Monthly Economic Monitoring of Ukraine

No. 226, November 2023

Resume

- According to the IER estimate, real GDP growth slowed to 6.5% yoy in October from 11.1% yoy in September.
- Ukraine has successfully broken through the blockade of seaports and was able to resume the sea exports of not only grains but also metals, but so far, the volumes are insufficient.
- Ukraine has almost completed the repair campaign of power stations before the new heating season.
- The strike of Polish carriers since November 6 undermines the exports of Ukrainian goods.
- The trade deficit in goods and services has reached a new all-time high.
- The State Budget for 2024, approved by the Parliament, envisages external financing at USD 41 bn: USD 29 bn is not yet guaranteed by international partners.
- In October, consumer inflation was 5.3% yoy, within the NBU's target. That happened for the first time since 2020, but the economic recovery may lead to more inflation.
- The NBU did not change operational interest rates, but it changed the definition of the discount rate to be equal to the rate on overnight certificates of deposit. Therefore, the discount rate is now 16% per annum.
- Changes in the hryvnia exchange rate against the dollar have so far remained small: the hryvnia strengthened by 1.4%

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GDP and real sector: Slowdown in economic growth due to statistical base effect

According to the IER, real GDP growth slowed to 6.5% yoy in October from 11.1% yoy in September. That is primarily a consequence of agriculture's smaller contribution to growth due to the higher statistical base of October last year. However, real GDP in October 2023 is estimated to be 28% lower than in October 2021.

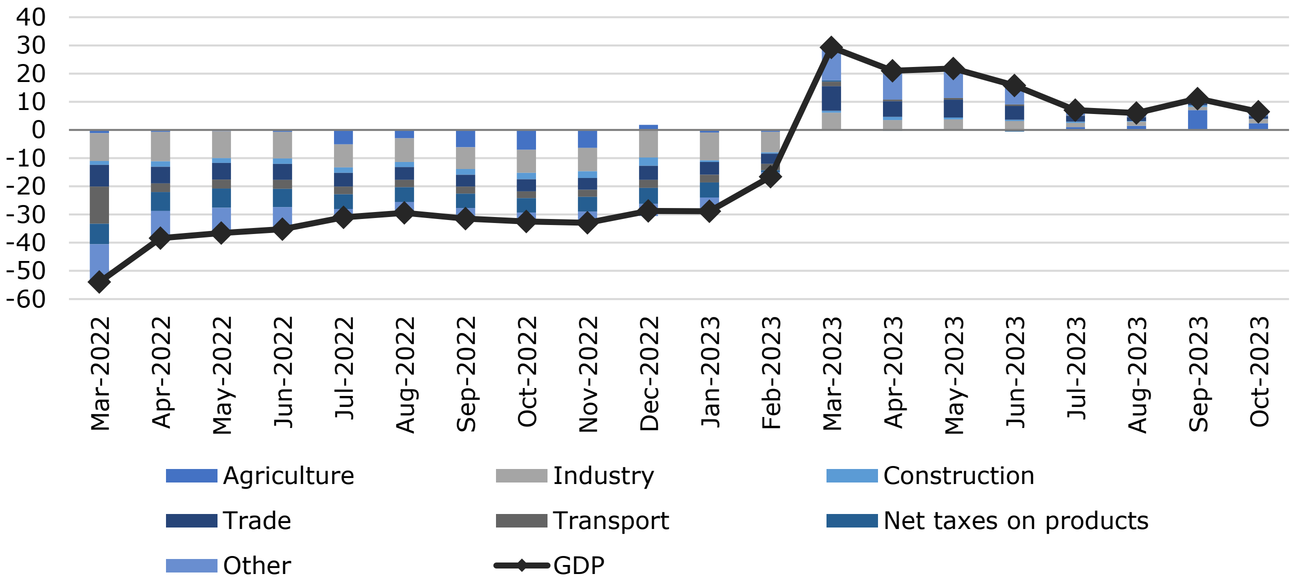
At the same time, according to estimates, real gross value added (GVA) in industry, on the contrary, grew faster due to a lower base in October 2022, when Russia began to strike at energy infrastructure. In the manufacturing, real GVA increased by 16% yoy. The situation has improved both in metallurgy and mechanical engineering. The results of the business survey, conducted monthly by the IER, show that the business remains optimistic and plans to increase production.

Higher extraction of ores and construction materials contributed to the growth of real GVA in the extractive industry estimated by the IER at 5% yoy. Energy production increased by 6.4% yoy due to a lower base last year, when the energy sector suffered from russian shelling, as well as due to the completion of scheduled repairs at nuclear power plants and thermal power plants. However, the recovery was limited by emergency shutdowns of the TPP due to bad weather or shelling.

