Monthly Economic Monitoring of Ukraine

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Summary

- In July, the "Grain Deal" was suspended, and russian massive shelling of the infrastructure of Odesa seaports and river ports on the Danube created risks for the exports resumption.
- According to the IER estimate, real GDP growth in July slowed to 8% yoy compared to 15% yoy in June, primarily due to a higher statistical base.
- In July, Ukraine was actively preparing for winter: it repaired nuclear power units and thermal power plants and increased natural gas and coal reserves. However, the risks remain high.
- Due to the shutdown of the "grain corridor", queues for transporting goods by rail and road transport have increased again.
- In July 2023, exports of goods fell to the lowest level since the beginning of russia's full-scale military aggression.
- More than half of the State Budget expenditures are directed to defence and security, and international assistance is channelled as previously for social expenditures and salaries.
- Many local budgets have a surplus, but according to the law, they cannot spend money on weapons.
- The number of state-owned banks has increased: Sense Bank has been nationalized. So far, recapitalization by the state is not envisaged.
- In July, consumer inflation slowed to 11.3% yoy due to restrained consumer demand and the NBU's keeping the hryvnia exchange rate fixed. That allowed the NBU to reduce the discount rate from 25% to 22%.

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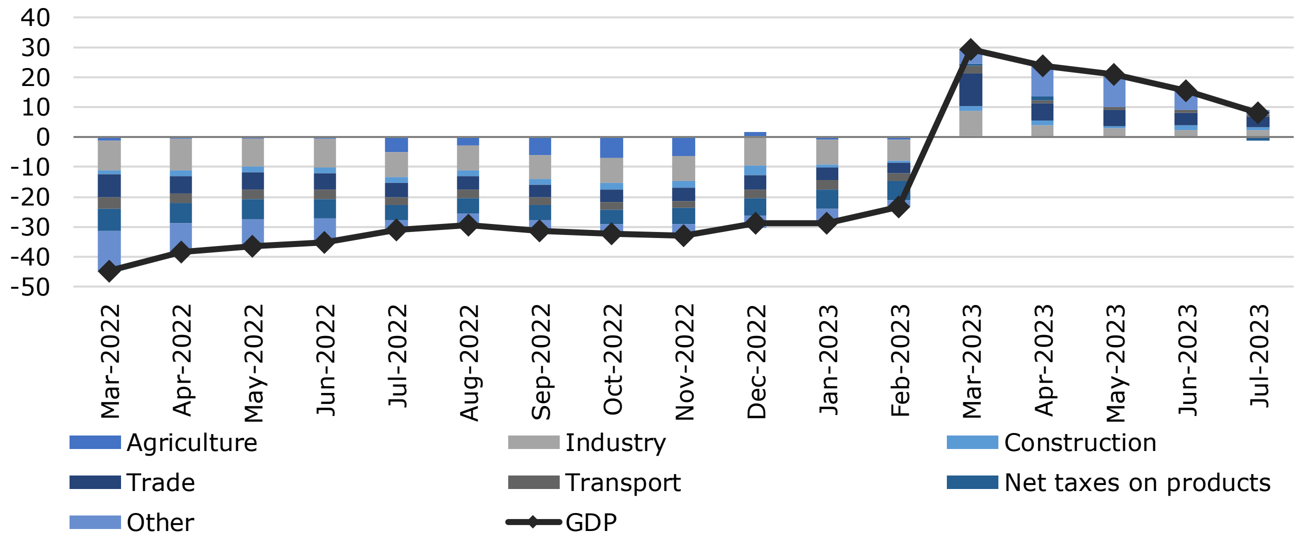
GDP and the real sector: Risks to economic recovery are high

In July, the Grain Initiative was terminated, and russian troops carried out numerous shelling of the infrastructure of the seaports of Big Odesa and the river ports of Izmail and Reni on the Danube. The suspension of exports by sea and the slowdown in goods exports through the Danube ports slowed the economic recovery in July. Russian shelling of port facilities continued in August. It also hurts the future recovery of exports and the economy. Although there are discussions on possible negotiations with russia on extending the Grain deal, the question has now arisen about Ukraine's ability to restore export volumes. At the same time, russia benefits from a slowed decline in world grain prices, partly caused by a decline in exports by Ukraine. The restriction of ports operation also negatively affects the industry's logistics chains, particularly regarding iron ore mining and metallurgy. Now, they will compete more with grain traders for the railway freight capacity.

