INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING

Monthly Economic Monitoring of Ukraine

No.218, March 2023

Resume

- Starting in February, we compare the performance indicators of different sectors with the period of the full-fledged war: the effect of the statistical base becomes essential in the analysis.
- According to the IER estimate, the drop in real GDP decelerated in February to 26.7% yoy due to the improvement of the situation in different sectors of the economy and the statistical base effect.
- Since February 12, there has been no electricity shortage, which has contributed to the economic recovery.
- Negotiations have begun on the extension of the Grain Initiative.
- Maize took the first position in the structure of goods exports, and the second was sunflower seeds oil.
- Negotiations have begun on a new IMF program, which, according to the Government's expectations, will envisage a loan of USD 15 bn to Ukraine.
- The monthly consumer price increases were below 1% for four months due to low domestic demand and a decrease or stabilization of prices on global markets.
- NBU expenditures to maintain a fixed hryvnia exchange rate in February decreased significantly in February, which likely reflects a reduction in the trade deficit in goods.

IER is preparing the publication of Monthly Macroeconomic Monitoring of Ukraine with the financial support of the European Union within the framework of the project "Ukraine's economy during the war and support for Ukrainians affected by the war."

Authors: Oleksandra Betliy, Iryna Kosse, Vitaliy Kravchuk, Veronika Movchan

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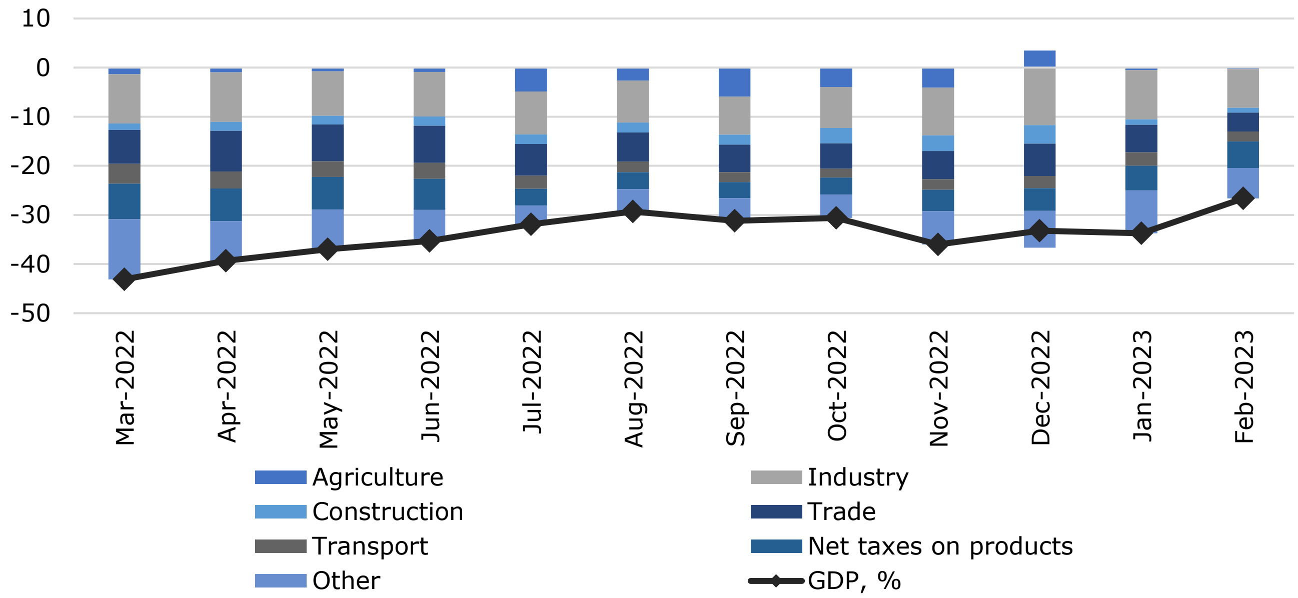
GDP and the real sector: Lack of electricity shortage is a positive for the economy

According to the IER estimate, in February the drop in real GDP decelerated by 7.1 percentage points to 26.7% yoy due to improved performance in many sectors and a lower statistical base. In February 2023 we start a comparison of the performance of different sectors with the period of the full-fledged war, which must be considered during the assessment.

