Monthly Economic Monitoring of Ukraine

No. 225, October 2023

Resume

- According to the State Statistics Service, real GDP in the second quarter grew by 19.5% yoy (year over year) due to the recovery of economic sectors from the low base of 2022.
- Due to high harvesting compared to last year and further recovery of other sectors of the economy, real GDP grew by 12% yoy in September, according to the IER estimate.
- Ukraine resumed electricity exports in September, as electricity production increased due to the completion of repairs of several power units and good weather.
- The Armed Forces of Ukraine, together with international partners, have provided a humanitarian corridor for the transportation of goods from the seaports of Odesa: 20 ships have already used it.
- In September, the trade dispute with Poland, Hungary, and Slovakia over the export of Ukrainian agricultural products to these markets deepened.
- The priority of the State Budget in 2024 will remain the financing of defence and security. International aid is not yet guaranteed and is crucial to finance other expenditures.
- In September, consumer inflation decelerated further and amounted to 7.1% yoy. However, price growth may accelerate slightly in the coming months.
- The slowdown in inflation led to a further cut in the key policy rate to 20% per annum. At the beginning of October, the NBU took the first step from a fixed hryvnia exchange rate to controlled exchange rate fluctuations. Changes in the hryvnia exchange rate against the dollar have been insignificant.

Фінансується Європейським Союзом

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GDP and the Real Sector: Agriculture Supports Economic Growth

According to the State Statistics Service, real GDP grew by 19.5% yoy (year over year) in the second quarter of 2023, which is close to the IER estimate. Official data on the development of industries, retail, transport, and construction for the year's first six months was also published.

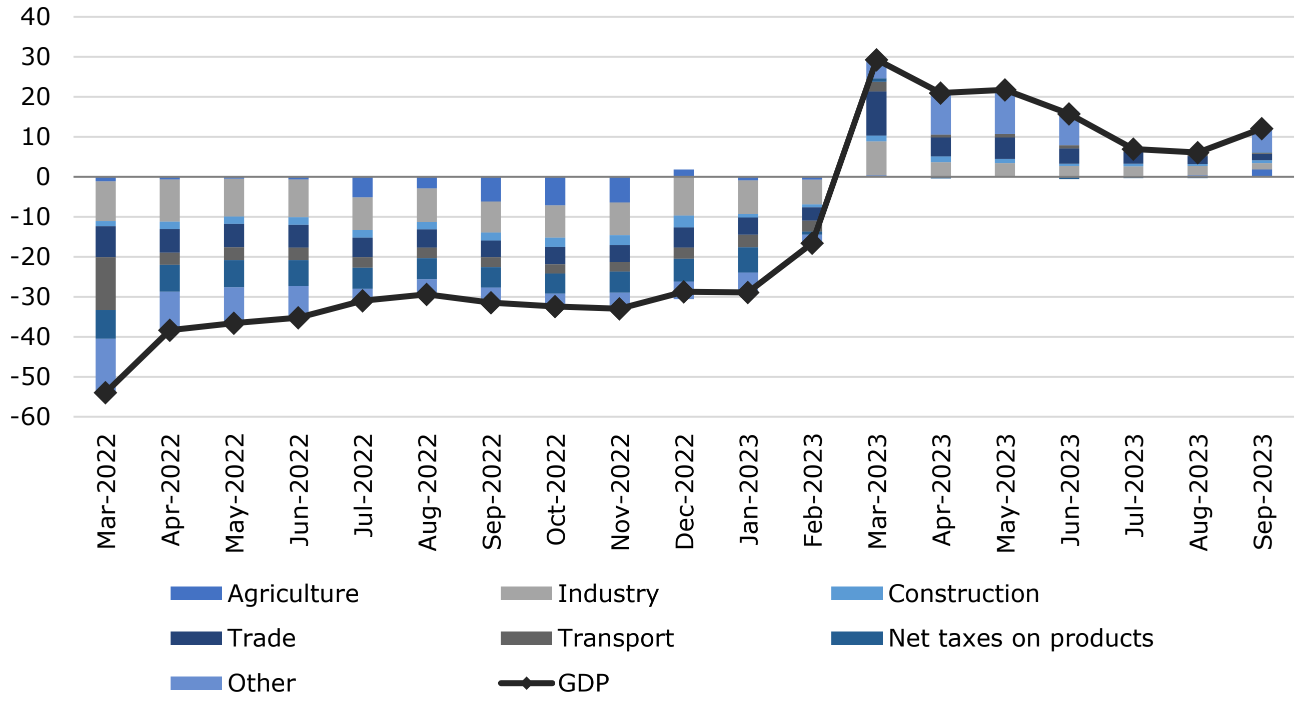
In June 2023, the mining industry grew by 6.5% yoy. Crude oil and natural gas production declined by 2.3% yoy, while all other extractive industries increased. Mining of metal ores increased by 43.8% yoy due to higher demand and better logistics than a year ago. The increase in the extraction of construction materials by about 40% yoy is associated with both new construction and the processes of reconstruction and restoration of damaged and destroyed facilities.