At the same time, the results of a monthly IER business survey show that production and sales indices remained positive as well as expectations. Monitoring the work of large enterprises showed positive changes in several sectors of the economy. According to the IER estimate, the real GDP growth rate in July decelerated to 8% yoy from 15% yoy in June. The slowdown in growth primarily reflected a higher statistical base (the pace of GDP decline in the third quarter of 2022 slowed down significantly). However, economic activity has not yet approached pre-war: according to our estimates, real GDP fell by 25% compared to July 2021.

According to the IER estimate, real gross value added (GVA) in agriculture increased by almost 5% yoy primarily due to the lower statistical base of July 2022. The grain harvest in July was close to last year due to higher yields. The flooding of territories in June due to the destruction of the Kakhovka dam by russians slowed the pace of crop recovery. The mining industry grew insignificantly compared to last year. At the same time, we estimate that the processing industry grew by more than 20% yoy due to the recovery of all sectors from a low base. The growth rate of real GVA in transport slowed to 9% yoy, while the GVA in trade continued to grow rapidly (about 27% yoy). However, the real GVA was significantly lower than in 2021 in all sectors.

Figure 1: Contributions to real GDP, p.p.



Source: IER assessment made with the support of the USAID Competitive Economy Program

Energy: Ukraine is preparing for winter

Electricity. Ukraine continues the repair campaign in the energy sector. As of August 7, five nuclear power units, nine power units of thermal power plants, and six hydraulic units have been repaired. As a result of the repair campaign, the government plans to add 2.9 GW of capacity to the grid compared to April and put into operation all nine available nuclear power units. However, even this additional volume will not be able to cover the country's electricity needs. The rest is planned to be covered by imports. According to experts, the generation deficit will be 1.2 GW, or about 10% of consumption, in August and September.

In summer, the energy system often had to use coal-fired power units at TPPs to overcome the deficit. Therefore, only 1.4 m tons of coal have been accumulated in the warehouses of TPPs, which is 100 thousand tons lower than what was planned for the beginning of August. The Ministry of

Energy encourages thermal power plants to use fuel oil to save coal. At the beginning of the heating season, it is planned to accumulate 1.8 m tons of coal and 14.7 billion cubic meters (bcm) of gas.

Due to the hot weather, the population increases electricity consumption in the evening. Ukrenergo warns that simultaneous switching on air conditioners and powerful devices creates a significant load on the power system. The operator calls for reducing their use from 16:00 to 23:00.

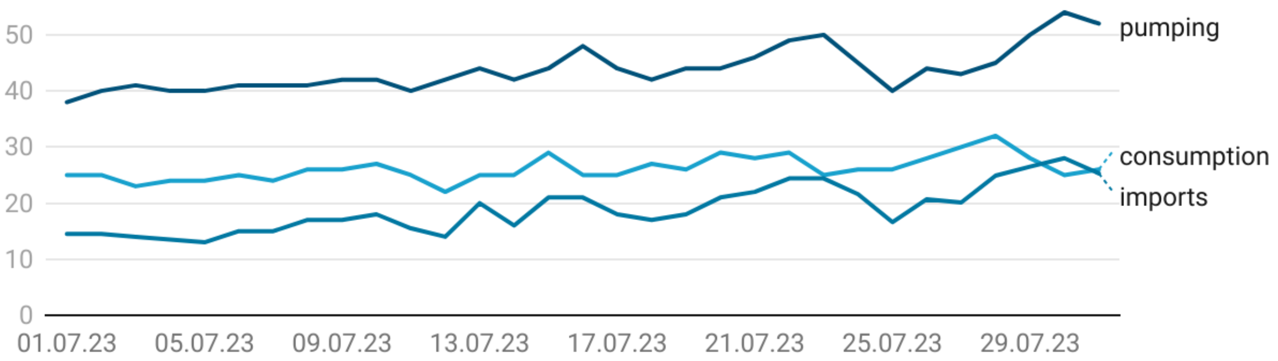
Legislation. The President signed the Law on Green Transformation, which establishes certification of the origin of "green" electricity and biomethane. That lays the legal basis for auctions to distribute support quotas for commercial projects to construct new generating capacities, export electricity from renewable energy sources, etc. Guarantees of origin will confirm the "green" status of Ukrainian electricity produced from renewable sources (RES, sun, wind, biomass, biogas, HPP). They will allow duty-free exports to the EU of goods produced using "green" energy. Such export introduces an opportunity for consumers to install power generation facilities and to release unconsumed surplus electricity to the grid at free market prices. At the same time, the government has repeatedly announced that there are no plans to return to a high green tariff, and the debt to the current green generation will be extinguished after the war.