The most positive factor in February was the lack of electricity shortage since February 12. As a result, many industrial enterprises increased production compared to January. In particular, there was an increase in the production and exports of iron ore and metallurgy products overall. Compared to the previous year, the pace of contraction decelerated in the rest of the industries. This improvement is reflected in the monitoring of news and business surveys conducted by the IER.

Against the background of a lower statistical base, the drop in trade and construction decelerated as well. It also contributed to a lower contraction in transport, which faced slow inspections by Russians in sea transportation and lengthy veterinary checks by the Polish border services for rail and road transport. At the same time, the latter should accelerate due to the agreements reached between the governments of Poland and Ukraine on the abolition of veterinary control for transit cargoes of grain and oilseeds, provided that special seals will be applied to vehicles.

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



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

In February, agricultural enterprises continued to harvest maize. According to the Ministry of Agrarian Policy, from February 3 to February 16, 0.7 million tons of corn were harvested. Some agricultural enterprises reported harvesting maize even after February 16, but data on the corn crop were not updated. At the same time, these indicators are not included in the calculation of GDP for February, which corresponds to the Ukrstat methodology.

An IER monthly business survey indicates that the companies are still optimistic about their development for the short term. At the same time, among the impediments, the problems with logistics are becoming more critical.

Energy: 25 days without electricity shortage

On February 11, Ukraine returned two NPP power units to operation, which significantly reduced the electricity production shortage. There was no power shortage in the system for 25 days until another massive Russian missile attack on March 9. More than half of the country's electricity was produced by Rivnenska, Pivdennoukrainska, and Khmelnytska NPPs. Electricity generation at hydroelectric and pumped storage power plants has also increased due to abnormal melt-rain flooding in the basins of Ukrainian rivers this winter. Winter flooding was observed, in particular, in the basins of the Dnieper, Sozh, Desna, and Pripyat rivers. SPP and WPP continue to increase electricity production under favorable weather conditions. In February, DTEK Renewables' power plants doubled their electricity production at solar power plants. According to ENTSO-E, Ukraine carried out minor commercial electricity imports in February from Slovakia and Moldova.

Ukraine will be able to complete the heating season of 2022-2023 successfully: at the beginning of March, there were 9.7 billion cubic meters of gas in storage facilities, and coal reserves in the warehouses of TPPs and CHPPs on March 3 amounted to 1160 thousand tons, which is 375 thousand tons more than on the same date last year. In winter, Naftogaz purchased more than 400 million cubic meters of gas from Norway and almost 130 million from Germany. At the same time, Naftogaz noted the consistent assistance of the G7 countries and the Norwegian Government in financing the purchase of required gas volumes.

In February, there were changes in the corporate structure of state-owned energy enterprises. Thus, on February 6, the Verkhovna Rada approved the corporatization of Energoatom, which was one of Ukraine's obligations under the Association Agreement with the EU and a condition of one of the IMF programs. It is expected that the new organizational and legal form of Energoatom will increase the efficiency of its activities, facilitate the attraction of foreign investment and strengthen the transparency of management.

There have also been changes in Naftogaz. The Government has agreed to transfer to Naftogaz the seized shares of several gas distribution companies (regional gas companies) to prevent the risk of an emergency situation in the energy sector. Most likely, we are talking about "Ternopilgaz," "Korostyshivgaz," "Khmelnitskygaz," and "Melitopolgaz." This latest transfer is the completion of transferring regional gas companies to Naftogaz, which started in May last year when another 26 regional gas companies were transferred to the management of Naftogaz.

Naftogaz of Ukraine ended 2022 with a loss of about UAH 40 billion. One of the reasons for the losses is the growth of receivables, which at the end of the year amounted to about UAH 270 billion. The central part of this debt is the compensation not received by Naftogaz from the budget for PSO obligations (UAH 158 billion), that is, the gas supply to the population, district heating companies, and state entities at a price lower than the market price. To remedy the situation, the Government will have to raise gas tariffs.

Transport: waiting for the continuation of the "grain agreement"

Sea transport. On February 24, the Verkhovna Rada of Ukraine adopted amendments to the state budget for 2023, providing for the use of UAH 20 billion to compensate for possible losses for civilian vessels entering Ukrainian ports. The source of payments is the Road Fund. It is expected that the guarantee of compensation for risks will be a signal to resume civilian shipping in the Black Sea. The amendments adopted by the Parliament concern the vessels flying the flag of Ukraine and the flags of foreign states.