Manufacturing growth was high due to a low base in 2022 but decelerated from 34.6% yoy in April to 18.2% yoy in June. Several industries have reduced output compared to last year or increased slightly, primarily those that fell less than a year ago. At the same time, the food industry continues to recover its production indicators (growth by 11.8% yoy) due to higher demand. Some other industries showed strong growth rates on the back of a low base and a recovery in demand. The chemical industry grew by 23.2% yoy, metallurgy – by 23.5% yoy, and mechanical engineering – by 38.0% yoy. At the same time, the production of weapons, ammunition, and military vehicles proliferated.

Electricity, gas, steam, and conditioned air supplies grew by 10.2% yoy. Increased demand, primarily from industry and other commercial consumers, facilitated this growth.

According to the IER, real GDP growth accelerated to 12.1% yoy in September (compared to 7.0% yoy and 6.0% yoy in the previous two months). The high pace of harvesting facilitated this compared to last year when it rained in September. Thus, according to the IER, the real gross value added (GVA) of agriculture increased by almost 65% yoy in September 2023.

Figure 1: Contributions to real GDP, pp



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

Against the background of a higher statistical base, according to the IER, real GVA in the extractive industry increased in September by 2.0% and in electricity by 2.4% yoy. In the processing industry, GVA increased by 13.0% yoy but remained more than 30% lower than in 2021 due to the temporary occupation of some enterprises, the destruction or damage of individual enterprises, the inability to export products due to complex and expensive logistics, and limited domestic demand.

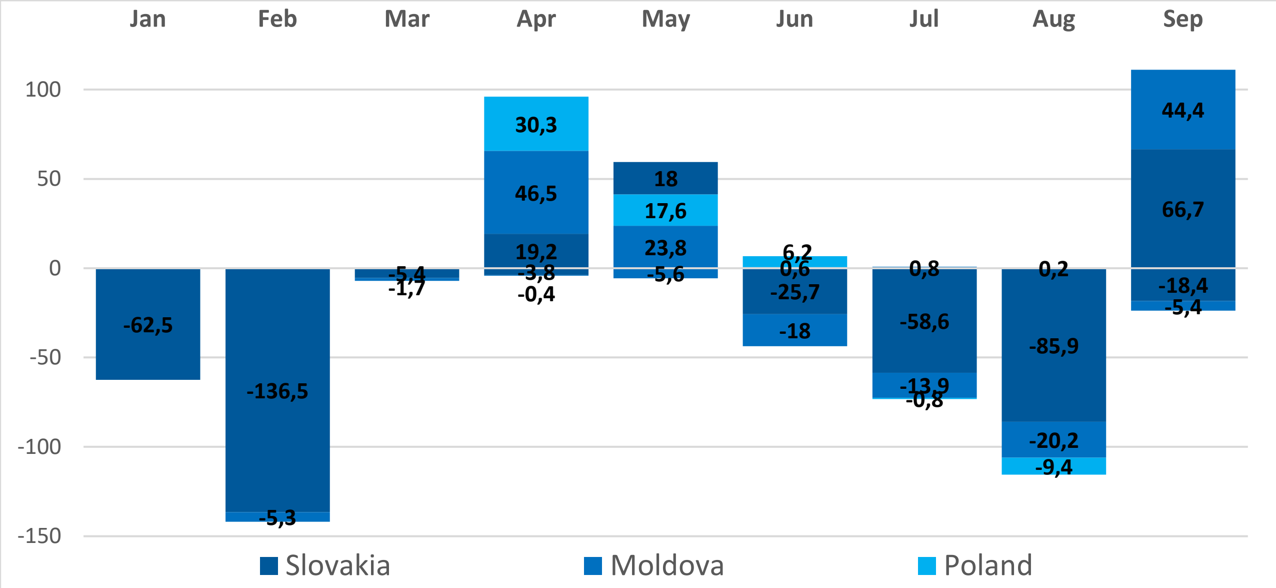
According to estimates, the growth rate in trade remained high at 11% yoy. At the same time, due to the further blockade of seaports, long queues on the western border, and constant shelling of the port infrastructure of the Danube ports by the Russians, the real GVA in transport increased by only 3.0% yoy.

Energy: Ukraine is exporting electricity again

Electricity. In September, electricity exports reached record levels for 2023 – almost 111 thousand MWh: 60% of electricity went to Slovakia and 40% to Moldova. However, compared to last year's September (419.8 thousand MWh), electricity exports decreased almost four times. Ukraine takes advantage of the opportunities for integration with ENTSO-E; therefore, exports and imports co-occur. Ukraine imported 23.6 thousand MWh in September, 4.8 times less than in August.

At the beginning of October, another nuclear generation unit was repaired ahead of schedule. It added 415 MW of capacity to the power grid. Also, hydroelectric units of hydroelectric power plants and TPP units are gradually being repaired. According to DTEK's estimates, Ukraine will need up to 2 GW of electricity imports during peak hours in winter.

