INSTITUTE OF ECONOMIC RESEARCH AND POLITICAL CONSULTATIONS

Monthly Economic Monitoring of Ukraine

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Resume

- According to the IER, real GDP growth slowed to 19.9% yoy in May compared to almost 22% yoy in April.
- According to the State Statistics Service, real GDP decreased by 10.4% yoy in the first quarter, but this estimate has open issues.
- Russians destroyed the Kakhovskaya hydroelectric power plant and its dam, causing flooding in the south of Khersonska, Zaporizhska, and Mykolaivska regions, electricity shortages, and risks for the Zaporizhzhya nuclear power plant.
- Grain exports by sea slowed down again.
- If the current trends are maintained, the cumulative deficit of merchandise trade in June will almost equal the deficit for 2022.
- The Government of Ukraine and the IMF reached a staff-level agreement on the first review of the IMF Program.
- The NBU has left the discount rate at 25%, marking a year of such a rate. It may change in the coming months.
- Inflation remains restrained: in the last seven months, except for March, the monthly growth of consumer prices did not exceed 1%.

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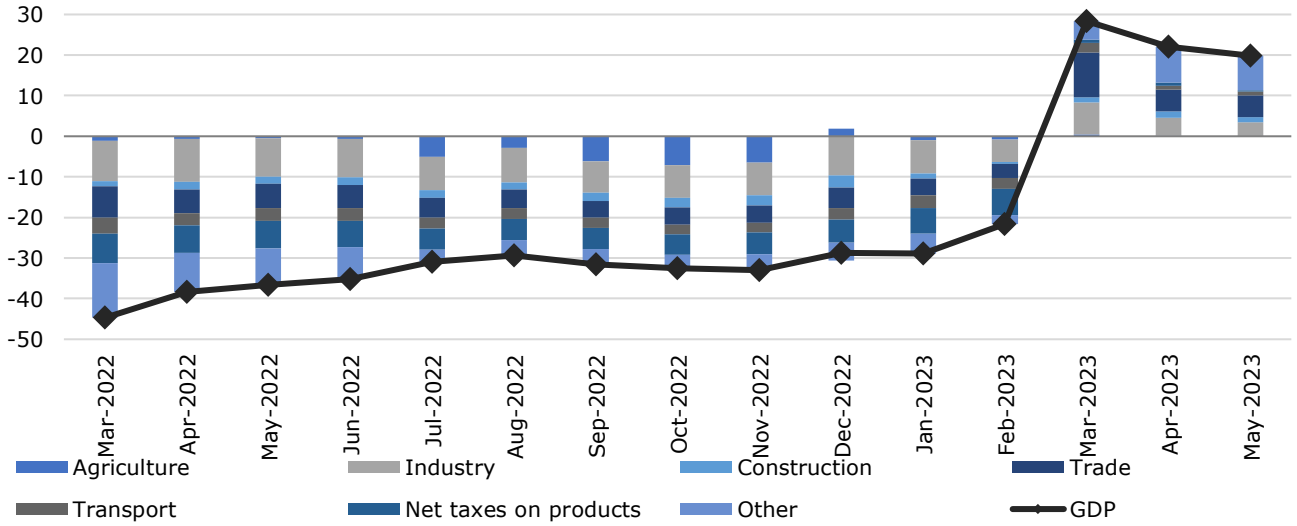
GDP and the real sector: The State Statistics Service GDP estimate for the first quarter adds optimism

In May 2023, russian missile and drone attacks on the entire territory of Ukraine intensified. These attacks harmed the recovery of economic activity in several sectors. According to the results of the monthly business tendency survey conducted by IER, the importance of impediments such as "disruptions of the access to electricity" and "danger of working" increased in May. Other impediments in May were sabotage by russian representatives in the Grain Initiative inspections and restrictions by neighbouring EU countries on Ukrainian imports.