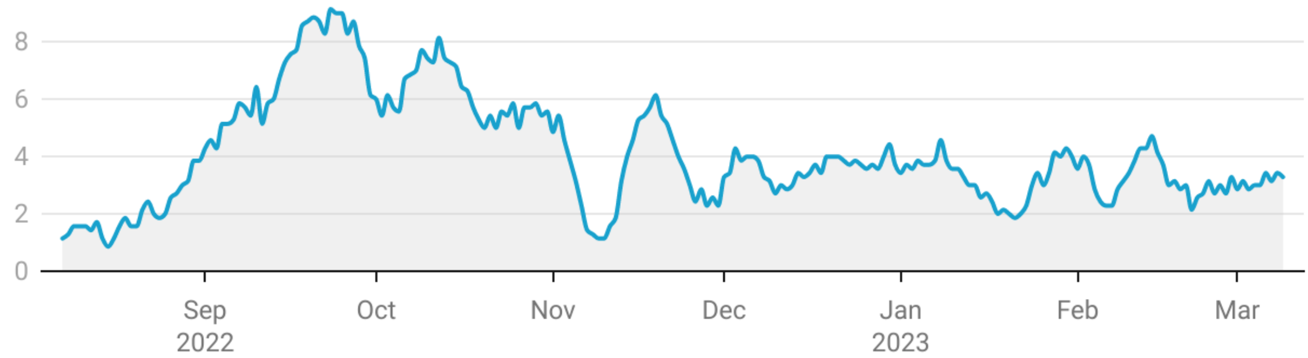
Ukraine cleaned the mouth of the Bystre channel and increased the permissible draft of ships to 6.5 meters: the passage draft of vessels in the section from the 0^{th} kilometer of the mouth of the Bystre on the Danube River to the 77^{th} kilometer of the Kiliya mouth became 6.5 meters, and from the 77^{th} kilometer to the 116^{th} kilometer of the Kiliya mouth – the draft was 7 meters. In 2022, the permissible draft was 3.9 m. The EU allocated money for the removal of sediments from the soil and the elimination of shallows within the framework of the Solidarity Lanes program. After restoring passport depths at the mouth of Bystre, the Danube ports reached a record value of 12 ship calls and 90 thousand tons loaded per day.

The pace of transportation of Ukrainian grain through the "grain corridor" in February remained low due to the slow inspection of ships. According to the Ministry of Infrastructure, due to the Russians' sabotage of inspections in the Bosphorus, more than 140 vessels are consistently under consideration for the passage of the strait. From August 1, 2022, Ukraine exported 22.1 million tons of Ukrainian food products through three ports of Greater Odesa. On March 18, the term of the "Grain Agreement" expires, and negotiations with partners on the initiative have already been launched, namely with the UN and Turkey, regarding the terms and conditions for its extension.

Railway transport. In February 2023, Ukrzaliznytsia transported for exports 5.1 million tons, 43.2% less than in February last year. In the structure of export transportation, the first place is taken by grain cargoes — 2.9 million tons (57%), iron and manganese ore are in the second position with 1.3 million tons (26%), and ferrous metals are in the third position with 321 thousand tons (6%).

The total queue of cars on the railway in February increased by 3% to 17,183 wagons. The most problematic were the transfer points of Batevo, Chop, and Uzhgorod.

Figure 2: Number of inspections of vessels passing along the "grain corridor" (moving average for 7 days)