According to our estimates, the real GVA in transport decreased by 1.8% yoy in October, resulting from logistical problems. Ukraine has successfully broken through the blockade of seaports and resumed the exports of not only grain but also metals by sea, but so far in much smaller volumes. Last year, in October, the grain corridor was fully operational. However, in October 2023, exports, particularly by road across the western border, were limited by the policy of our neighbours, primarily Poland.

According to IER estimates, real GVA in trade increased due to the resumption of imports and an increase in the nominal incomes of consumers against the background of lower inflation. An increase in demand for devices needed in case of power outages due to the expected russian shelling of energy infrastructure played a role in this.

Figure 1: Contributions to real GDP, pp



Source: IER assessment supported by the USAID Competitive Economy Program in Ukraine

The Ministry of Economy has revised the forecast for this and subsequent years as part of the budget process. The budget figures are based on the forecast of real GDP growth of 5.0% yoy in 2023 and 4.6% yoy in 2024. At the same time, the government's forecast predicts a slower growth in inflation than previously expected. The NBU also revised its macroeconomic forecast in its latest inflation report: its GDP estimate is more pessimistic than the government's, and its inflation forecast is lower. Given the slightly changed policy of the NBU, the government also now expects a stronger hryvnia than before. In general, changes in the macroeconomic forecast almost did not lead to changes in the planned budget revenues due to the diversity of the impact of these changes (the projected nominal GDP decreased by only 2% after the Ministry of Economy updated the forecast).

Table 1: Key economic indicators for 2023-2024

Indicator	2022 fact	Ministry of Economy				NBU	
		2023, forecast for the 1st reading	2023 updated forecast	2024, forecast for the 1st reading	2024 updated forecast	2023 forecast	2024 forecast
Nominal GDP, UAH bn	5 191	6 370	6 466	7 825	7 643	6 625	7 730
Real GDP, % yoy	-29.1	2.8	5.0	5.0	4.6	4.9	3.6
CPI, December to December, % yoy	26.6	14.7	7.1	10.8	9.7	5.8	9.8
Average wage, UAH	14 847	18 118	18 527	21 852	21 809		
Exchange rate, UAH / USD aop	32.3	37.5	36.9	41.4	40.7		

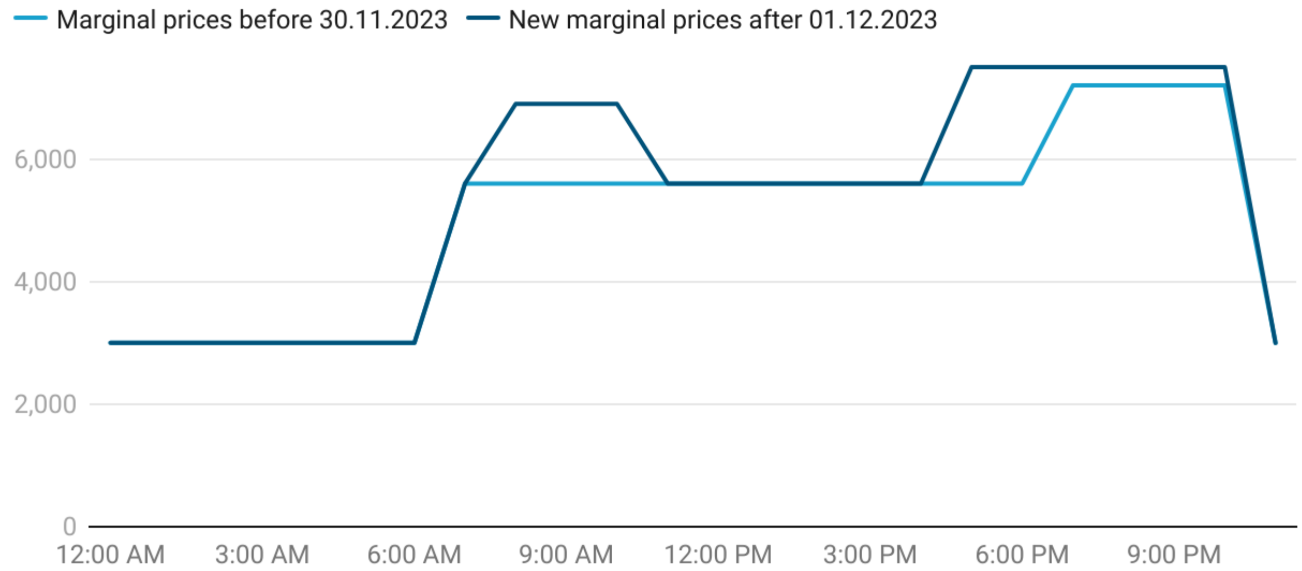
Source: Draft State Budget for 2021, NBU Inflation Report for October 2023

Energy: increased prices in the electricity market

Electricity. Ukraine has almost completed the repair campaign before the new heating season. However, some power units of thermal power plants and wind farms are shut down for emergency repairs due to russian shelling.