However, economic recovery generally continued, albeit at a somewhat slower pace. According to the IER, real GDP growth slowed in May to around 20% yoy (year-on-year) compared to almost 22% yoy in April due to the higher statistical base of May 2022. According to estimates, real GDP in May remained 24% lower than in May 2021.

The pace of growth in livestock production, which reflects the agriculture indicators in May, slowed down. But agriculture will likely decline from June compared to the previous year, as the indicators will already include crop production. At the same time, the area of sown land was higher than expected, which gives more optimism about the grain harvest. The slowdown in real GVA growth in the manufacturing industry is due to the statistical base effect.

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



Source: IER assessment, made with the support of the USAID Program "Competitive Economy of Ukraine."

The IMF took into account the better-than-expected passing of winter by the Ukrainian economy and improved its estimate of real GDP growth rates in 2023 from [-3%]-[+1%] to [+1%]-[+3%]. This estimate is closer to the IER forecast for 2023, where we estimated real GDP growth at 3%. We, most likely, will revise our forecast for this year since, according to the published estimate of the State Statistics Service, real GDP in the 1st quarter of 2023 decreased by 10.3% yoy, while we estimated a drop of 13.7% yoy, the Ministry of Economy https://t.me/ukreconomic/1962at https://t.me/ukreconomic/196214.1% yoy, and NBU at 13.5% yoy. The difference can be explained by the fact that Russian efforts to destroy the Ukrainian energy system had less impact on the economy than earlier estimated. At the same time, the growth of economic activity after the shelling lessened was probably faster than expected. It is also worth considering that the State Statistics Service has not yet explained how it changed the methodology for calculating GDP due to no reporting from some enterprises. It is also unclear how the reporting of enterprises from the temporarily occupied territories is considered and how widespread such reporting is.

Energy: the Russians destroyed the Kakhovska HPP and its dam

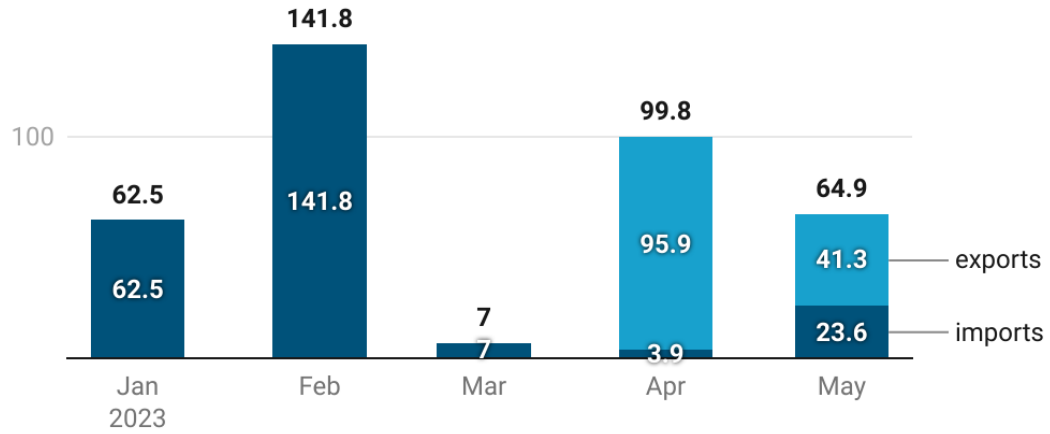
Electricity. On June 6, the Russians destroyed the Kakhovska HPP and its dam, causing flooding in the south of the Khersonska, Zaporizska, and Mykolaivska regions. According to Ukrhydroenergo, the Kakhovska HPP is destroyed and cannot be restored. The destruction of the reservoir will also negatively affect the Zaporizhzhya NPP, which uses this water to replenish its cooling ponds. Already on June 8, the level in the Kakhovka reservoir dropped below the "dead point," which made it impossible to draw water for the needs of the Zaporizhzhya NPP and settlements. The last power unit of the ZNPP went into a "cold shutdown" state. In addition, 20,000 consumers in the Kherson

Region were left without electricity due to the explosion of the Kakhovska HPP and the resulting flood, and the pumping station of the Kherson CHP was flooded. "Ukrhydroenergo" has reduced the capacity of hydropower plants on the Dnipro River and is accumulating water in the upper reservoirs to prevent further water spills.