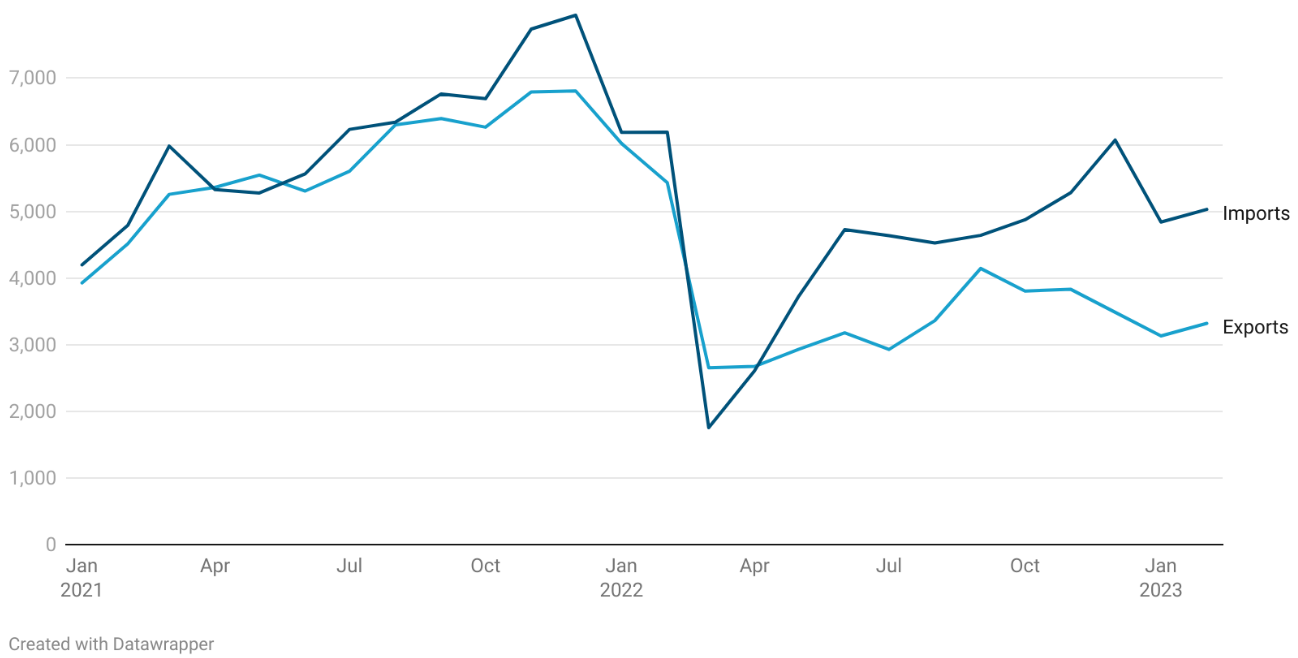
Source: Black Sea Grain Initiative Vessel Movements https://data.humdata.org/dataset/black-sea-grain-initiative-vessel-movements

Road transport. In mid-February, Poland strengthened veterinary control of feed grain and oil for Ukrainian carriers, which formed long queues at road and rail border crossings. In early March, the governments of Ukraine and Poland agreed to simplify the procedures for exporting Ukrainian grains and oilseeds in transit through Poland to other countries. To prevent the sale of transit cargo in Poland, the Governments decided that trucks with oilseeds and grains should be sealed at customs points.

Foreign Trade: Food dominates exports

According to preliminary estimates of the Ministry of Economy, in February 2023, Ukraine's exports of goods amounted to USD 3.3 bn, 39% less than a year ago. Imports of goods reached USD 5.0 bn, corresponding to a 19% drop yoy. Noteworthy, February 2023 is the last month when the annual trends of foreign trade are compared to a high base before the full-scale Russian military aggression. The indicators will improve starting next month if there is no additional negative shock.

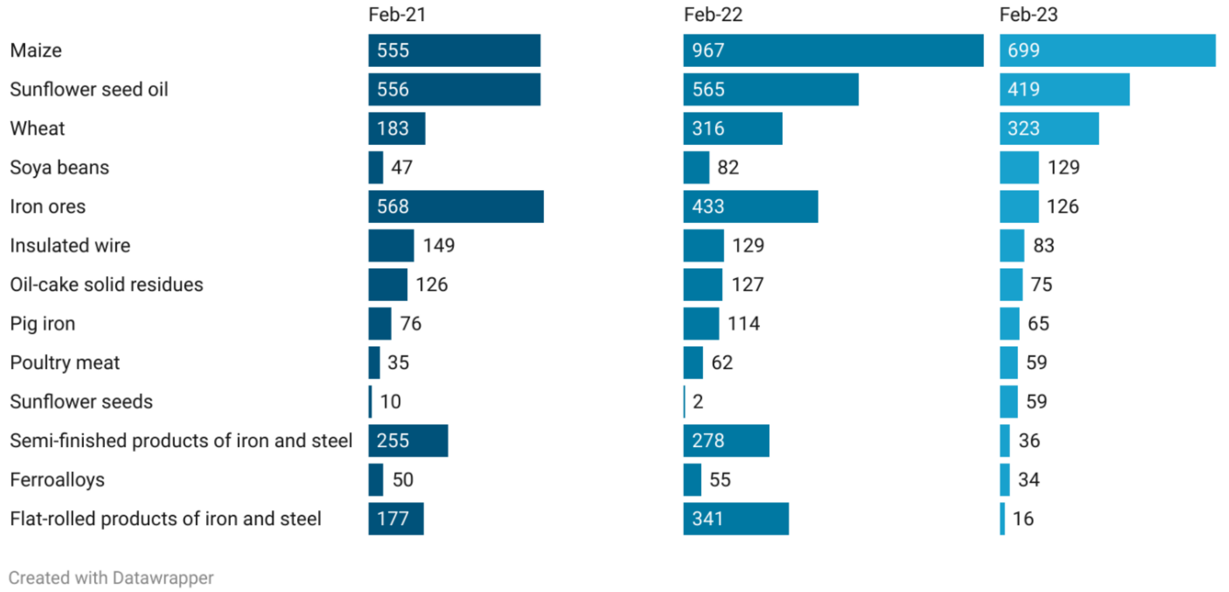
Figure 3: Ukraine's foreign trade in goods, 2021-2023, USD m



