Deposit Guarantee Fund. This will make it possible to maintain the public sector fiscal deficit within 3% of GDP.

Investment activity will recover at a faster pace than predicted in the previous forecast. The need to diversify trade flows toward European markets will prompt Ukrainian exporters to increase investments while taking advantage of more favorable terms of trade. At the same time, the rally in global energy prices and the adjustment of heating and gas tariffs to economically sound levels will encourage the development and deployment of energy saving solutions.

The **current account** balance forecast was also improved with the deficit revised downwards from USD 2.3 billion to USD 1.8 billion. Thanks to more favorable terms of trade and a projected increase in this year's grain harvest, we expect the decline in exports volumes to decelerate to just 2% in 2016. However, a stronger recovery in exports will be held back by the tightening of restrictions by the Russian Federation on the transit of Ukrainian goods through its territory to Kazakhstan and Kyrgyzstan, effective from 1 July 2016. However, given the general trend of decreasing Ukraine's foreign trade with Russia and other CIS countries in recent years, the impact of new restrictions will be much less painful than that of the previous ones. The downward revision in the current account deficit forecast was also prompted by expectations of lower volumes of natural gas imports and larger private remittances from abroad. Also, we do not expect the current account deficit to widen significantly in the coming years.

A key assumption of the baseline forecast scenario is continuing cooperation with the IMF, although the disbursements of official financing were delayed again. The forecast of **net financial inflows** was also revised downwards to USD 2.8 billion in 2016 as some official loans are now expected in 2017.

The expected overall balance of payments surplus and accessing the IMF funds will allow increasing **international reserves** to USD 17.2 billion as of the end of 2016 and to USD 23.5 billion by the end of 2017.

Monetary policy easing continues

Given a steady decline in inflationary pressure, improving inflation expectations, and a relatively stable foreign exchange market, the NBU continued to soften its monetary policy. From the beginning of April, the regulator reduced its **key policy rate** four times. From 29 July 2016, it was set at 15.5%.

The key policy rate cuts and formation of market expectations that monetary policy will continue easing facilitated a decrease in **market interest rates**. This was accompanied by the improvement of banks' resource base. **The stock of domestic currency deposits** continued growing, and an inflow of foreign currency deposits of the corporate sector (in the US dollar equivalent) resumed in June. At the same time, **lending activity** remained weak.

With the supply of foreign currency exceeding demand in the domestic FX market, the NBU not only actively purchased excess FX supply to replenish international reserves and mitigate exchange rate volatility, but also continued to relax FX market restrictions previously implemented. Such NBU actions did not hamper a gradual appreciation of the exchange rate triggered by fundamental factors.

Balance of risks: Inflation may be lower than 12% in 2016

The risks for further inflation developments this year have abated. As a result, headline inflation might come in below 12% if the evolution of some key variables, on which projections are relied heavily, deviate from the paths underlying the baseline scenario. Alternative paths may refer to weaker consumer demand and oversupply of grains and other crops in the domestic market resulting from a higher harvest, more favorable external conditions, as well as enforcement of select utility tariff moratoriums announced by local authorities.

In the medium-term, the resumption of cooperation with the IMF, the absence of adverse shocks in external markets, de-escalation of hostilities in the east of Ukraine, and, consequently, further improvements in inflation expectations remain the key factors supporting disinflation. Should these assumptions not hold, leading to an increase in the risk premium, depreciation and additional inflationary pressures, a return of inflation to its targeted level will require tighter monetary policy than in baseline scenario.

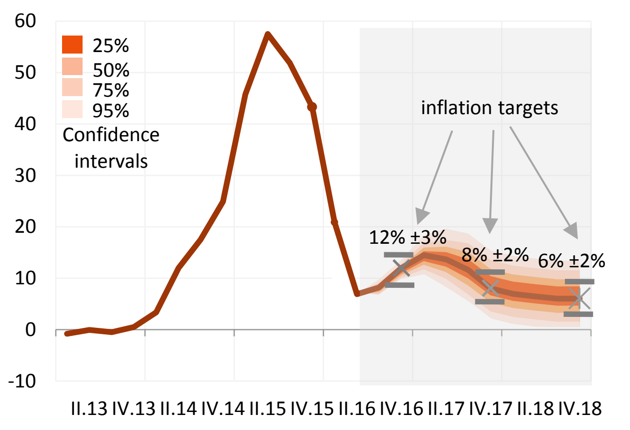
Alternatively, a rapid rise in world commodity prices, stronger foreign demand for Ukrainian goods, and speeding up the implementation of reforms may become a **positive shock**. Under such conditions, growing economic activity will be accompanied by strengthening of the hryvnia thanks to higher export proceeds and capital inflows in the financial account. Compared with the baseline scenario, this will lead to faster disinflation, which will make it possible to ease monetary policy at a faster pace.

Realization of the above-mentioned and other risks during the forecast horizon may cause actual inflation to deviate from the target path, prompting a relevant NBU response.

Monetary policy will be eased further if inflation targets remain within reach

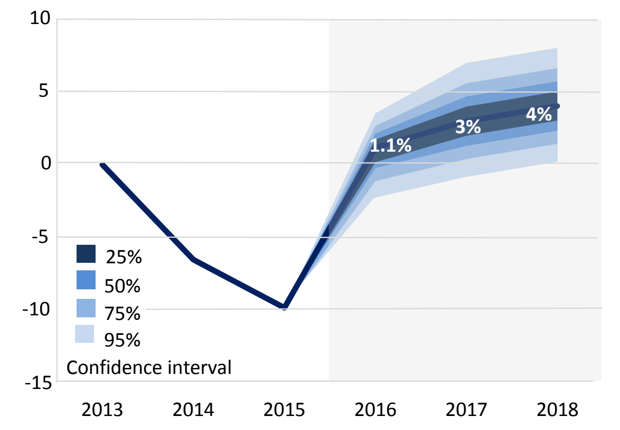
Should the situation evolve according to the NBU baseline scenario, i.e., the risks for price stability further abates, the NBU will continue to ease its **monetary policy**. Consequently, this will facilitate a gradual reduction in market interest rates. A trend towards monetary sector stabilization will support moderate inflation consistent with the targets and promote further economic recovery.

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



Source: NBU

Real GDP Growth, % y-o-y



Source: NBU

2. CURRENT ECONOMIC SITUATION

2.1. EXTERNAL ENVIRONMENT

The unexpected results of the UK's referendum on the country's membership in the European Union (Brexit) became a major event in the global economy in Q2 2016. This event triggered a sharp response in world financial and commodity markets and a downward revision of the global growth outlook against the background of a significant increase in the uncertainty related to Brexit process. At the same time, Brexit has worsened a generally favorable situation in world financial markets that prevailed during Q2.

The situation in world commodity markets, despite significant fluctuations in the oil market after the announcement of the results of the UK vote, was influenced by commodity-specific factors. Thus, during April-May 2016 world oil prices significantly rose due to a decreasing oil extraction in the USA, as well as supply disruptions from Nigeria, Venezuela, and Canada. However, as oil production rose in some countries and the effects of temporary factors subsided, the growth of oil prices have ceased since early June. Steel and grain prices (excluding wheat) have shown similar trends.

As a whole, external price environment for Ukrainian producers improved during Q2 2016. Thus, the price growth for key Ukrainian export commodities exceeded our expectations. However, at the end of Q2 2016 and in July, most commodity prices resumed their decline.

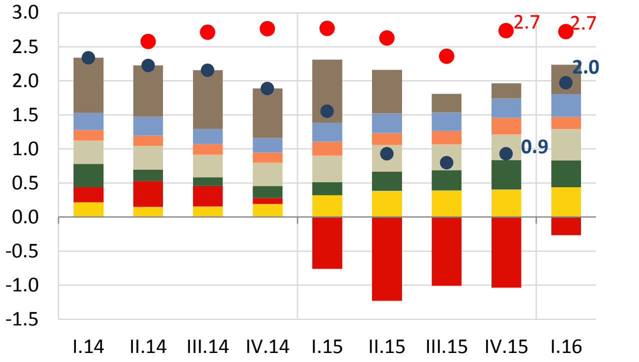
During Q1 2016, the weighted average economic growth in Ukraine's MTP countries (as expressed by the UAwGDP[2] index) accelerated. Although it was primarily related to a decrease in negative contributions from Russia, the economic activity in other MTP countries remained at a relatively high level.

External economic conditions for the Ukrainian economy improved during Q2 2016, as expected. At the same time, improvements in price environment for Ukrainian exporters, despite commodity price correction at the end of Q2 2016, exceeded our expectations.

In particular, world steel prices showed rapid growth in Q2 2016, fully offsetting a steep decline during Q1 2016. The rally in steel prices in the first half of Q2 2016 was underpinned by:

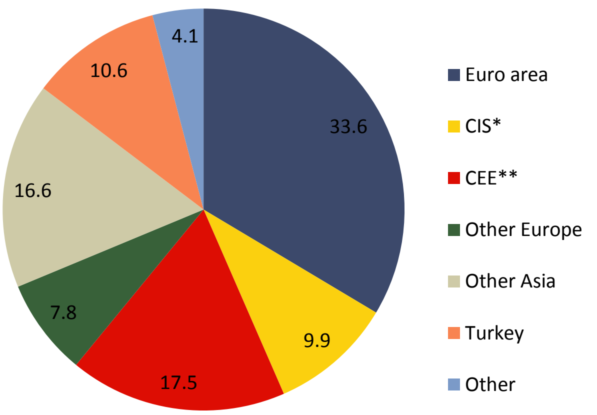
– strong steel demand in the Chinese domestic market on the back of the recovery of the state-supported construction sector, which led to a reduction in China's steel exports by 9% m-o-m in April;
– heightened demand for steel products for the urgent delivery due to a seasonal upturn in business activity;
– imposition of anti-dumping measures worldwide, mostly against China and Russia;
– a shift of production facilities abroad by Chinese companies, including to Russia, Serbia, and Bolivia that temporarily reduced steel production.

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



Source: NBU staff estimates (preliminary data)

Countries' Share in the UAwGDP, Normalized Weights, Excluding Russia, %



**CIS – Belarus, Kazakhstan and Moldova. This group of countries includes Georgia.*
***CEE – Bulgaria, Czech Republic, Poland, Romania, Hungary.*
Shares are calculated according to the geographical structure of Ukraine's goods and services exports in 2015. The combined share in Ukraine's total goods and services exports of the countries, included in UAwGDP index structure (excluding Russia), is 60%.

Source: SSSU; NBU staff estimates

[2] UAwGDP index measures the annual GDP growth rate of the countries that are MTPs of Ukraine, weighted by the volume of Ukrainian export of goods and services to the relevant countries. The index is used to assess external demand conditions.

From the second half of May, prices of steel products have been falling rapidly due to:

– measures of Chinese authorities to limit speculations in the steel market and reduce feverish demand in the Chinese domestic market;
– a seasonal decline in global steel demand in the Middle East countries due to Ramadan;
– increased steel production due to higher capacity utilization by leading producers and resumption of activities by steel companies that have suspended production due to low prices (particularly in the UAE, Oman, Vietnam, Algeria, and the Philippines).

Despite the correction in the second half of Q2 2016, the average steel prices were close to the Q2 2015 levels. Accordingly, despite June's decline, export prices for selected steel products of Ukrainian production (Steel Billet ExpFOB Ukraine) increased by about 40% q-o-q in Q2 2016.

Since the beginning of July 2016, the prices of steel products in various markets showed diverse trends. Thus:

– in the Middle East and North Africa, prices remained virtually flat due to weak business activity before the end of Ramadan (5 July 2016);
– in Europe, prices declined slightly due to a sharp drop in scrap metal prices. With Great Britain being the largest exporter of scrap, the British pound depreciation contributed to price reduction of scrap metals and, thus, rolled steel;
– prices for steel of Chinese production have resumed growth, in particular due to intensified construction works in China amid improved weather conditions.

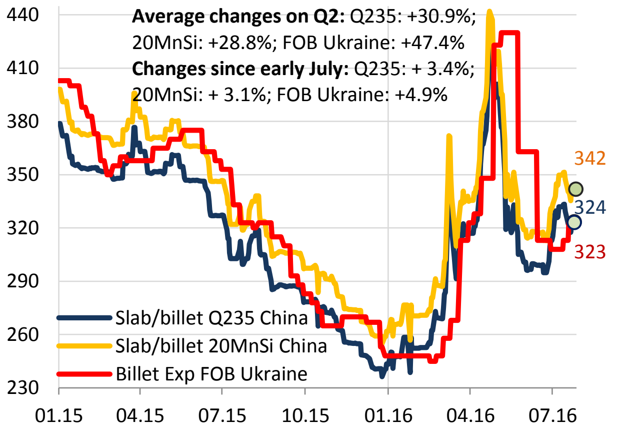
The Ukrainian External Commodity Price Index (ECPI)[3] increased by 17.4% q-o-q in Q2 2016. Steel and iron ore prices were responsible for the largest contribution to ECPI growth (with iron ore prices up by 16% q-o-q). At the same time, additional factors behind the ECPI growth were:

– higher corn and barley prices due to adverse weather conditions in Latin American countries, despite slightly lower wheat prices due to high carry-over stocks. However, due to the seasonal increase in supply, prices for both corn and wheat were mainly decreasing at the end of Q2 2016 and in July;
– higher wood and plastics prices due to a further increase in construction activity in the Northern hemisphere countries;
– higher prices for oilseeds, thanks to steady demand for sunflower seeds from producers due to the significant increase in the sunflower sowing area in the world in 2016-17 marketing year.

World crude oil prices significantly increased in Q2 2016 (on average by 35% q-o-q) as a result of:

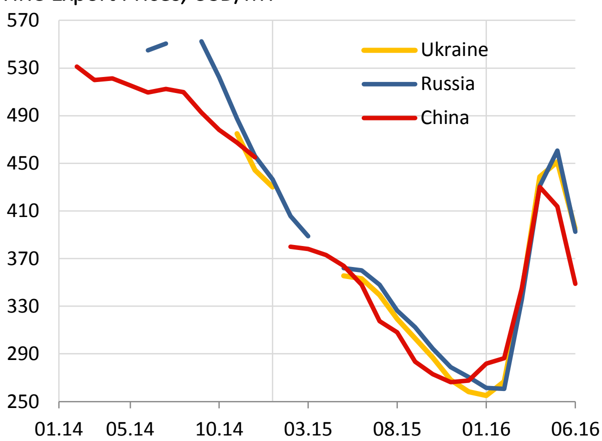
– reduction in oil production in the USA to the lowest levels since the end of 2014 (down by 4.1% q-o-q) coupled with strengthening demand for oil;
– armed conflict in Nigeria (oil production fell by seven times to 250,000 barrels per day);

Semi-finished Steel Prices in China and Ukraine, USD/MT, as of 27.07.2016



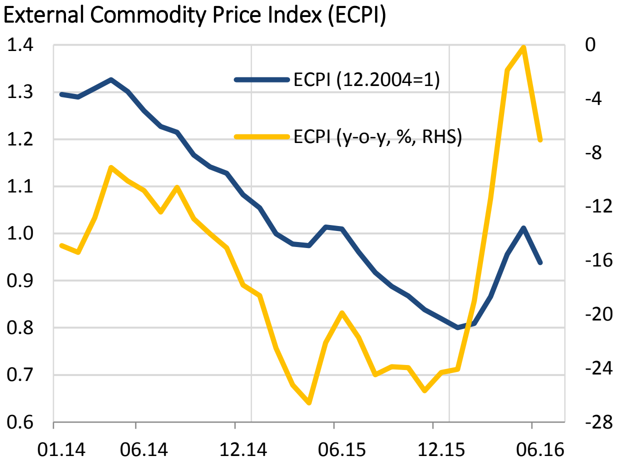
Source: Thomson Reuters Datastream

HRC Export Prices, USD/MT



Source: Metal Expert

External Commodity Price Index (ECPI)



Source: NBU staff estimates

[3] See Macroeconomic and Monetary Review (February 2016) for more details on the Ukrainian External Commodities Price Index (ECPI) .

– significant disruptions in oil supplies from Venezuela, where oil production has declined several times as severe drought caused electricity supply shortages;[4]
– forest fires in Canada.

Starting from the end of May, oil prices have lost momentum and were fluctuating within the range of USD 45-50 per barrel due to:

– a further increase in oil extraction and its exports by Iran;
– a gradual recovery of the oil supply from Canada and Nigeria;
– recovering shale oil production in the USA;
– a slowdown in demand for oil in India as a result of auto sales slump and in China due to high load of its strategic storages (about 80%);
– a lack of agreement between OPEC countries on production freezes at a regular meeting in June. At the meeting, it was decided to follow the policy of non-interfering in the market situation;
– increase in oil production (to 10.8 million barrels per day) and exports (by 5% y-o-y) by Russia;

The announcement of the results of the referendum in Great Britain initially triggered a sharp drop in oil prices (by 8%), which however was short-lived. At the same time, downward pressure on prices intensified in July as supply continued to grow coupled with mounting concerns over weaker demand in the European market as a result of the Brexit.

Despite heightened volatility triggered by the referendum results in the United Kingdom, Q2 2016 was more favorable for major stock market indexes in comparison with the previous quarter. The S&P 500 index advanced 1.9% q-o-q for the third quarter in a row. The Eurostoxx 50 index was predominantly on a rise till 23 June 2016, but lost its gains due to the Brexit impact. The main factors behind the positive dynamics of indexes in Q2 2016 were:

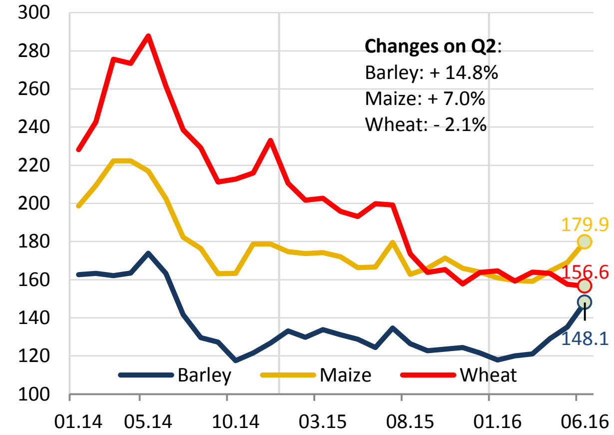
– expectations of a FED fund rate increase already this summer;
– abating investors' concerns over global economic and financial market outlook;
– favorable situation in world commodity markets.

The results of the UK's referendum to leave the EU triggered increased volatility in the markets. Although the announced results were unexpected for market participants, stock indices predictably responded with a significant drop, which, however, was short-lived. However, heightened uncertainty spurred demand for safe haven instruments. Thus, in early July, for the first time in history, Germany placed 10-year bonds with a negative yield (-0.05%, attracting more than four billion euro. In addition, US dollar appreciation against leading currencies has gained momentum.

Despite surges in volatility in global financial markets, demand for EM financial assets remained solid (the MSCI EM index stayed virtually unchanged on average in Q2 2016), supported by:

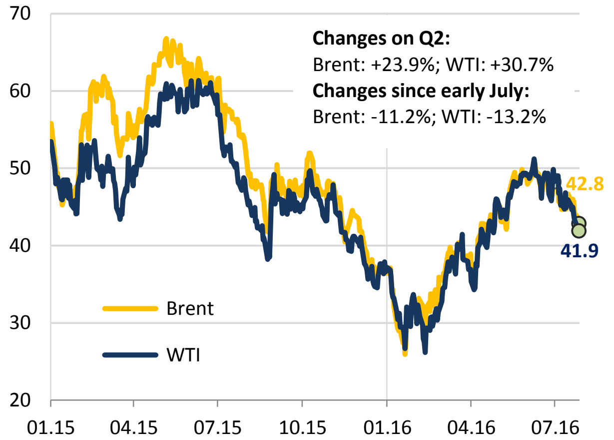
– a cautious approach by the FED to rates increase;
– soft monetary policy pursued by other leading central banks;
– the global search higher-yielding instruments by investors amid spreading negative interest rates;

World Cereal Prices, USD/MT



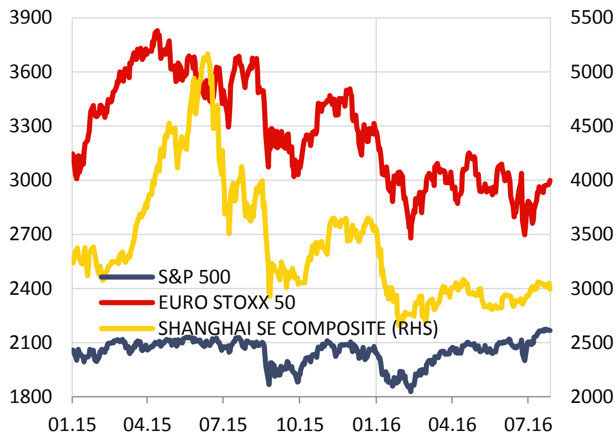
Source: IMF

Brent and WTI Crude Oil Prices, USD/bbl, as of 27.07.2016



Source: Thomson Reuters Datastream

World Stock Indices, as of 27.07.2016



Changes on Q2:
S&P 500: +1.9%; Eurostoxx 50: -4.7%; MSCI EM: -0.3%
Changes since early July:
S&P 500: +3.2%; Eurostoxx 50: +4.7%; MSCI EM: +4.8%

Source: Thomson Reuters Datastream

[4] Most of Venezuela's electricity is generating by HPP.

– Investors' expectations that the Brexit would have limited consequences for EMs, and the investment attractiveness of some of these countries will increase.

Accordingly, the risk premium for EMs remained unchanged for sovereigns and decreased for corporates (by 13.7% q-o-q). More favorable dynamics of the risk premium for corporate bonds was due to significant volumes of sovereign bonds issued, while supply of new corporate bonds have decreased from their highs in 2012-2014.[5]

EM currencies predominantly strengthened during Q2 2016 amid largely favorable trends in global commodity markets. However, they sharply depreciated at the end of Q2 2016 amid strengthening US dollar and investors' flight to safety in the aftermath of Brexit vote. The Turkish lira demonstrated one of the highest rates of depreciation following an unsuccessful military coup attempt.

The weighted average index of annual real GDP growth of Ukraine's MTP countries (expressed by dynamics of UAwGDP index) increased in Q1 2016. However, this was primarily the result of lower negative contribution of Russia's economic contraction. The decline in Russia's real GDP slowed to 1.2% y-o-y, and so did its weight in Ukraine's total exports of goods and services. Excluding Russia, the UAwGDP index has remained flat at high levels thanks to:

– a steady pace of growth in the Euro area (up by 1.7% y-o-y) as a result of increased gross fixed capital formation and stronger household consumption, facilitated by the ECB's quantitative easing program;

– China's economy growing at high paces. Economic growth in China has proved to be more resilient than expected as evidenced by acceleration in industrial production, investments into fixed assets, and solid retail sales;

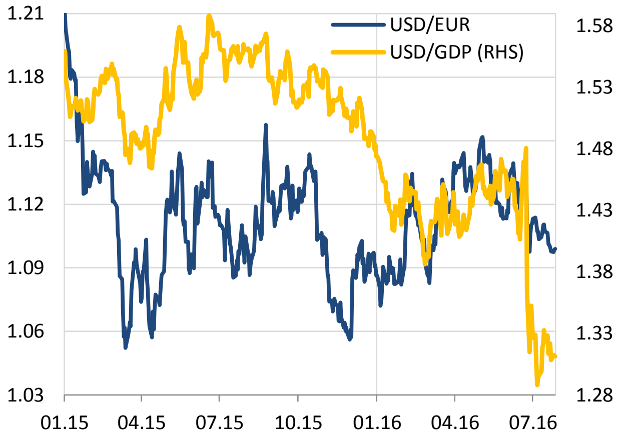
– steady economic growth in Turkey (by 4.8% y-o-y, driven by robust domestic consumption) and the rapid growth of the real GDP of India (7.9% y-o-y, supported by soft monetary and fiscal policies and helped by a significant drop in oil prices).

At the same time, growth in CEE countries has slowed (except for Romania) due to adverse external conditions and a significant decrease in financing from the European development funds. The contribution the CIS countries that are included in the calculation of the index stayed virtually unchanged from the previous quarter, with the exception of Russia and Georgia.

In Q2 2016, economic performance of MTP countries was rather diverse. In particular, due to a pick-up in retail sales, China's real GDP growth remained stable at 6.7% y-o-y. Economic recovery in Russia has continued driven by the processing industry. However, industrial production in the Euro area has remained rather weak, primarily due to a further reduction in industrial production in Germany amid weak exports.

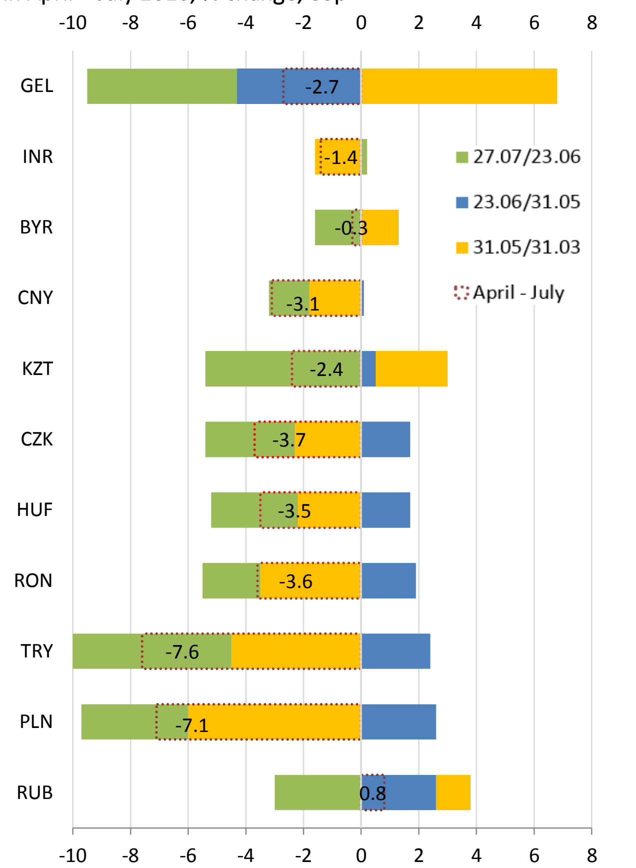
The weighted average index of consumer inflation in MTP countries (UAwCPI index) continued to decrease in Q2 2016, owing to:

US Dollar Exchange Rate against Euro and Pound Sterling, as of 27.07.2016



Source: Thomson Reuters Datastream

Exchange Rates of Emerging Market Currencies versus US Dollar in April – July 2016, % change, eop

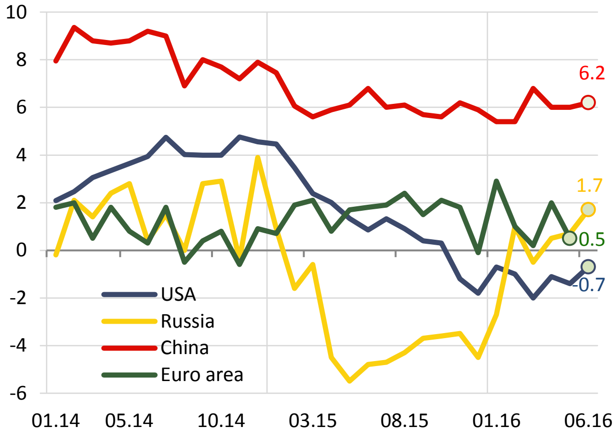


Source: Thomson Reuters Datastream

[5] According to Morgan Stanley, the estimated gross amount of sovereign bonds issued in 2016 will be USD 127.3 billion, which is significantly higher than the annual issuances in the post-crisis period (USD 81 billion). Instead, the amounts of corporate bonds issued are expected at USD 220 billion compared to USD 355 billion in the post-crisis period.

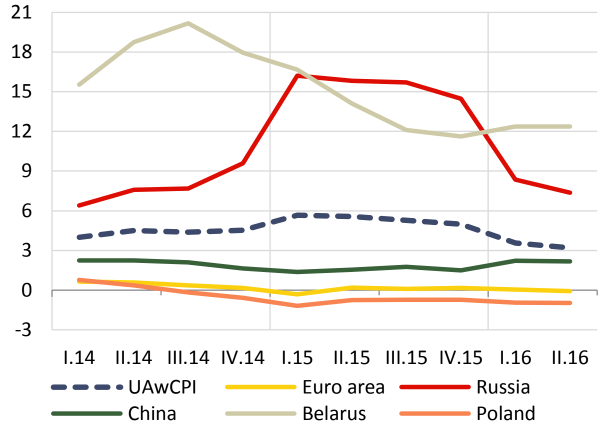
– easing of depreciation pressure on EM currencies (in particular, CIS countries and Turkey) given FED's cautious approach towards rates increase and rallying commodities prices;
– a further disinflation in Russia amid ruble to the US dollar;
– persisting deflationary pressures in the Euro area, despite the expansion of the quantitative easing program;
– stable inflation in China.

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



Source: National Statistical Offices

Consumer Price Indices in Ukraine's MTP Countries, % y-o-y



UAwCPI is the index of inflation in MTP countries of Ukraine, weighted by Ukraine`s total imports of goods and services from corresponding countries.

Source: NBU staff estimates (preliminary data)

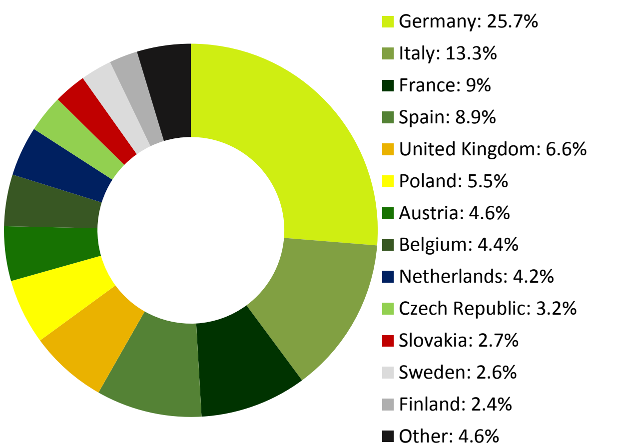
The Use of Protective Measures in the EU Market for Ferrous Metals: Consequences for Ukraine

The EU is one of the largest producers of steel (in 2015, it accounted for 10% of world production). At the same time, given regional diversity of steel production among EU countries and considering that domestic demand is only partially satisfied with own production, the EU market remains very attractive for steel producers from other countries.

Within the EU, only four countries – Germany, Italy, France, and Spain – account for more than a half of the total volume of steel output. At the same time, domestic production did not fully satisfy rising steel consumption in the EU, driving demand for imports (the latter was up by 7.4% in 2015).

Simultaneously, European steel exports have declined further (by 9% y-o-y in 2015). The main reason for the reduction in exports in recent years, both from the EU and from other steel producing countries, was China. The cost of producing steel is lower in China than in the EU due to lower labor costs and government subsidies.