Figure 2: Electricity exports and imports in 2023, thousand MWh



Source: Ukrenergo

The energy market regulator NEURC analyzed the balance of electricity production in the United Energy System of Ukraine from June to August 2023. Energoatom and Ukrhydroenergo exceeded the electricity production plan, while thermal generation enterprises underfulfilled it. During this period, TPPs underproduced 938 thousand MWh: Centrenergo - 307 thousand MWh, Donbasenergo – 115 thousand MWh, and DTEK Energy – 516 thousand MWh. At the same time, Energoatom exceeded the approved plan by 1530 thousand MWh and Ukrhydroenergo – by 71 thousand MWh. Thus, the NEURC denied the information that TPPs used more coal than planned in the summer due to Energoatom's repair campaign.

Gas. Naftogaz plans to have more than 16 bn cubic meters (bcm) of gas in gas storage facilities by winter. And if previously Naftogaz stated that 13 bcm would be enough to get through the heating season, now it believes that the winter of 2024 will be colder than last year's, so more gas will be needed. As of October 10, about 15.75 bcm of gas was accumulated in Ukraine's gas storage facilities. Of these, non-residents own about 2.5 bcm.

In September 2023, Ukraine received 983 million cubic meters of gas from the EU and Moldova, of which 553 m cubic meters came from Slovakia. Most of the resource is imported by non-residents for storage in Ukraine. The use of the southern branch of the Ukrainian GTS is growing — more than 120 m cubic meters of gas came from Romania through Moldova. This branch is essential for using the Trans-Balkan corridor, through which Southern European countries can transport gas for further storage in Ukrainian storage facilities.

Transport: Queues of trucks and wagons at the borders continue to grow

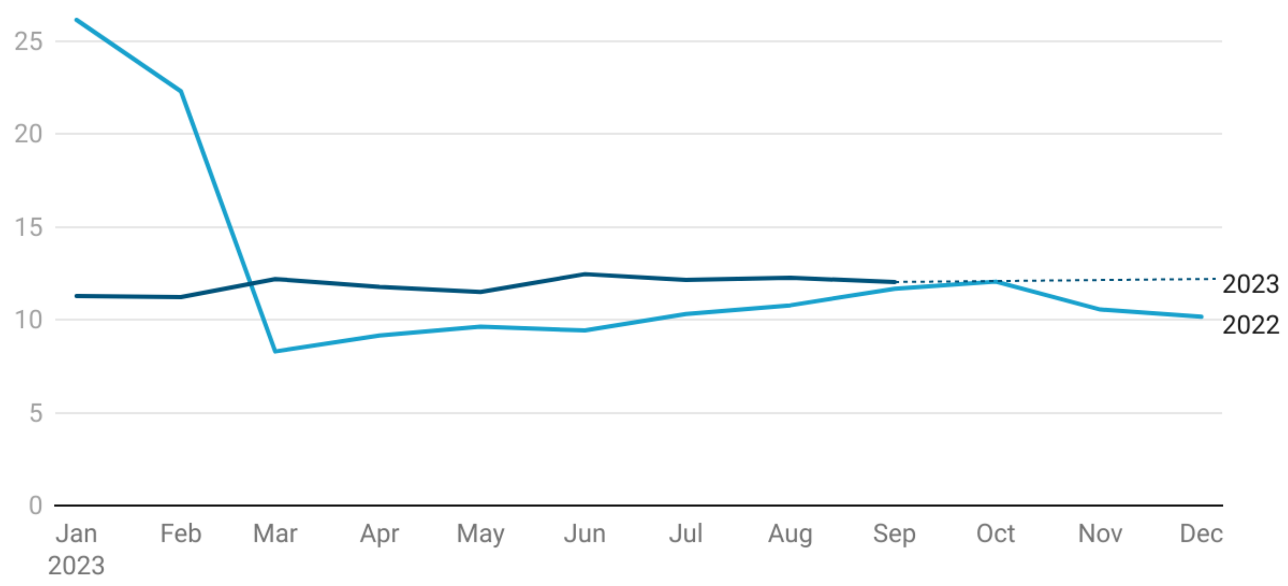
Maritime transport. On August 10, 2023, the Naval Forces of Ukraine announced a temporary humanitarian corridor for merchant ships going to and from the ports of Ukraine. Since then, more than 20 vessels have used the corridor.

In September, exports of Ukrainian agricultural products by sea and river transport amounted to 2.4 m tons, while 99% of exports occurred through the Danube ports. Approximately 50 thousand tons of products were exported through seaports.

Rail transport. Ukrzaliznytsia transported 12.035 m tons of cargo in September, 3% more than in the same period last year but 2% less than in August. In the direction of ports and the western border, the railway transported 3.8 m tons (an increase of 9% mom, but a decrease of 31% yoy). The primary export goods for Ukrzaliznytsia are iron and manganese ore (41% of all export traffic) and grain (30%). Transportation of ore to seaports in September increased by 33% compared to August and amounted to 226 thousand tons, and the transportation of grain to ports has almost doubled.