In May, the available capacity and reserves in the Ukrainian energy system significantly decreased. According to estimates, the deficit reaches 1-1.2 GW; in July, it may reach 1.7-1.8 GW, which is between 7 and 23% of electricity consumption. The reason is that four out of nine power units of nuclear power plants are stopped for repairs. A seasonal repair campaign at nuclear power plants is also underway (on June 1, one power unit of the nuclear power plant was already out of repair).

In addition, Ukraine exports and imports electricity to maintain the balance. Electricity exports are carried out mainly in the morning and afternoon to Poland, and imports are done in the afternoon and evening hours from Slovakia and Moldova. On May 15, Ukraine began commercial electricity exports through the power transmission line from Khmelnytska NPP to Poland's Rzeszów, which opened after modernization. The Polish operator PSE has announced a capacity of 200 MW for the line. Ukraine received emergency electricity aid from Romania and Poland. The total amount of assistance on June 8 was 1,200 MWh.

Figure 2: Import and export of electricity in 2023, thousand MWh



Source: ExPro Consulting

To restore the damaged equipment of CHPPs and TPPs, the Government allowed them to participate in the "5-7-9%" preferential lending program. Funds will also be accumulated by raising tariffs. NERC increased tariffs from June 1: for electricity for households to UAH 2.64 per kWh, for the distribution of electric power for regional energy suppliers by 7.5-28.1% for the first voltage class and by 6.9-25.5% for the second. The increase in tariffs should ensure the stability of the power system, damaged by Russian shelling, in the next heating season.

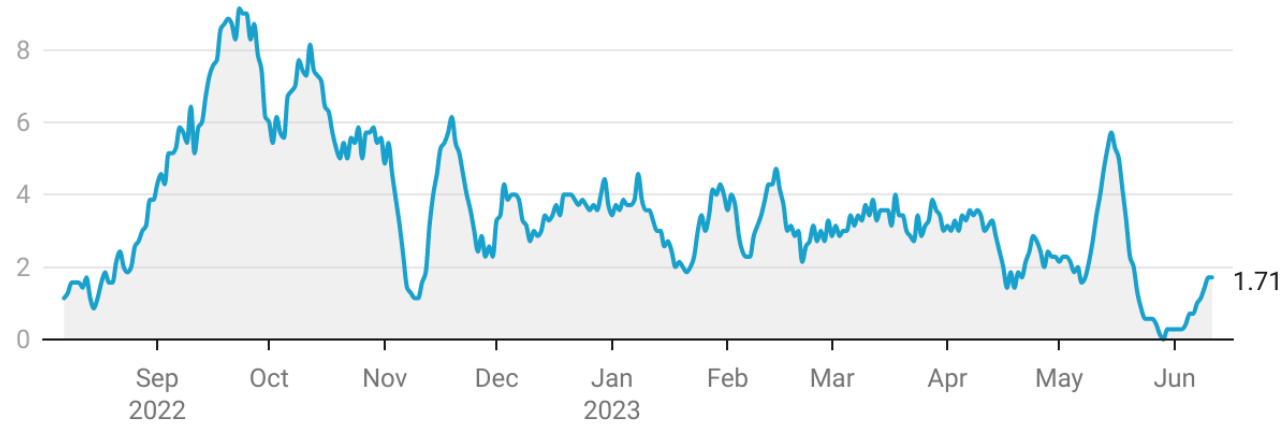
Power generation capacity is also being increased. DTEK launched a new Tyligul wind power plant just 100 km from the territory of the Mykolaivska region occupied by Russian troops. This is the world's first wind power plant built during a military conflict. The wind farm consists of 19 turbines with a total installed capacity of 114 MW. After the completion of the works, the full power of the station will reach 500 MW, making it the largest wind farm in Eastern Europe.