The EU Steel Producers Share in 2015



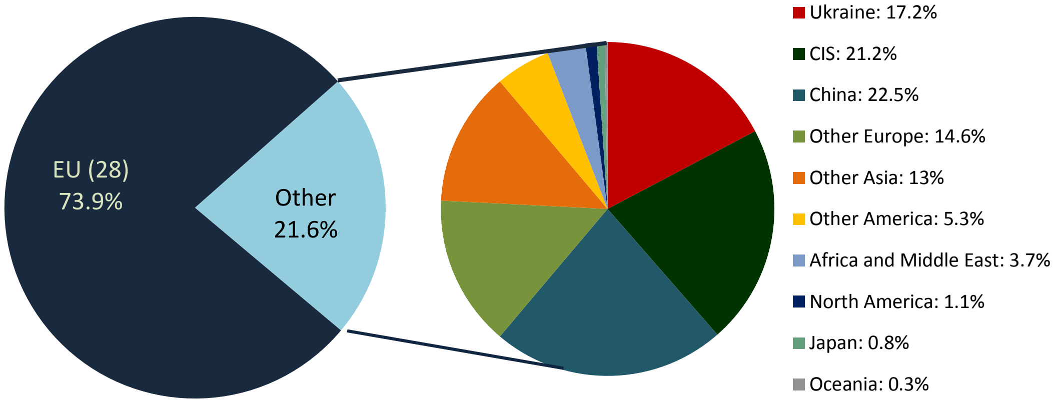
Source: World Steel Association

Therefore, Chinese suppliers are directly or indirectly are price setters on various markets. Moreover, business profitability and efficiency have not been a priority for Chinese producers. China's trade in the European market helped it to partially solve China's overcapacity problem given growing production amid cooling domestic demand. In 2015, China accounted for 22.5% of total steel imports to the EU.

Aggressive pricing policy of the Chinese producers provoked a slump in prices for steel products in the EU market. As a result, European producers began to reduce not only the costs of production but also production facilities and jobs (the number of jobs in the steel industry dropped by 21% over the last five years). In 2015, the EU turned from being a net exporter to a net importer of steel.

A few other steel producing countries also started to follow a policy of low prices (including Russia, which exports rapidly increase amid the significant depreciation of the ruble. Thus, according to *the Metal Courier*, the weakening of the ruble during 2015 has lowered the cost of rolled steel production by 30-35% in US dollar terms).

Main Steel Exporters to the EU in 2015



Source: World Steel Association

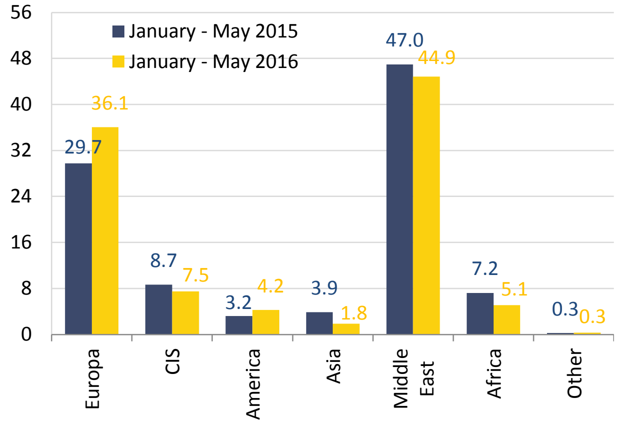
To counteract the low-price strategy in the market, in late 2015 and early 2016 several European countries, especially those where the share of steel production is quite high, announced the imposition of anti-dumping duties on selected types of steel products of Chinese and Russian manufacture, quotas, and other measures. During H1 2016, the EU has implemented measures to protect trade for more than 30 different kinds of steel products, with 56 of 73 anti-dumping measures targeted specifically against imports from China.

Such decisions (even the very fact of launching anti-dumping investigations) have a significant effect on the trade flows and prices of goods. Therefore, the imposition of temporary duties has led to a reduction in the total exports of cold-rolled steel from Russia to Europe by 44% only in 2015, and the price has risen by about 100 euros per ton.

Due to the use of protective measures against Chinese and Russian steel by the EU, the opportunities for Ukraine's exports of semi-finished steel products have widened. Accordingly, during January-May 2016, the volume of Ukrainian exports to the EU increased by 33.3% y-o-y, or by 800,000 tons, while the EU share in Ukrainian merchandise exports has increased by 6.4 ppts. This helped to partially compensate for the drop in exports to CIS countries, Africa, and Asia. Increasing the share of Ukrainian steel exports to the EU was also partly related to the fact that the largest Ukrainian metallurgical groups (namely, Metinvest, ISD) possess production facilities in the European countries, in particular, Poland, Italy, Hungary, and Great Britain. These assets were purchased to cooperate with Ukrainian enterprises producing semi-finished products.

At the same time, in early July, the European Commission started an anti-dumping investigation concerning hot-rolled steel from Russia, Brazil, Iran, Serbia, and Ukraine. Such EU measures may adversely affect the competitiveness of Ukrainian goods, although the process of investigation does not imply immediate enforcement of the anti-dumping duties. Furthermore, Ukrainian producers may face increased competition from Indian companies, which have been considering the EU market as a prospective one.

Geographic Breakdown of Ukraine's Ferrous Metals Exports, %



Source: NBU, SSSU

2.2. DOMESTIC ECONOMY

2.2.1. INFLATION DEVELOPMENTS

During Q2 2016, as expected, consumer inflation in Ukraine continued to slow down (to 6.9% y-o-y in June). The quarterly growth rate of the CPI was 3.4%, which appeared to be lower than projected by the National Bank (4.1%). The deviation from the forecast was due to core inflation, which came below the forecast (0.7% compared to a projected 2.1%) amid the appreciation of the hryvnia exchange rate and the second-round effects from lower raw food prices.

Non-core inflation was in line with the forecast (5.7% and 5.9%, respectively), although price developments across its components deviated from the NBU projections.

Thus, prices for certain raw food products decreased more significantly than expected amid ample supply of both domestic and foreign produce. As a result, raw food prices slightly declined in Q2 2016, while their moderate growth was predicted.

At the same time, a decline in prices for raw food products was offset by higher than expected growth in:

administered prices and tariffs, due to faster than expected growth in prices for tobacco products (reflecting the pricing policy of individual producers). In contrast, the growth of utility prices, mainly affected by the increase in the price for national gas to the population following the cancellation of the discount, was in line with the NBU forecast;

fuel prices in the domestic market amid growing global oil prices.

Core inflation

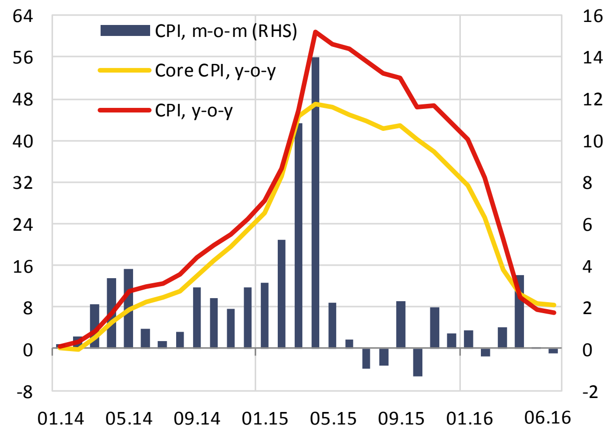
In Q2 2016, core inflation slowed faster than expected (to 8.3% y-o-y in June) owing to the appreciation of the hryvnia exchange rate and the second-round effects of lower prices for certain raw foods. Additional factors behind its slowdown were subdued consumer demand and improving inflationary expectations for the next 12 months within all groups of respondents. Inter alia, the latter was achieved thanks to sound monetary and fiscal policies.

Strengthening of the hryvnia has contributed to a deceleration in prices for non-food products that are part of the core CPI (down to 11.6% y-o-y in June). These goods are largely represented by imports, including clothing and footwear, vehicles, household appliances, pharmaceutical products, medical products, and equipment. At the same time, price growth for audio and photographic equipment and equipment for processing information accelerated, which was mainly attributed to a low base effect.

A reduction in prices for certain raw food products contributed to a deceleration of processed food inflation to 5.9% y-o-y in June.

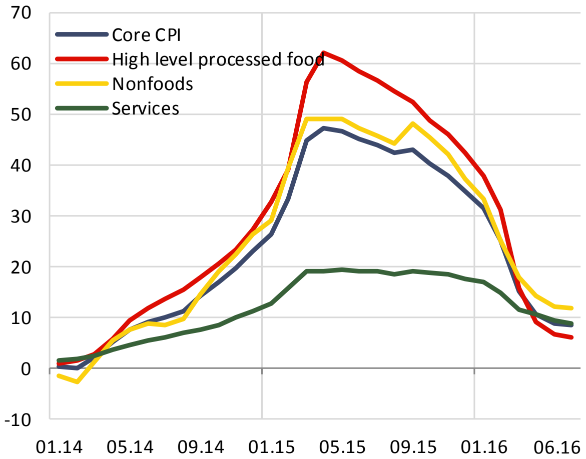
Services price inflation has been easing throughout Q2 2016, reaching 8.8% y-o-y in June, a high base of comparison and subdued demand.

Inflation Indicators, %



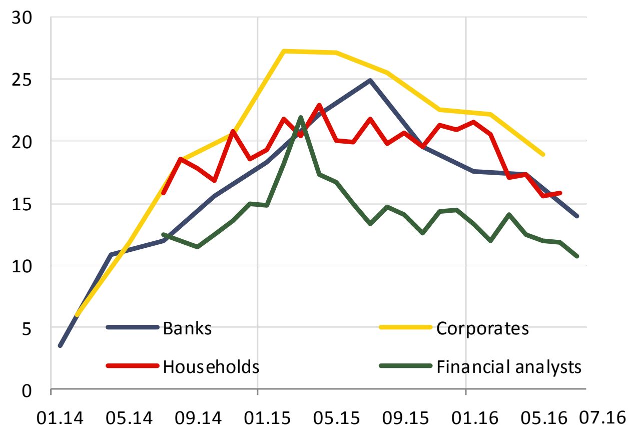
Source: SSSU

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



Source: SSSU; NBU staff estimates

Inflation Expectations for the Next 12 Months, %



Source: NBU, GfK Ukraine

Non-core inflation

The non-core inflation was in line with the forecast, slowing to 5.9% y-o-y in June.

In particular, raw food inflation moderated to 0.8% y-o-y in June. The slowdown primarily reflected a deeper decline in prices for vegetables thanks to ample supply of both domestic and foreign produce. In particular, the volumes of imported vegetables grew 2.7 times for January-May 2016 compared with the same period of the previous year. In particular, imports of certain vegetables from Belarus and Turkey increased significantly. Thus, the increase in imports of vegetables and fruit from Turkey was largely attributed to changes in Turkey's foreign trade flows in response to trade restrictions imposed by Russia. Furthermore, a depreciation of the Turkish lira to the US dollar contributed to a decrease in prices for products of Turkish origin.

The appreciation of the hryvnia exchange rate contributed to lower import prices. In particular, it had a direct downward impact on the prices for fruit, the decrease of which deepened in Q2 2016.

Additional factors behind the slowdown in raw food inflation, particularly the price growth for meat and meat products, as well as milk and dairy products, were subdued consumer demand and relatively low global food prices. Meat prices were also affected by higher meat supply compared to the respective period last year.

Furthermore, a decline in prices for eggs deepened during Q2 2016. This was primarily due to their ample supply in the domestic market under amid narrowed export opportunities, while a high base of comparison also had a significant contribution.

The low base of comparison was one of the main factors behind the acceleration in the annual growth of sugar prices over the quarter. Thus, in Q2 2015, sugar prices adjusted downwards after a previous quarter rally, prompted by feverish demand. During Q2 2016, prices for sugar have also been decreasing amid expectations of a high crop of sugar beet this year, but the rate of decrease was lower than in the respective period last year.

The growth of administered prices and tariffs continued to slow down during Q2 2016, descending to 10.9% y-o-y in June.

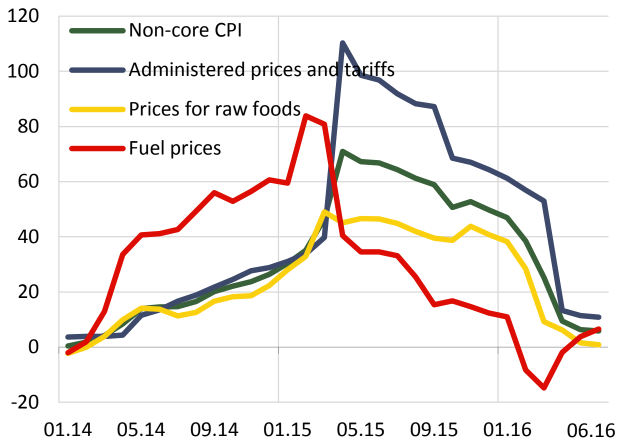
In particular, as expected, growth in utility prices moderated due to a high base effect, although in monthly terms they mostly grew at a moderate pace. At the same time, developments of natural gas prices differed significantly from other utility prices. Thus, since 1 April 2016, the gas price discount for the population has been cancelled, causing a 48.4% m-o-m increase natural gas price in April. At the same time, driven by the Government decision, gas prices have been reduced by 4.3% m-o-m since 1 May.

The annual growth in price for alcoholic beverages accelerated, due to lagged effects of the March's increase in excise duties, and was also consistent with the forecast.

Meanwhile, prices for tobacco products accelerated faster than expected due to pricing policies of individual producers.

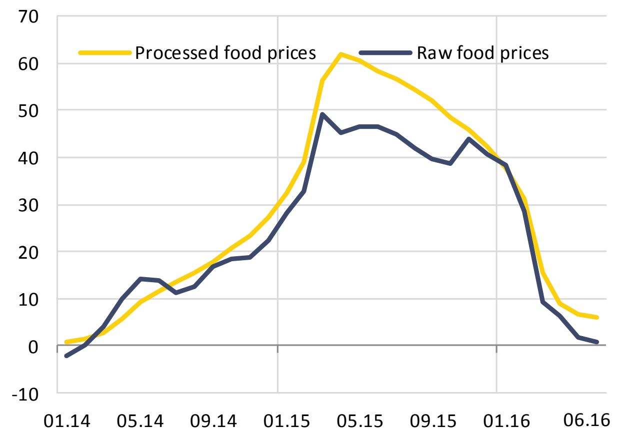
At the same time, higher prices for bread and bakery products caused by increased production costs, including for fuels, held back the slowdown in the growth in administered prices and tariffs.

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



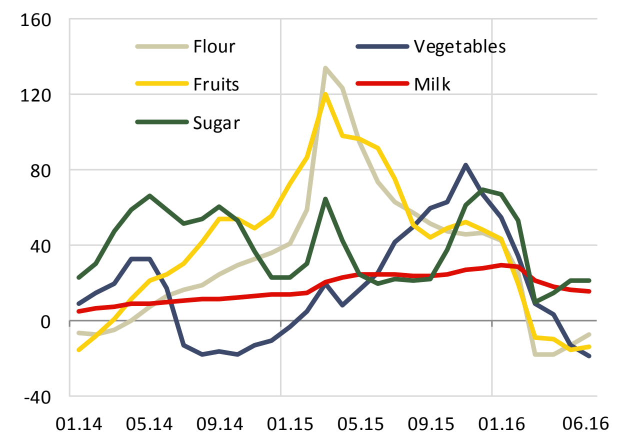
Source: SSSU; NBU staff estimates

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



Source: SSSU; NBU staff estimates

Raw Food Prices, % y-o-y



Source: SSSU

Domestic fuel prices have been on a rise since March, primarily due to growing global oil prices. As a result, prices for fuels resumed growth in annual terms too, accelerating to 6.5% y-o-y in June.

Producer price index

In Q2 2016, producer price inflation in Ukraine largely reflected global commodity price developments. Rising global commodity prices outweighed the effect from the appreciation of the hryvnia exchange rate and a reduction in gas tariffs for industrial consumers (on average by 10% since 1 May 2016). As a result, producer inflation accelerated during April-May. At the same time, due to a reversal of the uptrend in global commodity markets, the producer price index was flat in June, and resumed its growth slowdown in annual terms (to 15.7% y-o-y in June).

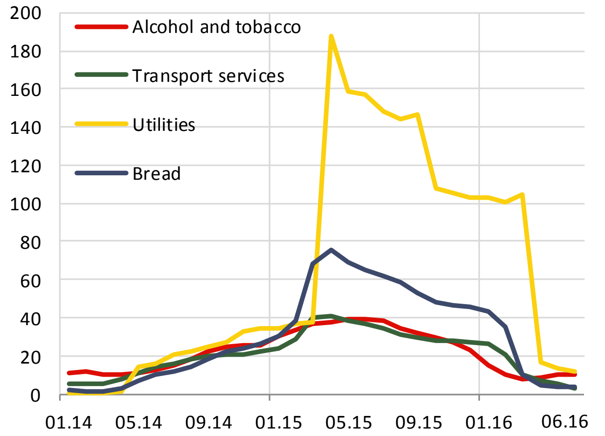
Rising global oil prices prompted price growth in domestic extraction of oil and natural gas. Renewed downward price trend for iron ore in global markets from the end of April led to the corresponding price dynamics in extraction of metal ores, where prices have started decreasing in June after their sharp increase during the first two months of Q2 2016. As a result, growth of prices in the mining industry has slowed to 35.3% y-o-y in June after accelerating in April-May.

Price developments in the mining industry and in global markets also affected producer prices in the processing industry, although with a certain lag. In Q2 2016, prices increased in the production of coke, oil refining, and metallurgy. As a consequence, in annual terms, the price growth in the coke and oil refining industry slowed down in Q2 2016, while the price growth in steel manufacturing has accelerated.

Prices in the chemical industry have been mainly decreasing since February. This was attributed to low global fertilizer prices, as well as high fertilizer supply on domestic market, including on account of imports.

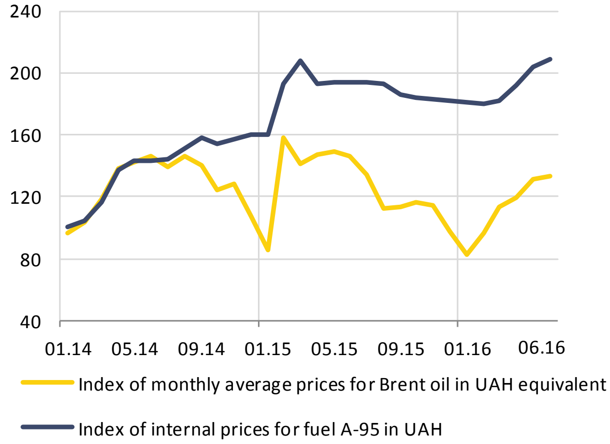
Producer price growth in other processing industries, mainly domestic market oriented, and in the supply of electricity, gas, steam and conditioned air has been mainly slowing down during Q2 2016.

Administered Prices and Tariffs, % y-o-y



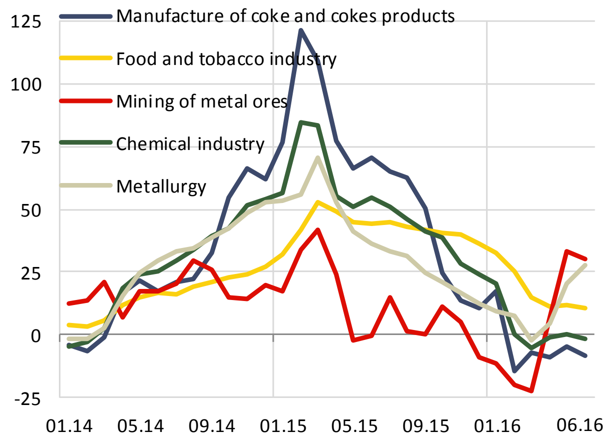
Source: SSSU

Price Indexes for Fuel and Oil (12.2013=100)



Source: SSSU, Thomson Reuters Datastream

Producer Price Index by Select Industries, % y-o-y

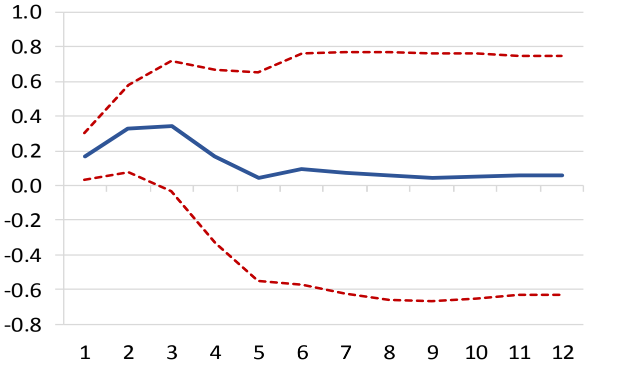


Source: SSSU

The Impact of Producer Price Inflation on Consumer Price Developments in Ukraine

The growth of producer prices potentially carries risks of acceleration of headline consumer inflation, because the PPI and the CPI are related through production chains. For example, an increase in prices in the manufacturing of foods generates upward pressure on consumer prices. As the latter has a significant share in the CPI, the upswings in these prices may materialize strongly in the overall consumer price index. However, in the short term, the PPI and the CPI may co-move, reflecting the impact of common factors. Additionally, according to the estimated model, overall changes in the PPI are loosely associated with developments in the CPI in Ukraine – an increase in the PPI by 10% per month on average contributes only about a 1% increase in the CPI.

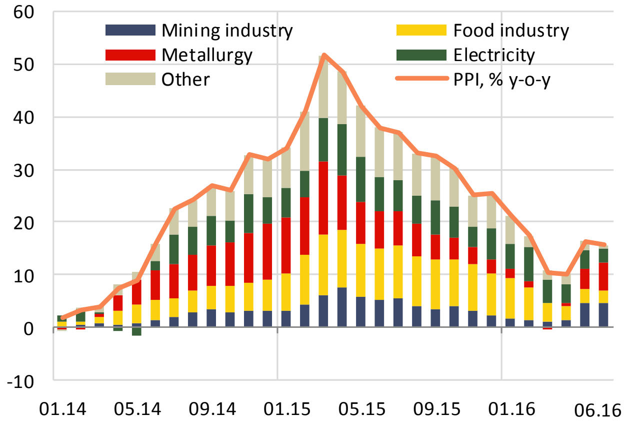
Cumulative Response of CPI to PPI change, %



Cumulative response of the CPI to changes in the PPI reflects the sum of CPI m-o-m changes caused by 1 standard deviation of the PPI change

Source: NBU staff estimates

Contributions to Annual PPI Growth, ppts

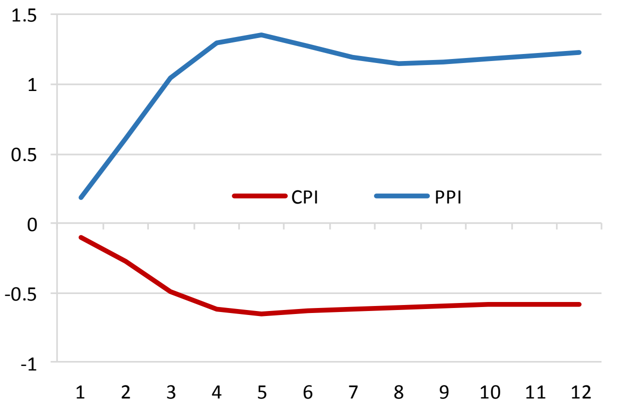


Source: SSSU; NBU staff estimates

Thus, the PPI developments are heavily affected by the evolution of global prices for tradable goods. In particular, the acceleration of producer price inflation in Q2 2016 was attributed mainly to the reversal of global commodity prices to an upward trend. Respectively, increases in prices in the mining industry and metallurgy accounted for 60% of the annual growth rate of producer price inflation. At the same time, thanks to the upswing in global prices Ukrainian export prices also edged up, ensuring larger inflows of foreign currency and generating appreciation pressures on the hryvnia exchange rate. This, in turn, passed through to consumer prices, particularly through the imported goods. Thus, producer and consumer prices developed in a very different manner in response to global steel price growth - producer prices have increased, while the overall impact on the CPI was the opposite.

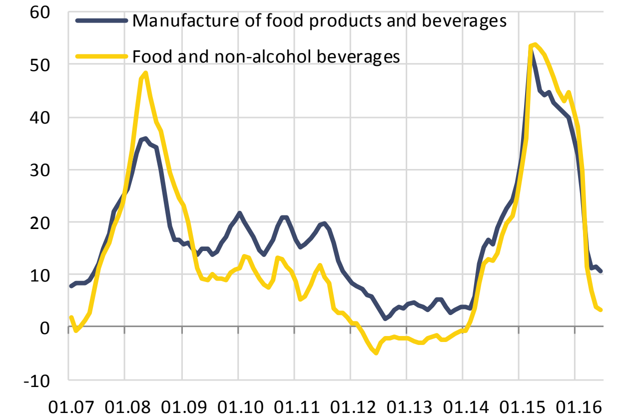
Manufacturing of foods, beverages, and tobacco products has a large weight in the PPI (about 21%). Price developments in this industry closely correlated with the evolution of the CPI sub-index 'food products and non-alcoholic beverages' (the latter accounts for about 51% in the total CPI basket). At the same time, both producer and consumer prices for these goods, have recently slowed their growth, largely reflecting the impact of common supply and demand factors.

Cumulative Response of the CPI and the PPI to Changes in Global Steel Prices, %



Source: NBU staff estimates

Price Developments for the Food Component of the PPI and the CPI, % y-o-y



Source: SSSU

In addition, the pass-through of producer price changes to consumer prices may occur indirectly through increases in salaries in the industry. Stronger demand as a result of this may exert upward pressure on consumer prices. In particular, in the past higher global commodity prices amid fixed exchange rate regime underpinned a strong growth of the hryvnia denominated profits of exporters. This, in turn, contributed to a fast wage growth not only in export-oriented industries but also in other sectors. Along with soft fiscal and monetary policies, this supported a solid growth in consumer demand contributing to the acceleration of consumer inflation. Also, periods of short-term co-movement of the CPI and the PPI under the de facto fixed exchange rate regime in the past may be attributed to the impact of a sharp adjustment of the hryvnia exchange rate o for the accumulated macroeconomic imbalances.

Although this year producer price inflation was also driven primarily by external factors accompanied by a solid wage growth, it currently does not generate additional demand-side pressures on consumer prices due to a still weak labor market. Moreover, the floating exchange rate functions as a built-in stabilizer that restrains inflationary expectations through the strengthening of the hryvnia caused by the inflow of foreign currency into the country. Thus, current growth of producer price inflation does not involve risks for a pickup in consumer inflation.

2.2.2. DEMAND AND OUTPUT

In Q1 2016, for the first time since the beginning of 2014, real GDP grew in annual terms, expanding by 0.1%. However, the actual growth was weaker than predicted.

As expected, net exports made a major positive contribution to the growth of real GDP. However, such contribution decreased (to 2.5 ppts) in Q2 2016 due to a significant slowdown in the decline of imports. Imports were supported by deferred demand that realized after the cancellation of the import duty surcharge. Although the decline in exports continued to slow down, this process was restrained by trade and transit restrictions imposed by the Russian Federation and low global commodity prices. Additionally, stronger domestic investment demand contributed to the growth of the economy. In particular, the growth of gross fixed capital formation accelerated to 4.2% y-o-y.

Private consumption, which is the main component of domestic aggregate demand, remained weak, despite the impetus received from the cancellation of the import duty surcharge and a slight improvement in consumer confidence.

High-frequency data indicate that during Q2 2016 production sectors demonstrated uneven performance. External environment was more favorable than assumed in the forecast. However, at the end of Q2 2016, unforeseen internal risks materialized. In particular, a rail transportation lockout occurred due to the strike of railway workers in the East of the country. This caused a temporary but significant decline in industrial production in June (primarily in the mining industry and metallurgy) as well as a deterioration of freight turnover. Therefore, according to the NBU estimates, real GDP growth accelerated during Q2 2016 in annual terms, however, less significantly than expected earlier.

Output

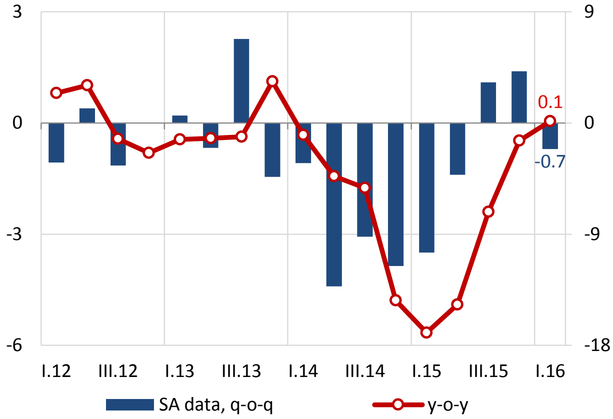
In Q1 2016, real GDP decreased by 0.7% q-o-q in seasonally adjusted terms. Adverse effects on economic activity were exerted by temporary external factors. In particular, trade and transit restrictions of the Russian Federation adversely affected business expectations of domestic enterprises. In addition, global commodity prices continued declining.

In the second half of Q2 2016, transit through the Russian territory was almost fully unlocked and global prices for major commodities started their uprise. However, economic recovery was restrained by political uncertainty.

At the same time, real GDP recorded positive growth for the first time since the beginning of 2014 – up by 0.1% y-o-y. This rate was lower than expected because performance of most services worsened significantly. However, the growth in production sectors and closely linked to them transportation and trade has predictably recovered, primarily due to the low comparison base.

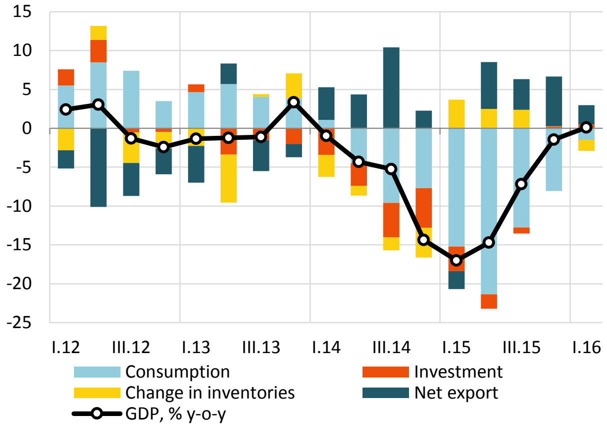
GVA of the industry has increased by 5.5% y-o-y for the first time since 2012. The growth was broad-based across major industries, but mostly on the back of a very favorable base effect. Seasonally adjusted figures indicate that a substantial upturn occurred only in the mining industry in Q2 2016. Coal mining was supported by

Real GDP Growth, %



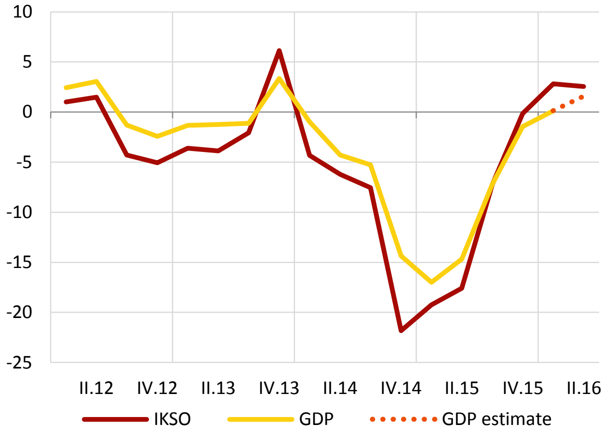
Source: SSSU

Contributions to Annual GDP Growth, ppts



Source: SSSU; NBU staff estimates

Index of Key Sectors Output and Real GDP, % y-o-y



Source: SSSU; NBU staff estimates

steady demand from power plants. Extraction of metal ores has been growing, driven by rapidly rising prices in global markets.