The queues of freight cars at the western border crossings in September 2023 increased to 13 thousand cars, which is 27% more than in August. Most of the cars accumulated at the crossings Izov - Hrubieszów (Poland) - 3124 cars, Mostyska-2 - Medyka (Poland) - 2340 cars, and Vadul-Siret - Dornesti (Romania) - 1742 cars. The queue is more than a week.

Figure 3: Transportation of goods by rail, million tons



Source: Ukrzaliznytsia

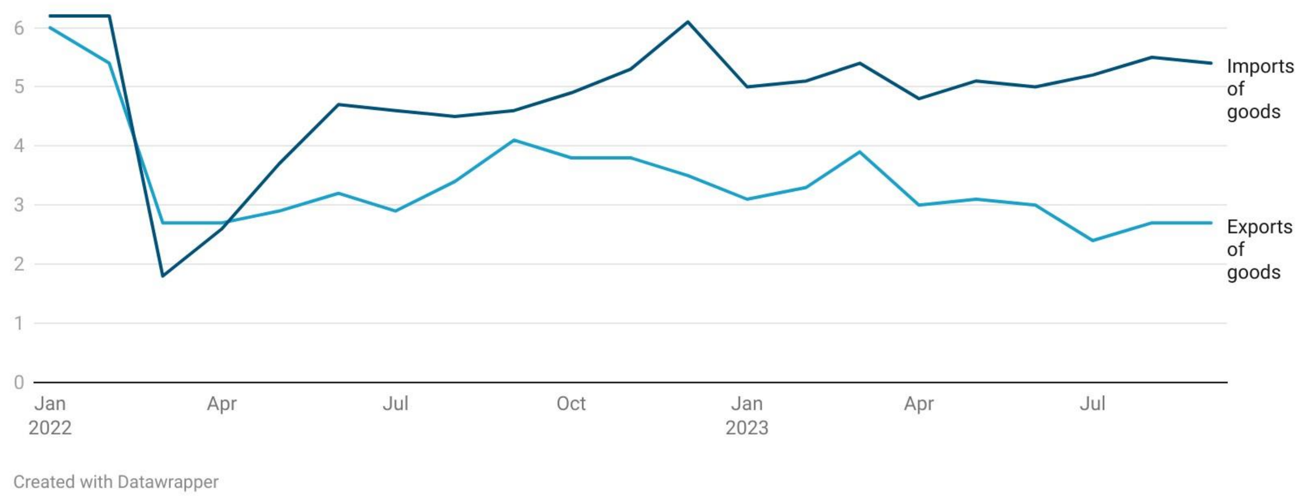
Road transport. As of September 30, the queue of trucks registered in the eCherha (eQueue) system for crossing the western border was 17106 trucks with cargo and 2090 empty ones. In September, the average daily passage of trucks across the border increased to 2716 units. This amount was the highest value since June, when the eCherha started working at most checkpoints. Accordingly, the queue for crossing the border is eight days. The busiest border checkpoints are "Yahodyn – Dorohusk" (Poland), "Porubne – Siret" (Romania), and "Krakowiec – Korczowa" (Poland).

Ukraine and Moldova have extended the "transport visa-free regime" until the end of 2025. The agreement provides the possibility of carrying out bilateral and transit transportation by road without special permits.

International trade: The trade dispute with Poland and other neighbouring countries became the central event of September

In September, foreign trade in goods remained almost unchanged compared to the previous month. Ukraine exported products worth USD 2.7 bn and imported USD 5.2 bn. In general, in the first three quarters, exports of goods amounted to USD 27.1 bn (-19% yoy), while imports reached USD 46.5 bn (+19% yoy), which led to a further widening of the goods trade deficit to USD 19.4 bn.