The energy market regulator NEURC has raised the marginal prices for electricity on the day-ahead market. On average, the increase ranges from 4% to 23%, depending on the time of day, and will affect the cost of electricity for businesses. Thus, the maximum cost of electricity during the morning peak of consumption will increase in December from 5600 to 6900 UAH/MWh. According to experts, after the first increase in marginal prices in June this year by 40-80%, the average price of electricity for businesses has increased by 23%. According to the National Energy and Utilities Regulatory Commission (NEURC), the primary purpose of the changes is to make electricity imports profitable in winter to avoid possible shortages.

Figure 2: Marginal prices in the electricity market, UAH/MWh



Source: National Energy and Utilities Regulatory Commission

Gas. Ukrgasvydobuvannya drilled two high-performance wells, which increased the daily production of the state-owned producer by 500 thousand cubic meters of gas. In 2022, the company produced 12.5 bn cubic meters (bcm) of natural gas, 3% less than in 2021. The goal is to increase natural gas production to 13.5 bcm in 2023.

In January-October 2023, "Operator of Gas Transportation System of Ukraine" transported more than 4.2 bcm of natural gas from the EU and Moldova to Ukraine. This volume is three times more than was transported in the same period last year (1.4 bcm). Of this volume, 2.5 bcm of gas belongs to foreign companies and is stored in Ukrainian gas storage facilities. The interest of foreign traders in Ukrainian UGS facilities has increased after the certification of the facilities according to European standards. Natural gas reserves in underground storage facilities already exceed 16 bcm, enough to pass the heating season.

Oil. The blocking of checkpoints by Polish carriers may adversely affect the fuel supply to the country. The protest, which began on November 6, may last until the end of the year and complicate fuel delivery. According to experts, the most vulnerable is the supply of liquefied gas, 36% of imports of which are imported by road.

Transportation: The work of ports has improved, but vehicles on the border with Poland are blocked

Maritime transport. On August 10, 2023, the Naval Forces of Ukraine announced a temporary humanitarian corridor for merchant ships going to and from the Ukrainian ports. Since then, more than 100 vessels have used the corridor. The use of the alternative sea corridor is subject to a daily limit on the number of vessels entering and exiting. The Ukrainian Navy sets these restrictions to ensure the convoy's safety.

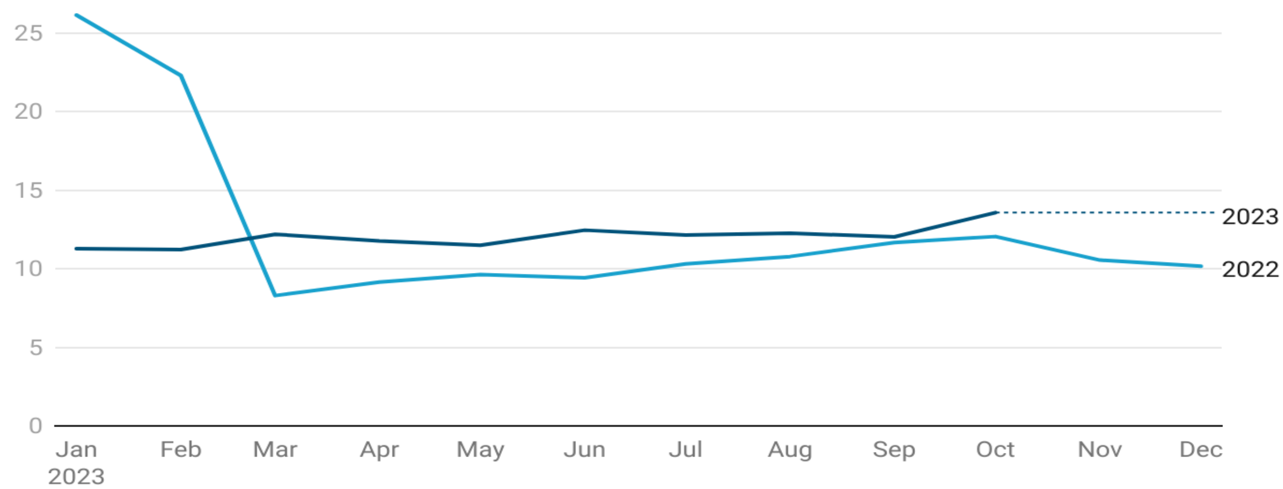
From August 8, 2023, to November 13, 100 vessels exported 3.7 m tons of agricultural, iron, and steel products. Most importantly, the ports have started working to both export and import goods. However, the temporary corridor has not yet become a full-fledged replacement for the grain deal – from August 8 to November 13, 2022, 10.3 m tons of grain and oilseeds were exported through the ports of Odesa.