Gas. "Ukrgazvydobuvannya" launched one of the most potent wells in recent years. Currently, 580,000 cubic meters of gas are extracted from it daily. The prospective gas resources of this block are estimated at more than 6 billion cubic meters.

Transport: the operation of the "grain corridor" was effectively blocked in May

Maritime transport. Although the Black Sea Grain Initiative was extended in May for two months until July 18, it became operational only at the end of the month, if only to a limited extent. For almost two weeks, the passage of vessels decreased to zero. Currently, an average of two ships per day pass through the "grain corridor." The number of ship calls to the ports of Greater Odesa in May was only 32 compared to 58 in April and 92 in March.

Figure 3: Number of inspections of vessels passing through the "grain corridor" (moving average for 7 days)



Source: Black Sea Grain Initiative Vessel Movements https://data.humdata.org/dataset/black-sea-grain-initiative-vessel-movements

Accordingly, the load on the Danube ports increased. So, in May 2023, the port of Reni handled 1 million tons of cargo, and the port of Izmail - more than 830 thousand tons. In total, the Danube ports handled more than 3 million tons of cargo in May, which is an absolute record for the ports of this region.

Railway transport. According to operational data, in May 2023, Ukrainian railways transported 11.49 million tons of cargo, 19.2% more than the previous year. In May 2023, domestic cargo transportation increased by 36.5% to 7.17 million tons, while exports decreased by 2% due to Russia blocking the sea "grain corridor." Exports of grain by railway decreased by 29% (to 806.9 thousand tons). Grain railway imports increased in May 2023 by 7% (up to 483.4 thousand tons).

The leaders in general cargo transportation in May 2023 are mineral building materials (sand, crushed stone, limestone), hard coal, iron and manganese ore, grain and grinding products, and ferrous metals. Transportation of construction materials showed the most considerable growth — by more than 70% yoy.

Queues of freight cars at western border crossings decreased by 11% to 10,765 cars as of May 2023. It's a queue for about a week, although the waiting time varies depending on the load of the crossing point.

Automobile transport. Queues at border road checkpoints continue due to the blocking of the sea "grain corridor" and the corresponding increase in land freight transportation, as well as periodic blocking of checkpoints by farmers and drivers of neighbouring countries. As of June 13, almost 11,000 cars were registered in line at 16 automobile checkpoints.

Aviation transport. Ukrainian airline Azur Air Ukraine changed its name to Skyline Express and resumed flights abroad after a one-year break. It operates charter flights to resorts in Egypt.

International trade: Food exports remain complicated

In May, Ukraine exported goods worth USD 3.1 billion, and growth slowed to 7% yoy. At the same time, imports amounted to USD 5.1 billion, 36% higher than last year. Accordingly, the May trade deficit in goods amounted to USD 1.9 billion, while the cumulative deficit in goods trade for the first five months of the year reached USD 9.0 billion. If the current trends are maintained, already in June, the cumulative trade deficit in goods will almost equal the figure for the entire year of 2022 (USD 11.2 billion).