Sources: Ukrstat, UN Comtrade, SCSU, Ministry of Economy of Ukraine

The structure of Ukraine's commodity exports has changed markedly compared to the situation before the full-scale invasion. However, these changes have strengthened the existing trends rather than led to a radical structure revision. The two main structural changes are the further increased role of agricultural products and the food industry and the decreased role of metals. This trend, although for other reasons, has been observed since 2008. Also, the goods exports remained concentrated. As in previous years, in February 2023, the top 10 items of commodity exports accounted for more than 60% of the total.

Figure 4: Key goods of Ukrainian exports, USD m



Note: We included goods that were among the top 10 goods export items in 2021-2023
Source: UN ComTrade, Ministry of Economy of Ukraine

In February 2023, maize took the first position in goods exports, with a share of 21% of the total (+3 percentage points (pp) compared to February 2022). The second most important export commodity was sunflower seed oil, with a share of 13% (+3 pp), and wheat, with a 10% share (+4 pp), came to the third position. Note that exports of wheat, soybeans and sunflower seeds increased in February 2023 compared to last year's data. At the same time, only pig iron remained among the leaders with a 2% share in February 2023 compared to February 2022, when the top 10 export goods included flat-rolled products of iron and steel, semi-finished products made of iron, and pig iron, jointly having 1 14% share of the total exports. Also among the leaders remained the export of insulated wires with a steady share of 2%, although its export value fell by 36% yoy.

In March 2023, a law was enacted on applying the export security regime for the period of martial law. It allows the Government to use additional tools to control export operations. According to this law, the Cabinet of Ministers of Ukraine received the right to introduce an export security regime for several essential export goods, including wheat, barley, maize, soybeans, sunflower seeds, sunflower oil, and sunflower meal. Only existing exporters who have received significant revenues from exports to accounts in Ukrainian banks over the past six months can freely export goods under the export security regime. Other exporters will be required to pay VAT on exports at a 20% rate and will be able to receive a VAT refund only after receiving foreign exchange earnings for exported goods. Although this step aims to combat VAT avoidance schemes and stimulate the fulfilment of requirements for the return of export revenues to Ukraine, there is a risk that it will slow down exports or lead to the intensification of so-called "black exports."