The total export of agricultural products by sea and river in October amounted to about 3 m tons. The resumption of export shipments by sea reduces the flow of goods in the direction of the Danube.

However, it is becoming more and more dangerous to work in ports. On November 8, Russia fired on a civilian ship under the flag of Liberia during its entry into one of the ports of the Odesa region; there were dead and wounded. This attack is Russia's 21st targeted attack on Ukrainian infrastructure since withdrawing from the grain deal: since then, the enemy has damaged more than 160 infrastructure facilities and 122 vehicles.

Rail transport. The revival of seaports has had a positive impact on rail transport. During October, 13.6 m tons of cargo were transported by the railway of Ukraine, an increase of 13% mom. Iron and manganese ore (39%) and grain and milling products (35%) are the primary export commodities. Transportation of ore to ports and to the western border in October increased by 33% mom to 2 m tons. 982.6 thousand tons of grain were sent by rail to Ukrainian ports, 3.2 times more than in September. At the same time, the shipment of grain in the direction of the western border crossings decreased by 2.6% to 748 thousand tons. In total, the volume of rail traffic to ports and the western border reached 4.88 m tons, which is 36% more than in September.

Figure 3: Transportation of goods by rail, million tons



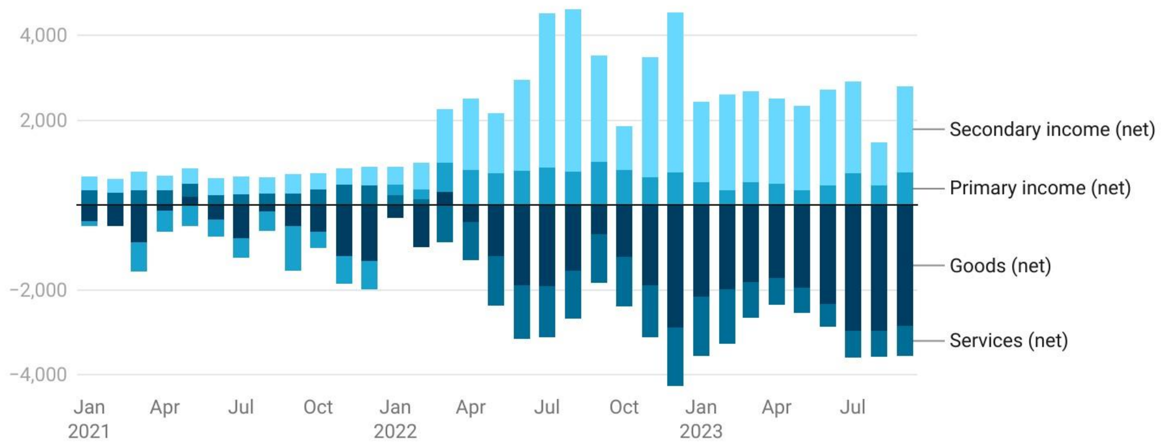
Source: Ukrzaliznytsia

Road transport. From 1:00 p.m. on November 6, Polish carriers blocked the three biggest checkpoints between the countries: "Korczowa - Krakivets," "Hrebenne - Rava-Ruska," and "Dorohusk - Yahodyn" for the movement of freight transport. The action is announced to last till the end of the year. As of November 9, more than 20 thousand trucks are blocked on both sides. Polish carriers demand the return of the permit system for Ukrainian carriers, tightening of the rules of transportation for foreign carriers according to the ECMT, prohibition of the registration of companies in Poland if the company's finances are not on the territory of the EU, creation of a separate queue for Polish carriers in the "eQueue" for cars with EU license plates, and creation of a separate queue at all borders for empty trucks and to provide Polish carriers with access to the "Shlyakh" system. The transport ministries of Ukraine and Poland are trying to negotiate with the protesters to allow certain groups of goods to pass. Ukraine's position is no changes or cancellation of the Agreement on the Liberalization of Road Transport.

Foreign trade: The deficit of trade in goods and services reached a new all-time high

In the second half of 2023, the current account of the balance of payments deteriorated, primarily due to an increase in the trade deficit. As of the first nine months of 2023, the trade deficit in goods and services amounted to USD 28.0 bn, a new all-time high. Most of the deficit was formed in trade in goods, where the increase in imports contrasts with the fall in exports. In January-September 2023, exports of goods, according to the NBU, amounted to USD 25.8 bn (-15% yoy), while imports reached USD 46.5 bn (+19% yoy). The export decline was due to trade restrictions imposed by neighbouring countries and complicated logistics. The resumption of maritime transportation without russian participation has been essential, but current volumes remain low. Polish carriers' partial blockade of road freight transportation, which began in November, creates additional risks.