Within the manufacturing sector, metallurgy expanded output production significantly (by 10.1% y-o-y). In addition to the base effect, metallurgy performance was favorably affected by a slight rebound in demand from construction and machine building.

In particular, production of machine-building products for the food processing industry grew at the highest rate (by 23.4% y-o-y). Such high growth rates may be explained by the need to modernize existing capacities in order to diversify their businesses. The growth in the production of railway locomotives and rolling stock was underpinned, in particular, by execution of a contract for the delivery of wagons to Turkmenistan.

In the food processing industry, production of alcoholic beverages grew at the highest rates as producers were eager to expand production prior to the increase in excise rates in early March.

Despite the signs of overall activity recovery in the industrial sector, some industries continued to decline hit by weak domestic demand, the loss of the Russian market and difficulties in accessing the markets of other CIS countries. The latter factors may explain output contraction in the domestic dairy industry (down by 3.4% y-o-y), in pipe production (down by more than 20%), and in the production of selected machinery products.

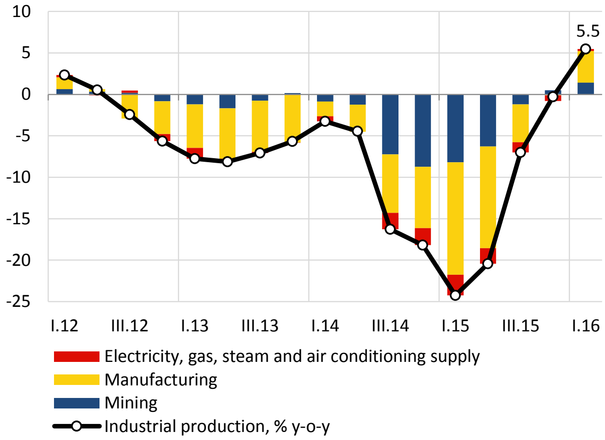
The low base of comparison also contributed to the increase in domestic trade turnover by 3.7% y-o-y. The growth of wholesale trade turnover (by 2.9% y-o-y) occurred primarily due to the increase in the trade in food, chemical products, and fuels. Among the food products, positive trends adjusted for statistical effects were observed only for certain commodity groups. In particular, the rebound in trade in grain mill products took place, in particular due to duty-free quotas for flour exports into the EU received by some enterprises. Trade in metal products resumed amid the improved situation in metallurgy compared with the corresponding quarter of the previous year.

Retail trade turnover resumed growth by 1.6% y-o-y, primarily due to deferred demand realized after the cancellation of the additional import duty as well as due to a gradual improvement in consumer confidence. Also, the seasonally adjusted retail trade turnover increased marginally compared with the previous quarter.

Also, the construction industry saw a continued recovery gaining further momentum in annual terms, with the GVA up by 6.8% y-o-y. In particular, a gradual improvement was observed in construction companies' expectations for new orders, as well as expectations concerning their own financial situation.[6]

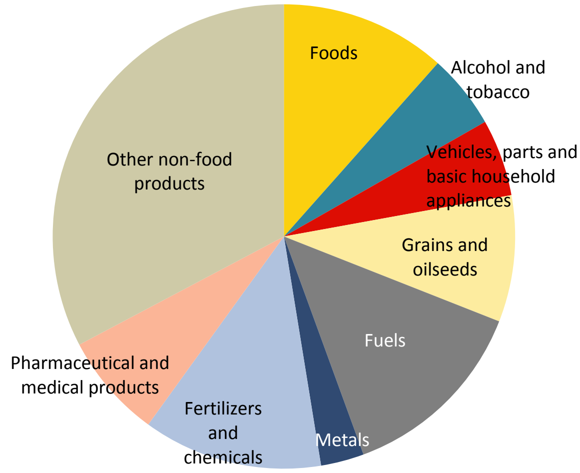
Among the services sectors, education and health care saw renewed decreases in GVA, which reflected a reduction in consolidated budget expenditures in the respective areas.[7] At the same time, while the decrease in GVA of the financial sector and

Contributions to Annual Industrial Growth, ppts



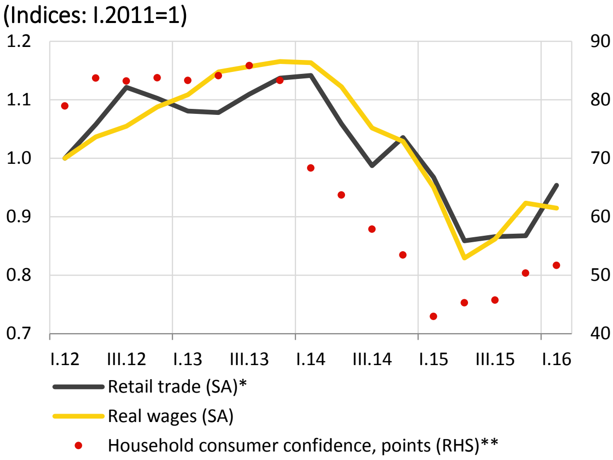
Source: SSSU; NBU staff estimates

The Structure of Wholesale Trade in Q1 2016, %



Source: SSSU; NBU staff estimates

Retail Trade Turnover by Main Factors (Indices: I.2011=1)



** As deflator the index was taken, calculated from the nominal retail trade turnover of enterprises and the real change of such turnover (published by SSSU)*

*** According to the consumer confidence index of GfK Ukraine*

Source: SSSU; GfK Ukraine; NBU staff estimates

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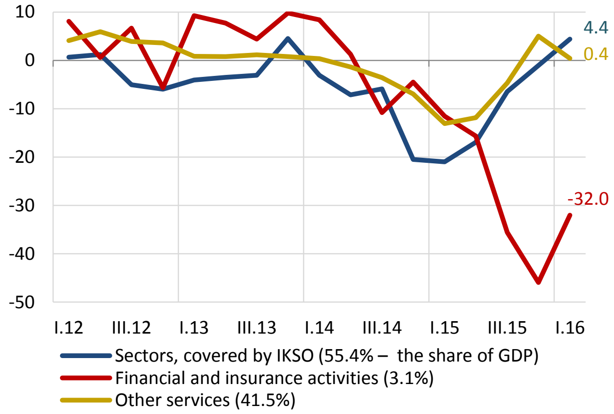
[6] The information according to the SSSU data based on poll results provided in the regular document Business *Expectations of Construction Firms.*

[7] According to NBU estimates, during Q1 2016, the consolidated budget expenditures for education and health care in real terms (deflated by the GVA deflator for the respective sectors) decreased by 2.2% y-o-y and 20.8% y-o-y, in contrast to the increase in the previous quarter.

insurance activity has slowed, it continued to make a significantly negative contribution to the GDP growth.

The reduction of GVA of agriculture that has already lasted for two years in a row slowed to 1.6% in Q1 2016 due to a further increase in the breeding of animals and a slower decline in milk production. However, the situation in the production of eggs remained difficult, with the fall accelerating due to a decline in exports, especially to the Middle East countries.

GVA Change by Groups of Economic Sectors, % y-o-y



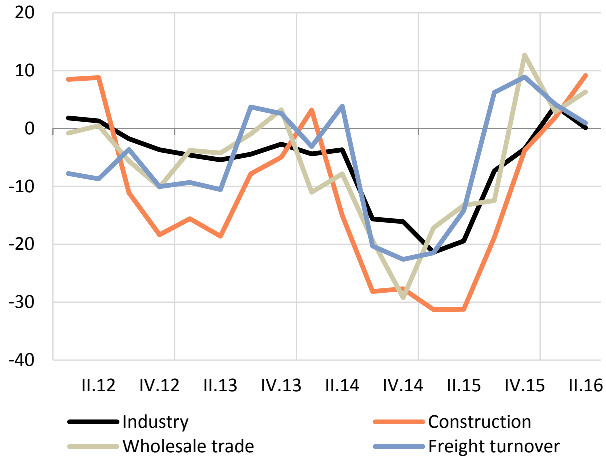
Source: SSSU; NBU staff estimates

Estimates for the Q2 2016

Output figures for April–June suggest muted performance in production sectors of the economy during Q2 2016. On one side, the growth of agricultural production has resumed and construction showed continued expansion. Unlike previous periods, improvements were observed in the residential segment of the construction industry as well. The residential construction was positively influenced by a lasting trend of shifting demand towards the primary housing market due to its relatively lower costs and wider opportunities for implementation of energy efficiency measures compared with the old housing infrastructure. The wholesale trade turnover increased at a high rate, reflecting in particular steady exports volumes.

On the other side, industrial production showed unstable performance. As expected, at the beginning of the quarter these sectors experienced a pick-up in activity determined by positive trends in global commodity markets. However, at the end of the quarter, unexpected complications happened related to rail transportation lockout due to the strike of railway workers in the East of the country. As a result, mining and metallurgical enterprises faced difficulties with the raw materials supply and shipment of finished products, causing substantial declines or a temporary stoppage of production. This adversely affected the aggregate indicators for both industry and freight turnover. As in previous periods, a tenuous recovery was observed in retail trade turnover.

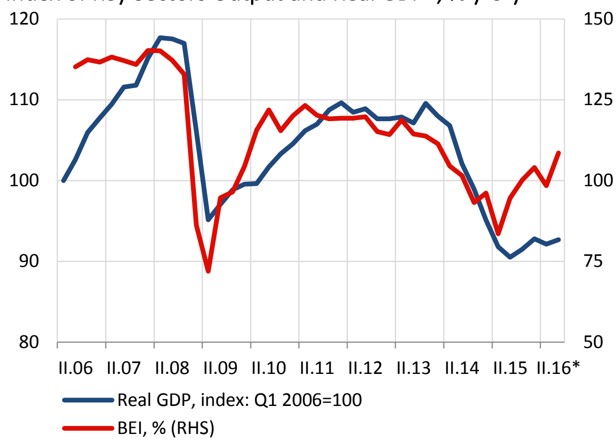
The Output in Selected Economic Sectors, % y-o-y



Source: SSSU; NBU staff estimates

The production performance in key sectors gives grounds to expect that real GDP growth, accelerated during Q2 2016 (to 1.6% in annual terms), albeit less significantly than expected earlier. The rapid growth of the business expectations index also provides evidence of a gradual improvement in the economic situation.[8] But given that the survey of enterprises was conducted in the middle of the quarter, further developments related in particular to periodic complication of the situation in the East of the country could significantly change the perception of the economic environment by market participants.

Index of Key Sectors Output and Real GDP*, % y-o-y



Source: SSSU; NBU staff estimates

Domestic demand

As predicted, among the domestic factors, only domestic investment demand made a positive contribution to economic growth in annual terms in Q1 2016. At the same time, private consumption, being the main component of domestic aggregate demand, remained sluggish. However, the cancellation of the import duty surcharge at the beginning of the year and a slight improvement in consumer confidence provided an impetus to

[8] Business Expectations Index is an aggregated indicator of the expected performance of enterprises in the next 12 months. It is calculated according to the results of NBU surveys. The index value above 100 implies the prevailing positive economic sentiments in the society, and the index below 100 indicates the prevailing negative economic sentiments. In the Q2 2016, the index rose to 108.5 from 98.4 in the previous quarter.

private consumption amid easing depreciation expectations and a sharp slowdown of inflation. As a result, household consumption rose compared with the previous quarter (by 1.8% in seasonally adjusted terms), and its fall in annual terms slowed to 2.2%.

Across individual household consumer spending categories, real expenditures for foods and transportation services have resumed growth. At the same time, consumption of utilities has been declining significantly, as in the previous periods amid their substantially higher costs.

The structure of consumption indicated that households redistributed their expenses in favor of vitally important goods and services, while reducing those on consumer durable goods. This is evidenced by a significantly higher share of food expenditures (up by 42%), as well as by a simultaneous decrease in the share of expenditures for clothing and footwear and domestic appliances (to 3.9% and 3.3%, respectively). At the same time, the share of expenditures for utilities has, predictably, increased (to 16%).

General government final consumption expenditure was virtually unchanged in annual terms in Q1 2016 following a substantial increase in the previous quarter.

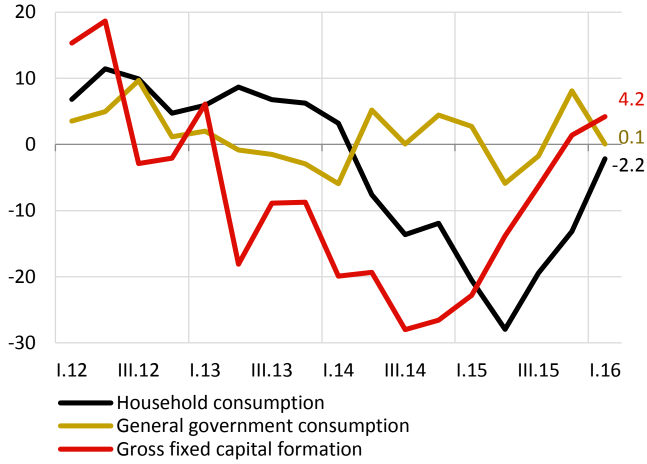
Growth of gross fixed capital formation accelerated to 4.2% y-o-y, primarily due to investments in machinery and equipment (up by 14.4% y-o-y) driven by the need of modernization of fixed assets.

One of the factors restraining the recovery of GDP in Q1 2016 was a negative contribution of changes in inventories. According to NBU estimates, the reduction in inventories during Q2 2016 occurred primarily due to a contraction of the natural gas reserves in domestic storages (more significantly than in the previous year), as well as a strong recovery in grain exports. Instead, according to wholesale inventory data, food and livestock inventories have increased. This in particular might be related to clearing the backlogs due to the cancellation of the additional import duty (for the import of these products, the highest rate of the relevant duty was applied amounting to 10%).

External demand

In Q1 2016 exports were adversely affected by transit restrictions and still low prices in global commodity markets. Therefore, the decline in exports slowed down insignificantly (to 3.8% y-o-y compared with 5.8% y-o-y in Q4 2015). In turn, the drop in imports has drastically slowed due to the effect of deferred demand realization diminished. As a result, the contribution of net exports to real GDP change in Q1 2016 remained positive, albeit, significantly lower.

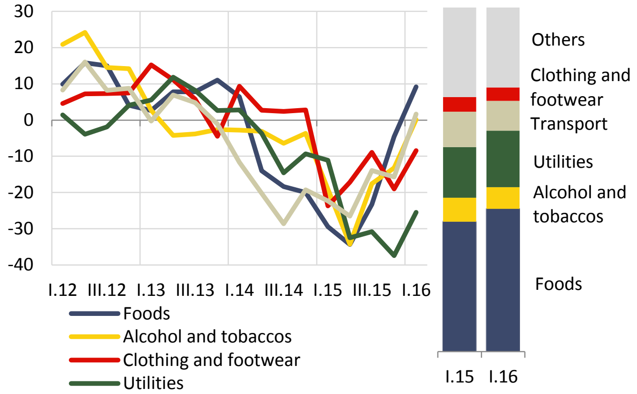
Domestic Consumption Categories, % y-o-y



Source: SSSU

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

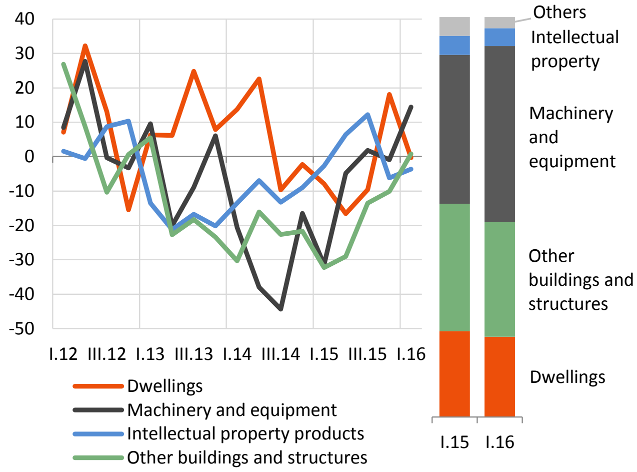
Expenditure structure, %



Source: SSSU

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

Structure of Gross Fixed Capital Formation, %



Source: SSSU

Estimating the Potential GDP and the Cyclic Position of the Ukrainian Economy

The total output in the economy is determined both by cyclical factors and structural changes in the economy. Cyclical fluctuations mainly depend on the impact of temporary factors, including changes in monetary and fiscal policies, while the structural ones are determined by technological progress and significant economic transformations. Among the latter is the temporary occupation of part of the territory of Donetsk and Luhansk regions, poor investment activity, and a reduction in the number of economically active population. As a result of such changes, the potential GDP, the level that ensures the most effective use of available economic resources given non-accelerating inflation pressures, decreased significantly.

The output gap, being the deviation of the actual GDP from its potential level, reflects the contribution of cyclical factors into the GDP developments and shows the phase of the business cycle of the economy. A positive GDP gap reflects *overheating of the economy* that is accompanied by increased inflationary pressure from aggregate demand. At the same time, a negative GDP gap indicates a slump in the economy. To take this into account when making monetary policy decisions, one has to pay attention both to the current phase of the economic cycle and to the expected deviation of GDP from the potential level on the forecast horizon. That is, monetary policy parameters should primarily be adjusted so as to smooth economic cycles in the medium term and to close the output gap.

As the potential level and the output gap are non-observed variables, the NBU, like other central banks around the world, estimates them. There are several approaches for obtaining such estimates, in particular:

- univariate model based on the Hodrick-Prescott (HP) filter. This is solely a statistical technique used for trend detection, which is subsequently assumed to be the potential output level;

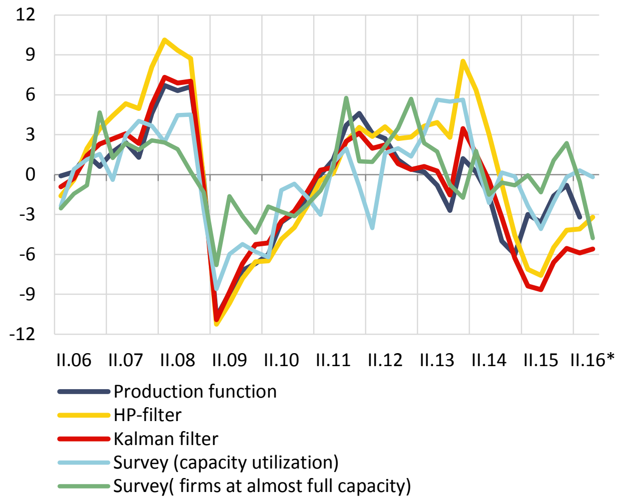
- multivariate model based on the Kalman filter, allowing to take into account economic and theoretical peculiarities of the formation of the GDP gap and to get the decomposition of its factors;[9]

- Cobb-Douglas production function, taking into account the utilization of capital and labor resources and the effectiveness of their combination;[10]

- survey-based estimates (the SSSU survey on the rate of capacity utilization at industrial enterprises and NBU survey on the share of enterprises operating at a full capacity utilization rate).

The gaps estimated using all methods available have demonstrated high correlation in the estimation period. The only exception to this was 2015, when the gap rapidly declined according to the production function. Structural changes in 2015 were related in part to a decrease in the economically active population due to a substantial migration processes. As a result of this, the contribution of total factor productivity could be positively biased.

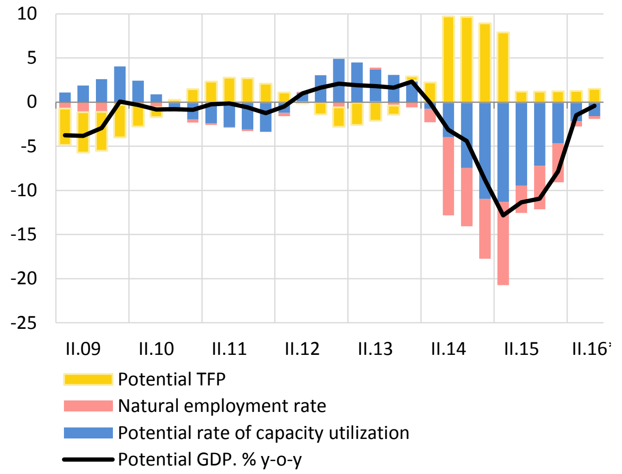
GDP Gaps Estimated by Different Methods, %



** NBU staff estimates*

Source: SSSU; NBU staff estimates

Contributions to Potential GDP Estimated by Production Function, ppts



** NBU staff estimates*

Source: SSSU; NBU staff estimates

The GDP gaps calculated according to the results of the surveys are the most volatile, as they reflect expert judgment of enterprises and are sensitive to the structure of the sample. Therefore, these methods are used as complementary ones.

[9] See more details in: Nikolaychuk S. Mariyko Y. Assessment of the equilibrium and the cyclical components of macroeconomic indicators by using Kalman filter// NBU Visnyk. – 2007. – No 5. – P. 58-64.

[10] See more details in: Potential of Ukraine and its realization // Analytical report of the International Centre for Policy Studies. - 2008. - 55 p.

Methods based on the Cobb-Douglas production function and Kalman filter have more solid theoretical underpinnings and take into account a number of other factors in addition to the GDP dynamics itself. Their results are considered most relevant for policy decision-making at the NBU. Estimates based on such approaches indicate that the Ukrainian economy remains significantly below its potential level. Since the middle of 2015, the trend towards a reduction of the GDP gap has continued interrupted in Q1 2016 by temporary factors.

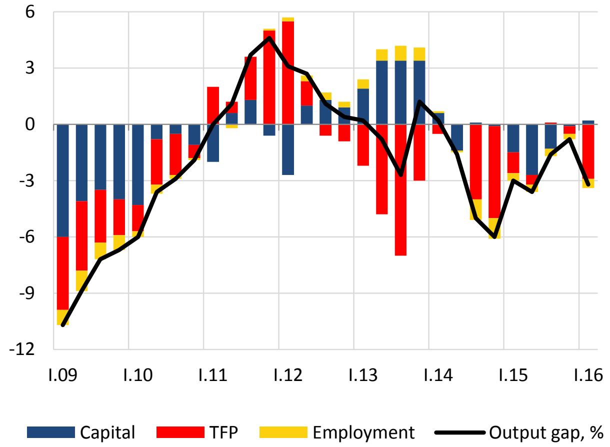
Estimates of GDP gaps based on the Kalman filter and Cobb-Douglas production function provide an opportunity to carry out an analysis of the factors determining potential GDP and the GDP gap.

Potential GDP fell significantly in 2014 and 2015. The decline of the capital utilization natural rate is explained by the withdrawal of the occupied territories from statistical reporting, as well as by the destruction of some industrial facilities in the eastern regions. Reduction in the number of economically active population, among other factors, is caused by the intensive migration processes during the last two years. This negatively impacted natural level of employment, while improving total factor productivity (due to the statistical effect).

The negative GDP gap in 2015 was determined by a low capital utilization rate, while at the beginning of 2016 the main contribution was caused by a negative shock of total factor productivity. The situation on the labor market caused a minor additional contribution to the negative GDP gap.

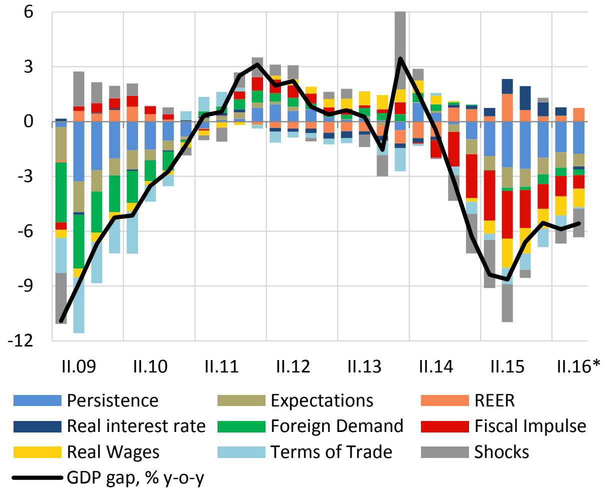
Decomposition based on the Kalman filter indicates that the tough fiscal policy, reduction in real incomes of the population, as well as negative expectations remained the main factors affecting the GDP gap in H1 2016. Furthermore, the significant impact of other shocks has resumed, which may reflect both the transit restrictions on the part of the Russian Federation and recurrent complications in the eastern regions of the country. The contribution of the terms of trade in Q2 2016 remained negative, although significantly smaller amid improved external price conditions. Instead, the stimulative effects of monetary conditions during the recent quarters have become weaker.

Decomposition of GDP Gap Estimated by Production Function, ppts



Source: SSSU; NBU staff estimates

Decomposition of GDP Gap Estimated by Kalman Filter, ppts



* NBU staff estimates

Source: SSSU; NBU staff estimates

2.2.3. LABOR MARKET AND HOUSEHOLD INCOME

Despite gradual economic recovery, the situation on the labor market remained tense, and in Q1 2016 slightly worsened again. The seasonally adjusted unemployment rate according to the International Labor Organization (ILO) methodology has slightly increased (from the beginning of 2015 it fluctuated within 8.9% to 9.5%). The increase was mainly attributed to weaker economic activity in Q1 2016. In Q2 2016, there were signs of a gradual recovery in labor demand.

The average nominal wages and the nominal household income grew during Q1 2016, however, at slower paces (by 27% y-o-y and 13.2% y-o-y, respectively). In Q2 2016, the growth in nominal wages moderated further (to 23.3% y-o-y). The slowdown was expected and related to weakening inflation pressure, lower exchange rate volatility, and the high base of comparison. Along with this, the weakening of inflationary pressure led to a further slowdown in the decline in real household disposable income, and real wages resumed growth in annual terms for the first time in two years. However, the growth rebound was largely explained by statistical effects and did not result in the respective revival of consumer demand and, therefore, did not generate inflationary pressures.

In Q1 2016, household savings reported the deepest decrease in the history of observations (by UAH 46 billion), including due to FX sales by the population. Accordingly, the propensity to save reached its historic minimum as well. This signalled the population may have been using their savings to maintain consumption.

Labor market[11]

The seasonally adjusted unemployment rate according to the ILO methodology (as a percent of the economically active people aged 15 to 70) was 9.1% in Q1 2016, remaining at high levels since the beginning of 2015 (in unadjusted terms, unemployment increased to 9.9%). The increase in unemployment was due to both the still poor economic activity and a large number of seasonal workers, mostly male, looking for a job (primarily in construction and agriculture sectors).

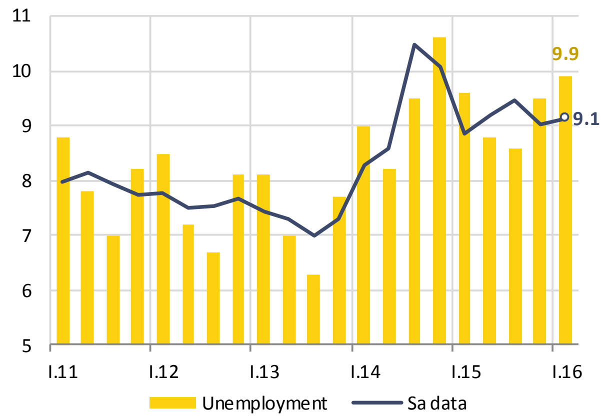
For reference: Registered unemployment was 1.5% as of the end of June 2016, and in seasonally adjusted terms varied within the range of 1.5% to 2.0% since the end of 2009. The number of unemployed people registered in the State Employment Service of Ukraine in annual terms had the tendency to decline starting from July 2015, and as of the end of June 2016 amounted to 388,900 people. The differences with the ILO statistics 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.[12]

Along with this, according to the ILO methodology, the number of employed population aged 15 to 70 years during Q1 2016

Seasonally Adjusted ILO Unemployment[1-2] and Real GDP[3], %

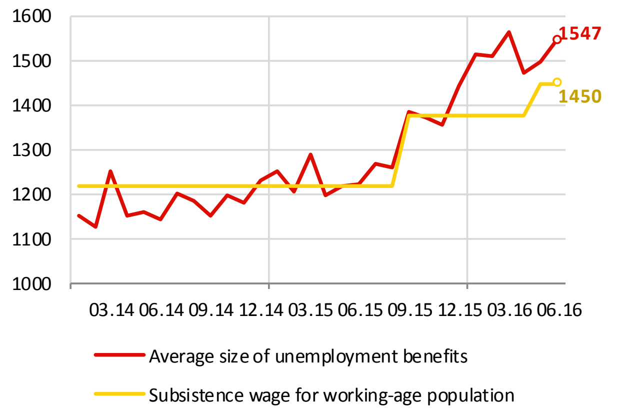
[1] % of economically active population aged 15-70
[2] Excluding Crimea and Sevastopol, since 2015 also part of ATO zone
[3] Excluding Crimea and Sevastopol, since 2014 also part of ATO zone
Source: SSSU; NBU staff estimates

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 2016

[11] From the beginning of 2015, the SSSU publishes data excluding part of ATO zone; therefore, some labor market indexes may be underestimated.
[12] In Q2 2016, the average level of unemployment benefits almost equaled the subsistence wage for working-age persons. The SESU reported that as of 1 April 2016 half of all vacancies had been for jobs paying less than UAH 2,000 per month, or less than 40% of the average wage for the end of 2015. Only 3.2% of vacancies were for jobs paying over UAH 5,000. Along with this, the minimum offered wages on the websites of recruitment agencies for different professions varied from UAH 3,400 (accounting, finance) to UAH 13,000 (information technologies, Internet, telecom).

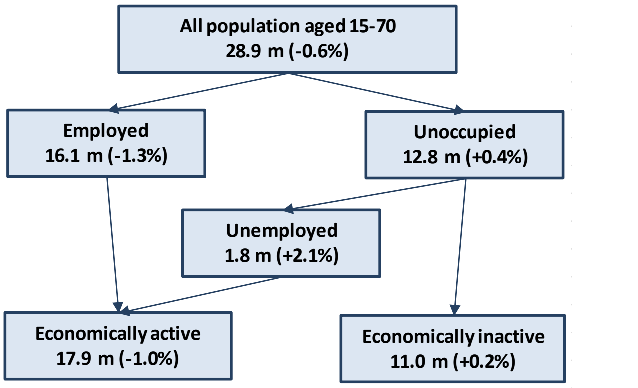
decreased, while the number of unemployed has increased. The number of the economically active population as well as the employed population decreased primarily as the result of demographic processes.