Figure 4: Ukraine's foreign trade in goods, USD billion



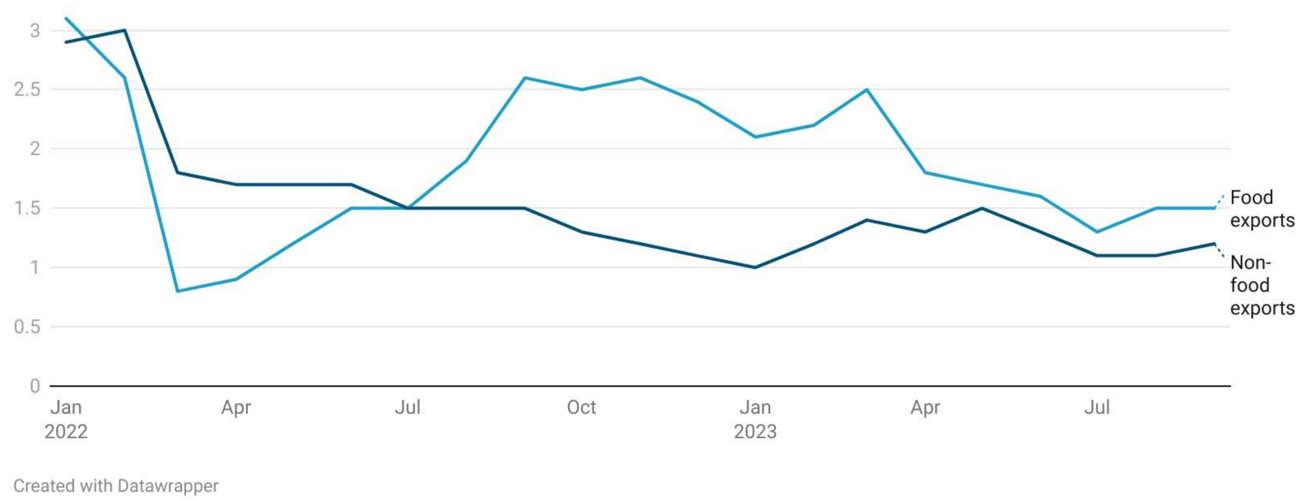
Sources: UN ComTrade, SCSU

The key event of the month was the deepening of the trade dispute with Poland, Hungary, and Slovakia over Ukraine's agricultural exports to these markets. On September 15, the temporary exceptional restrictions the European Commission (EC) imposed in May 2023 expired. The restrictions envisaged the ban of the supply of four goods (wheat, corn, rapeseed, and sunflower seeds) from Ukraine to the markets of five member states (Poland, Hungary, Slovakia, Bulgaria, and Romania) (see details in MEMU #220). According to the EC, these restrictions were lifted as "market distortions" were eliminated. Instead, Ukraine pledged to control supplies to neighbouring countries from September 16 to prevent "any market distortions" and to propose legal measures that would avoid a rapid increase in grain exports to these markets in the future.

However, Poland, Slovakia, and Hungary disagreed with the EC's decision. These three countries have imposed individual restrictions, with Poland and Hungary adding new commodities to the list of bans. In response, on September 18, Ukraine registered with the WTO Dispute Settlement Body a request to hold consultations with these three countries.

Emotions have subsided since the beginning of October, but the conflict remains unresolved. On September 18, Ukraine presented a legal mechanism for supply control to neighbouring countries and the EC. Discussions are ongoing, but there is no decision to lift the restrictions.

Figure 5: Food and non-food exports of Ukraine, USD billion



Source: SCSU

This conflict has two dimensions of negative impact on Ukraine. The first and most apparent is business losses due to lack of access to the nearest markets and complicated transit since compliance with restrictions requires additional control measures. Against the backdrop of russia's active shelling of port infrastructure on the Black Sea and the Danube, all this is a deterrent to Ukrainian exports. The second negative dimension is that the individual restrictions of the member states undermine the basic principles of the functioning of the EU as a single customs territory with the exclusive right of the EC to conduct trade policy. And this is not in Ukraine's strategic interests.

State Budget: Constrained Budget for 2024

Budget-2023. In September, revenues due to the State Budget's general fund amounted to UAH 144.1 bn. They were higher than in August, primarily due to receiving a regular grant from the United States for USD 1.25 bn (equivalent to UAH 45.7 bn), which more than compensated for the seasonal decline in CIT revenues.

First, due to the difference between the hryvnia exchange rate set in the budget and the actual one (UAH 36.6 per USD currently vs. assumed in budget UAH 42 per USD), revenues from payments administered by the State Customs Service amounted to 92.4% of the planned in September. That relates to the under-execution of VAT on imported goods, revenues from which still increased by 29.7% yoy. At the same time, the State Tax Service reported on the over-execution of the plan for its payments by 2.4%.

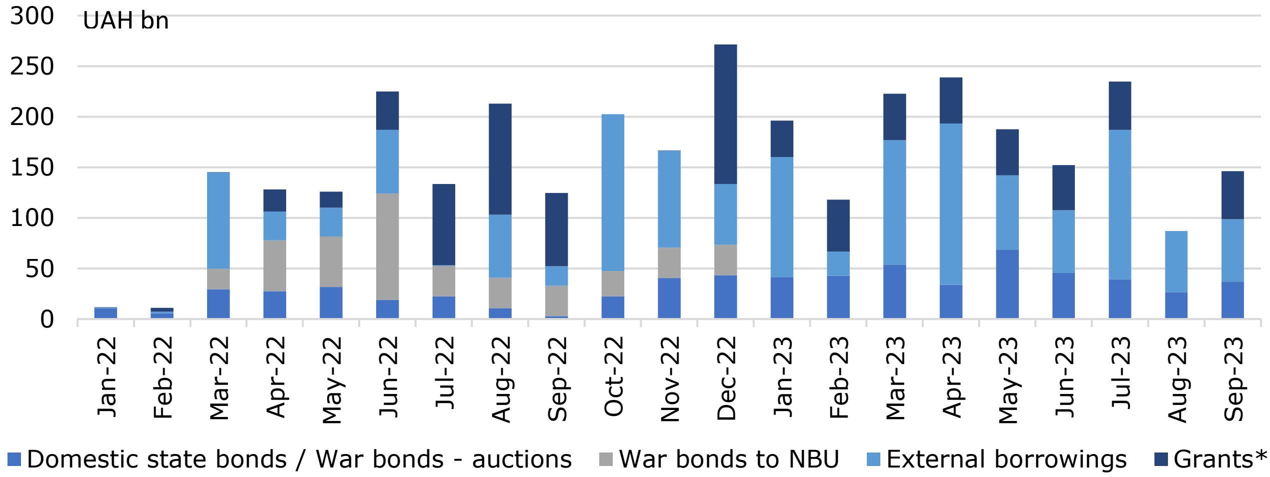
Gross domestic VAT revenues increased by 12.1% yoy, i.e., slightly faster than inflation, indicating a slow recovery in consumption. At the same time, VAT refunds amounted to UAH 10.7 bn, which generally corresponds to the average monthly refund in recent months.