Figure 4: Structure of the current account of the balance of payments

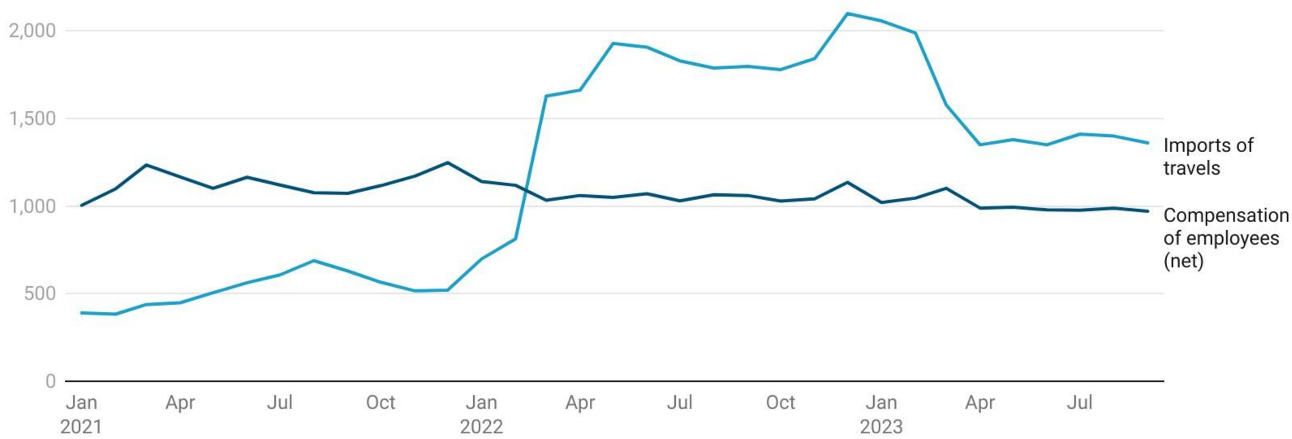


Source: NBU

If until February 2022, the trade deficit in goods was partially compensated by a surplus in trade in services, after the start of the full-scale aggression of the russian federation, a deficit was also formed in trade in services. In the first nine months of 2023, it amounted to USD 7.2 bn. The key reason for this deficit has been the large number of citizens who went abroad after the start of a full-scale war. That led to high travel imports, which amounted to USD 13.9 bn in the first nine months of 2023 (-1% yoy). At the same time, the compensation of employees transferred from abroad, which used to be the main item of the current account related to migration, decreased to USD 9.0 bn.

As it was in 2022, the primary source of compensation for the trade deficit was secondary income, formed mainly by grants from international partners. The net inflow of secondary income amounted to USD 17.8 bn for nine months, including private transfers. However, the political crisis in the United States is currently hampering the allocation of grants. That means a further increase in the current account deficit, which reached USD 5.5 bn in the first nine months of 2023.

Figure 5: "Mirror of Migration": Travel Imports and Payroll



Source: NBU

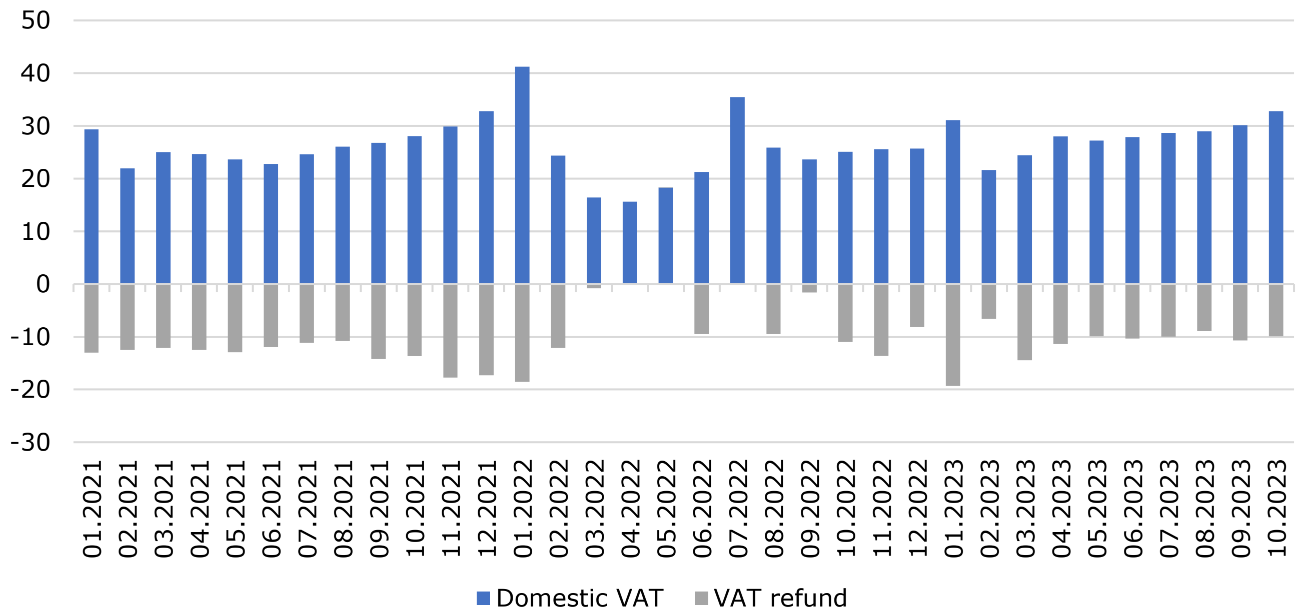
State Budget: The priority of the State Budget for 2024 is to win the war