The government has simplified procedures for the installation of mobile gas turbines. Decentralization of generation is one of the ways to protect power facilities from enemy attacks.

Gas. As of August 2, 12.4 bcm of gas has been accumulated in underground gas storage facilities in Ukraine, and 13.8 bcm is planned for September 1. In July, 1.358 bcm were pumped into storage facilities (in July last year - 1.065 bcm). Gas consumption in July increased by 46% yoy to 0.803 bcm due to the increased use of gas by CHPs and TPPs for electricity production at a reduced price for the population. The government continues to refuse to raise the gas tariff for households. That leads to financial losses for Naftogaz and other companies in the sector.

On August 1, daily gas imports in Ukraine reached a three-year high of 38.1 m cubic meters. Most gas came from Slovakia – 21.9 m cubic meters, or 57%.

Figure 2: Natural gas in July 2023, m cubic meters



Source: ExPro Consulting, Naftogaz

European traders have stepped up the use of Ukrainian gas infrastructure. In July 2023, natural gas inflows and imports to Ukraine amounted to 589 m cubic meters; more than 99% arrived for storage at the "customs warehouse" and in transit. Thus, Ukraine received from Hungary 223.8 m cubic meters (38% of total revenues in July), from Moldova – 142.9 m cubic meters (24%), Slovakia – 119.6 m cubic meters (20%), Poland – 102.8 m cubic meters (18%).

Transport: Russia withdrew from the "grain deal"

Maritime transport. In the first half of July, 292 thous. tons of agricultural products were exported through seaports within the framework of the "grain corridor". On July 18, Russia withdrew from the Black Sea Grain Initiative and threatened to consider any ships heading to Ukrainian ports as military targets. In response, Ukraine noted that it would pursue maritime trade despite the threats, allocated temporary corridors for passage through the Black Sea, and began registering vessels. Ship owners and captains were informed of the risk from the Russian fleet and the threat of mine danger in the Black Sea. On August 14, Russia tried to stop and inspect a Turkish ship heading to the port of Izmail. The threat to merchant shipping in the Black Sea is increasing.

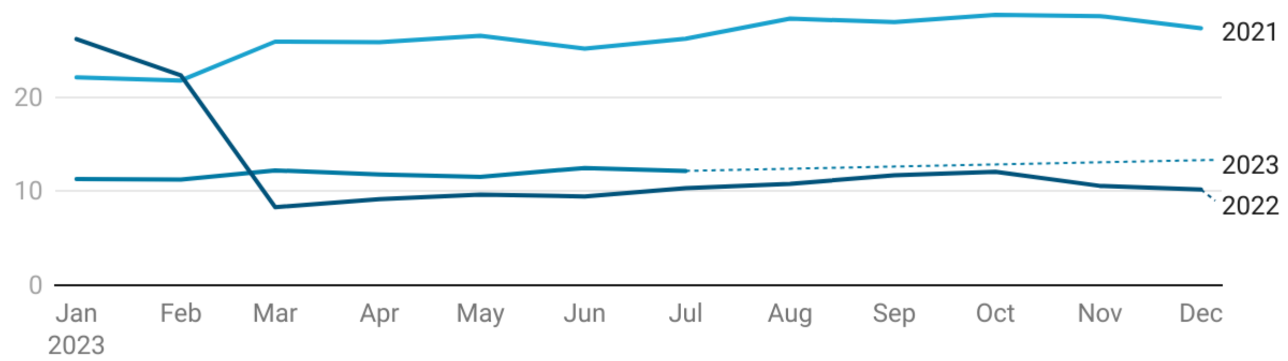
In July, Ukraine exported 2.1 m tons of grain and oil through river ports. To increase transshipment in river ports, the USPA is organizing raid transshipment of grain in the port of Ust-Dunaisk, where the boundaries of its water area were expanded. Raid transshipment of Panamax-class vessels will also be arranged in the port of Izmail.