Figure 4: Ukraine's foreign trade in goods, 2021-2023, USD bn



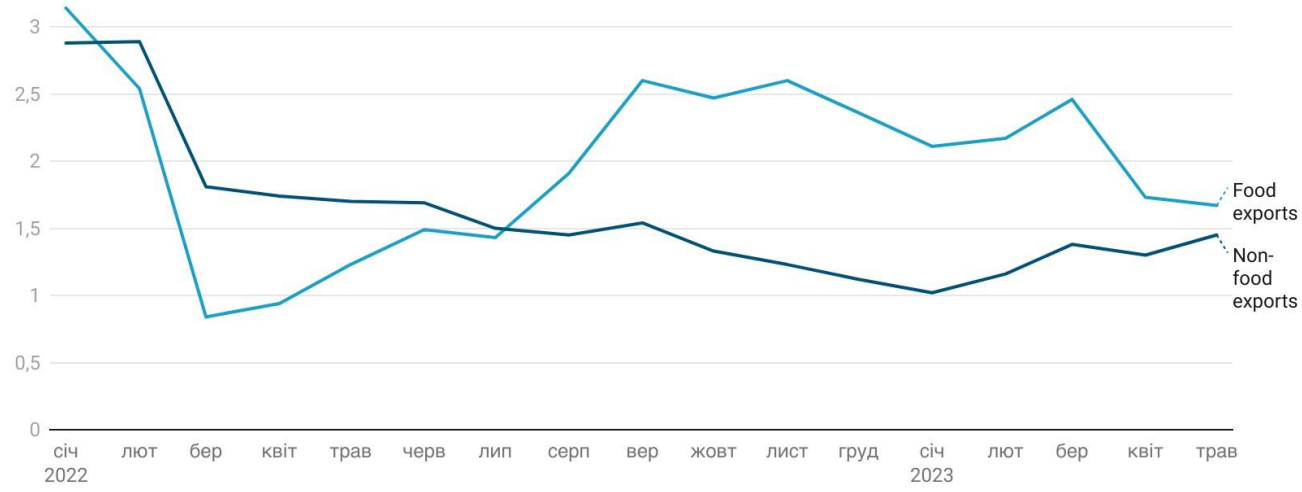
Sources: UN ComTrade, State Customs Service of Ukraine (SCSU)

The food exports crisis that erupted in April continued in May. This month became the worst month of the Black Sea Grain Initiative (see "Maritime transport"). Only 1.3 million tons of cargo were shipped in May, while the average monthly shipments for the previous eight months of the Grain Initiative operation was 3.45 million tons.

Second, partial restrictions on access to the EU market remained. According to the agreement between the European Commission and five neighbouring countries of Ukraine, namely Poland, Hungary, Slovakia, Bulgaria, and Romania, temporary extraordinary preventive measures were introduced at the beginning of May. According to these measures, the Ukrainian export of four goods - corn, wheat, sunflower seeds, and rapeseeds - was prohibited to the market of these five countries. In turn, Ukraine's neighbouring countries committed to ensuring the free transit of these goods through their territory and cancelling unilateral restrictions that applied to a broader list of agricultural products. On June 5, the European Commission extended the ban until September 15. Moreover, as of May 24, Hungary still has not lifted the individual ban. On the positive side, the work of the river ports was intensified, making it possible to compensate for the losses partially.

Accordingly, in May 2023, food exports of Ukraine amounted to USD 1.67 bn, which is almost a third lower than the average indicators of August-March, when the EU's Solidarity Lanes and the Black Sea Grain Initiative started working in parallel. At the same time, non-food exports gradually recovered after the minimum recorded in January 2023 and reached USD 1.4 bn. As a result, the share of food exports decreased from 67% in January to 54% in May 2023.