Reduction in the number of employed people corresponded to the changes in the number of full-time employees: as of the end of May 2016, the number of full-time employees amounted to almost 7.9 million persons (decreased by 2.3% y-o-y; however, it has practically not changed since the beginning of the current year). Various sectors demonstrated employment trends diverged: in agriculture, trade and transportation, the number of full-time employees has increased, but it declined in the vast majority of sectors, possibly as the outcome of massive layoffs that were planned before. According to the SESU, during January – May 2016 the number of employees informed about the layoff in the future has grown nearly by 1.5 times compared with the corresponding period of last year and amounted to 159,100 persons.

At the end of Q1 2016 and during Q2 2016 certain signs of a gradual increase in labor demand were observed – as evidenced by the decrease of the seasonally adjusted load per 10 vacancies (in annual terms, this indicator dropped in May and June 2016 for the first time in the last two years). Also, labor demand has increased by almost 12% in seasonally adjusted terms since the beginning of the year.

For reference: According to an online recruitment project, in H1 2016 the ratio of the number of resumes to the number of vacancies decreased compared to H2 2015 (from 3.9 to 3.4). Reduction in the ratio was attributed to an increase in the number of vacancies and a decline in the activity of persons looking for a job. The highest competition was recorded in such professions as "Top managers" and "Lawyers", the lowest one in “Insurance” and "Working personnel".[13]

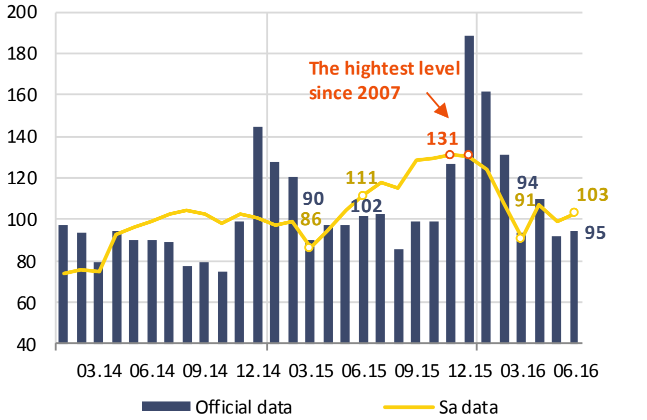
The Structure of the Ukraine's Population in Q1 2016*, million people and %, y-o-y



** It may differ from the official data for 0.1 million people due to rounding*

Source: SSSU; NBU staff estimates

Load of Registered Unemployed per 10 Vacancies*, end of month, person



** Excluding Crimea and Sevastopol since 2014 and also part of ATO zone since 2015*

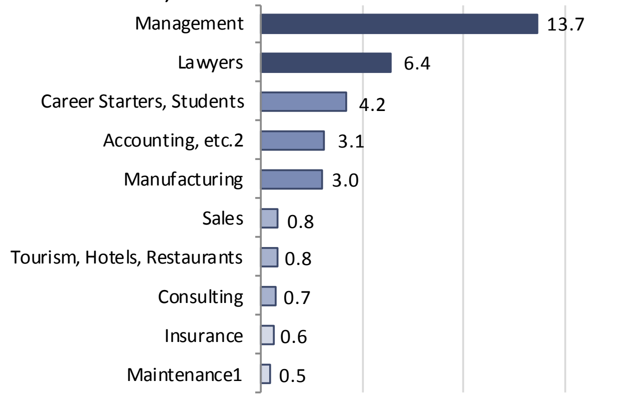
Source: SSSU; NBU staff estimates

Household income and savings

In Q1 2016, the nominal household income increased, but the pace of its growth slowed down substantially. The increase in nominal household income occurred mostly on account of wages, the share of which grew to 46% in Q1 2016. So, wages as a component of nominal household income grew by 26.1% y-o-y.[14] At the same time, social and other transfers grew by only 1.4% y-o-y in Q1 2016. This was the result of lower social benefits (by 13.8% y-o-y) due to declining proceeds from the Pension Fund. However, such dynamics was caused by a temporary factor – the advance pension payments for January 2016 carries out at the end of 2015.

The growth average nominal wages (for a full-time employee) have slightly slowed down in Q1 2016 and continued to descend in Q2 2016 (to 23.3% y-o-y to a quarter average of UAH 5,072), mainly due to lower exchange rate volatility and high base of comparison. Along with this, during Q2 2016, the growth of wages has been supported by the increase in the minimum wages (since 1 May

Ratio of the Number of Resumes to the Job Vacancies for Selected Activities, H1 2016



[1] Maintenance and Operations Personnel

[2] Accounting, Management Accounting, Corporate Finance

Source: HeadHunter Ukraine

[13] This data should be carefully considered if interpreted for all Ukraine, because job searches over the Internet are more focused for specific types of specialties, as well as are more common in large cities.

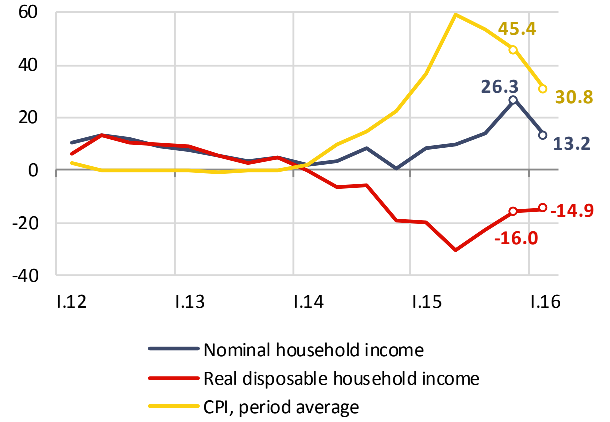
[14] The growth rate of wages within the structure of incomes and nominal average wages (per permanent employee) are different as a result of methodological peculiarities in the course of corresponding calculations. Thus, calculation of wages as a part of household incomes was performed on the basis 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.

2016 by 5.2% - up to UAH 1,450), increased provisions for soldiers and border guards, as well as the increase in seasonal works.

Easing inflationary pressures contributed to further reduction in the rates of decline for both real household disposable income and real wages. In March 2016, real wages increased for the first time in two years in annual terms, with their growth accelerating to 12% in Q2 2016.

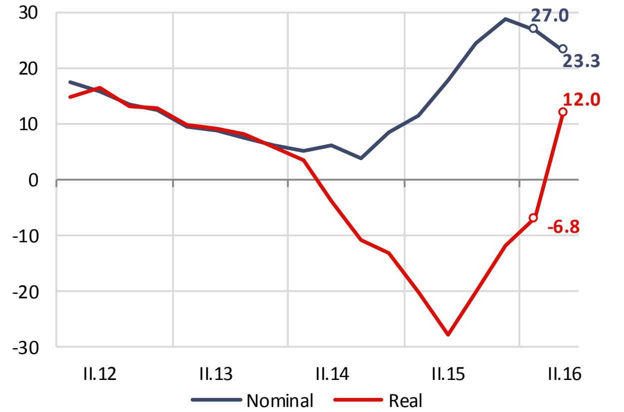
In Q1 2016, household savings have rapidly declined (by UAH 46 billion, the most significant decline for the entire period of observations). This was caused both by a decrease in non-financial assets (mainly due to depreciation of the residential buildings) and a decline in financial assets (in particular due to larger FX sales by the population). Accordingly, household propensity to save, which remained close to zero over the past year, significantly decreased and reached a historic minimum in Q1 2016 (both in seasonally adjusted and unadjusted terms). Thus, the population used savings that were accumulated in previous periods to support their consumption amid increasing expenditures on utility services.

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



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

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

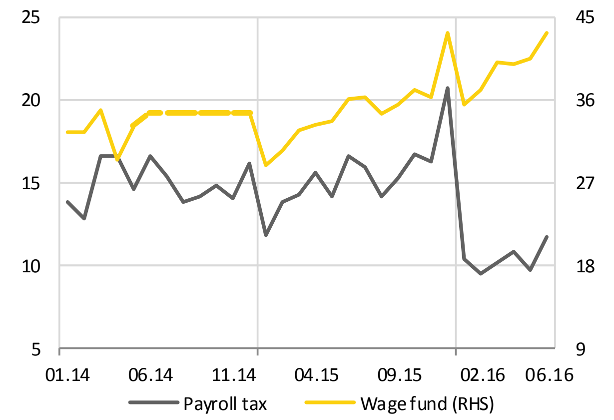
The Impact of Social Security Contribution Rate Reduction on Wages

In order to improve business environment, reduce tax burden on the wage fund, and encourage de-shadowing of income, a SSC reform was enforced since 1 January 2016, envisaging:

- a reduction in the SSC rate paid by employer by about a half to 22%;
- widening of SSC tax base from previous 17 to 25 minimum monthly wages;
- elimination of the SSC rate paid by workers.

As a result, proceeds from the SSC decreased expectedly (by 28% y-o-y in H1 2016). However, the reduction in proceeds was less significant than the rate cut, which was partly attributed to the growth of the wage fund (by 21% y-o-y for January–June 2016).

Payroll Tax and Wage Fund, UAH bn

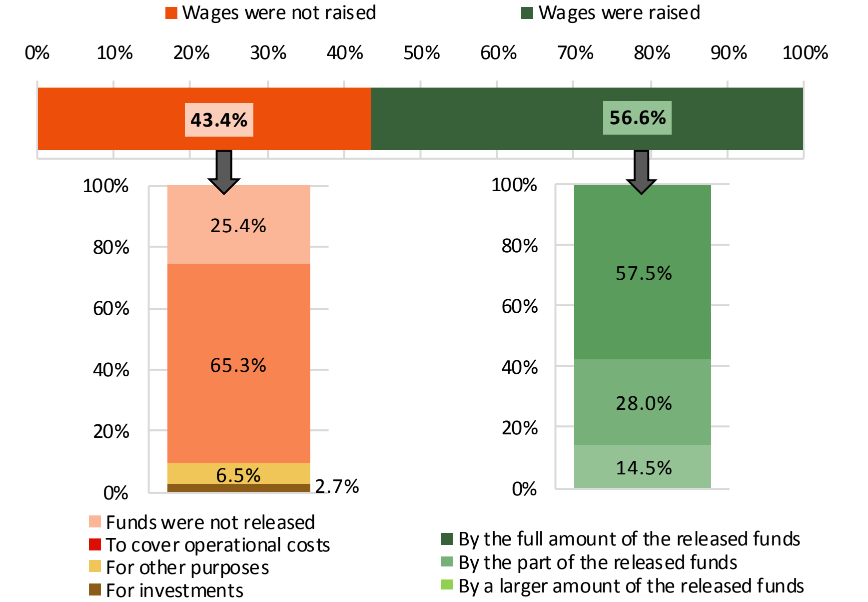


Source: SFSU, SSSU, NBU staff estimates

For a more detailed assessment of the impact of the SSC rate cut on the enterprises' wage policies, the relevant question was added to business survey carried out in Q2 2016.[15] According to the survey results, more than half of the enterprises have directed the funds released from SSC rate cut to increase wages. But only a small share of them increased wages for the full amount of released funds. Enterprises that did not increase wages have directed the funds to finance their current activities. About a quarter of surveyed companied reported they did not experience a release of funds from the SSC rate cut at all.

The largest share of the enterprises that raised wages were in those economic sectors where the average nominal wage at the end of 2015 was lower than the average for the economy as a whole (primarily in agriculture, forestry, and fishery, where the increase in wages exceeded the savings from the SSC rate cut, according to the estimates of the enterprises). A significant number of retailers also noted the increase in wages but not to in full amount of savings. In turn, in the mining industry, the share of enterprises that raised wages was the lowest, though these enterprises have the largest potential for wage increases (in the mining industry, the rate of charges was substantially higher compared to the average for whole economy due to one of the highest professional risks for employees). Medium-sized enterprises more often raised wages, while small businesses that operate in tighter financial conditions than larger enterprises directed the released funds to other purposes, in particular to the payment of other taxes.

Allocation of Released Funds from Payroll Tax Reduction

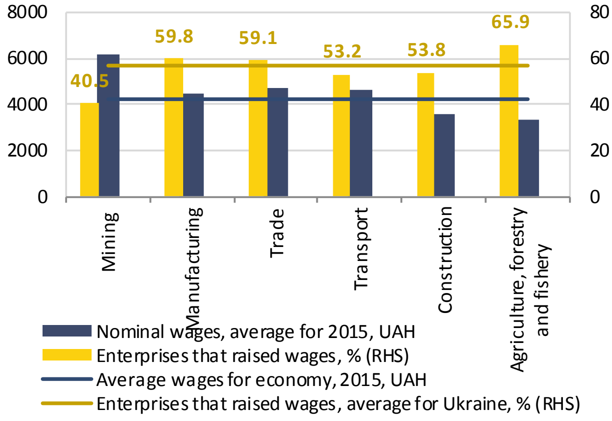


Source: Business Outlook Survey of Ukraine (NBU)

[15] The NBU conducts a survey quarterly on business expectations. The businesses of the non-financial sector participate in the survey. Quota sampling is formed depending on the contribution of the region and the type of activity in Ukraine's GVA. The NBU held the next round of the survey from 11 May to 7 June 2016. Some 683 enterprises from 22 regions of Ukraine participated in the survey (excluding Crimea, Sevastopol, Donetsk and Lugansk regions). More detailed information is posted at the link: https://bank.gov.ua/control/uk/publish/category?cat_id=58374

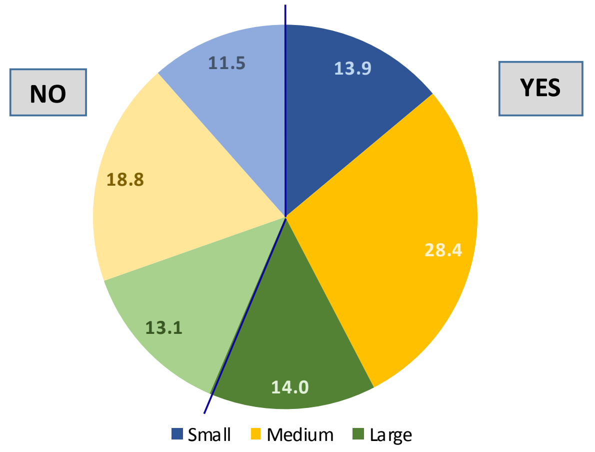
Among other purposes for directing the released funds, the enterprises named the covering of losses from the fluctuations of the hryvnia exchange rate, the payment of the increased land tax, royalties and utilities, PIT, VAT, and hiring new employees. An important result of the lowering the payroll tax was the reduction in gross expenses of enterprises, which allowed improving their financial results.

Nominal Wages and Share of Enterprises that Raised Wages after Payroll Tax Reduction



Source: SSSU; NBU staff estimates

Distribution by company size, %



Source: NBU

Thus, as expected, enterprises considered the impact of SSC rate cut favorable as a whole and partially already reflected it through raising wages. Along with this, greater effect from the implemented changes will become visible with a significant lag, and more significant impact, including a widely expected de-shadowing of wages, requires, inter alia, comprehensive reforms of the pension compensation of employees systems.

2.2.4. FISCAL SECTOR

In H1 2016, fiscal policy stance was somewhat less restrictive compared with the respective periods in 2014 and 2015. This was evident from higher spending growth, primarily on account of current expenditures. In particular, expenditures on social assistance rose significantly following SSC reform and a faster adjustment of utility tariffs to their cost covering levels. Furthermore, in Q2 2016 local budgets expanded their capital expenditures.

However, revenue growth has significantly slowed primarily due to a notable reduction in non-tax revenues. At the same time, thanks to a number of tax changes implemented at the beginning of the year, as well as temporary effects (such as very low settlement of VAT refund claims in June), tax revenues rose quickly.

In contrast to a surplus recorded in Q1 2016, a consolidated budget deficit was reported in Q2 2016 as the State budget deficit widened and the surplus of local budgets narrowed. As a result, in H1 2016, the cumulative consolidated budget deficit was registered, which, however, was lower than the average level for the respective periods over the last seven years (even taking into account the surplus reported for the respective period in 2015). Furthermore, this year a significant primary fiscal surplus was maintained.

Revenues

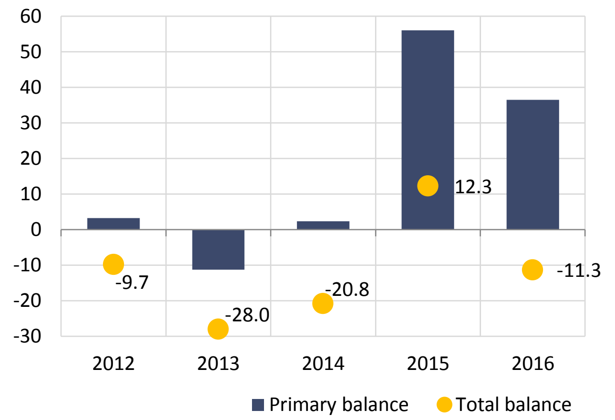
The annual growth of consolidated budget revenues slowed down to 11.2% y-o-y in Q2 2016, and 13.7% y-o-y in H1 2016.

The slowdown was mainly a result of a 44.7% y-o-y reduction in non-tax revenues in Q2 2016 (43.3% in H1 2016). In turn, this was due to the lack of NBU transfers[16] to the budget in the current year. Also, there were one-off proceeds to the budget in the respective period last year (from the sale of 3G licenses).

At the same time, the growth of tax revenues remained relatively high at 29.3% y-o-y in Q2 2016 and 29.9% in H1 2016. Tax revenues were favorably affected by improvements in tax administration and economic performance of select sectors. However, transitory factors, such as unexpectedly very low settlement of VAT refund claims in June (just UAH 0.1 billion), contributed significantly to a strong growth of tax revenues in Q2 2016. Considering also that the average monthly amounts of VAT refund in April-May were somewhat lower than in Q1 2016 (UAH 6.9 billion and UAH 7.4 billion, respectively), the total amount of VAT refund payments declined by 5% y-o-y in Q2 2016 (whereas it grew by 84.5% y-o-y a quarter before). As a result, the stock of VAT refund arrears picked up to UAH 21.7 billion as of 1 July 2016, according to SFS data. At the same time, along with a certain intensification of VAT payments by agricultural enterprises, revival of retail trade turnover in Q2 2016, and a favorable comparison base,[17] this led to a significant increase in overall VAT receipts.

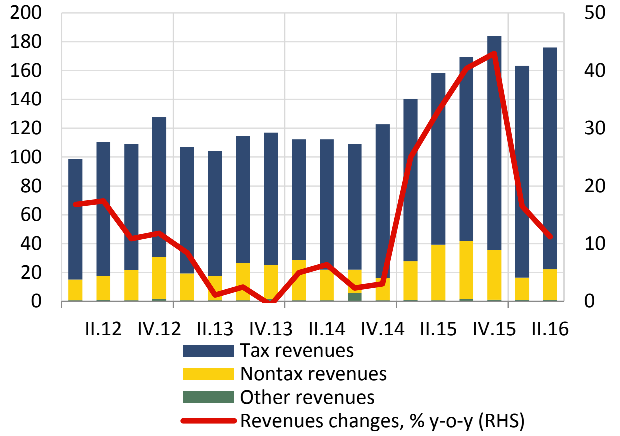
Also, in Q2 2016, revenues from excise taxes grew significantly, due to higher rates (raised earlier this year) and strengthened administration (by introducing excise invoices on operations with

Consolidated Budget Balance in H1, UAH bn



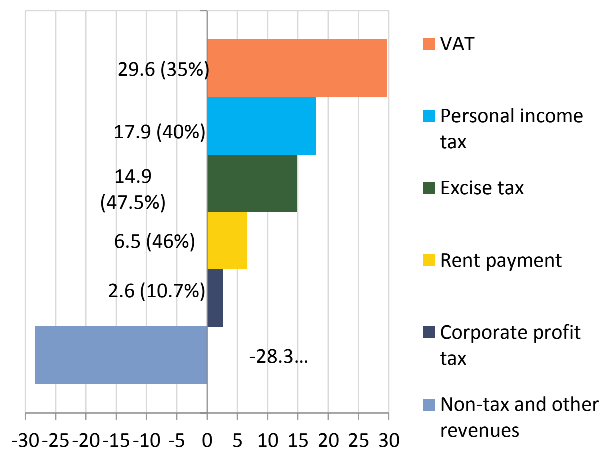
Source: Treasury; NBU staff estimates

Consolidated Budget Revenues, UAH bn



Source: Treasury; NBU staff estimates

Consolidated budget revenues in H1 2016, compared with the respective period of the previous year, UAH bn and %



Source: Treasury; NBU staff estimates

[16] According to 'Article 5[1]. Profit before distribution' of the Law of Ukraine *On the National Bank of Ukraine,* the transfer of the profit for distribution to the State budget of Ukraine is carried out only after the confirmation by the external audit and approval by the NBU Council of annual financial statements, as well as after the formation of the general and other reserves at the expense of this profit in certain volumes provided for by the law. For H1 2015, the amount of UAH 25.1 billion was transferred.

[17] In February-March 2015, inflation and devaluation effects significantly influenced the VAT, excise tax, and taxes on international trade, but their effects began to exhaust since April 2015.

fuel). High volumes of imports and the increasing value of certain excisable goods also supported the increase of these proceeds.

As in the previous period, receipts from personal income tax reported buoyant growth, advancing by 39.8% y-o-y in Q2 2016. The growth was the result of unification of the tax rates at a single 18% rate at the beginning of the year and the increase in nominal wages. This quarter, significant revenues were received from corporate profit tax that exceeded last-year's volumes by 39.2%. In particular, in Q2 2016, as well as in Q1 2016, state-owned enterprises paid significantly larger amounts of profit tax than in the corresponding periods last year, which may be attributed to further adjustment of utility tariffs to their cost covering levels. Also, revenue performance from corporate profit tax reflected changes in this tax administration implemented since the beginning of the year (in particular, a shift towards a quarterly scheme of paying corporate profit tax).

Proceeds from taxes on international trade have moderately increased (in comparable terms, after adjusting for the abolition of the import duty surcharge) as well. In 2015, receipts from the import duty surcharge accounted for 62.5% of total revenues from taxes on international trade. Hence, its abolition since the beginning of 2016 led to a considerable decline in revenues from taxes on international trade compared with the previous year in unadjusted terms. Also, in Q2 2016, royalty proceeds decreased significantly. While a decrease was mainly driven by economic factors, tax administration weaknesses also contributed.

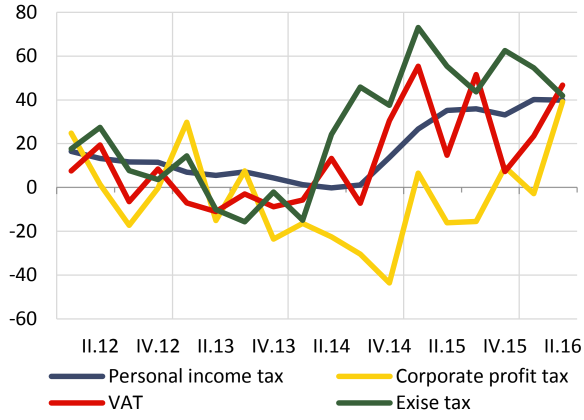
Expenditures

Expenditures of the consolidated budget continued to increase in Q2 2016 but at a slower pace (19.6% y-o-y) –. The slowdown was mainly attributed to lower growth of current expenditures (18.2% y-o-y in Q2 and 23.6% in H1 2016). This, in turn, reflected a seasonal decrease in expenditures on utility subsidies to households and the new service payments schedule for public external debt after restructuring. However, given significant increase in Q1 2016, a cumulative growth of the consolidated budget expenditures picked up to 22.9% y-o-y for H1 2016.

Within current expenditures, spending on social assistance and social insurance programs continued to increase at high paces. Thus, social security spending kept accelerating, underpinned by significant transfers to the Pension Fund as cutting SSC rate, a major revenue source for the Fund, led to a noticeable reduction in its own revenues.[18] During Q2 2016, the volume of these transfers were larger than in the previous one since January's pension expenditures were made in advance in December 2015. At the same time, with the end of the heating season expenditures on utility subsidies to households decreased compared to Q1 2016. As a result, their growth in annual terms has slowed down while remaining high. Budget expenses on wages and salaries grew fast (by 37.2% y-o-y), driven by increases in allowances for soldiers and the minimum wage. At the same time, expenditures on employers' social contribution decreased in Q2 2016 (by 17.5% y-o-y) due to a reduction in the SSC rate.

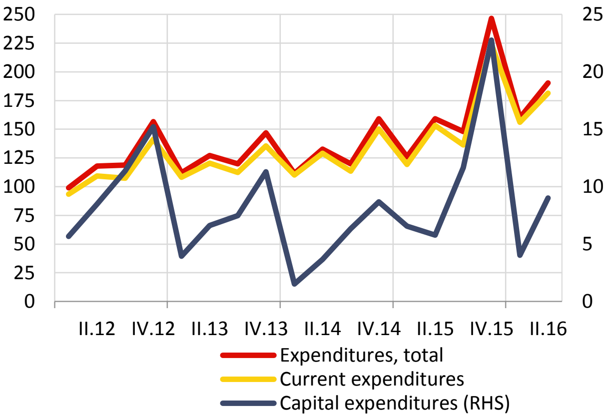
As in the previous period, a substantial growth in expenditures on social assistance and social insurance was partially offset by lower current expenditures on other programs. Thus, in Q2 2016, expenditures on use of goods and services exceeded last year's amount by only 3.2% y-o-y. In particular, expenditures on purchase

The Main Budget Taxes, % y-o-y



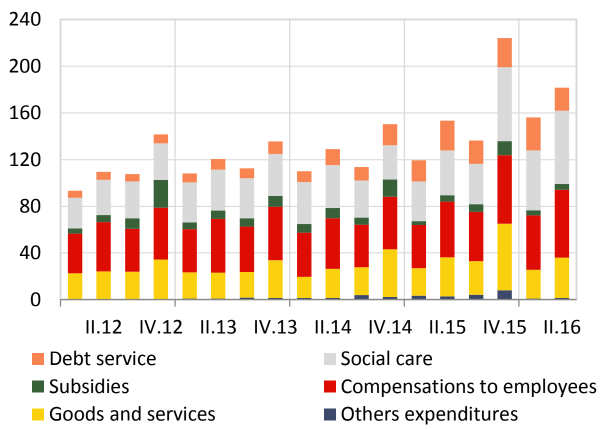
Source: Treasury; NBU staff estimates

Consolidated Budget Expenditures, UAH bn



Source: Treasury; NBU staff estimates

Current Expenditures Components, UAH bn



Source: Treasury; NBU staff estimates

[18] In 2016, budget support to the Pension Fund increased substantially.

of goods, equipment, and utility payments have declined. Expenditures on debt service, especially its external component, significantly decreased. After a rapid increase of expenditures on debt service in Q1 2016 due to a resumption of the coupon payments on government bonds,[19] those expenditures were minor in Q2 2016. At the same time, domestic debt service expenditures remained at the level of last year.

Since April 2016, capital expenditures resumed growth in annual terms, which lasted throughout Q2 2016. Their increase was related, in particular, to the repair of the road infrastructure. A significant part of capital expenditures was carried out by local budgets.

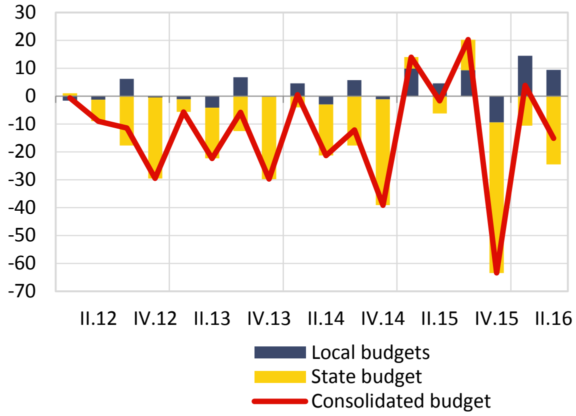
Balance

As expected, in Q2 2016, the consolidated budget reported a deficit (UAH 15.2 billion). This was a reflection of the widened State budget deficit to UAH 24.5 billion and the narrowed local budgets' surplus to UAH 9.4 billion. For H1 2016, the consolidated budget deficit amounted to UAH 11.3 billion.

The deficit was principally financed with the funds on the single treasury account and the proceeds from issuance of domestic debt securities. In H1 2016, the budget received a total amount of UAH 21.9 billion from the issuance of domestic debt securities with the lion's share of issued during Q2 2016. Within the new domestic securities issuances, government bonds maturing in one to three years prevailed. This reduces pressure on the expenditure part of the budget for the current year. Also, the government was active issuing domestic debt securities denominated in foreign currency. At the same time, external borrowings were relatively small. In Q2 2016, Ukraine received loans from the EBRD and IBRD. Furthermore, external debt statistics reflected completion of the public and publicly guaranteed debt restructuring. Thus, extra issuances of 2015 government bonds as well as the state derivatives were carried out in February and April of this year. Also, redemption payments amounted to UAH 24.4 billion in Q2 2016.

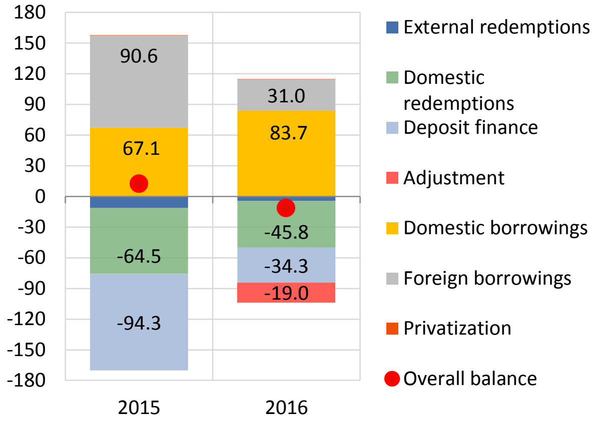
All of this affected the volume of the public and publicly guaranteed debt denominated in local currency, which as of the end of June declined by 2.5% compared with end-March 2016, inter alia thanks tithe strengthening of the hryvnia. However, since the beginning of the year, the debt increased by 6.1%.

Fiscal Balance Indicators, UAH bn



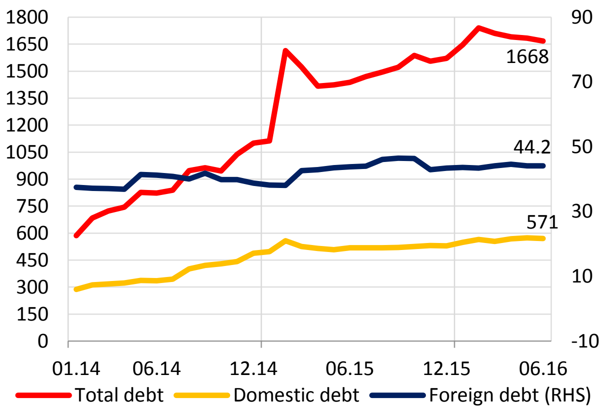
Source: Treasury; NBU staff estimates

Consolidated Budget Financing in H1, UAH bn



Source: Treasury; NBU staff estimates

Public and Publicly Guaranteed Debt, UAH bn (Foreign debt inUSD bn)



Source: MFU; NBU staff estimates

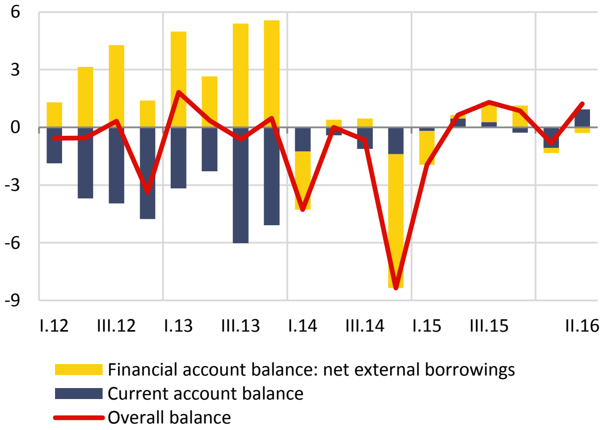
[19] On 1 March 2016, the Ministry of Finance made the first coupon payment on government bonds that were issued in November 2015 within the framework of debt operation with the public and publicly guaranteed debt. The coupon payments are scheduled for 1 March and 1 September each year.