Budget-2023. In October, the revenues due to general fund of the State Budget amounted to UAH 139 bn, which is slightly less than in September this year. This month, a grant from the United States in the equivalent of UAH 42 bn was received, which might be the last for this year: this poses challenges for the government to finance expenditures in the last two months of 2023.

The execution level of the budget plan for tax revenues has improved. Taxes administered by the State Tax Service were over-executed by 4.5% of the plan, and the underperformance of revenues administered by the State Customs Service decreased to 1.6%. Imports tax revenues were driven by higher-than-expected growth in imports in dollar terms and the abolition of tax breaks. At the same time, their growth was restrained by a stronger hryvnia than was assumed in the Budget for 2023. Thus, VAT revenues from imports increased by 48% yoy, but in real terms (adjusted for inflation), they were lower than in October 2021 by 17%.

Gross VAT revenues from goods and services produced in Ukraine increased by 30.6% yoy and were 13% lower in real terms than in October 2021. Higher amounts of VAT revenues reflect a further recovery in consumption. VAT refunds of UAH 9.9 bn were slightly lower than in September 2023.

Figure 6: Domestic VAT, UAH bn



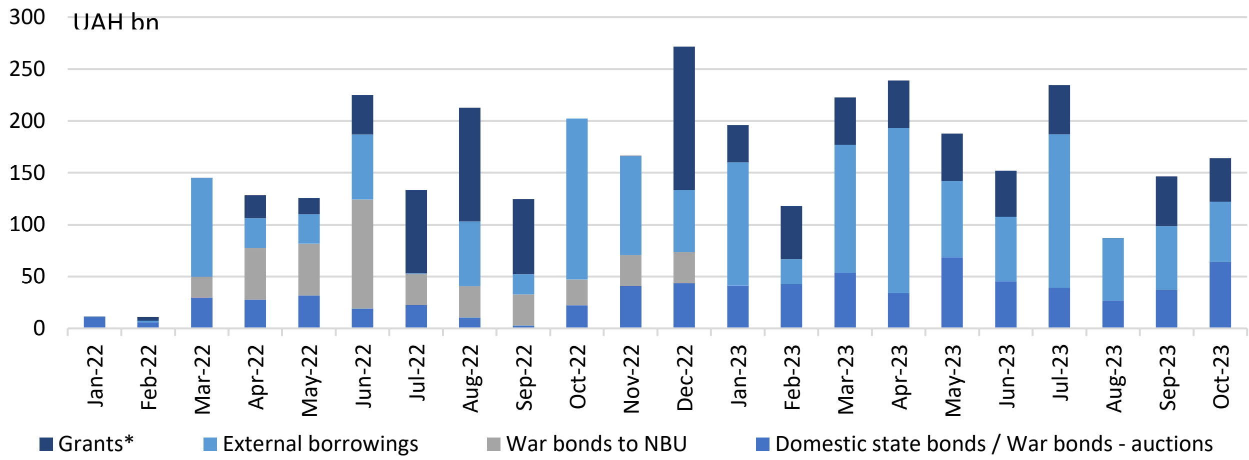
Source: Ministry of Finance, openbudget.gov.ua

Personal income tax revenues were 2.5% lower than in September, although the situation in the labour market is improving. Therefore, it is probably a temporary factor. Revenues from this tax were 15.5% higher than in October 2022.

In October, the government received UAH 63.8 bn from the placement of domestic government bonds, compared to UAH 36.9 bn a month earlier. A third of the funds were received from foreign-currency-denominated securities. The increase in domestic government bond placement was likely facilitated by investors' expectations of a reduction in the NBU discount rate and, accordingly, a decline in the yield on domestic government bonds. The Ministry of Finance has only slightly reduced the yields, as it is crucial to maintain demand for securities. In particular, when making changes to the budget for 2023, domestic borrowings were planned as an essential source for financing higher defense spending.