Figure 5: Food and non-food exports of Ukraine, 2022-2023, USD billion



Source: ITC Trade Map, SCSU, food exports are defined as HS 01-24

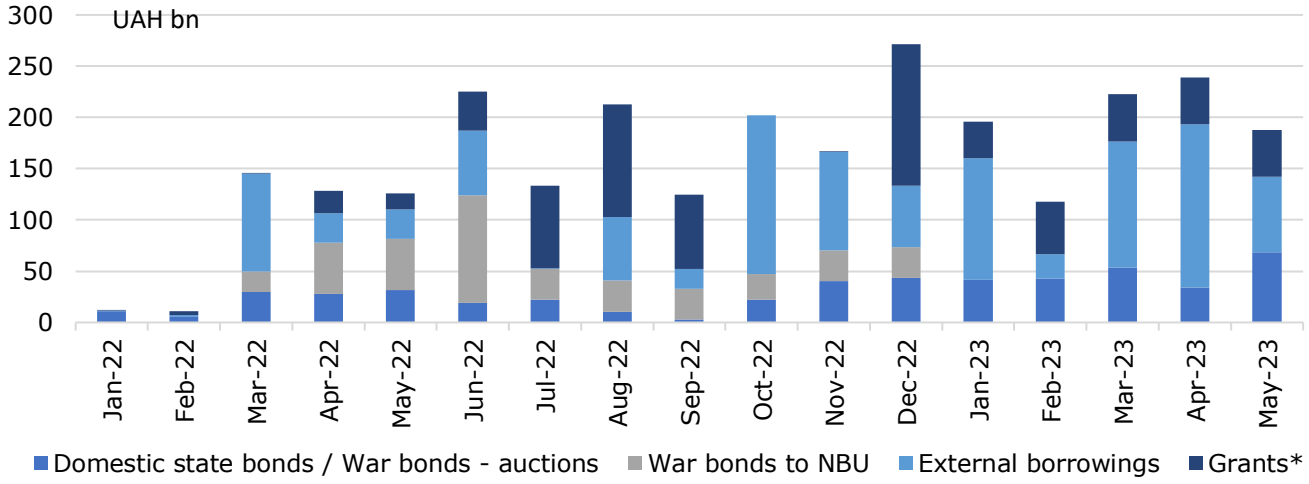
State budget: So far, Ukraine has fulfilled the terms of the IMF program

Budget. In May 2023, the state budget revenues were supported by the receipt of dividends from the Private Bank for UAH 24.2 bn. Companies paid UAH 28.5 bn in corporate income tax, the highest figure during the full-scale war, although it is 4.5% less than in May 2021. Revenues from personal income tax due to the state budget grew by 27.3% yoy to UAH 14.1 bn, which is connected with the recovery of wages and employment growth in the civilian sectors, and reflects the financing of the remuneration of the military personnel. Revenues from the excise tax on tobacco products also increased in May.

Revenues from domestic VAT (gross) continued to grow at a noticeable pace, although slower than in April due to the statistical base effect. They increased by 48.6% yoy in May, although net VAT revenues decreased. In May, VAT refunds amounted to UAH 9.9 bn, while they were close to zero last year.

In May, Ukraine received regular tranches of financial aid from the EU and the USA. Thus, the grant from the USA amounted to USD 1.25 bn (UAH 45.7 bn in equivalent), and the EU provided a concessional loan at EUR 1.5 bn (UAH 61 bn in equivalent). It is worth reminding that Ukraine receives a subsidy for paying the interest under the EU loan. That is, the EU member states currently fully cover the interest on EU borrowing for Ukraine. Ukraine must apply for a subsidy every year. Also, almost UAH 69 bn of government bonds were raised to finance the budget and repay the domestic debt. Nearly a May 3 placements of domestic government bonds are from the benchmark government bonds, which the NBU allows commercial banks to include in mandatory reserves. The value of bonds denominated in foreign currency increased to the equivalent of about UAH 39 bn.

Figure 6: Funding and grants received in 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

IMF: On May 30, the Government of Ukraine and the IMF reached a staff-level agreement on the first review of the IMF Program. After the approval of the decision by the Board of Directors of the IMF, Ukraine will be able to receive a loan for USD 900 m.

According to the press release of the IMF, Ukraine has fulfilled all indicative benchmarks and structural beacons. Thus, changes were made to the State Budget 2023, which took effect in April (structural benchmark 1). The Government also made changes to the Budget Code, which regulated the procedures of opening NBU accounts to collect funds for the needs of various ministries (in particular, within the framework of the United24 initiative) and increased the transparency of the use of these funds.

On May 30, the Government submitted draft law No. 9346 to the parliament, which implements two structural benchmarks - 2 and 7. Thus, the draft law provides for more controlled amendments to the State Budget Law - only if there is a favourable opinion of the Ministry of Finance. It also restores medium-term budgeting: the Government must submit a medium-term forecast of revenues and expenditures and prepare a report on the fiscal risk assessment by the end of September (probably together with the draft budget for 2024), adopt a State debt management strategy by September 25 and adopt a Budget declaration in 2024.