2.2.5. BALANCE OF PAYMENTS

In Q2 2016, the current account switched to a surplus (USD 917 million). Favorable external economic conditions, high carryovers of grain, and relaxation of transit restrictions by Russia contributed to a significant deceleration in the decline of merchandise exports in annual terms. At the same time, investment goods imports continued to increase at unexpectedly high rates, although this was partially offset by lower volumes of energy imports.

In Q2 2016, the financial account net inflows amounted to USD 287 million due to a significant reduction in FX cash outside banks (by USD 1.6 billion). The public sector only repaid its external liabilities given delays with official financing from IFIs. As a result, the overall BoP balance switched to a surplus of USD 1.2 billion in Q2 2016; however, it was lower than expected. Due to the overall BoP surplus in Q2 2016, international reserves increased to USD 14.0 billion (or 3.6 months of future imports).

Overall Balance of Payments, USD bn

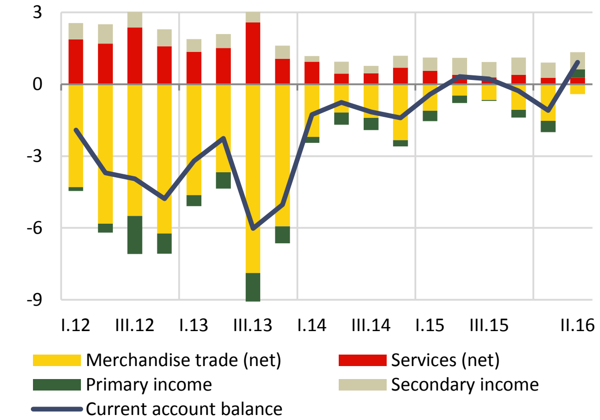


Source: NBU

Current account

In Q2 2016, the current account balance exceeded our expectations and switched to a surplus amid the improving trade balance and the primary income account surplus.

Current Account Balance, USD bn



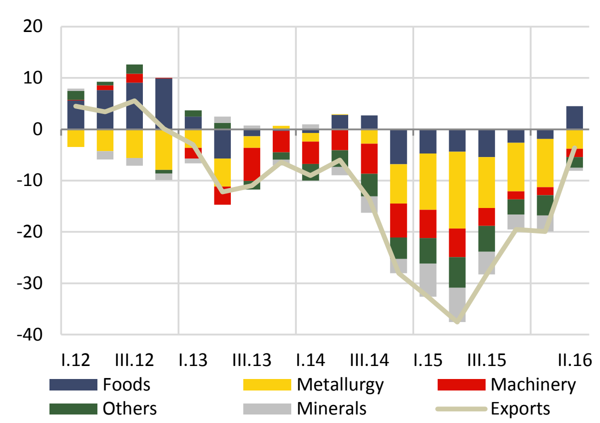
Source: NBU

Exports of goods recovered at a faster pace than expected, underpinned by favorable situation on global commodity markets. Its rate of decline decelerated to 3.6% y-o-y in Q2 2016 (compared with 19.9% y-o-y in Q1 2016). Agricultural products, primarily grains, and steel products contributed the most to export improvements.

Due to the high grain harvest in 2015, as well as significant carryovers, grain exports in the 2015/2016 marketing year increased to a record high 39.5 million tons, according to the Ministry of Agrarian Policy and Food data. According to these results, Ukraine was among world's Top-3 grain exporters along with the United States and EU countries. Grain exports increased by 6.1% y-o-y in Q2 2016. In 2016, exports of corn and wheat to some European countries have increased thanks to a launch of the EUR.1 movement certificate issuance from 1 January 2016.[20] Exports of wheat to the countries of South-East Asia have substantially increased as well, since last year's drought in the region resulted in a low harvest of grains there. At the same time, China's policy of limiting grain imports, including corn, caused a twofold reduction in export to this region in annual terms.

Given an uprise in the world iron ore prices, the decline of these products exports decelerated to 6.9% y-o-y in Q2 2016 (from 41.9% y-o-y in Q1 2016). A sharp increase in steel prices at the beginning of Q2 2016 contributed to the deceleration of decline in exports of metallurgical products to 13.4% y-o-y in Q2 2016 (from 33.3% y-o-y in Q1 2016).

Contributions to Annual Changes in Exports, ppts



Source: NBU staff estimates

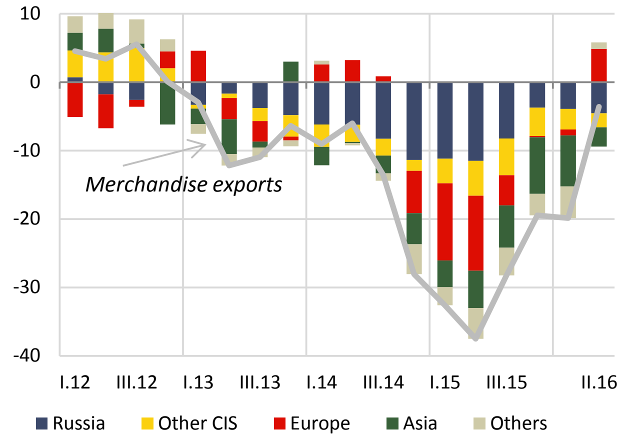
Exports of wood and wood products, which started to grow since March 2016, increased by 7.6% y-o-y in Q2 2016. However, before 2016, the lion share of these export commodities was represented by unprocessed timber, while this year the finished wood products prevailed. In particular, this happened owing to a ten-year

[20] According to the Association Agreement between Ukraine and the European Union, preferential duty rates are applied to the Ukrainian goods delivered with the EUR.1 movement certificate.

moratorium on exports of round wood[21], which came into effect since 1 November 2015. This has given the impetus to the development of a cluster of related manufacturing industries and, therefore, exports of lumber, furniture, windows, doors, construction materials, etc.

In Q2 2016 the increase in the share of the EU in the total export continued (up to 32%) amid the decrease in the Russian share (to 9.1%). At the same time, the share of exports to other CIS countries decreased (to 9.4%) thanks to the de facto easing of the Russian transit restrictions since the late February 2016. However, Russia implemented additional ban on transit to Kazakhstan and Kyrgyzstan22 through the Russian territory since 1 July 2016, which has negatively affected the exports performance in H2 2016. Asia remained the largest consumer of Ukrainian products; its share almost has not changed (34.3%) in Q2 2016.

Contribution to Annual Change in Exports by Regions, ppts



Source: NBU staff estimates

Export of goods to EU countries rose by 4.2% y-o-y in January-May 2016, the growth accelerated to 17.4% y-o-y in April-May. In 2016, the main export groups were agricultural products (41%), metallurgy products (26%), and minerals (11%).

EU's imposition of restrictions on Chinese and Russian steel enabled Ukraine to increase the volumes of ferrous metals exports to the EU countries. However, low world steel prices at the beginning of the year resulted in a reduction of exports of metallurgical products by 10.3% y-o-y for January-May. Export of minerals declined by 18% y-o-y due to a decrease in coal production and lower imports of refined oil products.

However, this was compensated for by growth in agricultural products exports (up by 25% y-o-y in January-May), of which corn had the largest share (up 34% y-o-y) followed by fats and oil (up 32% y-o-y). These two groups contributed more than 10 ppts to annual growth of merchandise exports to the EU in January-May 2016.

Export to EU countries in January-May 2016

	Share, %		Change in Jan-May, %
	In exports to EU	In total exports	
Agricultural products	40.9	13.9	25.0
grain	16.7	5.7	9.4
wheat	2.4	0.8	25.4
corn	14.0	4.8	7.7
fats and oils	13.1	4.5	207.6
Minerals	10.8	3.7	-18.0
Chemicals	5.2	1.8	-15.3
Woods	8.1	2.8	21.0
Industrial products	2.0	0.7	8.1
Metallurgy	25.8	8.8	-10.3
Machinery	5.7	2.0	1.8
Total	**100.0**	**34.1**	**4.2**

Source: NBU

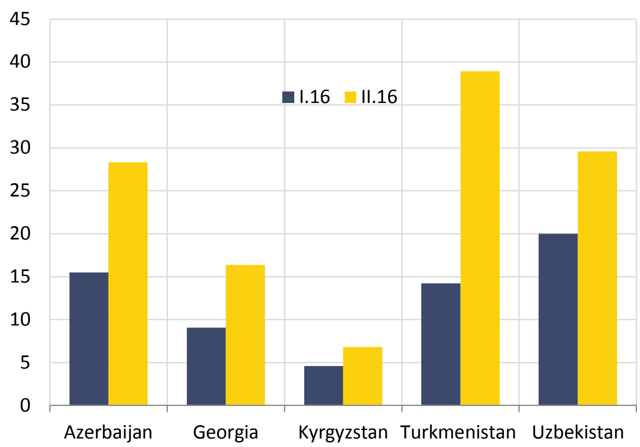
The EU countries were the biggest buyers of Ukrainian grains in the current marketing year (more than 25%). Among the Top-10 countries, which are exporting Ukraine's agricultural goods, five are from the EU: Spain, the Netherlands, Italy, Poland, and France. Ukraine became the seventh-largest importer of agricultural products to the EU.

In Q2 2016, imports of goods were in line with our expectations. However, non-energy imports grew faster than forecast, while the reduction of energy imports was more significant.

Due to the abolition of import surcharge and the partial reorientation of Turkish exports following worsened relations with Russia, non-energy imports increased by 17.8% y-o-y in Q2 2016. In particular, imports of agricultural products increased by 15.9% y-o-y and industrial products by 21.3% y-o-y.

Machinery imports increased by one half in annual terms in Q2 2016, which led to a further increase in the share of investment imports. The increase in export proceeds, hryvnia appreciation and changes[23] to the Tax Code at the beginning of the year, stimulated

Transit through the Russian Territory, USD million



Source: SFSU

[21] The Draft Law 'On Amendments to the Law On Specifics of Government Regulation of the Enterprises' Activity Related to the Sales and Exports of Woods as to the Moratorium on Exports of Woods and Timber' (registration number 1362) provides that exports of unprocessed timber will be prohibited for 10 years – trees (except pine) since 1 November 2015 and pine trees since 1 January 2017.
[22] According to the Decree of the President of the Russian Federation as of 1 July 2016 No. 319 *On amendments to the Presidential Decree as of 1 January 2016 No. 1 'On Measures to Ensure Economic Security and National Interests of the Russian Federation during the Transit of Freight from Ukraine to the Republic of Kazakhstan Through the Territory of the Russian Federation'.*
[23] Abolition of the preferential regime of VAT taxation for agricultural producers since 1 January 2016.

higher purchases of imported machinery, namely for agricultural purposes[24]. Imports of motor vehicles almost doubled owing to the effect of deferred demand. Moreover, it was underpinned by an upgrade of the National police car fleet.

In H1 2016, energy imports were recorded low. The volumes of natural gas imports decreased to 0.4 billion m^3 in Q2 2016, while overall Ukraine imported only 3.0 billion m^3 in 1H 2016. In 2016, no Russian natural gas was imported. The largest volumes of natural gas were imported via the Slovak route and amounted to 2.5 billion m^3. Such low volumes of gas imports led to the reduction of gas reserves in the underground storages to 9.7 billion m^3 as of 1st July 2016, down by 19% y-o-y.

In Q2 2016, the surplus in trade of services (USD 272 million) decreased in annuals terms and also was in line with our expectations.

Exports of services were almost unchanged in Q2 2016, falling by (-0.2% y-o-y). A decrease in the number of visitors and a reduction of their spending in US dollar terms were reflected in lower proceeds under the "travel" item (down by 25.2% y-o-y in Q2 2016). This was offset by higher pipeline transportation services exports; although in annual terms they declined by 8.1% y-o-y due to elimination of a low base of comparison effect. Also, exports of IT services continued to grow at a relatively high pace (5.6% y-o-y), and its share in exports of services reached 17.8%.

The recovery of economic activity and improvement of the consumer confidence stimulated the growth of services imports by 4.1% y-o-y, in particular under the "travel" item by 13.9% y-o-y. Also, the reduction of transportation services imports slowed significantly (to 3% y-o-y).

In Q2 2016, private remittances to Ukraine continued to grow (up by 6.7% y-o-y to USD 1.4 billion), owing to the increase in remittances from the EU countries and the United States. Meanwhile, remittances from the CIS countries decreased as expected due to the worsening economic situation in most of these countries and tightened requirements for migrant workers in Russia.

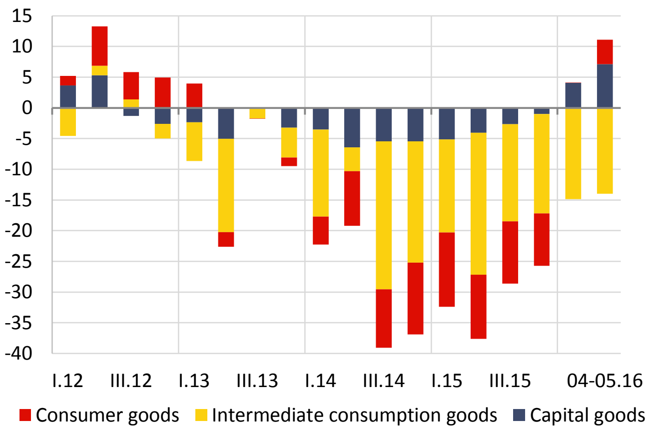
Interest payments on investment income decreased to USD 776 million in Q2 2016 (from USD 1.5 billion in Q1 2016) due to the redistribution of interest payments within the year after the reprofiling of Eurobonds[25]. As a result, in Q2 2016, a surplus on primary income account has been recorded for the first time since 2008.

Financial account

In Q2 2016, the financial account net inflows amounted to USD 287 million due to a noticeable reduction of FX cash outside banks. However, financial inflows were lower than we expected due to delays with official financing.

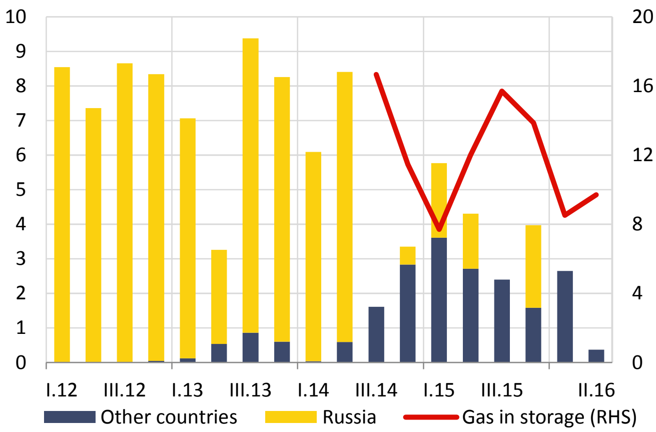
In Q2 2016, the public sector foreign liabilities declined due to the NBU swap operations and public debt principal payments by the government.

Contribution to Annual Change of Imports of Goods by Broad Economic Categories, ppts



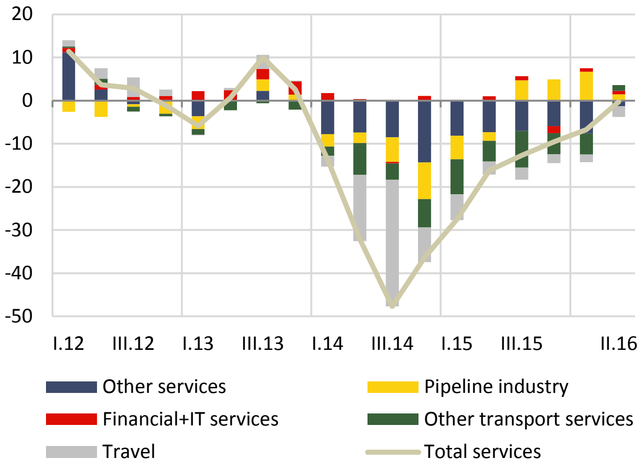
Source: NBU

Natural Gas Imports, bn m^3



Source: Naftogaz, Ukrtransgaz

Contributions to Annual Growth in Exports of Services, ppts



Source: NBU staff estimates

24 According to the agricultural development departments of regional state administrations, in January-May 2016, Ukrainian agrarians purchased 3,422 units of machinery worth about UAH 3.4 billion, which is 1.5 times higher than in the respective period last year.
25 Since 2016, the payment of interest under the restructured government bonds is made twice a year - in March and September, the coupon is USD 0.5 billion.

The main reason for a decrease in foreign assets of the real sector was the reduction of FX cash outside banks (by USD 1.6 billion), that significantly exceeded our expectations. In Q2 2016, net debt outflows by the real sector amounted to USD 253 million, underpinned by net repayments of long-term loans.

In Q2 2016, the corporate sector's arrears continued to increase at the same pace as in the previous quarter (by USD 1.1 billion). According to NBU estimates, the stock of arrears as of the 1st July 2016 accounted for USD 14.5 billion.

Unlike previous periods, one third of the foreign direct investment inflows (USD 200 million) were directed to the corporate sector. FDI to the banking sector (USD 497 million) were driven by recapitalization needs both in the form of FX cash and debt-to-equity operations.

In Q2 2016, overall debt outflows from the banking sector amounted to USD 805 million and were related mainly to the repayment of loans by Ukrainian banks to their parent institutions. The rollover of LT private external debt was lower than expected, although it increased up to 38%. Excluding debt-to-equity operations, the rollover of LT private external debt[26] met our expectations (60%).

Rollover of Long-Term Private External Debt (%)

	Q1.15	Q2.15	Q3.15	Q4.15	Q1.16	Q2.16
Banks	35	79	18	22	9	18
Real sector	49	31	26	57	67	51
Total	42	54	22	35	31	38

Reserve assets

Due to the overall balance of payments surplus in Q2 2016, international reserves increased by USD 1.3 billion and amounted to USD 14.0 billion as of the end of quarter (or 3.6 months of future imports).

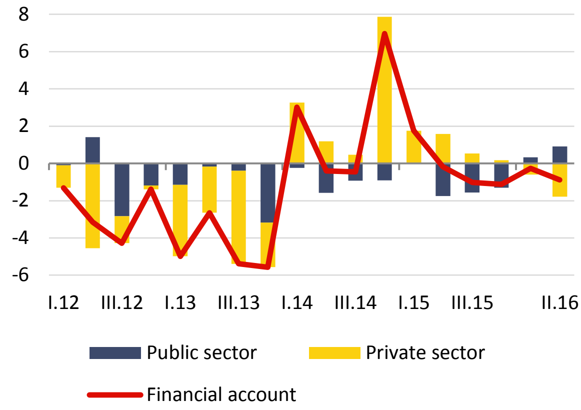
External sustainability

The outstanding gross external debt and short-term external debt by remaining maturity kept decreasing, leading to improvement in most of the external sustainability indicators in Q1 2016. At the same time, international reserves adequacy indicators remained almost unchanged.

The gross external debt of Ukraine in Q1 2016 decreased by USD 1.4 billion (to USD 117.4 billion) mainly due to a further deleveraging of Ukrainian banks by paying off their debts to parent institutions. Real sector's outstanding debt remained almost unchanged; however, arrears continued to increase.

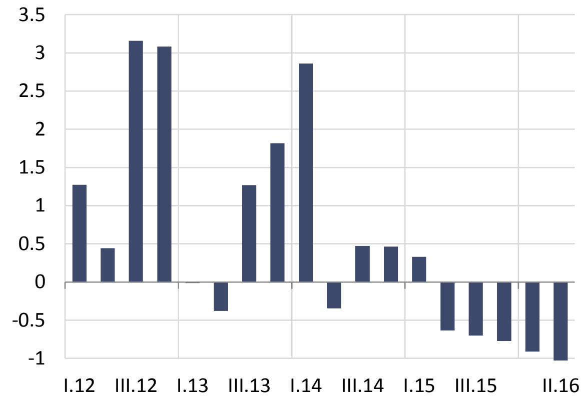
External debt of the public sector increased by USD 0.5 billion due to a loan attracted by the Government from the Japanese International Cooperation Agency and an additional issuance of Eurobonds restructured in 2015. At the same time, the NBU has made repayment under the swap contract.

Financial Account: Net External Assets, USD bn



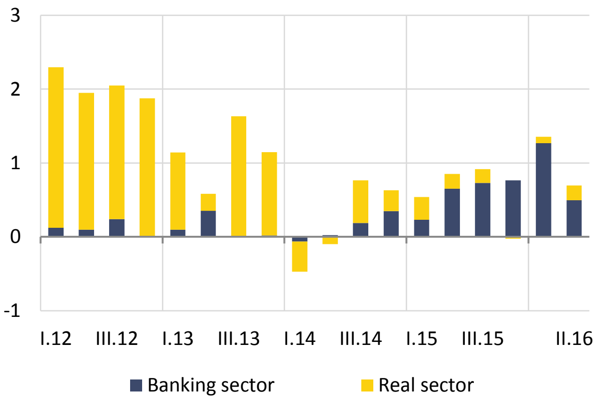
Source: NBU

FX Cash outside Banks, USD bn



Source: NBU

Foreign Direct Investment, USD bn



Source: NBU

[26] Debt-to-equity operations of the banks are taken into account when calculating the rollover in the part of the debt repayment to the parent banks, but are not taken into account in the part of the receiving FDI with the purpose of additional capitalization.

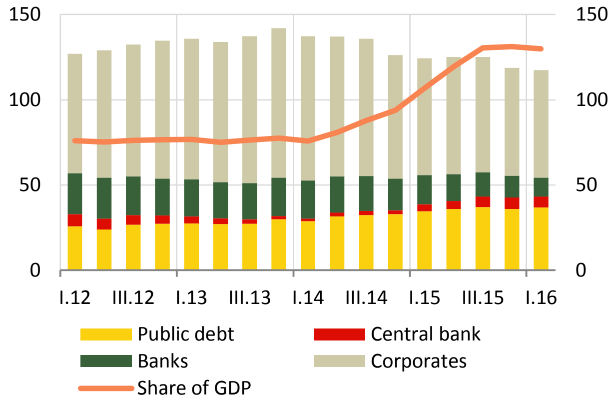
Indicators of external sustainability and adequacy of international reserves

%	Q1.2015	Q2.2015	Q3.2015	Q4.2015	Q1.2016
External debt/GDP	106.7	119.3	130.5	131.3	129.8
External debt/exports of goods and services	207.0	230.1	248.6	248.4	256.0
Short-term debt/gross debt	43.5	43.5	41.0	43.1	40.6
Short-term debt/GDP	46.4	52.0	53.5	56.6	52.7
Short-term debt/exports of goods and services	90.0	100.2	101.9	107.1	103.8
Trade openness[27]	106.5	106.8	107.8	107.5	104.1
Reserves/short-term debt	18.4	18.8	24.9	26.0	26.7
Reserves, composite IMF measure	31.9	32.9	41.9	45.2	44.8
Reserves in months of future imports (3 months)	83.3	86.9	109.7	114.8	110.3
Reserves as a share of broad money	22.8	22.1	29.4	32.1	33.1

In Q1 2016, the short-term external debt by remaining maturity decreased by USD 3.6 billion to USD 47.6 billion. Debt of general government sector declined to USD 0.9 billion following the lift of the time limits of the moratorium on paying off ‘Russian’ Eurobonds worth USD 3.0 billion issued in December 2013[28]. The private sector debt remained unchanged. The banking sector deleveraging (by USD 1.2 billion) was offset by an increase in debt by the real sector (USD 1.5 billion) mainly on account of trade loans.

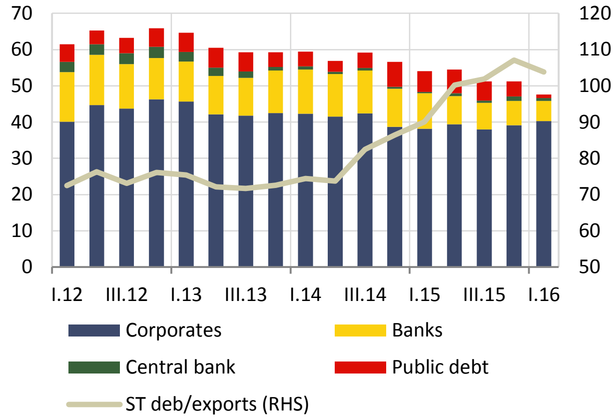
Despite a decrease in the international reserves in Q1 2016 (by USD 0.6 billion), most of the reserves adequacy criteria have remained unchanged. In particular, the ratio of reserves to short-term debt (Guidotti-Greenspan criterion) and a composite IMF measure (ARA metrics) remained at 27% and 45%, respectively, far below the norm (100%). At the same time, the ratio of reserves to the broad money continued to increase, while the level of reserves in months of future imports has declined insignificantly.

Gross External Debt, USD bn



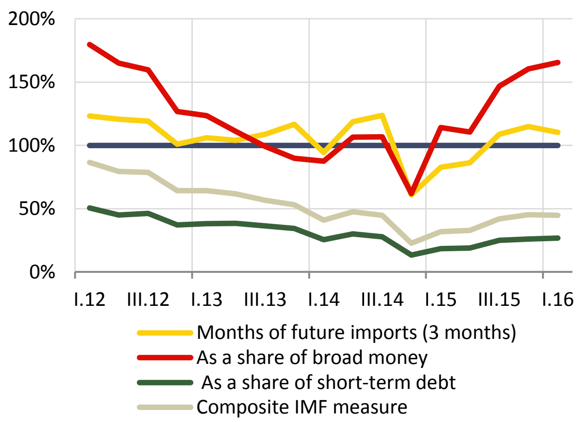
Source: NBU

Short-term External Debt by Remaining Maturity, USD bn



Source: NBU

Adequacy Criteria of International Reserves, %



Source: NBU staff estimates

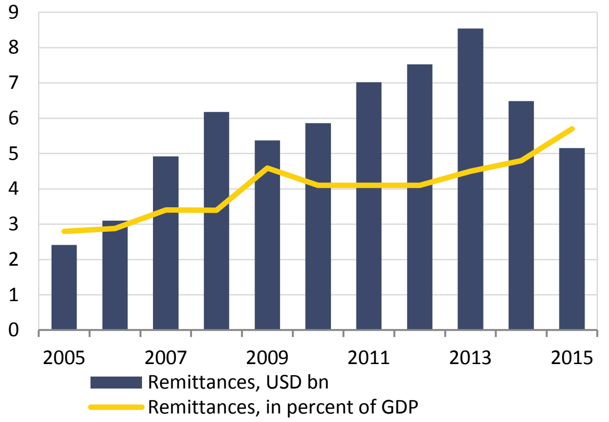
[27] Calculated as the ratio the 12-month moving sum of changing exports and imports to GDP.
[28] In December 2015, the Cabinet of Ministers of Ukraine introduced a moratorium on servicing Russian debt for the term up to 1 July 2016. In May 2016, the VRU has canceled the final date of validity of the moratorium. Therefore, it was removed from the statistics of the short-term external debt by remaining maturity.

Private Remittances to Ukraine

Private remittances (hereinafter – remittances) are quite important for many developing countries. In particular, they could compensate for the deficits on other sub-accounts of the current account, finance economic growth, and help maintain consumption at high levels. The growth of remittances in Ukraine somewhat restrained the widening of the current account deficit in 2011-2013 and was one of drivers of private consumption growth.

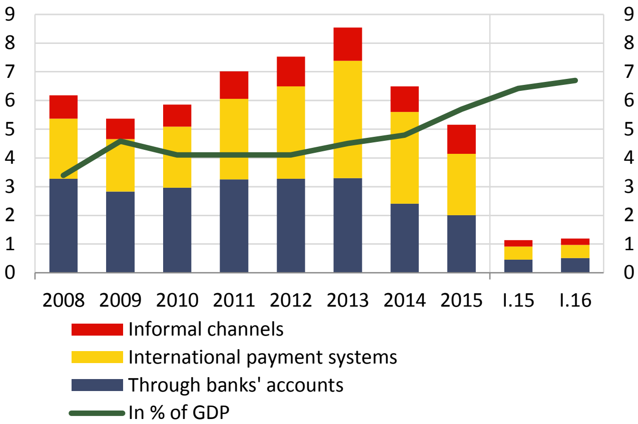
In 2004-2014, remittances to the Top-13 recipient countries, which accounted for 50% of total world remittances in 2014, increased by 2.7 times up to USD 264 billion. According to the classification of the World Bank, Ukraine belongs to the group of Lower-Middle-Income Economies, which also includes most of the countries where remittances account for more than 10% of GDP (Tajikistan, Kyrgyzstan, Moldova, Kosovo, Armenia, and Ghana). According to the World Bank data, in 2013 Ukraine was ranked 13th in the world and 1st among the CIS counties by the amount of remittances, in 2014 the rank was 17th and 2nd, respectively.

Remittances to Ukraine



Source: NBU; World Bank

Remittances to Ukraine by Transfer Channels, USD bn

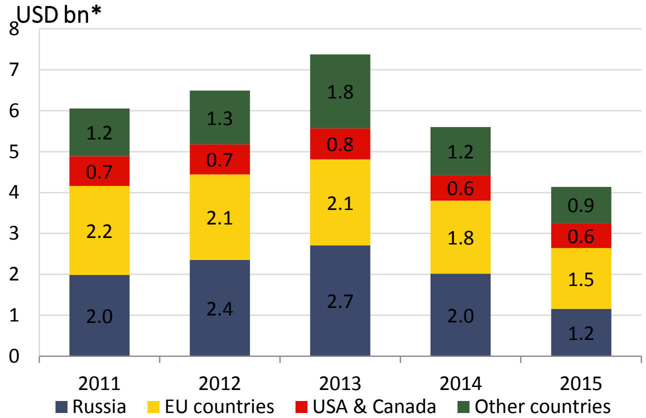


Source: NBU

The role of remittances in the Ukrainian economy has grown steadily in recent years. In particular, from 2005 to 2015, their amount increased by 2.1 times from USD 2.4 billion to USD 5.1 billion (or from 2.8% to 5.7% of GDP).[29] The maximum amount of remittances (USD 8.5 billion) was recorded in 2013. The lion's share of remittances in Ukraine is from migrant workers.