In October, a regular tranche of concessional loans from the EU was also received. Since the beginning of this year, a total of USD 35 bn has been received from international partners to finance the budget. USD (equivalent), which is more than in the entire 2022. These funds are the only source of financing budget expenditures unrelated to defense and security, financed at the expense of domestic revenues. Such a distribution is a requirement of international partners who finance military aid from budgets other than financial assistance to Ukraine.

Figure 7: Funding and grants received by the state budget, UAH bn



*Note: * Grants are part of budget revenues, which are accounted for under the code 42000000 "From the European Union, foreign governments, international organizations, donor institutions".*
Source: Ministry of Finance, openbudget.gov.ua

Budget-2024: The Verkhovna Rada adopted the State Budget 2024, which the government prepared for the second reading. Changes in key budget indicators were insignificant: revenues were increased by UAH 22 bn, and external financing was reduced by the same amount. The deficit of the State Budget is planned at UAH 1,571.5 bn or 20.6% of GDP. Expenditures on defense and security at UAH 1,693 bn will account for 50.5% of the total expenditures of the State Budget.

For 2024, external grants and loans are planned in the amount equivalent to USD 41 bn. At the same time, according to the Minister of Finance, USD 29 bn are not yet guaranteed. In particular, the United States has not yet been able to find political support for adopting an aid package for Ukraine. The EU is developing a mechanism to support Ukraine, the Ukraine Facility, which the European Parliament has already supported with some changes. However, there is still a vote ahead in the EU Council, where unanimous support from all EU countries is needed for the rapid adoption of the document. So far, Hungary is still slowing down the process of provision of aid. Therefore, the risks of financing next year's budget remain high. On the positive side, Ukraine and the IMF have reached an agreement at the expert level on the second review of the program, which reinforces hopes for budget funding in the future.

Limited budgetary space, coupled with high risks, forced the government to significantly reduce capital expenditures, including those for reconstruction and recovery. There is practically no funding for the Fund for the Elimination of the Consequences of Armed Aggression for the next year: the costs will be within the balance of funds this year, which are almost non-existent, and at the expense of confiscated Russian assets. At the same time, the actual financing of recovery and reconstruction will be higher than the UAH 12.5 bn allocated for the special budget fund, primarily programs financed by the World Bank and the EIB. Thus, provided that the government and local governments can implement projects in a timely and effective manner, funding will be higher: today, the budgeted amounts are lower than those provided for in the agreements between Ukraine and the relevant IFIs.

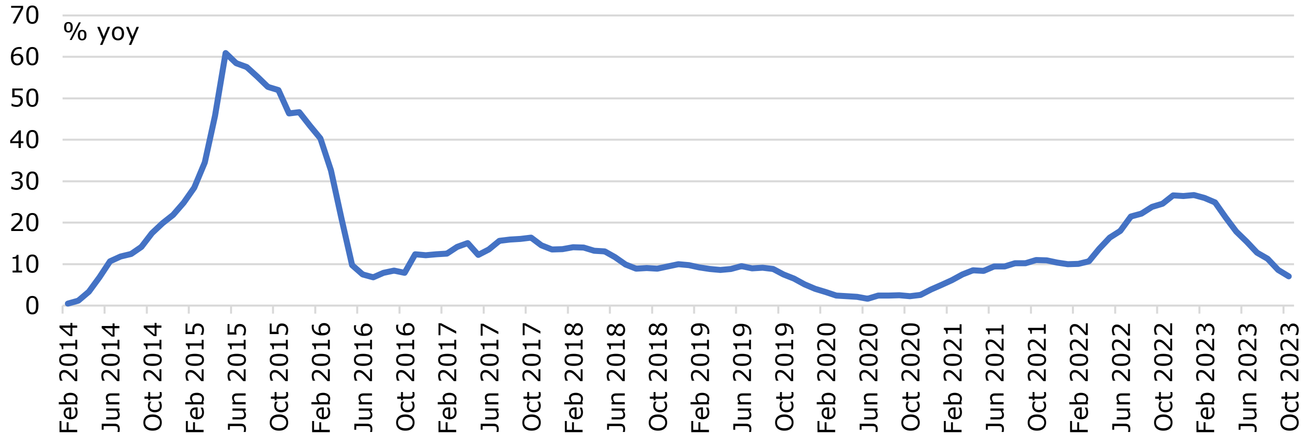
Inflation: Temporarily within the NBU's target

In October, consumer inflation decelerated for the tenth month in a row and reached 5.3% yoy. Before the full-scale war, the NBU set a target for inflation in the 4-6% range. The last time inflation met the NBU's target was in December 2020. The main drivers of the inflation slowdown remained unchanged: economic policy (fixed hryvnia exchange rate, preservation of macroeconomic stability, fixed tariffs for heating, water and gas), consumer demand that is significantly lower than in 2021 (although it is gradually recovering), unfavourable prices for agricultural producers in foreign markets, and high export costs, which keeps prices down in the domestic market. The restoration of supply chains after disruptions in the supply of several goods in 2022 and the associated price increase also slowed inflation.