Railway transport. Due to the cancellation of the "grain deal," cargo traffic to Ukrainian ports on the Danube increased, and queues formed on the railway. The most extensive line of more than 7.5 thous. wagons formed at the port of Izmail. With an average daily transfer of 278 cars, the queue is 27 days. Therefore, Ukrzaliznytsia announced that the port of Izmail will not accept orders from recipients whose waiting queue exceeds 30 days. Currently, there are 16 such recipients in the port.

In July, 12.2 m tons of cargo were transported by rail. This volume is 2.5% less than in June and 17.5% more than in July 2022. Transportation of goods for export (including transportation to ports) decreased by 16.8% mom — to 3.3 m tons. The most popular export goods transported by rail were grain and ore (44% and 24% of total export traffic by rail).

In July 2023, the queues of freight wagons at the western border crossings increased to 8800 cars, which is 26% more than in June. The grain wagons accumulation in the border crossings' direction increased by 46.5%.

Figure 3: Transportation of goods by rail, million tons



Source: Ukrzaliznytsia

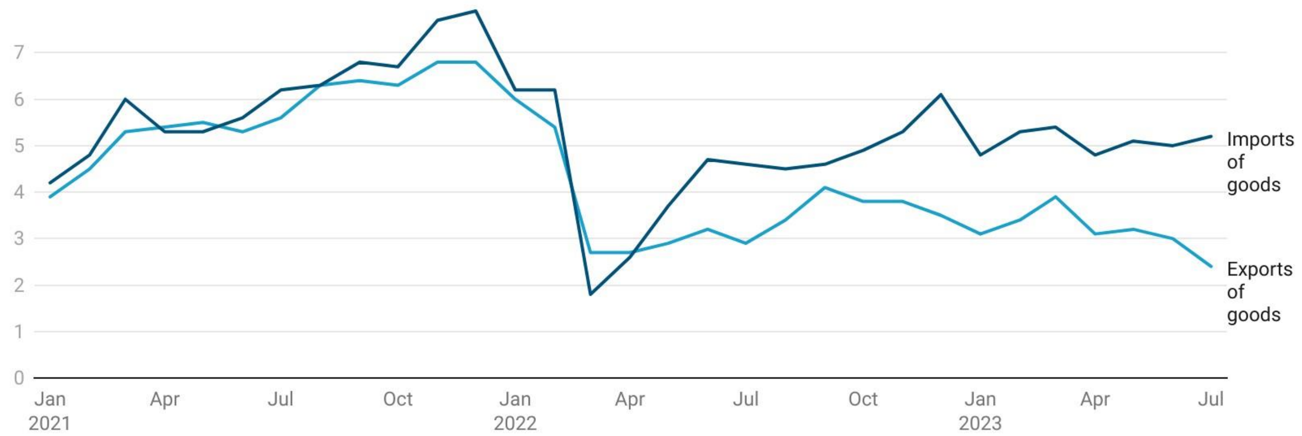
Road transport. As of July 31, about 3.5 thous. trucks were registered in the electronic queue for border crossing at 16 international road checkpoints, which is 5% less than at the end of June. In June, 197 thous. tons of grains and oilseeds were exported by road, 4% more than in June.

In August, the Ministry of Infrastructure launched a test mode of border crossing for regular bus routes. For the pilot testing of eQueue, a checkpoint on the border with Poland – "Yagodyn-Dorohusk," was selected. Now the pilot is also extended to the "Ustilug-Zosin" checkpoint. Bus drivers must register the vehicle in the eQueue system and arrive at the border at the time specified in the route.