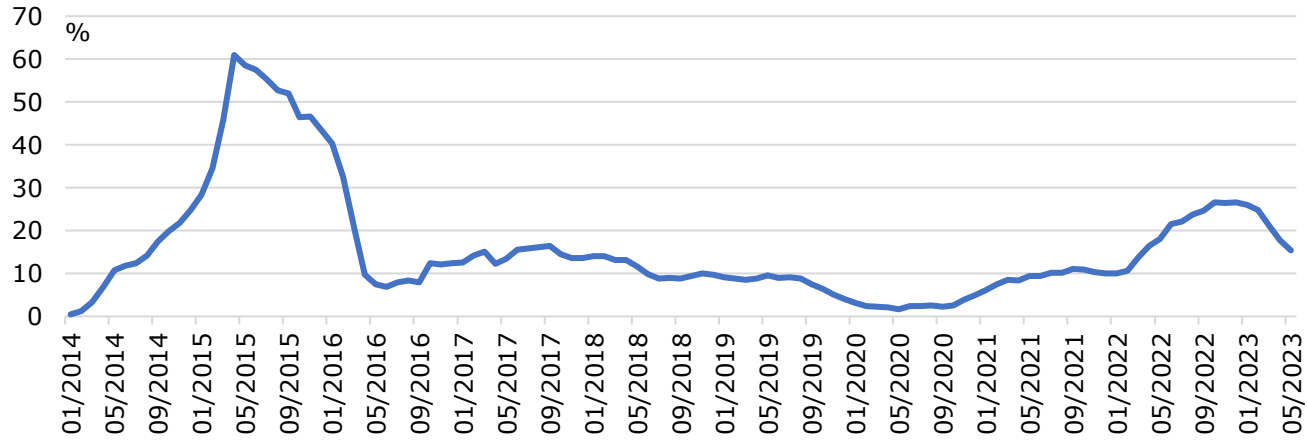
There is a lack of open information regarding implementing structural benchmark 6. It refers to the " Prepare an action plan, including addressing the weaknesses identified in taxpayers' perception survey, as an input into National Revenue Strategy roadmap". At the same time, the Government must approve the Strategy by the end of the year, which will be challenging given the lack of consensus on tax reform.

In May, the Government adopted draft law No. 8401 in the first reading, which restored the taxation system that existed before the full-scale war. It is about abolishing the 2% single tax, exempting private entrepreneurs in groups 1-2 of simplified taxation from paying the single tax, and several other norms. At the same time, there is a risk that the parliament will not have time to adopt this draft by the end of June due to many suggestions provided by deputies. That then would violate structural benchmark 3, which must be completed by June 2023.

Inflation: Inflation continued to slow in May

In May, inflation slowed to 15.3% yoy compared to 17.9% yoy in April and 26.0% yoy in January. At the same time, the growth rate of food prices exceeded 20% on average. On the one hand, after a recent decline, egg prices remained more than twice as high as a year ago. Also, the prices of meat and meat products, vegetables, and fruits proliferated. That reflected a decrease in domestic livestock production, a gradual increase in exports of livestock products, and a sharp reduction in fruit and vegetable production following the Russian occupation of southern Ukraine. On the other hand, the high export value of plant products and significant grain stocks kept domestic prices relatively low. As a result, the prices of cereals in May were lower than last year, and the growth of prices for bread and bread products was slower than for other food products.