Subsequently, expenditures on security and defense grew the most (by more than 20% yoy) due to higher expenditures on both financial support and the purchase of military equipment and appliances. Social protection expenditures increased by almost 5% yoy. Like most other non-defense expenditures, they were provided by international aid flow. In September, in addition to a grant from the United States, Ukraine also received a regular tranche of a soft loan from the EU for EUR 1.5 bn and USD 100 m under UK guarantees.

In September, the government also raised UAH 36.9 bn from the placement of domestic government bonds. Of these, UAH 10 bn was received from benchmark domestic government bonds, and UAH 14 bn was denominated in foreign currency. Indeed, foreign currency domestic government bonds were refinancing the previous ones. There was almost no decline in yields, despite the lower key policy rate, due to limited demand in the market.

In general, in the first nine months of 2023, the State Budget deficit amounted to UAH 802 bn and was financed mainly by international aid. According to the Ministry of Finance, as of October 12, international aid amounted to USD 33.8 bn, 8.7% more than in 2022.

Figure 6: Funding and grants received by the state budget, UAH billion



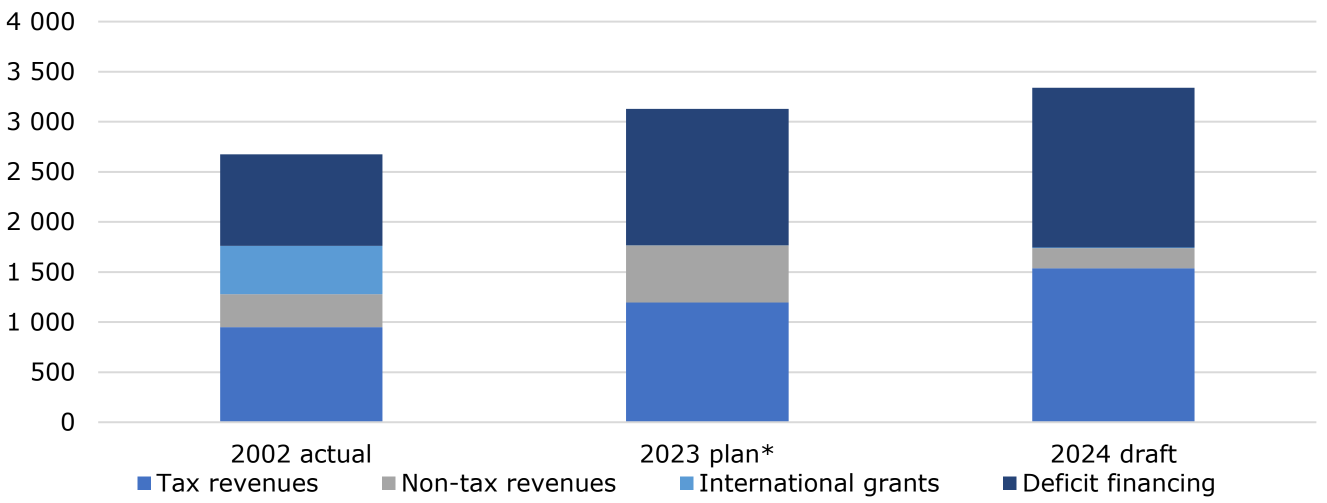
*Note: * Grants are part of budget revenues, which are accounted for under the code 42000000 "From the European Union, foreign governments, international organizations, donor institutions".*
Source: Ministry of Finance, openbudget.gov.ua

Amendments to the Budget for 2023. The draft State Budget for 2023 was prepared on the assumption that hostilities would reduce activity in mid-2023, but, unfortunately, this did not happen. Accordingly, the government was forced to amend the State Budget law for this year to allocate more funds to finance defence and security. On October 6, MPs approved amendments to the budget, which increased spending on defense and security by UAH 303 bn, of which UAH 225 bn is for defense financing. Additional expenditures will be primarily financed by higher domestic borrowings (UAH 290 bn), which is a rather ambitious plan.

Budget-2024: The draft law on the State Budget for 2024 submitted by the government provides for State Budget revenues of UAH 1,746 bn and expenditures of UAH 3,308 bn. Budget revenues are based on the government's initiative to direct the military personal income tax to the state budget, not local budgets, which still need to be voted on in parliament. The main priority of the budget remains the financing of defence and security. At the same time, domestic sources of income (revenues and internal borrowings) are barely enough for the planned expenditures for these purposes. Therefore, dependence on international financial assistance to finance other expenditures remains exceptionally high.