The total number of Ukrainian migrant workers was estimated at 688,000 by the IOM[30], including 424,000 long-term and 264,000 short-term migrant workers. By the number of migrant workers, the Western region of Ukraine is considerably ahead of the rest of the regions (60% of the total number of migrant workers).[31]

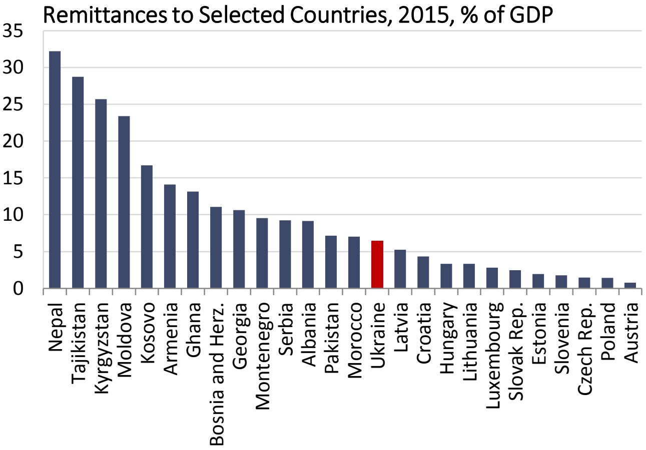
Remittances to Ukraine by the Country of Origion, USD bn*



Source: NBU

* informal channels are not included

Remittances to Selected Countries, 2015, % of GDP



Source: World Bank

In recent years the role of Poland in terms of labor migration has been rapidly growing: Poland is already ahead of Russia in the number of long-term migrant workers, and it is the main country of destination for Ukrainian students abroad (32% of the total number). The military conflict with Russia, the tightening of requirements for migrants in Russia, and the worsening of the economic situation in Russia (depreciation of the ruble, falling real GDP, etc.) led to a decrease in the role of Russia as one

[29] We used data from the World Bank (World Development Indicators - http://data.worldbank.org/indicator/BX.TRF.PWKR.CD.DT). Discrepancies in the remittances data from various sources (the World Bank, IOM, and NBU) are explained by methodological differences.

[30] A study on the nexus between development and migration-related financial flows to Ukraine, IOM, Kyiv, 2016.

[31] CARIM-East Research Report 2012/02.

of the main directions for labor migration. This is also confirmed by the fact that the rate of reduction in remittances from Russia was almost twice as high compared with EU countries in 2015 (down by 57% and 29%, respectively).

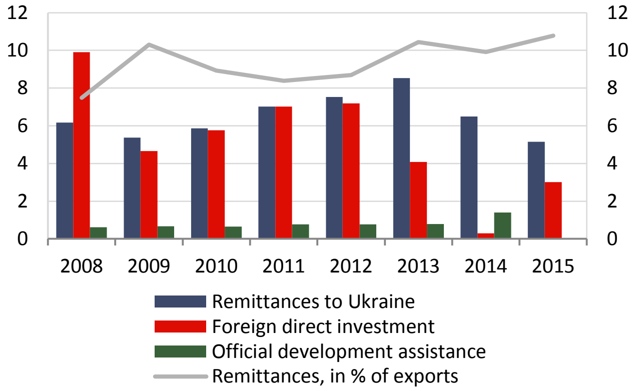
Remittances are transferred through both official channels (banks, international money transfer systems, post offices) and informal ones (through transfer of cash or material assets from one household to another). The main reasons for making transfers through informal channels are high costs for the official transfer, the lack of external oversight, and the possibility to avoid paying any taxes. In Ukraine, the share of remittances coming from informal channels amounted to about 13% in 2008-2013, and has risen drastically to 20% in 2015 due to FX restrictions imposed by the NBU.

Remittances play a special role during financial crises or other macroeconomic shocks. In 2009 and 2014-2015, remittances to Ukraine declined less than exports or FDI inflows, and were less volatile than other potential sources of foreign financing (portfolio investments, official funds, etc.). They also provide the opportunity to mitigate the negative effects of a significant reduction in export proceeds and real disposable income.

However, remittances may have a number of disadvantages. The most typical are the loss of "economic motivation" of households (recipients of remittances), rising vulnerability to external shocks, upward price pressures in the regions that are the largest recipients of remittances, and "overheating" of certain sectors of the economy (for example, construction and real estate). Thus, the increase in remittances to Ukraine was one of the additional factors of the real estate prices growth in the past.

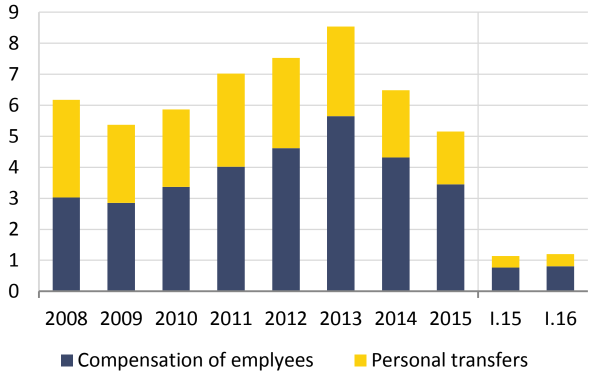
Quantitative assessment of the impact of remittances on the GDP of Ukraine was calculated through the expenditures of households (GDP by final expenditure approach). The main purposes of spending received funds are savings, consumption, purchase of durable goods or real estate, education, etc. According to the IOM study, in 2014 about 42% of remittances in Ukraine were sent by migrant workers in order to accumulate savings, 57% – for consumption and investment. However, in the actual budget of households that receive remittances, savings make up 18.5% of the total income, which corresponds to the situation in the other studied countries of the South-Eastern Europe region.

Remittances, FDI and ODA, USD bn



Source: NBU, World Bank

Remittances by BoP items, USD bn

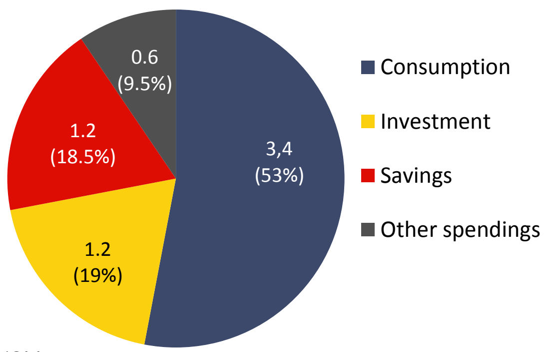


Source: NBU

In 2010-2014, remittances accounted for about 3% of private consumption and investment expenditures, but due to the significant deterioration of the economic situation, this share has risen to 4% in 2015, and to 4.4% in Q1 2016.

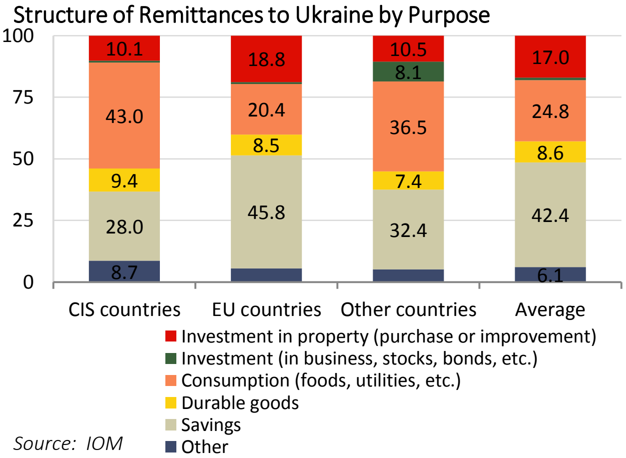
According to NBU estimates, remittances as a share of Ukrainian GDP should decrease gradually over the medium term. This would be primarily the result of a steady economic growth recovery in Ukraine, but remittances should remain an important source of external financing. At the same time, according to the IOM study, the investment potential of these funds is currently insufficiently realized.

Estimated structure of remittances usage by households in 2014, USD bn



Source: IOM, NBU staff calculation

Structure of Remittances to Ukraine by Purpose



Source: IOM

2.2.6. MONETARY SECTOR AND FINANCIAL MARKETS

The appreciation trend of the exchange rate of the hryvnia, which emerged in the FX market in March, has strengthened during Q2 2016 amid improved external conditions and significant volumes of FX sales by households. In addition, FX demand from energy companies considerably decreased. This enabled the NBU to purchase the FX surplus from the market to replenish its international reserves, to smooth the exchange rate volatility, and to continue relaxing temporary anti-crisis measures introduced earlier.

Subsiding inflationary pressure thanks to improving inflation expectations and the favorable situation on the FX market has allowed the NBU to continue easing monetary policy. Since the beginning of April, the regulator lowered its key policy rate four times. Effective on 29 July 2016, the rate was set at 15.5%. The key policy rate cuts, as well as the buildup of market expectations of further policy easing consistent with inflation targets, have started to be passed on market interest rates.

Also during Q2 2016, the resource base of banks continued to improve – the stock of domestic currency deposits grew and the corporate sector FX deposits (denominated in USD) registered inflows in June. At the same time, lending activity remained weak.

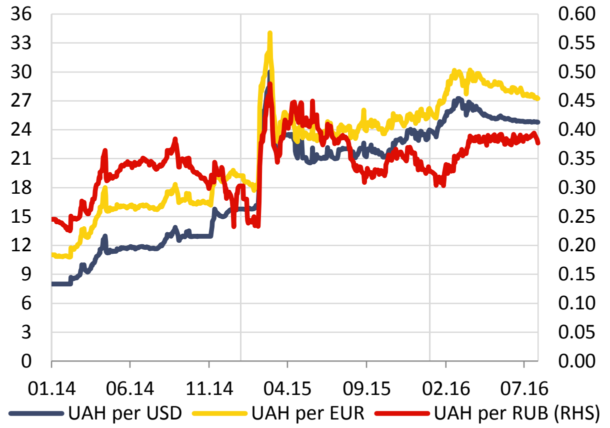
FX Market

Thanks to favorable external environment and significant volumes of households' FX sales, supply of foreign currency increased in Q2 2016. In particular, in Q1 2016 average daily amounts of FX cash sold by households stood at USD 10.3 million, and in Q2 2016 these amounts were almost twice higher. Along with this, average daily volumes of FX cash purchased by population remained almost unchanged compared to the previous quarter. Furthermore, FX demand from energy companies significantly decreased. Thus, the appreciation trend that emerged in the second half of March strengthened in April-July.

These allowed the NBU to continue purchasing foreign currency from the market to replenish international reserves and to smooth exchange rate volatility. Overall, NBU's FX purchases amounted to over USD 1.4 billion in Q2 2016 (FX sales operations were not carried out over the period). Such NBU actions did not counteract a gradual appreciation of the exchange rate triggered by fundamental factors. The exchange rate of the hryvnia to the US dollar appreciated by 5.2% in Q2 2016.

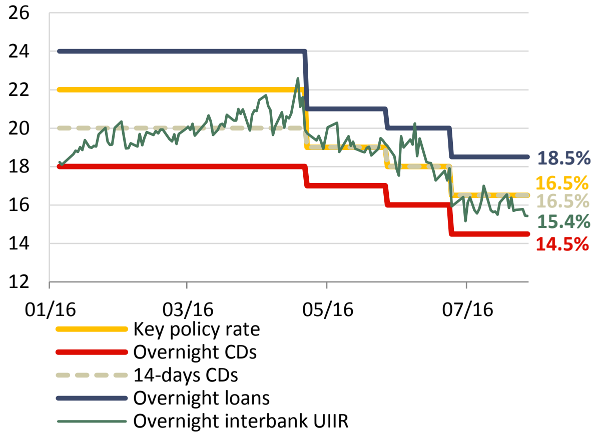
Despite the hryvnia strengthening during Q2 2016, MTP currencies appreciated even faster. As a result, NEER of the hryvnia depreciated (on average by 2.9% q-o-q). Despite a steady slowdown, consumer inflation in Ukraine remained higher than in MTP countries, primarily due to the further adjustment of administratively regulated prices and tariffs to their cost-covering levels. Thus, the REER of the hryvnia remained virtually unchanged in Q2 2016.

The Official Hryvnia Exchange Rate, as of 27 July 2016



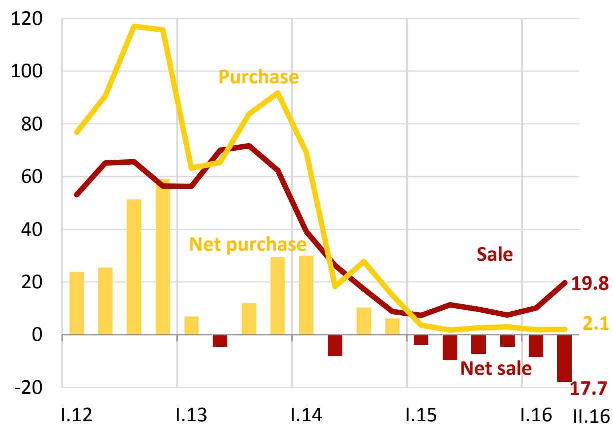
Source: NBU

NBU's Policy Rates and UIIR (as of 27.07.2016), % pa



Source: NBU

Daily Average Amounts of Cash FX Purchased/Sold by Households, USD million



Source: NBU

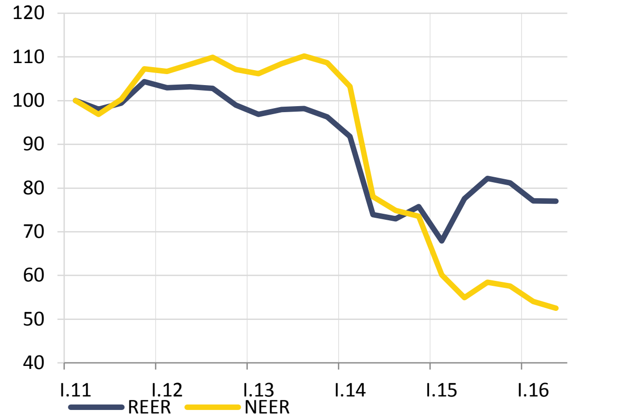
Base Money and Liquidity

In Q2 2016, the Ukrainian banking system continued to have a liquidity surplus, which, however, slightly narrowed compared to the previous period. It was due to the reduction of the average daily balances on the NBU CDs in view of more active liquidity absorption through other channels.

By the end of June, banks' correspondent account balances with the NBU grew by 14.7% from the end of March, while their average daily balances have almost not changed in Q2 2016 compared with Q1 2016.

Net NBU FX purchases (equivalent to UAH 36.4 billion) were the main contributor to the growth of banks' correspondent account balances in Q2 2016. DGF operations were another source of.[36]

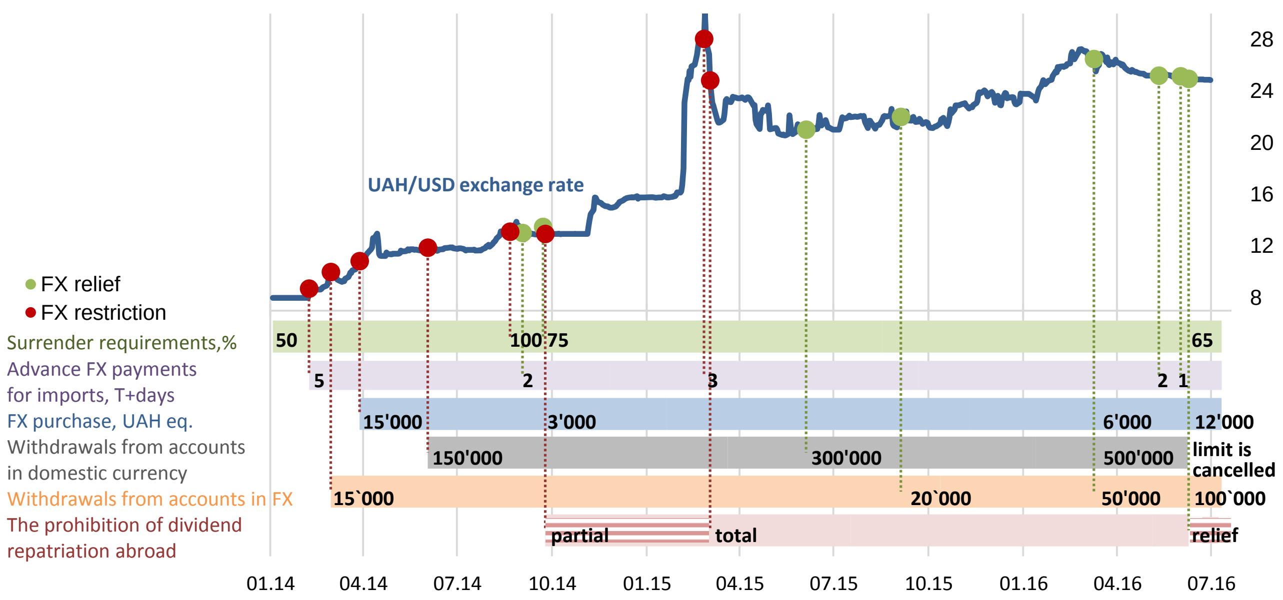
Hryvnia REER and NEER Indexes (Based on Interbank Exchange Rate, I.2011=100, average)



** preliminary data*
Source: IFS; NBU staff estimates

In view of favorable FX market developments, in Q2 2016 the NBU continued relaxing administrative restrictio n introduced earlier.[32]
In particular, the NBU:
- eased surrender requirements for certain foreign currency loans received from abroad;
- exempted funds intended for investments projects in Ukraine from surrender requirements;
- shortened the provisioning period for banks to deposit funds in hryvnia required to purchase foreign currency upon clients' instructions;
- lifted a ban on FX purchases to settle bills for goods imported to Ukraine under certain foreign trade contracts;[33]
- eased surrender requirements for FX proceeds of legal entities;
- doubled the maximum amount of FX cash and banking metals that banks are allowed to sell to an individual per day;
- increased the maximum amount of FX cash and banking metals withdrawals per day;
- cancelled all restrictions for withdrawal of funds in domestic currency;
- allowed the repatriation of dividends, accrued in 2014 and 2015;[34]
- streamlined procedures for carrying out foreign exchange operations.[35]

Relaxation of Select Anti-Crisis Measures Taken to Stabilize Situation in the Money and FX Markets



[32] More detailed information is posted at the link: http://www.bank.gov.ua/document/download?docId=30432157.
[33] More detailed information is posted at the link: http://www.bank.gov.ua/document/download?docId=30770962.
[34] More detailed information is posted at the link: http://www.bank.gov.ua/document/download?docId=32236400.
[35] More detailed information is posted at the link: http://www.bank.gov.ua/document/download?docId=31580124.
[36] During Q2 2016, the DGF transferred UAH 3.1 billion to banks' counterparties for further payments to depositors of banks in liquidation.

In Q2 2016, excess liquidity was partially absorbed through higher cash holdings (up by UAH 19.6 billion). The strengthening of demand for cash was the result of the appreciation trend of the domestic currency and a steady reduction in inflationary pressures. Also, a decrease in the banking system liquidity was caused by government operations (the net impact of which was estimated at UAH 17.9 billion[37]) and repayment of previously granted refinancing loans (net volumes stood at UAH 12.5 billion). These operations resulted in a lower demand for NBU CDs, the average daily balances of which declined by 15.5% q-o-q in Q2 2016, but still were twice as high as in the respective period of the previous year.

The increase in banks' correspondent account balances as of the end of the quarter along with higher cash holdings, have contributed to the expansion of the monetary base by 7.8% q-o-q in Q2 2016. Its growth in annual terms has resumed as well to 6.7%.

Money Supply and its Components

The money market has shown signs of a gradual restoring of confidence in the banking system. Continued inflows of domestic currency deposits were among such signals. Furthermore, in June an inflow of corporate sector deposits in foreign currency (denominated in US Dollar) resumed.

During Q2 2016, domestic currency deposits held by both the households and non-financial corporations recorded m-o-m growth. Their overall volume has increased by 6% q-o-q. In the annual terms, its growth accelerated to 12.5% in June compared with 10.2% in March.

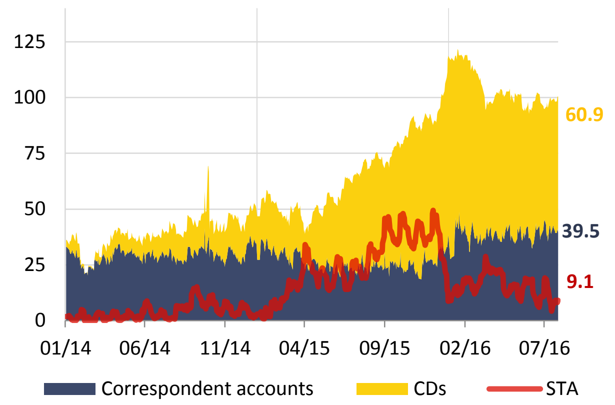
The stock of FX deposits (denominated in USD) has shown positive dynamics. In particular, in June deposits held by non-financial corporations resumed growth (by 6.5% m-o-m). Furthermore, the stock of households' deposits remained almost unchanged for a prolonged period. This contributed to the increase in the total stock of FX deposits (denominated in USD) by 2.1% q-o-q in Q2 2016. In the annual terms, their outflows slowed down to 11.4%in June 2016 compared with 19.0% in March.

A gradual recovery in deposit inflows to the banking system has correspondingly affected the dynamics of the money supply. The pace of its growth in annual terms has accelerated to 6.2% as of the end of Q2 2016 (compared with a 1.7% decline as of the end of Q1 2016).

Loans

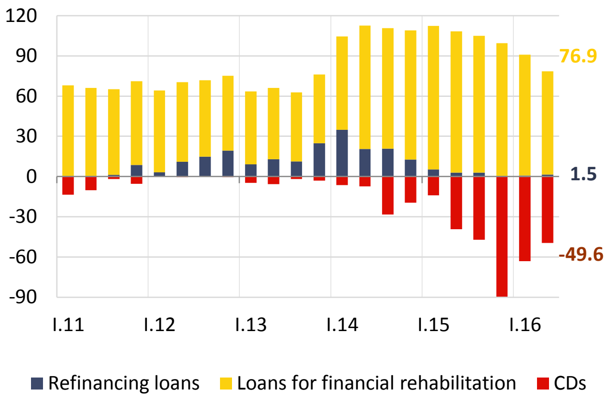
Given a gradual softening of lending standards both for corporate borrowers and households, signs of certain revival in demand for some types of bank loan products were observed. However, lending activity of banks remained weak during Q2 2016.

Select Indicators of Banking System Liquidity (as of 27.07.2016), UAH bn



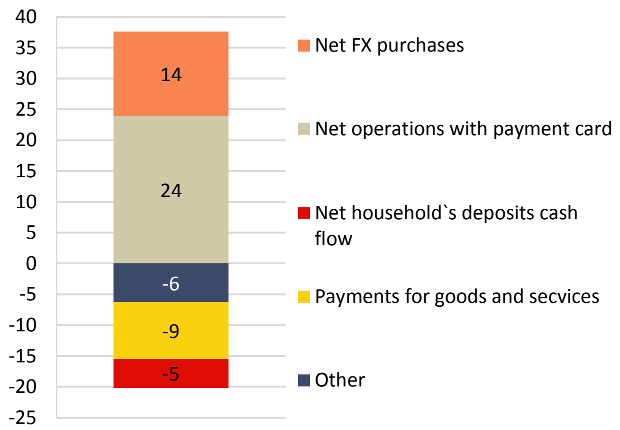
Source: NBU

Banking System Liquidity by Type of Operation, Stock, UAH bn



Source: NBU

Channels of M0 Issuance/Withdrawal, Q2 2016 compared withQ2 2015, UAH bn



Source: NBU

[37] The impact of fiscal factors on the growth of liquidity of the banking system was calculated based on changes in balances on the Single Treasury Account at the NBU (declined by UAH 3.1 billion in Q2 2016), government debt service payments for bonds in the NBU portfolio (UAH 25.9 billion) and conversion by the Treasury of funds in foreign currency (almost UAH 5 billion).

According to the *Lending Survey*[38], in Q1 2016, for the first time in the last two years, the lending conditions for the corporate sector have improved, and 20% of the respondent banks noted definite softening of the standards for consumer lending to households. In addition, in Q2 2016, banks' assessment of the demand for loans from both the corporate sector and households continued to grow. That was reported by 45% and 47% of the respondent banks, respectively.

As of the end of Q2 2016 the total volume of domestic and FX (denominated in USD) loans remained virtually unchanged compared to the end of the previous quarter. However, due to the lower comparison base their decrease in annual terms as of the end of June 2016 slowed down to 13.3% and 17.2%, respectively.

Weak bank lending activity was attributed to high credit rates, high credit risks, and further increase in non-performing loans. Thus, the share of past due loans (excluding insolvent banks) increased from 22.1% as of the beginning of the year to 24.1% as of 1 July 2016.

In order to ensure proper and timely assessment of the credit risks by banks, the NBU in late June changed credit risk assessment approaches.[39] The new methodology is based on Basel principles of banking supervision and combines both clear detailed rules and general principles for credit risk assessment.

Interest Rates

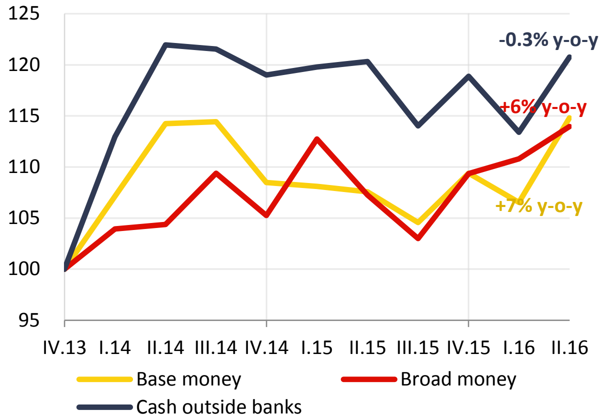
A steady reduction in inflationary pressure amid improved inflation expectations and the favorable FX market developments have enabled the NBU to continue gradual easing of its monetary policy. Effective on 27 May 2016, the key policy rate was reduced to 18%,[40] on 24 June 2016 - to 16.5%[41], and on 29 July 2016 - to 15.5%.

A coherent easing of monetary policy by the NBU, as well as the buildup of market participants' expectations of further easing, if it is consistent with reaching the inflation targets, contributed to a reduction in the interest rates for domestic currency funds in the interbank market (to 17.6% in June). Also since May, average weighted interest rates on new hryvnia deposits have started to decline.

Given the accumulation of sufficient amounts of foreign currency funds by banks and a steady trend towards the hryvnia exchange rate appreciation, the rates on new FX deposits have decreased as well.

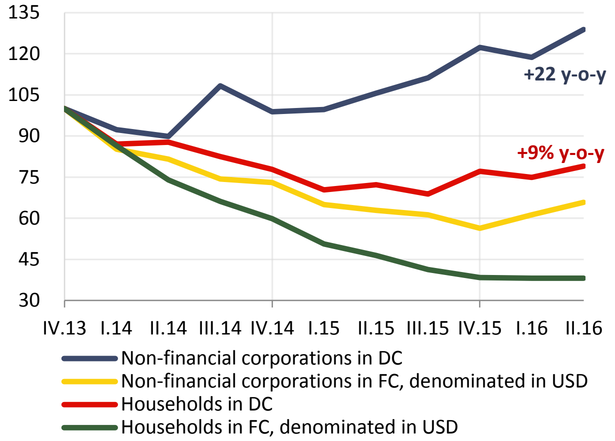
Instead, the average weighted interest rates on new loans showed a slight increase at the end of Q2 2016 compared with the end of Q1 2016. This reflected banks' response to a gradual revival of demand for loans from the corporate sector as well as households.

Monetary Indicators, IV.2013=100



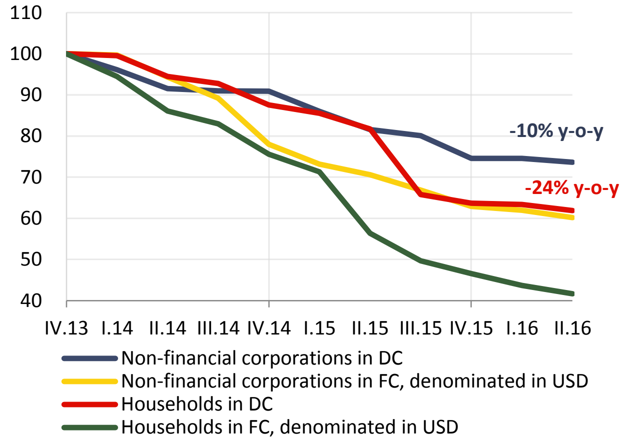
Source: NBU

Deposits, IV.2013=100



Source: NBU

Loans, IV.2013=100

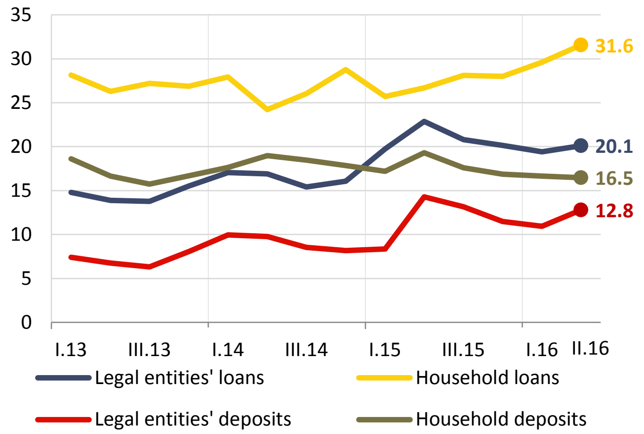


Source: NBU

[38] Survey of banks is carried out by the NBU on a quarterly basis. Detailed information on the survey results is posted at the link: http://www.bank.gov.ua/doccatalog/document?id=30391036.
[39] A new methodology will be applied in test mode since 1 September 2016. More detailed information is posted at the address: http://www.bank.gov.ua/document/download?docId=33378802.
[40] More detailed information is posted at the link: http://www.bank.gov.ua/control/uk/publish/article?art_id=31627402&cat_id=55838.
[41] More detailed information is posted at the link: http://www.bank.gov.ua/control/uk/publish/article?art_id=32898568&cat_id=72996.

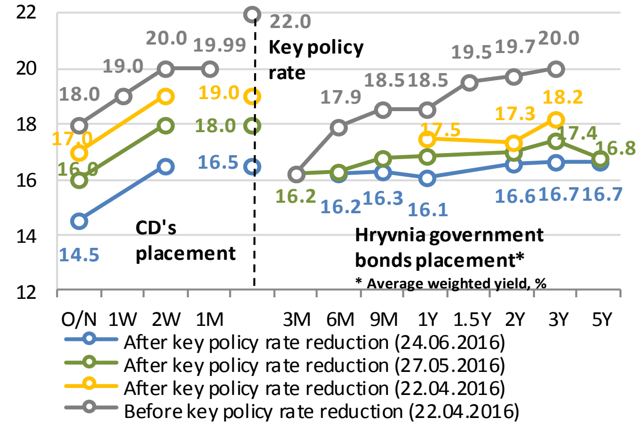
Assigning the discount rate the status of the key monetary policy rate with the simultaneous implementation of a symmetrical and fixed corridor of interest rates on standing facilities, contributed to limited fluctuations of short-term interest rates in the interbank market and the development of a yield curve in cooperation with the Ministry of Finance. Along with the NBU reducing the key policy rate, it has enabled the Ministry of Finance to lower the yields on the hryvnia government bonds with 1 to 3 year maturities.