International trade: In July, exports of goods fell to the lowest level since the beginning of a full-scale war

In July, Ukraine exported goods worth USD 2.4 bn, or USD 0.6 bn less than in June. That is the lowest figure since the beginning of russia's full-scale aggression against Ukraine. Compared to July 2022, exports decreased by 18%. At the same time, imports amounted to USD 5.2 bn, 13% higher than last year. In total, in the first seven months of 2023, Ukraine exported goods worth USD 21.9 bn (-16% yoy) and imported USD 35.7 bn (+ 19% yoy). The trade deficit in goods reached USD 13.7 bn, thus, for the second month in a row, exceeding the cumulative deficits in goods trade for the entire year of 2022.

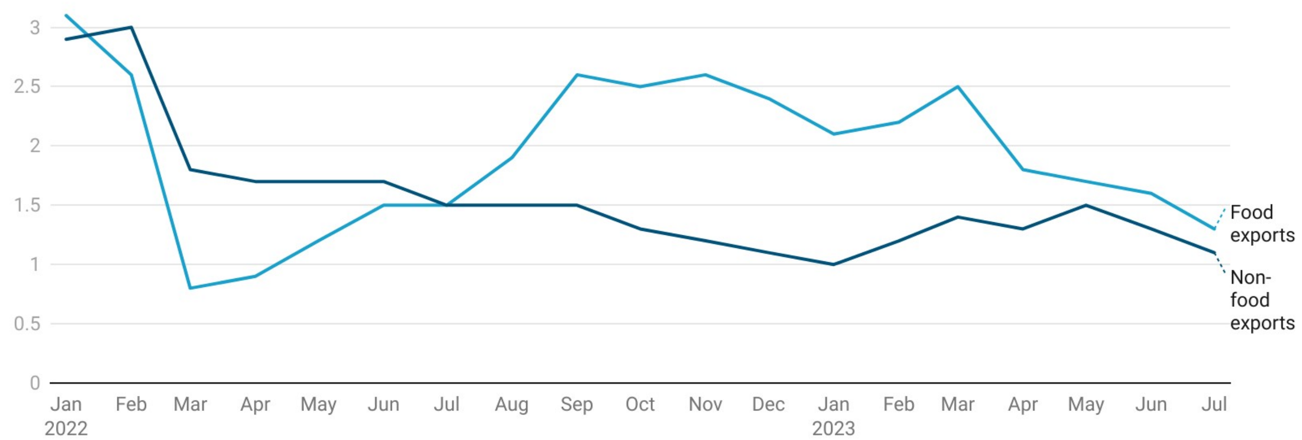
Figure 4: Ukraine's foreign trade in goods, USD bn



Source: UN Comtrade, State Customs Service of Ukraine

Although the decline in food exports was the main driver for the drop in goods exports in July compared to June, non-food exports also reduced. In food, the main shock came from grain exports, which fell by USD 0.4 bn or 2.2 m tons - the lowest since August 2022. The main reasons were the termination of the Black Sea Grain Initiative, the bombardment and destruction of part of the infrastructure of ports in Odesa and on the Danube, the deterioration of access to ports due to security threats, as well as the continuation of the ban on grain exports (wheat and corn) to Poland, Hungary, Romania, Slovakia and Bulgaria. Logistical problems caused by the need to reorient food exports also put pressure on exports of other goods. Additional negative factors for non-food exports were the consequences of the explosion of the Kakhovka HPP and the ongoing bombardment of industrial facilities.

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



Source: State Customs Service of Ukraine, food exports include HS groups 1-24

State budget: Resumption of medium-term budgeting

Medium-term planning: The Parliament adopted amendments to the Budget Code of Ukraine (BCU) to resume medium-term budgeting. In 2024, the government should prepare a Budget Declaration. At the same time, a medium-term forecast of revenues and expenditures should be submitted with the draft Law on the State Budget for 2024. Also, these amendments to the BCU determined that restrictions on state-guaranteed debt do not include financing projects at the expense of IFIs. That is important for funding recovery projects in the future.

The government has launched the elaboration of a four-year Ukraine Plan (full name: Action Plan within the framework of the implementation of the European Commission’s Proposal for a Regulation of the European Parliament and of the Council on Establishing the Ukraine Facility), which should become the basis for the provision of macro-financial assistance from the EU in the total amount of EUR 50 bn. Thus, it relates to determining the conditions for providing support to Ukraine based on the results of a quarterly assessment of the conditions met. Therefore, Ukraine Plan should be realistic and envisage reforms that will help the country achieve macro-financial stability and economic growth. Notably, the EU institutions have yet to adopt legislation to introduce a new instrument to support Ukraine (Ukraine facility).