Figure 7: Consumer price inflation



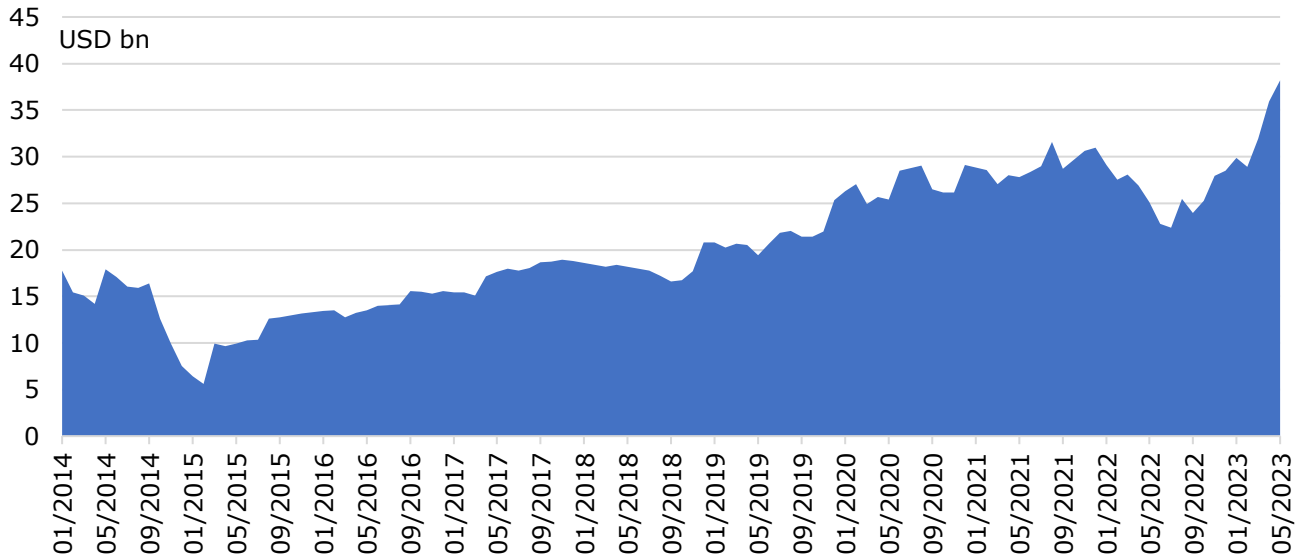
Source: State Statistics Service

The increase in consumer prices compared to the previous month in May was 0.5% yoy: as in five of the last six months, the average price change remained within 1%. That reflected subdued domestic consumer demand and falling global commodity prices. Global agricultural prices accelerated their decline in May, while energy prices fell after rising in April. The FAO price index fell by almost 5% mom for cereals in May and nearly 9% for vegetable fats; the World Bank's energy price index fell by 11% mom. The monthly price trends were also affected by seasonal factors: the prices of clothes, shoes, and eggs fell compared to April, while the prices of vegetables and fruits increased.

Monetary policy: the NBU is considering lowering the discount rate this year

At the regular monetary policy meeting held on June 15, the NBU discount rate remained 25%. The NBU set this rate a year ago, in June 2022. However, the NBU reported that the discount rate may be reduced already in the third quarter of this year. This may happen if real hryvnia rates rise faster than expected due to lower inflation or higher nominal rates. In response to the NBU's previous efforts to raise interest rates on deposits, they are gradually increasing, and banks' required reserves have reached almost UAH 300 bn. Therefore, reserve requirements for banks remained unchanged.

Figure 8: International reserves



Source: NBU

At the end of May, the NBU's international reserves approached the historical maximum of USD 38.2 bn (recorded at the end of August 2011) and reached USD 37.3 bn. Although the comparison of 2023 dollars with 2011 dollars does not consider the 34% increase in prices in the USA over 12 years, the increase in reserves allowed to increase in the safety margin in case of interruptions in the flow of external financing to Ukraine. According to the NBU, the Government attracted USD 2.95 bn in international reserves in its pure form. In May, the primary source of external funding was monthly tranches from the EU and the USA. Costs to support the fixed exchange rate of the hryvnia increased to USD 1.9 bn in May. According to the NBU, this reflected a decrease in foreign exchange sales by farmers and difficulties with exports.

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