Thus, the 20.4% of GDP deficit should be primarily financed by external borrowing equivalent to USD 42 bn (as in 2022-2023, all international financing is reflected as borrowing in the planned indicators). At the same time, so far, most of this amount is not guaranteed by international partners. The EU still has to fully approve allocating the Ukraine Facility support package to Ukraine, which assists with €50 bn. At the same time, approximately EUR 39 bn is budget support (mainly concessional loans), EUR 8 bn is investment guarantees (including war risk insurance), and the rest includes subsidies for the interest rate on the loan and technical assistance. Prime Minister Denys Shmyhal has already stressed that Ukraine hopes to receive EUR 18 bn in the program's first year.

Figure 7: Key budget indicators, UAH billion



*Note: * plan for 2023 as of the beginning of Sept.2023 - does not include amendments to the State budget, voted afterwards*
*Note: * 2023 plan at the beginning of September 2023 - does not include essential changes to the budget that the government submitted to parliament in September 2023.*
Source: Ministry of Finance

The United States failed to secure Ukraine's place in adopting the short budget, which was necessary for the government to continue its work. Various approaches to supporting Ukraine at the end of 2023 and in 2024 are currently being discussed. In particular, they are considering the possibility of a package vote for aid to Ukraine and Israel and other urgent expenses.

Of the promises, there are funds from the IMF, which Ukraine will receive in case of timely implementation of structural benchmarks, as well as the World Bank and other bilateral partners. In particular, we are talking about funds from Japan, South Korea, Canada, and EU countries.

Difficulties with budget financing have led to a sharp reduction in capital expenditures of the budget in general and expenditures on recovery and reconstruction in particular. The Fund for the Elimination of the Consequences of Armed Aggression will be financed from the remaining funds for 2023, as well as the confiscation of russian assets (the former are not so large, and the latter needs to increase the efficiency of the process). If 50% of the NBU's profit directed to the budget was allocated for the Liquidation Fund in 2023, then next year, all the NBU's profit is planned to be directed to general needs. That will happen as the estimated profit decreased from UAH 71 bn in 2023 to UAH 17.7 bn in 2024. At the same time, reconstruction programs will be financed at the expense of earmarked funds received from international partners. In particular, we are talking about the World Bank and the European Investment Bank.

MPs submitted proposals to the Draft Budget 2024 for more than UAH 12.5 trillion. For obvious reasons, the Budget Committee, when considering the proposals, rejected most of them. At the same time, the Committee identified certain items of expenditure that should be reviewed and noted 61 proposals that the Ministry of Finance should analyze. The Committee also stated that in case of adopting the draft law on taxation of excess profits of banks, Budget revenues should be increased by UAH 9.9 bn. Accordingly, no later than October 20, MPs must vote for the decision of the Committee to complete the consideration of the draft State Budget in the first reading.

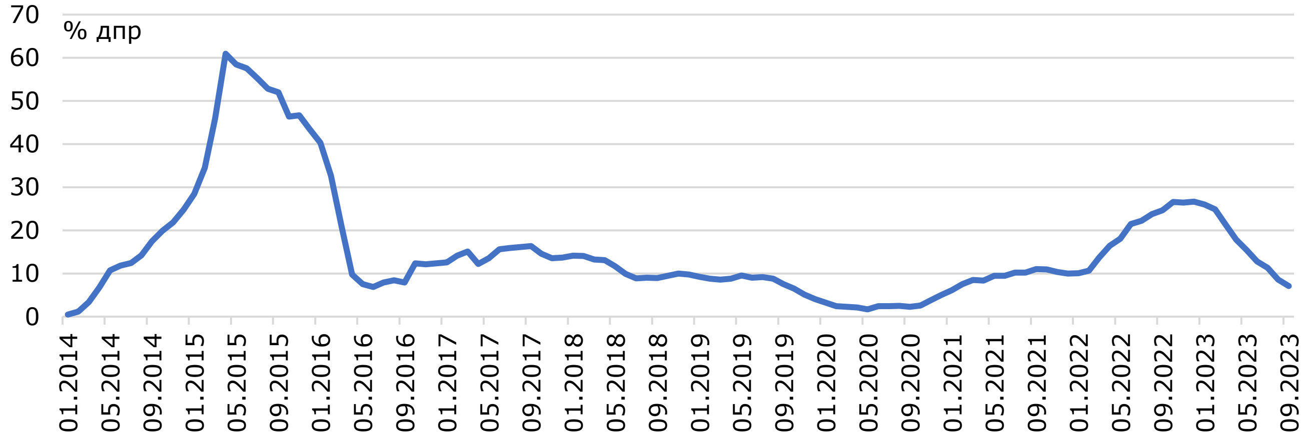
Inflation: Slowdown continues but may stop in the coming months

In September, consumer inflation continued to decelerate and reached 7.1% yoy. The last time it was slower was in January 2021. As before, the main drivers of the slowdown in inflation were restrained consumer demand (although it is gradually recovering), lower global prices for agricultural goods, and the NBU's support for the hryvnia exchange rate.