Of the EUR 50 bn, 78% (the Parliament suggests 75% with amendments) will be directed through the budget: these funds will primarily be spent on financing recurrent expenditures of the state, as in 2023. These are most likely primarily concessional loans from the EU, although the parliament stresses the need to increase the share of grants. 17% of the funds are provided for the Investment Guarantee instrument, particularly military risk insurance. We hope that insurance will be provided not only to EU companies but also to Ukrainian businesses. The remaining amount (respectively 5% or 8%) is international technical assistance and a subsidy for the interest on the loans provided under the first component of the support program. According to the current plan, the Plan of Ukraine should be adopted in October, although it remains unclear which entity will be the official author of the document.

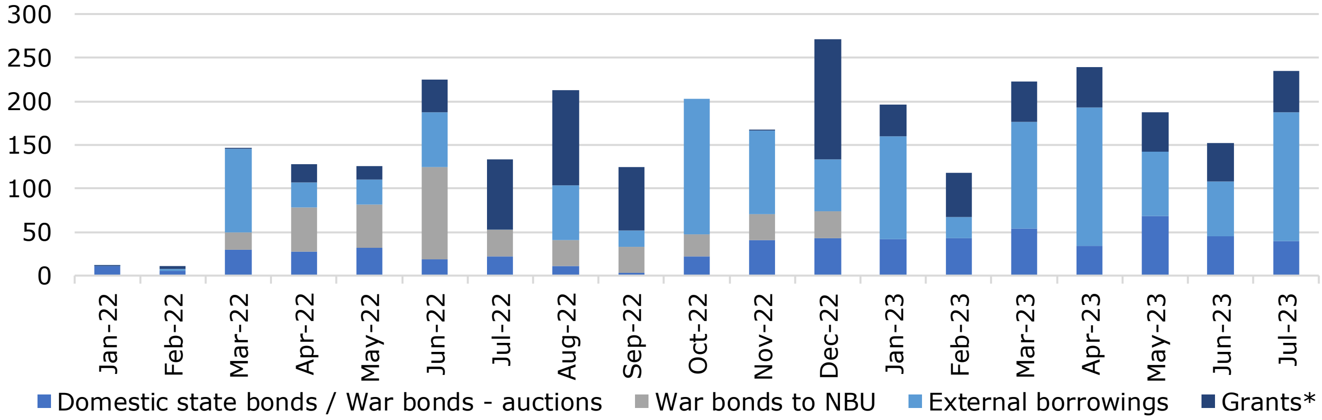
Budget. In July, budget revenues were lower than last year, primarily due to lower amounts of grants that are part of budget revenues. This year grants of UAH 47.6 bn (in equivalent) were 1.7 times less than last year when funds came from Germany and the United States. Tax revenues were also lower than last year. Notably, in July 2022, record amounts of gross VAT revenues were received due to the resumption of the monitoring system of invoices (particularly in submitting tax invoices) and the cancellation of import exemptions. At the same time, there was virtually no VAT refund at that time, whereas this year, it amounted to UAH 10 bn. Personal income tax revenues grew compared to both July 2022 and June 2023. That resulted from further high volumes of funding for military personnel remuneration and some recovery in labour demand. The IER business survey shows that difficulties in finding employees are growing.

Revenues from personal income tax also contribute to the growth of local budget revenues. As a result, during the last month, there was a heated discussion about the priority of financing expenditures: whether local authorities should continue to finance current repairs or channel money to support territorial defence and military units registered in communities. It is worth noting that according to the BCU, local authorities cannot buy weapons. At the same time, according to the amended rules, they can transfer a subvention (earmarked transfer) to the state budget for the purchase of appropriate weapons or transfer funds to a special account of the Ministry of Defense in the NBU. Current analysis shows that many local budgets are now in surplus primarily due to spending constraints allowed through the State Treasury.

In state budget expenditures, more than 50% are allocated for security and defence programs. The government finances them from domestic sources: tax and non-tax revenues and domestic bond placements.