In October, inflation in monthly terms amounted to 0.8% mom. In 11 out of the last 12 months, monthly growth of consumer prices did not exceed 1% (in July and August, prices even decreased). Inflation in October reflected seasonal increases in prices for vegetables and dairy products and rising fuel prices due to higher oil prices. Excluding these factors, consumer prices in October averaged close to those in September.

In the coming months, price growth may accelerate: a gradual recovery in consumer demand may allow manufacturers and retail chains to increase margins, and more expensive fuel has increased the transport costs of manufacturers and retail chains.

Figure 8: Consumer price inflation



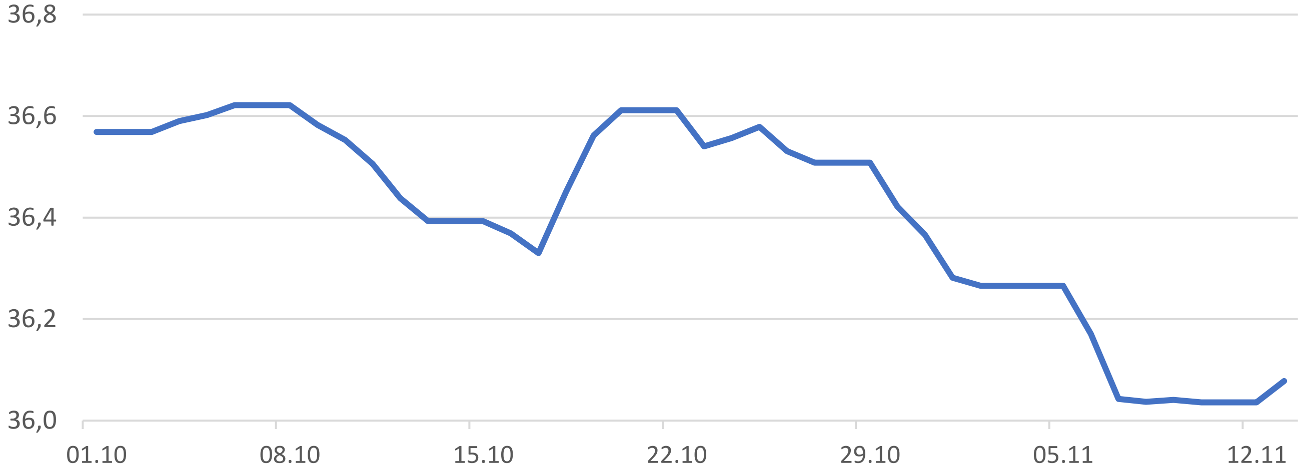
Source: State Statistics Service of Ukraine

Monetary and exchange rate policy: NBU keeps interest rates unchanged but changes the definition of key policy rate

Monetary policy. In October, the NBU decided to leave interest rates on its operations unchanged. In particular, the interest rate on overnight deposits of the NBU remained at 16% per annum. That reflected the NBU's efforts to maintain the attractiveness of hryvnia savings compared to foreign currency and the risks of accelerating inflation in the coming months.

The NBU also changed the definition of the NBU's discount rate, which is the NBU's key interest rate: it equated it to the rate on overnight certificates of deposit, which is the lowest of the NBU's interest rates. Previously, the key policy rate was equated to the rate on three-month NBU certificates of deposit, i.e. it was in the middle of the NBU's interest rate corridor. The overnight rate was four percentage points lower, and interest rates on loans to banks were higher. As a result of the redefinition, the key policy rate changed to 16% per annum from 20% per annum. According to the NBU, this will push businesses and households to pay more attention to the discount rate because they will know that this is the interest that banks can risk-free receive from the NBU for free funds. Time will tell whether such expectations of the NBU will be justified. Currently, the only consequence of revising the key policy rate is a decrease in interest rates tied to the NBU key policy rate. For example, the maximum penalty for late payments under business contracts will be reduced.

Figure 9: Official exchange rate of the hryvnia to the US dollar, UAH per USD



Note: Note that the exchange rate values in the figure start from 36.0 UAH/USD
Source: NBU

Exchange rate policy. In the first weeks of the fixed exchange rate, the hryvnia strengthened against the US dollar by 1.4% (as of November 13), and exchange rate fluctuations remained small. The NBU spent USD 4.1 bn in six weeks to support the exchange rate. After the first week, the NBU's expenses were close to the average in previous months. As expected, there were no significant changes in the exchange rate for the households. However, the NBU hinted at a gradual increase in exchange rate flexibility in the future but did not publish the time frame for such changes. Therefore, there is uncertainty about how long the exchange rate will remain close to fixed.

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