In monthly terms, inflation was 0.5% mom in September. On the one hand, prices for many goods and services increased due to seasonal factors and the peculiarities of the State Statistics Service's methodology. That includes eggs, clothing and footwear, as well as educational services. Fuel prices continued to rise: they started growing due to higher taxes and continued increasing due to higher global oil prices. Fuel prices increased by 4.9% mom in September and by almost 21% in three months (compared to June). On the other hand, according to the calculations of the State Statistics Service, prices for vegetables and fruits fell, including prices for beets, potatoes, onions, carrots, cabbage, and apples. Prices for other goods and services increased on average, but the increase was negligible.

However, price growth may accelerate slightly in the coming months: consumer demand continues to recover, more expensive fuel has increased the transport costs of producers and retail chains, and prices for fruits and vegetables are likely to rise this month and beyond.

Figure 8: Consumer price inflation



Source: State Statistics Service of Ukraine

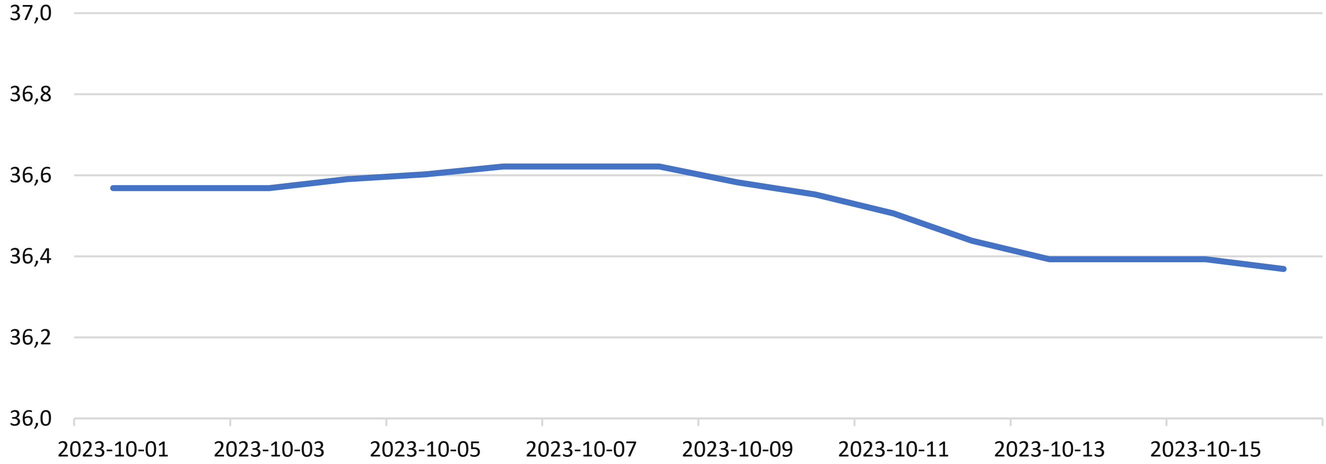
Monetary and FX policy: NBU cuts key policy rates and takes the first step away from a fixed exchange rate

Monetary policy. In September, the NBU lowered the key policy rate to 20% per annum from 22% in July. Before that, the NBU kept it at 25% p.a. since June 2022. The NBU justified its decision by declining inflation and improving the macroeconomic situation, which generally aligned with the NBU's July forecast. The NBU remained optimistic that lowering the key policy rate would not harm the attractiveness of hryvnia savings compared to investmentd in foreign currency.

Unlike the previous NBU monetary policy meeting, when the participants' opinions were divided, this decision was supported by the majority of the MPC members. Most members of the Monetary Policy Committee also expect a slowdown in the pace of interest rate cuts at the following meetings: they forecast the discount rate at 18% p.a. by the end of the year.

Foreign exchange policy. In early October, the NBU also took the first step towards increasing the flexibility of the hryvnia exchange rate against the US dollar. The official dollar exchange rate will no longer be fixed but will change daily following the results of trading on the interbank market. However, the NBU promised that at the first stage, fluctuations in the hryvnia exchange rate will be small, and the NBU's support for the exchange rate will continue. the NBU's initial goal is to get businesses used to exchange rate fluctuations and gradually return banks to normal operation in the interbank market. Banks will continue setting freely the hryvnia exchange rate in exchange offices and for card transactions.

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



Source: NBU

In the first weeks of the non-fixed hryvnia, changes in the exchange rate against the dollar were significantly less than 1%, and the hryvnia strengthened slightly vs US dollar. The NBU continued to sell dollars to support the hryvnia exchange rate: in the two weeks of October, the NBU spent USD 1.7 bn on this compared to USD 2.7 bn for September. This situation is likely to persist in the coming weeks. However, the NBU deliberately maintains uncertainty about the timing of the first stage and further steps to increase the fluctuations of the hryvnia against the dollar. The flexibility of the exchange rate will gradually increase, but the possibility of abandoning the managed hryvnia exchange rate is not yet seriously discussed.

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