At the same time, the government continues to fully finance social obligations and salaries with funds received in the budget from international partners. Recovery expenditures remain limited and are primarily carried out within the budget program of the Fund for the Elimination of the Consequences of Armed Aggression, which is filled with money from the confiscation of russian assets and part of the NBU's profits.

Figure 6: Funding and grants received in the state budget, UAH bn



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

In July, the Ministry of Finance placed domestic government bonds in the amount of UAH 39.1 bn, compared to UAH 45.4 bn in June. From this, the placement of bonds denominated in foreign currency decreased from UAH 17 bn to UAH 8.3 bn. The NBU has added another issue of government bonds to the list of benchmark bonds that commercial banks may include in mandatory reserves. After the National Bank lowered the discount rate, the Ministry of Finance is also trying to reduce the yield on government bonds somewhat, but the demand for bonds with reduced yields is still limited.

Nationalization: One state-owned bank has more

The government bought sense bank from the Deposit Guarantee Fund for UAH 1. The nationalization occurred after Verkhovna Rada adopted a special law on bank withdrawal from sanctioned shareholders. Still, the share of the Italian UniCredit, which indirectly owned 9.99% of the bank, was also seized. Consequently, another bank appeared in state ownership. The bank has not yet reported on the need for recapitalization by the state, and in the first half of 2023 reported a profit of more than UAH 2 bn.

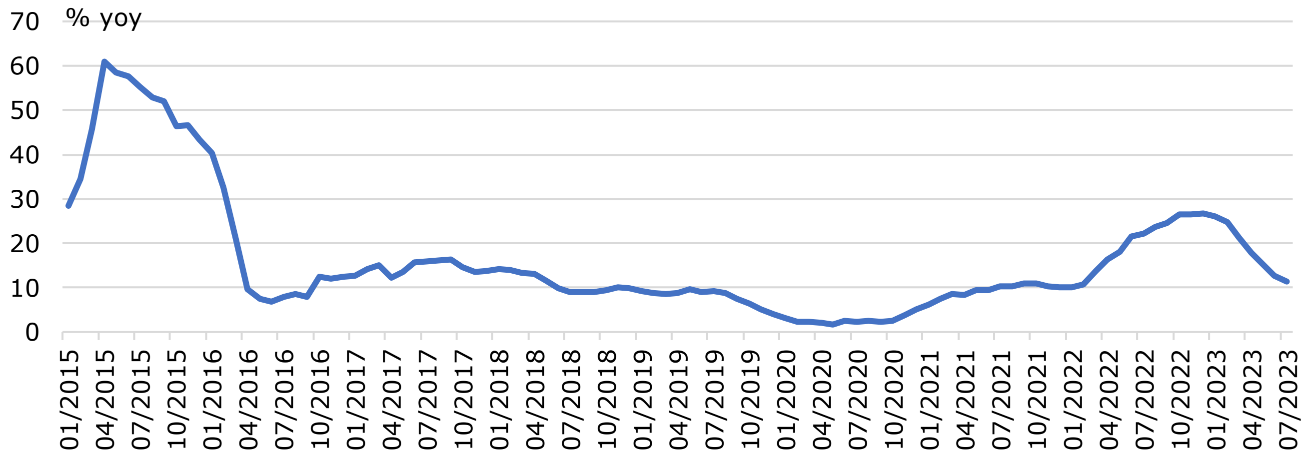
A few months earlier, the HACC had seized PINbank shares belonging to the sanctioned person in favour of the state, but that has not yet been reflected in the ownership structure on the NBU website.

Inflation: Prices in July remained at the level of May, excluding the increase in electricity tariffs

In July, consumer inflation slowed for the seventh consecutive time to 11.3% yoy (over the past 12 months) compared to 26.6% yoy in December 2022. That was due to restrained consumer demand and the NBU's keeping the hryvnia exchange rate fixed, limiting the growth of import prices and contributing to lower inflation expectations. Also, the supply of some goods increased, logistics chains partially recovered, and the price of energy and several other commodities on world markets decreased.