Average Weighted Interest Rates on New Hryvnia Loans (excl. overdrafts) and Deposits, % pa



Source: NBU

The Yield Curve on NBU's and Ministry of Finance Operations in 2016 (as of 27.07.2016), % pa



Source: NBU

Hryvnia Exchange Rate Volatility

The floating exchange rate regime for the hryvnia is one of the basic principles of the NBU monetary policy.

Ukraine is a small open economy. Thus, it is a price-taker in the global market rather than a price-setter. A flexible exchange rate has to play the role of a "buffer" against external shocks in such economy. For example, as demand for Ukrainian goods decreases in foreign markets, the hryvnia ought to depreciate to ensure price competitiveness of domestic goods and to maintain market shares by the enterprises and, respectively, to save jobs. Conversely, as a result of a positive external shock, when the growing external demand threatens to overheat the economy, the appreciation of the hryvnia restrains inflation.

Slight exchange rate volatility contributes to adequate exchange rate risk perceptions by firms and households. Accordingly, they make more cautious investment decisions or borrowing in foreign currency.

At the same time, the highly volatile exchange rate has a negative impact on investment decision-making, foreign economic transactions and financial stability. Furthermore, significant exchange rate fluctuations distort the pricing mechanism. Accordingly, it becomes more difficult for the central bank to reach inflation targets.

In the view of this, one of the tasks of the NBU FX interventions is to smooth excessive volatility in FX market.

The experience of other central banks that moved to inflation targeting suggests that volatility increased during the initial stages of the regime functioning. It appears quite logical, since most such counties abandoned a fixed exchange rate regime to switch to inflation targeting. However, this volatility has been reduced over time. The reason for this is that inflation targeting is a transparent and predictable monetary regime, which aim is to mitigate the impact of unpredictable shocks. Besides, FX market becomes more liquid and widens under the floating exchange rate. It enhances its self-adjustment ability.

Among inflation targeting countries, the volatility of the domestic currency stays in the range of 2 - 15%. Higher volatility, however, was temporarily observed during crisis periods (see chart).[42] Furthermore, deviations from the typical range may be attributed to the central banks' use of unconventional monetary tools. In particular, in recent years low volatility of the Czech koruna was the result of the Czech National Bank using the exchange rate as an additional monetary instrument to reach inflation targets. Thus, the Bank prevents the koruna from appreciating beyond CZK 27 per EUR, otherwise allowing it to fluctuate freely.

With regard to Ukraine, the volatility of the hryvnia against the USD was close to zero under the de-facto fixed exchange rate regime, except for periods of exchange rate adjustments (in 2005, 2008, and 2014). Those adjustments were the consequence of accumulated large macroeconomic imbalances. Noteworthy, the volatility of the hryvnia exchange rate in these periods was significantly higher than the corresponding indicators in the countries with a floating exchange rate. Fluctuations of the hryvnia exchange rate against other currencies reflected their volatility against the USD.

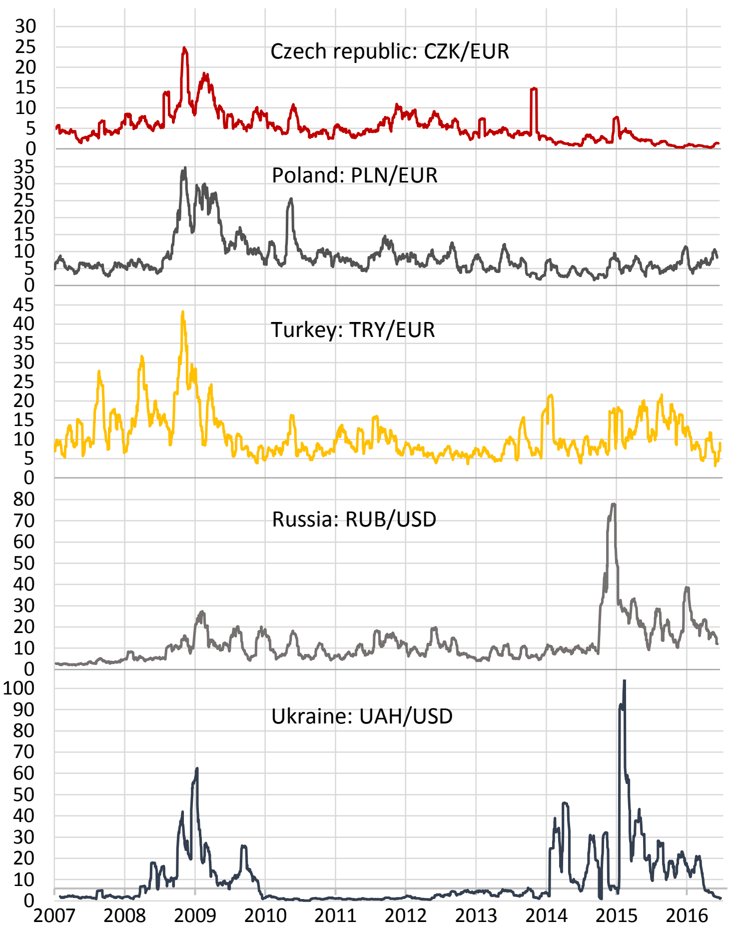
Since the transition to the flexible exchange rate regime in 2014, the hryvnia volatility was caused by external and internal factors. In particular, the surge in volatility of the exchange rate in early 2015 was caused by the coincidence of several negative factors (escalation of military conflict, rapid decline of global commodity prices, and trade restrictions imposed by Russia).

Further NBU policies contributed to reduction in the exchange rate volatility; however, its periodic surges were driven mostly by significant fluctuations in commodity prices and demand in the global markets and periods of exacerbation of the political situation.

Obviously, the overall economic development is essential to limit the volatility. Since March 2016 export receipts have increased under favorable conditions in the global commodity markets. In such circumstances the NBU bought foreign currency to replenish international reserves and to smooth exchange rate volatility. Hence, this indicator has been decreasing since April. It is important that the NBU followed a flexible exchange rate regime and did not counteract the fundamental trend towards exchange rate appreciation, and thus contributed to the continued decline of inflation.

Further implementation of the inflation targeting regime in Ukraine, following the experience of other countries, on the one hand, would halt a convergence of the volatility index to a zero. On the other hand, it would contribute to the moderating intensity of exchange rate surges in case of adverse domestic or external shocks. Furthermore, the deepened FX market will have positive effect and will limit excessive exchange rate volatility. The NBU`s steps are inter alia directed to gradual relaxation of FX restrictions.

Monthly Volatility of Select Currency Pairs, %



Source: ECB; CBRF; NBU staff estimates

[42] The moving average quadratic deviation of the daily changes of the exchange rate for the last month was used for the estimation of volatility.

3. PROSPECTS FOR THE DEVELOPMENT OF THE ECONOMIC SITUATION IN UKRAINE

3.1. ASSUMPTIONS OF THE FORECAST

In 2016-2017, we continue to expect the acceleration of economic growth in MTP countries, albeit at a slightly lower pace compared with the previous forecast. The major factor behind the downward revision of external assumptions was the referendum results in Great Britain. This has led to uncertainty in the global economy in the short and medium term, especially regarding the economies of Great Britain and, to a lesser extent, the EU. Additional exogenous factors of influence on the global economy will be a weaker than expected response of global trade to the positive dynamics of commodity prices and investors risk aversion reducing the mobility of capital flows.

Thus, Britain's economic growth will decelerate as a result of lower investment attractiveness due to uncertainty and, respectively, the increased risk premium (ratings have already been downgraded), as well as a substantial current account deficit. At the same time, loose Bank of England monetary policy will continue to stimulate the economy of the country.

The influence of the Brexit on the economy of the Eurozone will be slightly smaller in comparison to Great Britain due to the lack of necessity to change the trade relations with the rest of the world, unlike Great Britain. However, additional factors that adversely impact the Eurozone will continue to be low inflation, financial imbalances, and massive discontent with the actions of the government in some countries (due to labor reform in France, pension and tax reform in Greece, etc.). The ECB policy will also continue to stimulate the economy of the Eurozone.

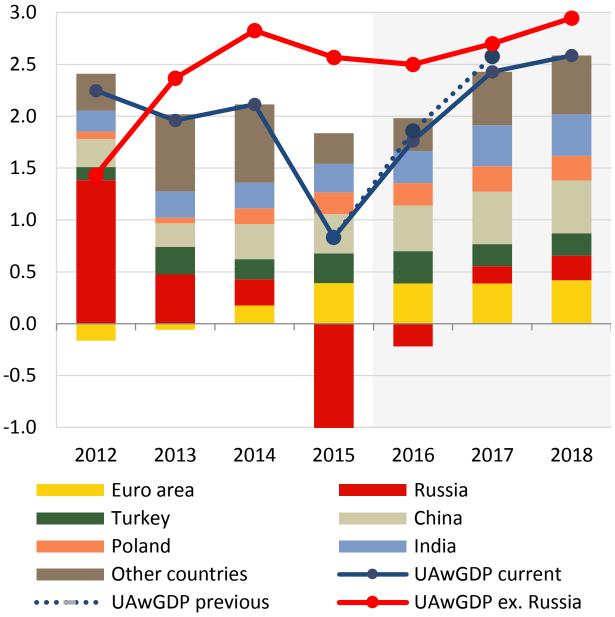
Excluding the Eurozone and Great Britain, the economic activity of Ukraine's MTP countries (expressed by the UAwGDP index) will continue to be weak in 2016 and, despite the impact of the Brexit, will gradually improve during 2017-2018. In particular:

– the upward trend in oil prices and stabilization of the exchange rate of the ruble against the US dollar will contribute to a slowdown of Russia's GDP decline the with the subsequent recovery in economic activity. However, the positive effect of such dynamics for Ukraine will be minimal in view of the existing trade restrictions. At the same time, a stronger Russian economy will have a positive effect on some of the CIS countries, such as Kazakhstan and Belarus. This will be indirectly reflected in improved external situation for Ukrainian producers as well;

– economic growth in the CEE countries will slightly slow in 2016 due to adverse external conditions, as well as a sharp slowdown in financing from the EU development funds. The latter against the background of the expected activation of the process of exit of Great Britain from the EU will have a negative impact in 2017;

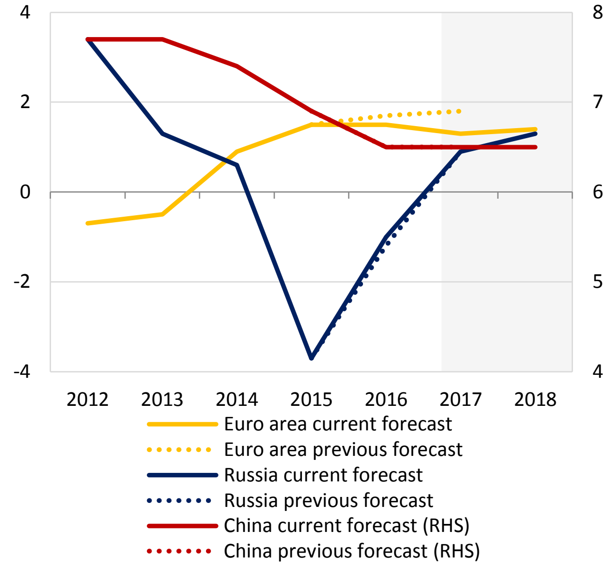
– China will continue the process of economic transformation, which has already had a significant impact on its business activity: this year the country will lag behind India in terms of economic growth. However, stimulative monetary and fiscal policies announced by the government should support the economy in the short term. Taking into consideration the high growth rates of the corporate sector lending and debt, China's economy has become increasingly vulnerable to negative shocks;

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



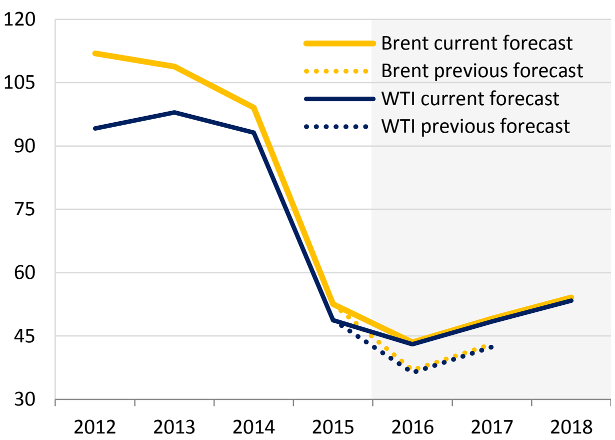
Source: NBU staff estimates (preliminary data)

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



Source: NBU staff estimates

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



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

– India and Turkey will continue to grow at a steady pace driven by increases in domestic consumption. At the same time, risks of economic slowdown have risen in Turkey taking into account the attempted military coup and downgraded sovereign ratings;

– the economy of the United States will continue to experience modest growth, although at a slower pace compared to the previous years. The main reasons for this include: low rates of labor productivity growth, increased income disparities across different strata of the population and poor exports (as a result of restrained external demand, low oil prices, and the strong dollar). At the same time, improvement in the labor market and the recovery of investment activity will lead to a slight revival of the economy of United States during 2017-2018.

In global commodity markets, the expected level of prices will remain higher compared with the previous forecast due to rapid increases in prices in April-May and despite a correction in June.

Till the end of 2016 and during 2017, a trend is expected towards balancing demand and supply in the global oil market. Thus, the demand for oil in 2016 will increase by 1.1 million barrels per day - to 93 million barrels per day, compared with the previous year and would support prices. Meanwhile, a large part of this increase will be attributed India. Oil production outside of OPEC[43] countries (such as in Canada, Brazil, and Colombia) will decrease in 2016 by 1.3% y-o-y to 56.4 million barrels per day. Along with this, higher oil prices will prompt further recovery of the shale sector in the United States, as well as oil production in Great Britain, Russia, and Azerbaijan. At the same time, one of the main factors influencing oil prices could become a long-lasting exit of Great Britain from the EU that will raise pressure on demand. According to NBU estimates, oil prices in the second half of 2016 will remain in the range of 45 to 50 USD/barrel and will trade between 47 to 55 USD/barrel in 2017 and 2018.

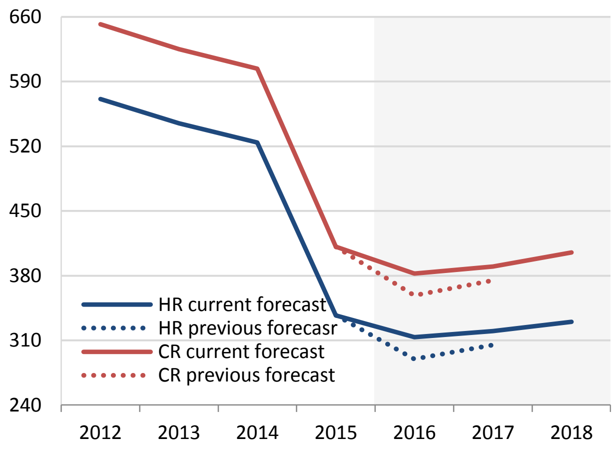
In the medium term, the dynamics of steel prices will continue to depend on the policy of leading producers (China, Japan, India, USA, Turkey). Despite measures aimed at reducing steel overproduction in China, the volume of supply in the market will remain rather high. However, higher demand from India, as well as the active implementation of anti-dumping duties by some countries will keep prices from declining further. As a result, steel prices in 2016 will stabilize at a higher level, compared with the previous forecast. The gradual recovery of the global economy in 2017 and 2018 will provide additional support to steel prices.

The forecast of world production of grain crops in the 2016 and 2017 marketing years has been significantly improved. According to the forecast of the International Grain Council (from 12 July 2016) the global crop could become the second highest in terms of production volumes in history. In particular, expectations for the wheat crop have been raised to 739 million tons (mostly due to the USA, EU, and Russia). Corn production volumes for the first time will exceed 1 billion tons (mainly due to favorable weather conditions in the USA and Argentina). Although the consumption of grain crops is expected to grow as well, reaching a new world record, the high crop and significant stocks will restrain the increase in the global prices for grain crops.

Under such conditions the external price environment for Ukrainian exporters will also gradually improve.

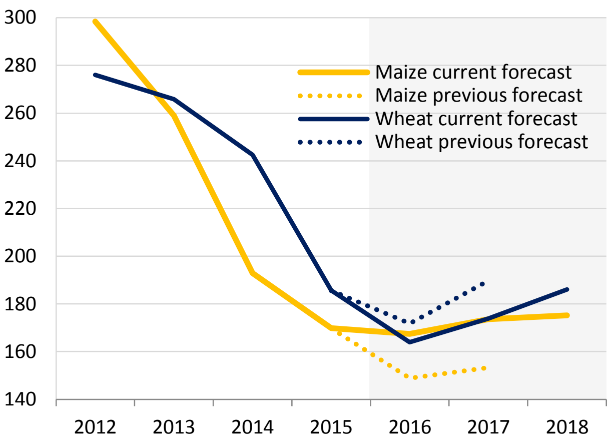
[43] According to the OPEC estimates.

Average Emerging Markets Steel Prices, USD/MT



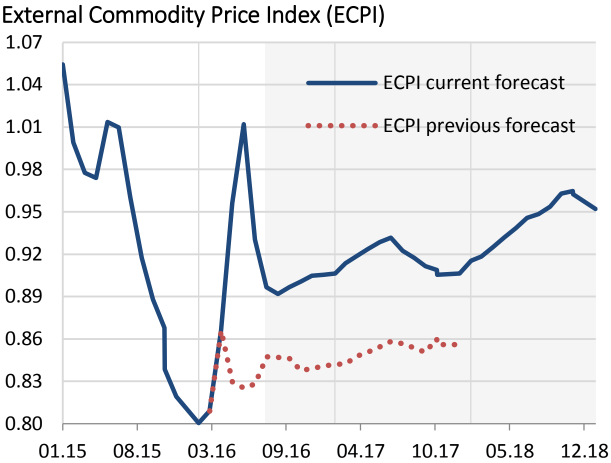
Source: NBU staff estimates, based on Steel Insight

World Cereal Prices, USD/MT, annual average



Source: NBU staff estimates, based on IMF

External Commodity Price Index (ECPI)



Source: NBU staff estimates

	CPI, change as of the end of period, %			GDP, annual change, %			Exchange rates*		Commodity Prices**, USD			
	Euro area	Russia	USA	Euro area	Russia	USA	USD/EUR	RUB/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	481.5	201.2
2015	0.2	12.9	0.7	1.6	-3.7	2.4	1.11	61.0	274.0	52.5	336.1	166.9
2016	0.1	6.8	1.4	1.5	-1.0	2.0	1.10	68.9	202.3	43.5	283.3	159.4
2017	1.1	5.0	1.9	1.3	0.9	2.1	1.09	67.5	228.6	49.1	293.1	168.3
2018	1.4	4.0	2.0	1.4	1.3	2.3	1.12	67.5	259.6	54.1	304.6	175.1
annual change, %												
2015							*-16.5*	*59.1*	*-6.3*	*-47.0*	*-30.2*	*-17.1*
2016							*-0.7*	*13.1*	*-26.2*	*-17.1*	*-15.7*	*-4.5*
2017							*-0.7*	*-2.1*	*13.0*	*12.8*	*3.5*	*5.6*
2018							*2.7*	*0.0*	*13.6*	*10.2*	*3.9*	*4.0*

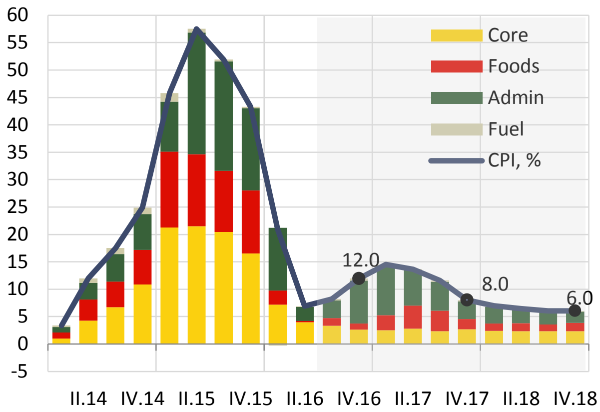
** Average for the year.*

*** Average weighted by volume, excluding oil*

3.2. PRICES

The inflation forecast remains unchanged, in line with inflation targets of 12% for the end of 2016, 8% for the end of 2017, and 6% for the end of 2018. In H2 2016, higher than expected growth of the administratively regulated prices will be compensated by a faster slowdown in price growth for other consumer basket components: core and raw foods. Raw food inflation will be restrained by supply factors – although we continue to consider them temporary, their influence should continue till the end of the year, and domestic food prices should mostly adjust upwards next year. Core inflation will fall faster helped by the secondary effects from a deceleration in raw food inflation, a slowdown in imported inflation given lower hryvnia exchange rate volatility, and improving inflation expectations.

Contribution to Annual Growth of CPI, p.p.



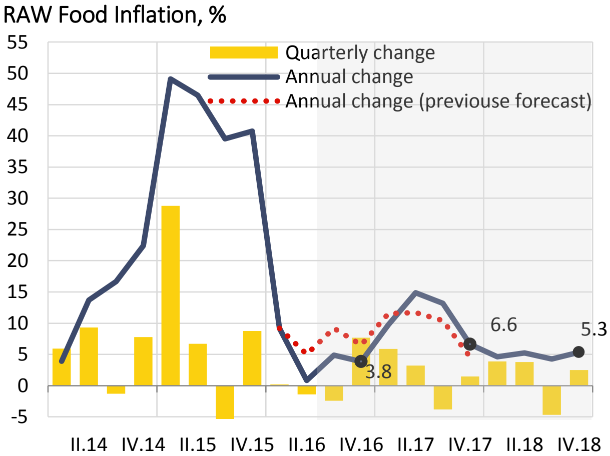
Source: SSSU; NBU staff estimates

Higher supply of food products on the domestic market amid weakening global prices in H1 2016 led to a considerably lower trajectory of raw food prices in Q2 2016 than it was expected in the previous forecast. Supply of food products continued to be affected by a shift in trade flows from other countries (in particular, Turkey) due to the trade bans imposed by Russia, as well as by difficulties faced by some Ukrainian exporters of food products to Middle Eastern countries.

Most of these factors are considered temporary, but the main effect of eliminating them, which will lead to an upward price adjustment in the domestic food market, will not be implemented in full by the end of the current year, and will partly affect prices next year.

Thus, raw food inflation forecast for 2016 has been reduced to 3.8% (from 6.5% in the previous forecast), but has been upgraded to 6.6% (from 4.6%) for 2017, also due to a recovery in global food prices.

RAW Food Inflation, %



Source: SSSU; NBU staff estimates

In the previous two years, core inflation in Ukraine (23% and 35%, respectively) reflected the effect of the rapid hryvnia depreciation and adjustment of the economy to the new environment. In 2016, core inflation declined to single digit reflecting the impact of tighter monetary and fiscal policies, subdued demand, low imported inflation, and a sharp drop in real wages. A faster reduction of core inflation (to 5.5%) than envisaged in the previous forecast (9.1%) is attributed to both the influence of the secondary effects from lower raw food inflation, as well as lower imported inflation on the back of decreasing exchange rate volatility (due to terms of trade improvement) strengthened by falling inflation expectations.

In the medium term, core inflation is expected to reach 5%. The core inflation stabilization at this level will be determined by neutral monetary policy, a return of domestic consumer demand to a sustainable growth trajectory, and an increase in the food inflation. Imported inflation will remain relatively low on the forecast horizon, given a rather low inflation environment expected in the main trading partners (primarily the EU and Russia) and moderate nominal exchange rate volatility. The trend towards the hryvnia real exchange rate strengthening, that is relatively higher domestic prices compared to the rest of the world, will be restrained by slow growth of labor productivity assumed in the baseline scenario.

The growth of fuel prices by 19% in 2016 will be caused primarily by a partial recovery in global oil prices while the pass-through effect to the prices of other goods and services will be limited. In the following years, the growth of fuel prices will reflect global oil prices in the hryvnia equivalent.

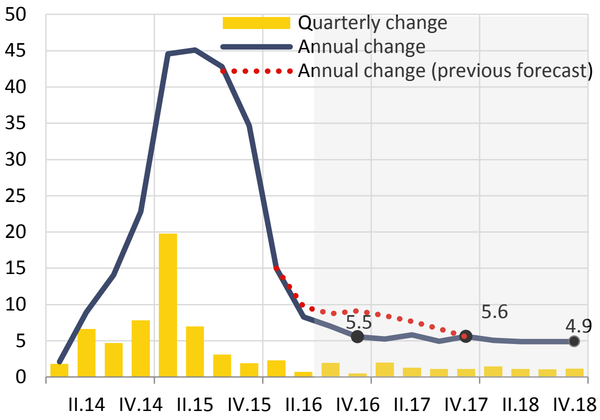
The increase in administered prices for 2016 has been revised upwards to 32% compared with the previous forecast (26%) based on the Government's decisions to set new natural gas tariffs for households without discounts during the forthcoming heating season. At the same time, facing significantly higher natural gas prices for heating companies, the NRCEU (National Regulatory Commission of Energy and Utilities) raised the tariffs for heating and hot water above the projected earlier levels. The announced price increases for cold water in August and for electricity in September have been taken into account in the forecast as well.

The active phase of price competition between the tobacco producers (that according to the NBU estimates has led to lower prices for tobacco products at the end of the last year and the beginning of the current year) is close to its end. This coupled with increasing excise duties on tobacco products will cause prices for these products to increase by 17% in 2016 and 16% next year.

Overall, in H2 2016, the contribution of administered prices to the CPI change is expected at around 4 ppts, which compensates for the projected negative contribution from other CPI components.

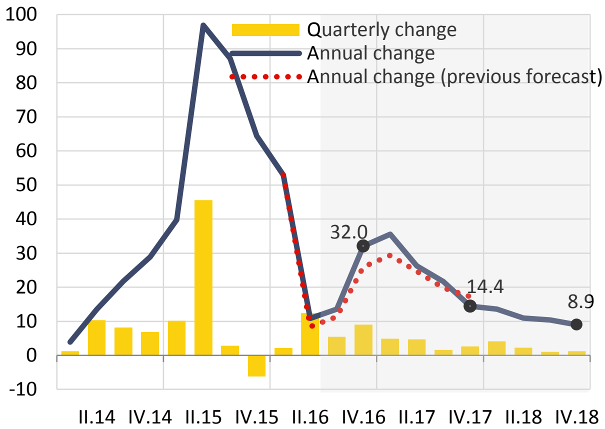
Main utility tariffs will reach their cost levels already this year. Therefore, we revised their forecast for the next year. As a result, the growth of administered prices in 2017 will be 14.4% compared with 17.3% in the previous forecast.

Core Inflation, %



Source: SSSU; NBU staff estimates

Administered Prices, %



Source: SSSU; NBU staff estimates

3.3. THE REAL ECONOMY

The economic growth forecast has remained unchanged: real GDP will increase by 1.1% in 2016, by 3.0% in 2017, accelerating to 4.0% in 2018. The absence of changes in the short-term forecast is explained by mutually offsetting effects of more favorable external conditions, strengthening REER of the hryvnia, and a delayed resumption of cooperation with the IMF.

The rapidly declining inflation and the weakening of depreciation expectations together with rising export prices and a recovery in external demand will stimulate businesses and households to implement deferred investment and consumer decisions. At the same time, more substantial investment growth is expected in comparison with the relatively slow recovery in consumption over the forecast horizon.

The forecast for private consumption growth in 2016 has been revised up to 1.6% (from 1%) due to the improvement of the consumer sentiments in Q2 2016, stronger than projected inflows of remittances, as well as taking into account the actual levels for Q1 2016, which appeared to be better than forecast. At the same time, a substantial increase in utility tariffs will restrain households' consumer spending. Prudent fiscal policy will not be able to provide a strong impetus to private consumption growth in 2016.

In the medium term, due to the realization of deferred demand and rising household income, the growth of private consumption will accelerate to 4.2% in 2017 and to 3.2% in 2018. The lower interest rates will contribute to recovery of lending activity, which will become an additional factor behind further private consumption acceleration.

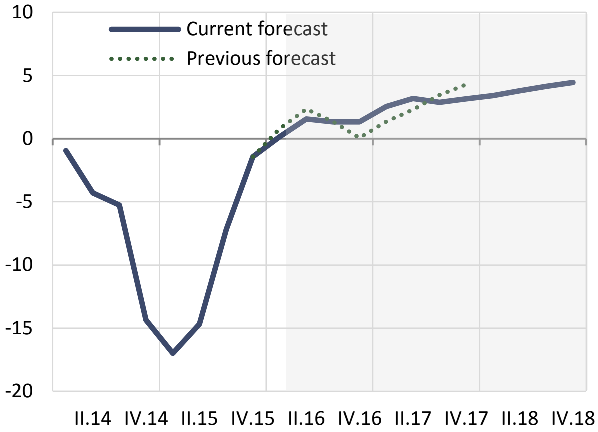
Faster growth rates of investment (6.3% in the current and the next years) compared to the previous forecast are determined by the improved financial results of exporters due to better terms of trade, as well as the need for trade flows reorientation to European markets. This has already been reflected in the growth of investment imports and domestic production of machinery and equipment, strongly evidenced from the investment intentions of the business. At the same time, higher global energy prices and the adjustment of heating and gas tariffs to cost covering levels will encourage the development of energy saving solutions.

The contribution of inventories to GDP growth in 2016 has been revised from positive in the previous forecast to negative number (-0.3 ppts). It reflects expectations of a significant drop in the carry-over stocks of grain crops (driven by a high level of exports in the last marketing year) and a partial reduction in estimates of natural gas reserves in the storages and coal in the warehouses of energy generating enterprises.

The decline in export volumes, according to NBU estimates, will slow down this year to 2.1%, and in the medium term its growth will resume at rates not less than 2% per year, mainly due to the improvement in terms of trade and the recovery of external demand from MTP countries. The export volume growth will be driven both by higher global prices for main exports and the output growth in export-oriented industries (including agriculture) as a result of higher investments.