As a result, prices for some goods were lower than last year. Prices for the key cereals and vegetable oil decreased due to lower world prices and export difficulties. According to the State Statistics Service, the average price of buckwheat has almost halved due to the increase in crops this and last year. Due to limited demand, prices for clothing and footwear fell slightly, and due to improved supply, fuel prices were lower than last year despite higher taxes. However, prices have increased significantly for most items compared to July 2022.

Figure 7: Consumer price inflation



Source: State Statistics Service

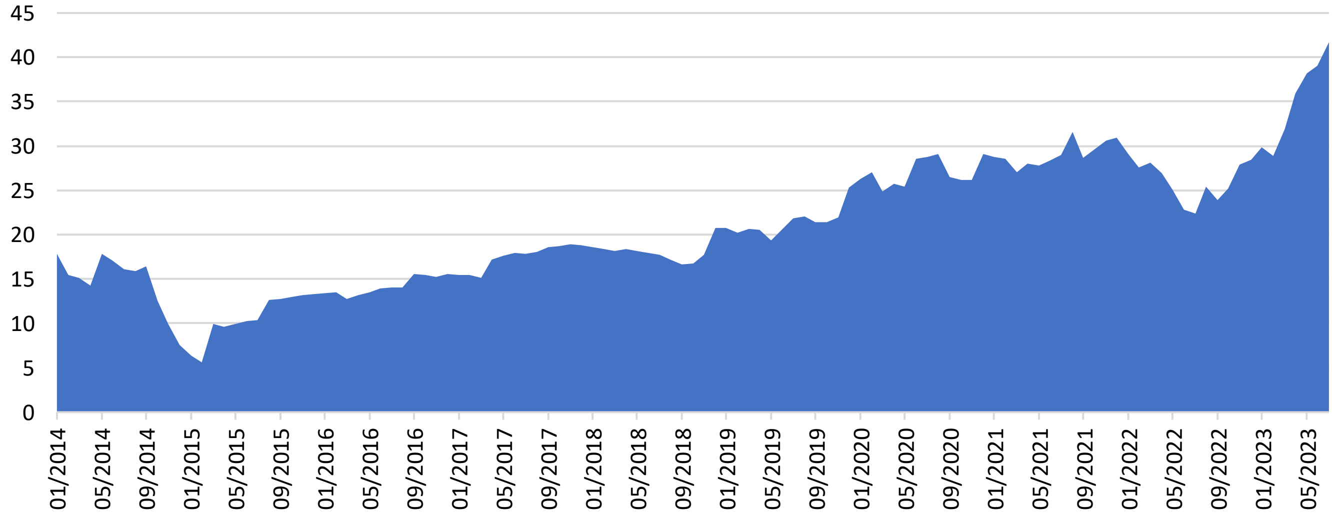
In July, for the first time since the beginning of the full-scale war, the State Statistics Service recorded a monthly drop in the Consumer Price Index. The CPI fell by 0.6% mom (compared to the previous month). However, before the start of a full-scale war, the CPI decline in July and August due to seasonal drops in prices for vegetables and clothing occurred quite often. The impact of seasonal price differences for vegetables on the overall price index this year was quite high due to the peculiarities of the CPI calculation methodology. In July, fuel prices also increased by 7% dpm due to the return of tax rates that were in force before the introduction of martial law.

Monetary policy: NBU lowered key policy rate for the first time since the beginning of the war

The NBU, as expected, lowered the discount rate at the last monetary policy meeting. Before that, the NBU kept the rate at 25% per annum for more than a year. However, the scale of the change, at three percentage points to 22% p.a., was higher than expected. Even the NBU forecast prepared for the meeting used a projection of 22.4% per annum at the end of September. The decision was justified by the fact that inflation slowed down faster than previous forecasts and, according to the updated forecast, will slow down even further. By the end of the year, most NBU monetary policy committee members expect a further reduction in the policy rate to 18-20% p.a. At the same time, the NBU expressed optimism that the rate reduction would not significantly affect deposit rates and demand for foreign currency.

In July, the NBU further increased international reserves to USD 41.7 bn, which can pay for almost half a year of imports. In addition to monthly inflows from the EU and the US, Ukraine also received the first loan guaranteed by Japan in July. The NBU's expenditures on maintaining the fixed rate remained stable in the USD 1.8-2.0 bn range within the last three months.

Figure 8: International reserves, USD bn



Source: NBU

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