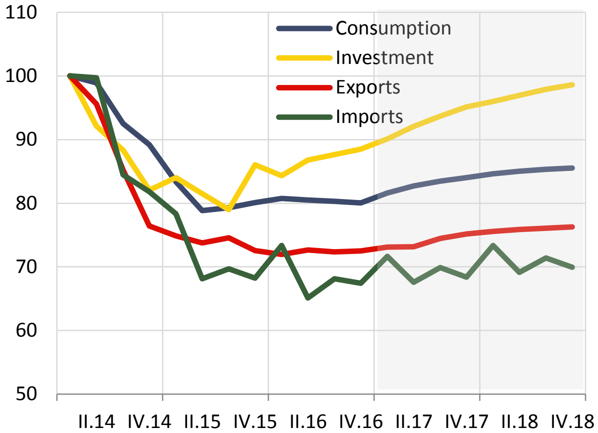
In 2016, we expect a further reduction in energy imports, primarily due to lower gas import volumes. This will be caused by

Real GDP, % y-o-y



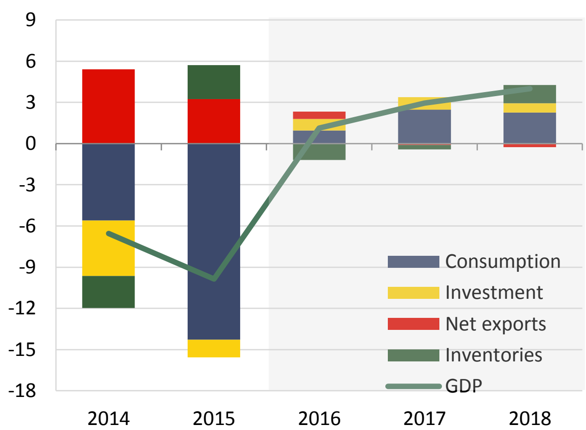
Source: SSSU; NBU staff estimates

Real GDP, I.2014=100



Source: NBU staff estimates

Contributions to Real GDP Growth, p. p.



Source: NBU staff estimates

significantly lower households demand for gas (due to more rapid than previously expected increase in tariffs for gas, centralized heating, and hot water supply) and rather high carry-over stocks in storages after the last heating season. Higher global prices for imported fuels and active implementation of energy efficiency programs will restrain the rise of consumer energy imports on the forecast horizon.

The growth of non-energy imports will be driven mainly by the investment component, further facilitated by the consumer demand recovery. Overall, the volume of imports is estimated to decline by 3% in 2016, and starting from the next year its growth will resume at a rate of over 2% annually.

Fiscal sector

Fiscal policy will remain tight in 2016 (the structural balance of the consolidated budget will be close to zero) with further gradual softening in the forecast horizon. Still high amounts of debt service expenditures (4.5% of GDP) will necessitate a positive primary balance of the consolidated budget in the amount of more than 1.5% of GDP (current estimate – 1.9% of GDP).

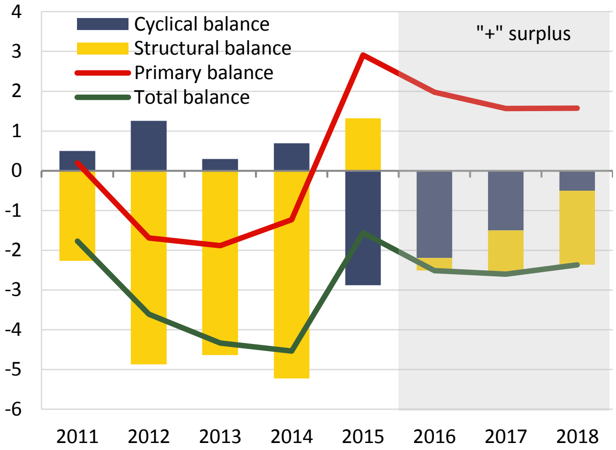
The ratio of consolidated budget revenues to GDP will decrease by 1.4 ppts in 2016 compared with the previous year, largely due to lower NBU profit transfers (1.7% of GDP, compared to 3.1% of GDP last year) and a twofold reduction in proceeds from foreign trade taxes (resulting from cancellation of the import duty surcharge).

The growth of utility subsidies to households that have accelerated significantly this year, as well as larger funds directed from the budget to cover the Pension Fund deficit due to the SSC rate cut will significantly narrow the resources available for development expenditures. Thus, it is expected that capital expenditures will not exceed the previous year level.

Pressure from other quasi-fiscal needs will ease significantly. The rise in utility tariffs to cost covering levels for primary energy will contribute to eliminating the practice of using budget funds to compensate for Naftogaz losses. The completion of the banking sector clean-up will help reduce the quasi-fiscal needs of the banking sector and the Deposit Guarantee Fund.

As a result, according to the NBU estimates, the implementation of such a fiscal policy will keep the consolidated budget deficit within the limits of 2.6% of GDP, and the deficit of the general government sector (excluding Naftogaz and banks recapitalization needs) within 3% of GDP.

Consolidated Budget, % of GDP



Source: NBU staff estimates

3.4. BALANCE OF PAYMENTS

The forecast for the current account deficit has been declined to USD 1.8 bn in 2016. Improvement of the forecast was owing to the reduction of natural gas imports, more favorable terms of trade, increasing expectations for the grain harvest and remittances in Ukraine. At the same time, deficit reduction was restrained by the fact that the NBU eased administrative restrictions on the FX market, in particular, for the dividends repatriation. However, in 2017 the widening of the current account deficit to USD 2.1 bn is expected due to increasing of dividends repatriation.

In 2016 the forecast for net capital inflows under the financial account has been reduced to USD 2.8 bn due to the part of official financing has been postponed to 2017. At the same time, in H1 2016 the higher than expected rates of reduction of FX cash outside banks were observed. This will be partly offset by lower borrowings of NJSC Naftogaz for the natural gas purchases. In 2017 the net borrowings under the financial account has been increased up to USD 3.8 bn due to an additional placement of US-guaranteed Eurobond in the amount of USD 1 bn and a loan from the EU (postponed from 2016).

As a result, in 2016 the overall balance of payments surplus (USD 1.3 bn) along with IMF financing will increase international reserves up to USD 17.2 bn, or 4.3 months of future imports. In the following years, the accumulation of international reserves will continue owing to the overall balance of payments surplus and further disbursements of IMF loans.

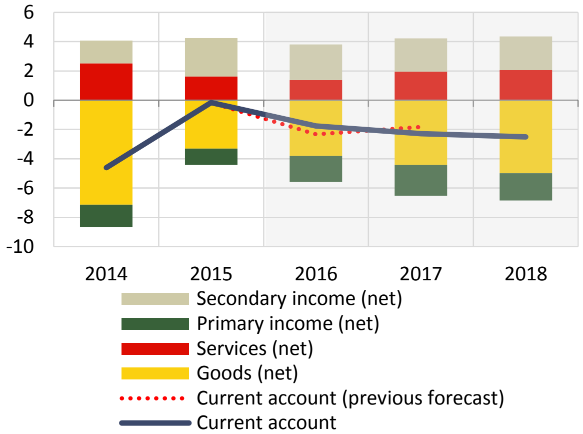
In 2016, the forecast for the current account deficit has been changed to USD 1.8 bn (from USD 2.3 bn in the previous forecast), or to 2.0% of GDP due to reduction in the trade balance deficit and growth of remittances in Ukraine. In 2016 the reduction of merchandise exports rates of decline is expected (to 8.8% compared with 12% in the previous forecast) due to the terms of trade improvement and volumes of exports for main product groups increase. A stronger recovery in exports is restrained by the introduction of additional restrictions on the transit of Ukrainian goods to Kazakhstan and Kyrgyzstan via Russia, effective from 1 July 2016.

The ferrous metals price growth, observed in the first half of Q2, ensured favorable conditions for a gradual domestic production recovery and the ferrous metals exports volumes forecast up to 12.7%. Also, the volumes of grain exports has been increased by 1.7 million tons (to 35.8 million tons) due to the improvement of grains market conditions and rise of the harvest forecast in 2016.

The imports of goods forecast was almost unchanged in 2016: the reduction by 6.8% is expected (in the previous forecast – by 6.9%). Estimated volumes of natural gas imports has been reduced by 1.5 bn m^3 (to 10 bn m^3) and was almost completely offset by an investment imports growth (primarily machinery). As a result, the forecast for non-energy import growth has been increased to 5.5% (from 3.3%).

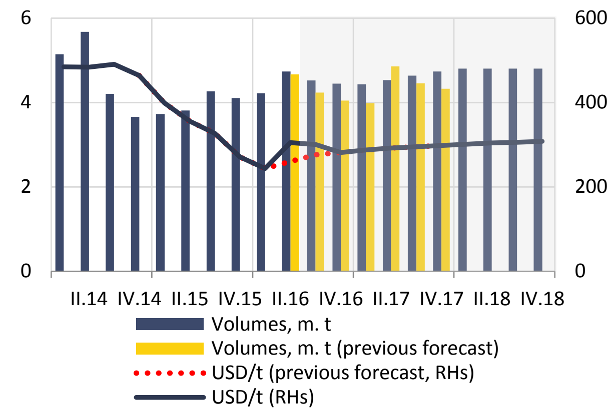
A deceleration of services imports decrease (to 1.1%) is expected along with the non-energy merchandise imports growth in 2016. It will take place both due to increasing of imports under the "Travel" item (as a result of the exchange rate appreciation) and transportation services growth owing to the recovery of economic activity. Services exports forecast remained unchanged.

Current Account, USD bn



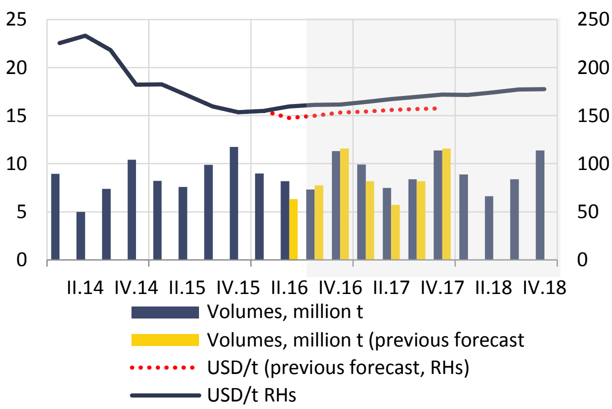
Source: NBU

Ferrous Metals Exports (for the four main sub-groups)



Source: NBU

Grains Exports



Source: NBU

In 2016, the rates of decline of remittances in Ukraine has been reduced to 5.9% (from 18.5% in the previous forecast) due to higher than expected inflows from the EU countries and the USA. At the same time, dividends repatriation is expected to increase due to the administrative restrictions relaxing, provided by the NBU.

In 2017, the forecast for the current account deficit has been increased to USD 2.1 bn, or 2.1% of GDP, due to the expected repatriation of dividends. However, the growth rates of exports and imports of goods and services (both 2.9%) have been reduced compared with the previous forecast (5.7% and 4.2%, respectively) due to a ban on the transit of goods to Kazakhstan and Kyrgyzstan introduced by Russia (that primarily affects the exports of machinery), as well as the introduction of adequate measures in response by the Ukrainian side. Furthermore, the decline in exports was underpinned by the subdued demand in the EU countries and United Kingdom (because of Brexit). In 2017, the increase in remittances from EU countries and the USA is expected to continue.

In 2018, the further widening of the current account deficit (to 2.3% of GDP or USD 2.5 bn) is expected. The growth rates of trade turnover will continue to accelerate: exports of goods and services – to 4.0% and imports – to 4.8% supported by a recovery of external and domestic demand, as well as the terms of trade improvement.

In 2016, the forecast of net inflows under the financial account has been reduced to USD 2.8 bn (compared with USD 3.3 bn in the previous forecast) as a part of official financing was postponed to 2017. At the same time, in Q2 2016 in the private sector the higher rates of reduction of FX cash outside banks was observed. However, lower net borrowings of short-term loans (e.g. NJSC Naftogaz to purchase natural gas) are expected in H2 2016. It would partially offset the underestimation of the net inflows under the financial account in Q2 2016.

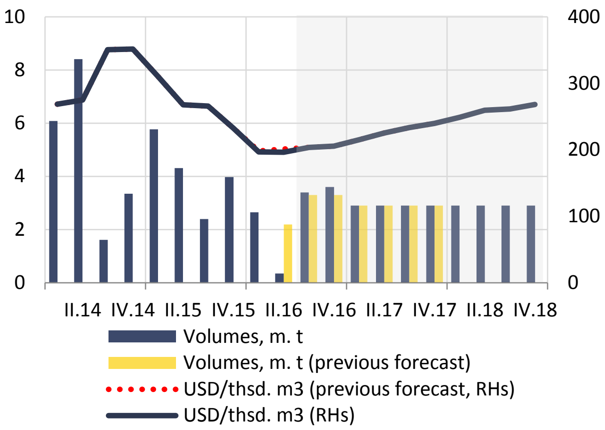
In 2016 the forecast of foreign direct investment inflows has been reduced to USD 2.4 bn (compared with USD 2.7 bn in the previous forecast) due to a decrease of recapitalization of the banking sector. Rollover of the private sector is expected to be almost unchanged at the level of 70%.

In 2016 the official financing inflows has been lowered to USD 5.0 bn (from USD 7.9 bn in the previous forecast) as the last tranche from the IMF and EU loan was postponed to 2017.

In 2017, the net borrowings under the financial account are expected to increase to USD 3.8 bn (compared with USD 3.4 bn in the previous forecast) primarily due to the scheduled issuance of USD 1 bn US-guaranteed Eurobonds. The net borrowings of the private sector will remain almost unchanged compared with 2016. The reduction of FX cash outside banks is expected to end up in 2017, which should be partially offset by an increase in the debt inflows of the private sector and the corresponding growth of rollover up to 100%. Foreign direct investment inflow is expected to decline down to USD 1.6 bn. However, in 2017 FDI will be directed mostly to the real sector, while in 2016 it reflects the debt-to-equity conversion by the banking sector.

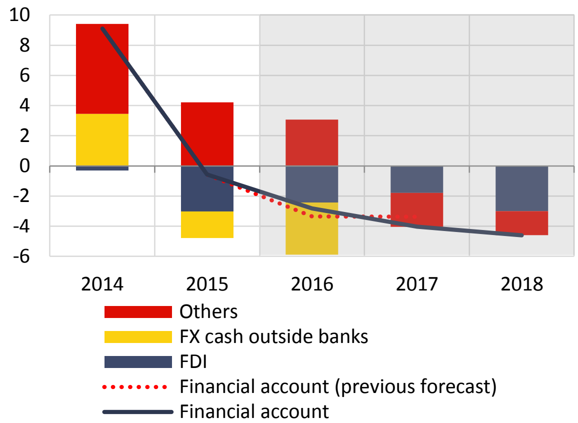
In 2018, the growth of net borrowings under the financial account is estimated up to USD 4.6 bn. It will be underpinned by an increase in the private sector's rollover to 120% and acceleration of foreign direct investment inflows (up to USD 3 bn) owing to the favorable

Natural Gas Imports



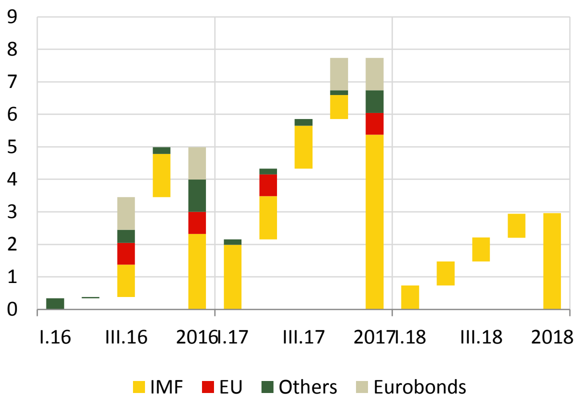
Source: NBU

Financial Account: Net External Assets, USD bn



Source: NBU

Official Financing in 2016 - 2017, USD bn

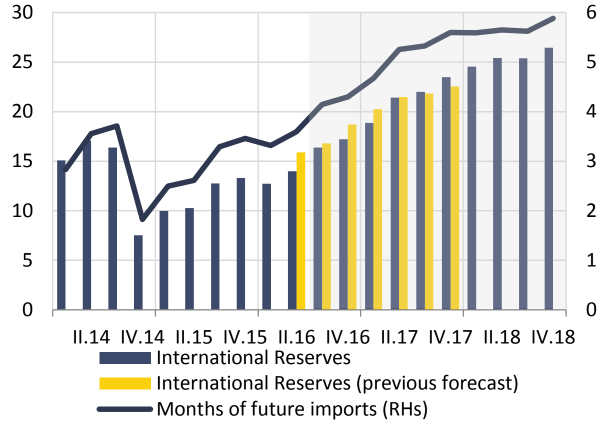


Source: NBU, IMF

investment climate recovery and further reduction of systemic risks in Ukrainian economy.

On the forecast horizon, the accumulation of international reserves is expected – up to USD 17.2 bn as of end-2016 and to USD 26.4 bn as of end-2018. Such a level will approach to the composite IMF reserves adequacy criterion. The corresponding reserves accumulation will take place owing to an overall balance of payments surplus over the next three years, as well as to the IMF disbursments under the EFF program.

International Reserves, USD bn



Source: NBU

3.5. MONETARY SECTOR AND FINANCIAL MARKETS

Over the forecast horizon, money demand is projected to recover owing to decreasing inflation and interest rates, a rebound in economic activity, and restoring confidence in the banking system. In view of declining inflation and depreciation expectations, the growth of both cash and deposit components of the money supply is expected to accelerate in 2016.

The banking system will continue to function under conditions of a sizable liquidity surplus, with the NBU FX purchases to replenish international reserves being one of its main sources.

Restoring confidence in the banking system and recovering economic activity, and thus rising real households' income, will contribute to an ongoing inflow of deposits into banks.

In 2016, money supply and monetary base are forecast to increase by 11% and 8%, respectively. The increase in banks' correspondent accounts will remain the major factor behind monetary base growth.

Given banking system liquidity surplus, the main NBU tool of its management will be operations with CDs.

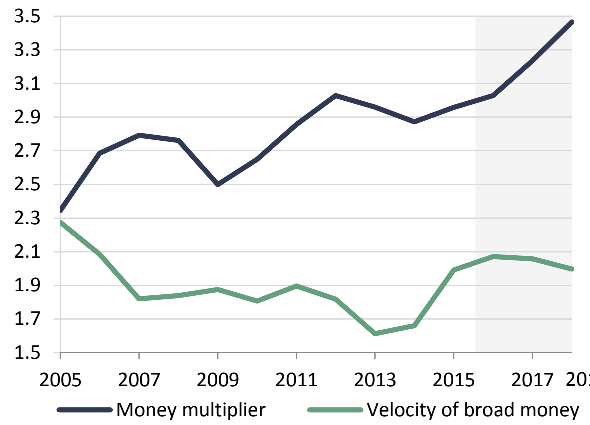
The NBU FX purchases to replenish international reserves will remain the main source of liquidity provision to the banking system. Instead, government debt service payments for bonds in the NBU portfolio will be a major contributor to liquidity absorption.

Reflecting the liquidity surplus in the banking system, banks will conduct repayments of previously granted refinancing loans. Given further alleviation of risks to the macroeconomic environment and, to price stability as well, the NBU will continue easing its monetary policy. Hence, a gradual pass through on market interest rates is projected.

The trend towards greater stability in the monetary sphere is expected to continue during 2017 and 2018. A further inflation slowdown and a pick-up in economic growth should contribute to strengthening money demand with a simultaneous decrease in the cost of funds.

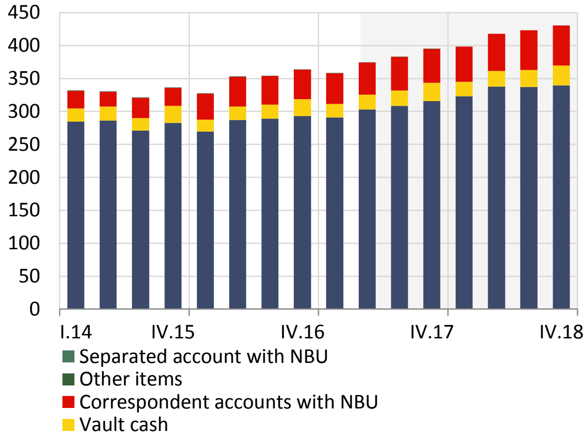
The growth of the money supply in 2017 and 2018 (by 16% and 17%, respectively) is expected to be driven by both deposit and cash components. The development of the banking system and the subsequent replacement of cash payments by non-cash transactions will determine, in particular, the further upward trend of money multiplication. Under such conditions, monetary base is forecast to grow at slightly lower paces (about 9%).

Money Multiplier and Velocity of Broad Money



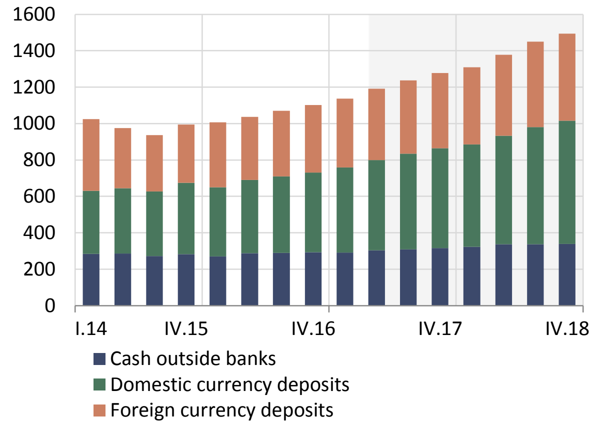
Source: NBU

Base Money by Components, UAH bn



Source: NBU

Money Supply by Components, UAH bn



Source: NBU

3.6. RISKS OF THE FORECAST

Possible escalation of hostilities in the East of Ukraine, falling global commodity prices, lower external support in the case of slow reform progress, as well as complete ban of Ukrainian exports through the territory of Russia remain the main negative risks to the economic growth forecast.

There is a probability that poor privatization campaign may cause investors to adopt a cautious attitude towards the economic outlook and will provide early warning of the reforms slowdown.

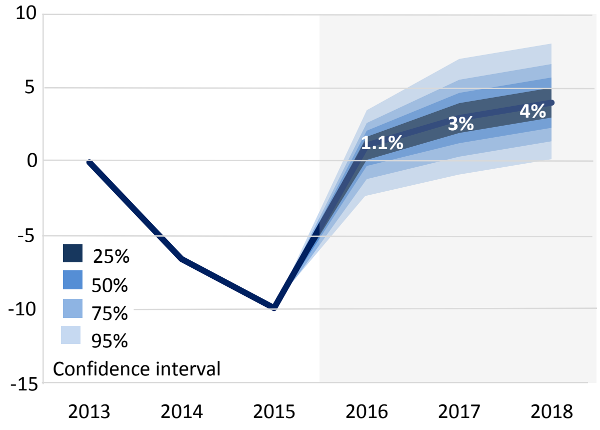
The potential rise of political tension, intensified by difficulties in overcoming the economic crisis, will limit the ability of the Government to implement urgent but unpopular reforms, thereby further reducing the investment potential of the economy. Intensified political tensions will worsen inflation and exchange rate expectations as well, thereby strengthening inflationary pressure and causing the NBU to maintain tight monetary policy in order to mitigate inflation risks.

A further decline in global demand against the background of a possible failure of stimulus measures in the leading countries will cause a worsening of the situation in global commodity markets. For the Ukrainian economy this would imply a slowdown in economic activity and a drop in export revenues. Given the fact that these factors will put countervailing pressure on prices the response of the monetary authorities will be determined by the balance of these factors.

The scenario of fast growth of global commodity prices, a further growth of demand for Ukrainian products, and acceleration of reforms are considered as "positive shocks." Under such conditions, acceleration of economic activity will be accompanied by strengthening of the hryvnia resulting from higher export surplus and financial account capital inflows. This will lead to a slowdown in inflation compared with the baseline scenario, and will increase the probability of lowering the key policy rate at a faster pace.

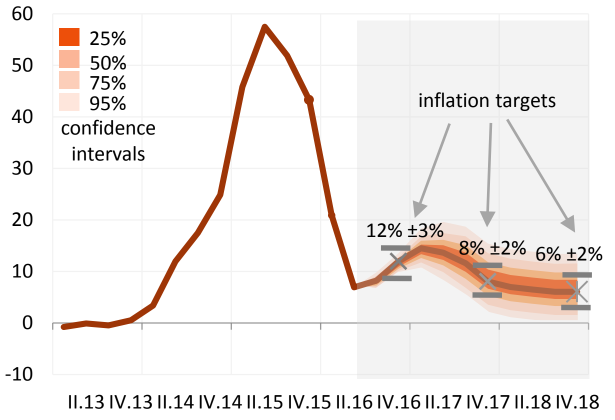
Overall, the distribution of risks to inflation outlook remains tilted to the downside this year and to the upside the next one. As a result, headline inflation might come in below 12% if the evolution of some key variables, on which projections rely heavily, deviate from the baseline scenario path. Alternative paths may refer to weaker consumer demand and oversupply of grains and other crops in the domestic market resulting from a higher harvest, more favorable external conditions, as well as enforcement of certain utility tariff moratoriums announced by local authorities.

Real GDP Forecast, % y-o-y



Source: NBU staff estimates

Headline CPI Forecast and Targets, % 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%.

Macroeconomic forecast (July 2016)

Indicators	2013	2014	2015	2016						2017						2018				
				I	II	III	IV	current forecast	forecast 04.2016	I	II	III	IV	current forecast	forecast 04.2016	I	II	III	IV	current forecast
REAL ECONOMY, % y-o-y, unless otherwise stated																				
Nominal GDP (SNA'2008), UAH billion	**1465**	**1587**	**1979**	453	519	660	650	**2282**	2262	531	600	760	741	**2632**	2585	602	678	861	841	**2983**
Real GDP	**0.0**	**-6.6**	**-9.9**	0.1	1.6	1.3	1.3	**1.1**	1.1	2.5	3.2	2.9	3.2	**3.0**	3.0	3.4	3.8	4.2	4.4	**4.0**
GDP Deflator	**4.3**	**15.9**	**38.4**	20.5	12.2	14.1	9.8	**14.0**	13.0	14.3	12.0	11.5	10.4	**12.0**	11.0	9.6	9.0	8.8	8.7	**9.0**
Consumer prices (period average)	-0.3	12.1	48.7	-	-	-	-	11.7	12.1	-	-	-	-	11.9	11.3	-	-	-	-	6.4
Producer prices (period average)	-0.1	17.1	36.0	-	-	-	-	14.2	10.9	-	-	-	-	11.1	10.0	-	-	-	-	8.9
Consumer prices (end of period)	**0.5**	**24.9**	**43.3**	1.5	3.4	1.7	4.9	**12.0**	12.0	3.8	2.7	-0.1	1.5	**8.0**	8.0	2.8	2.2	-0.6	1.6	**6.0**
Core CPI (end of period)	0.1	22.8	34.7	2.3	0.7	2.0	0.5	5.5	9.1	2.0	1.3	1.1	1.1	5.6	5.5	1.5	1.1	1.1	1.1	4.9
Non-core CPI (end of period)	0.9	26.8	50.9	0.8	5.7	1.5	8.8	17.7	14.6	5.4	3.9	-1.2	1.9	10.2	10.2	3.9	3.1	-2.0	1.9	7.1
administrative prices (end of period)	3.5	29.0	64.4	2.2	12.4	5.4	9.0	32.0	26.0	4.9	4.7	1.6	2.6	14.4	17.3	4.1	2.3	1.1	1.2	8.9
Producer prices (end of period)	**1.7**	**31.8**	**25.4**	4.4	9.1	1.5	1.3	**17.1**	13.6	2.8	3.6	1.9	1.3	**10.0**	8.4	2.7	2.9	1.4	1.1	**8.3**
FISCAL SECTOR																				
Consolidated budget balance, UAH billion	**-63.6**	**-72.0**	**-30.9**	-	-	-	-	**-58.3**	-68.1	-	-	-	-	**-70.0**	-59.3	-	-	-	-	**-74.4**
% of GDP	-4.3	-4.5	-1.6	-	-	-	-	-2.6	-3.0	-	-	-	-	-2.7	-2.3	-	-	-	-	-2.5
General government balance (IMF method), UAH billion	**-57.5**	**-70.3**	**-31.8**	-	-	-	-	**-66.9**	-76.8	-	-	-	-	**-77.8**	-65.8	-	-	-	-	**-81.4**
% of GDP	-3.9	-4.4	-1.6	-	-	-	-	-2.9	-3.4	-	-	-	-	-3.0	-2.5	-	-	-	-	-2.7
General government balance and Naftogaz financing, % of GDP	-5.8	-9.9	-2.9	-	-	-	-	-2.9	-3.6	-	-	-	-	-3.0	-2.5	-	-	-	-	-2.7
BALANCE OF PAYMENTS (NBU methodology)																				
Current account, USD billion	-16.5	-4.6	-0.2	-1.1	0.9	-1.0	-0.5	-1.8	-2.3	-0.7	-0.1	-1.1	-0.2	-2.1	-1.8	0.0	-0.4	-1.5	-0.6	-2.5
Financial account, USD billion	-18.6	9.1	-0.6	-0.3	-0.3	-2.2	-0.1	-2.8	-3.3	-0.4	-1.3	-0.7	-1.4	-3.8	-3.4	-0.9	-1.1	-1.2	-1.4	-4.6
BOP overall balance, USD billion	**2.0**	**-13.3**	**0.8**	-0.8	1.2	1.3	-0.5	**1.3**	1.2	-0.3	1.2	-0.4	1.3	**1.7**	1.6	0.9	0.7	-0.3	0.8	**2.1**
Gross reserves, USD billion	**20.4**	**7.5**	**13.3**	12.7	14.0	16.4	17.2	**17.2**	18.7	18.9	21.4	22.0	23.5	**23.5**	22.6	24.5	25.4	25.4	26.4	**26.4**
Months of future imports	**3.5**	**1.8**	**3.4**	3.3	3.6	4.1	4.3	**4.3**	4.7	4.7	5.3	5.3	5.6	**5.6**	5.3	5.6	5.6	5.6	5.9	**5.9**
Export of goods, % y-o-y	-7.5	-15.0	-29.9	-19.9	-3.6	-10.0	-1.9	-8.8	-12.0	8.5	-3.9	1.8	4.4	2.5	6.5	8.4	2.0	2.2	2.2	3.6
Import of goods, % y-o-y	-5.3	-27.8	-32.8	-13.4	-4.0	-4.0	-5.6	-6.8	-6.9	-1.6	4.1	6.4	6.5	4.0	4.7	2.8	3.9	5.4	6.3	4.7
MONETARY ACCOUNTS (a percentage change from the end of previous year)																				
Base money, %	**20.3**	**8.5**	**0.8**	-2.6	5.0	5.3	8.2	**8.2**	5.3	-1.5	3.0	5.4	8.7	**8.7**	8.7	0.9	5.8	7.1	9.0	**9.0**
Broad money (current exchange rate), %	**17.6**	**5.3**	**3.9**	1.3	4.2	7.6	10.8	**10.8**	8.1	3.2	8.3	12.4	16.1	**16.1**	12.5	2.4	7.8	13.4	16.8	**16.8**
Broad money (fixed exchange rate), %	**17.6**	**-11.0**	**-7.6**	-2.2	2.9	5.1	7.7	**7.7**	3.5	3.0	8.0	12.1	15.7	**15.7**	13.0	2.2	7.5	12.9	16.4	**16.4**
Velocity of broad money (end of year)	**1.59**	**1.64**	**2.0**	-	-	-	-	**2.1**	2.1	-	-	-	-	**2.1**	2.1	-	-	-	-	**2.0**