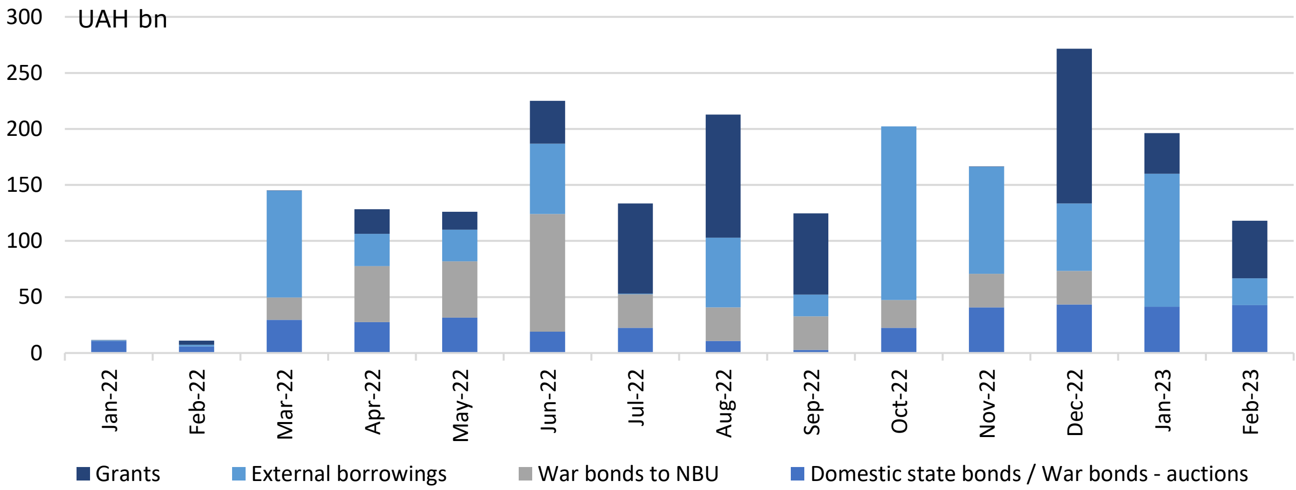
State Budget: Waiting for the IMF Program

Budget execution: According to preliminary data from the Ministry of Finance, in February, state budget revenues, excluding grants, amounted to UAH 74.6 bn and were 35% lower than in February 2022. As a result of the big war, revenues from all key taxes decreased, except for the personal income tax. PIT revenues were 2.9% higher than last year, as higher expenditures on the remuneration of military personnel compensated for the sharp decline in the number of people employed in other sectors of the economy. Gross domestic and import VAT revenues decreased by 11% yoy and 16.5% yoy, respectively. At the same time, the Government again reduced the amount of VAT refunds, for which it allocated UAH 6 bn after a record amount of UAH 19.3 bn in January. The decrease in rent payments in February to UAH 7 bn compared to UAH 10 bn in January is explained by the delay in their payment by Ukrgasvydobuvannya, but these revenues are expected in March. Revenues in February were also supported by the grants in the amount equivalent to UAH 51.4 bn.

The state budget deficit in February amounted to UAH 88.8 bn (UAH 72.3 bn in January), which is less than planned, mainly because the Government planned all external funding as borrowings (respectively, financing the deficit) and not as grants. At the same time, according to the Ministry of Finance, cash expenditures of the state budget in January-February amounted to UAH 446.6 bn, including UAH 410.3 bn of the general fund, or 86.8% of the budget plan for the reporting period. This underspending is partly due to the delay in adopting the procedures for the use of budget funds and budget passports and partly likely due to the lack of funds. Thus, in February, the Government reported a delay in the payment of assistance to internally displaced persons. At the same time, the Pension Fund timely and fully financed pensions, social insurance payments, housing and utility subsidies. In March 2023, the Government also indexed pensions.

In general, there is still a financing needs gap in Ukraine. Thus, according to our estimates, the financing need is USD 45-50 bn. At the same time, the committed amounts of support include USD 9.9 bn from the US and EUR 18 bn from the EU. Also, in February, the Government of Japan announced a plan to provide guarantees worth USD 5 bn to the World Bank for lending to Ukraine, but it is unknown whether all funds are committed for 2023 or for several years. Additional support is expected from Canada and the UK, and several bilateral loans and grants from individual EU members. Therefore, although the funding situation is better than in most of 2022, it is still a big challenge for the Government. The financing gap will be partially closed by more extensive than initially planned domestic borrowings. In February, the Ministry of Finance placed domestic government bonds worth UAH 42.6 bn due to the demand for benchmark domestic government bonds, an increase in yields, and issuing of FX-denominated bonds. The Ministry of Finance and the NBU reiterated that the direct purchase of government bonds by the NBU from the Ministry of Finance is not planned for 2023.

Figure 5: Funding and grants received in the state budget, UAH billion



*Note: * grants are part of the 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

Also in March, negotiations began between Ukraine and the IMF on a full-fledged support program, which means that if negotiations are completed in April, Ukraine will be able to receive the first tranche of a loan from the Fund. According to the Prime Minister of Ukraine Denys Shmyhal, the Government expects a program for USD 15 billion, of which Ukraine expects to receive about USD 5 bn this year. This program is vital also due to the fact that in 2023 Ukraine's payments to the IMF under previous obligations will reach about USD 2.9 billion.

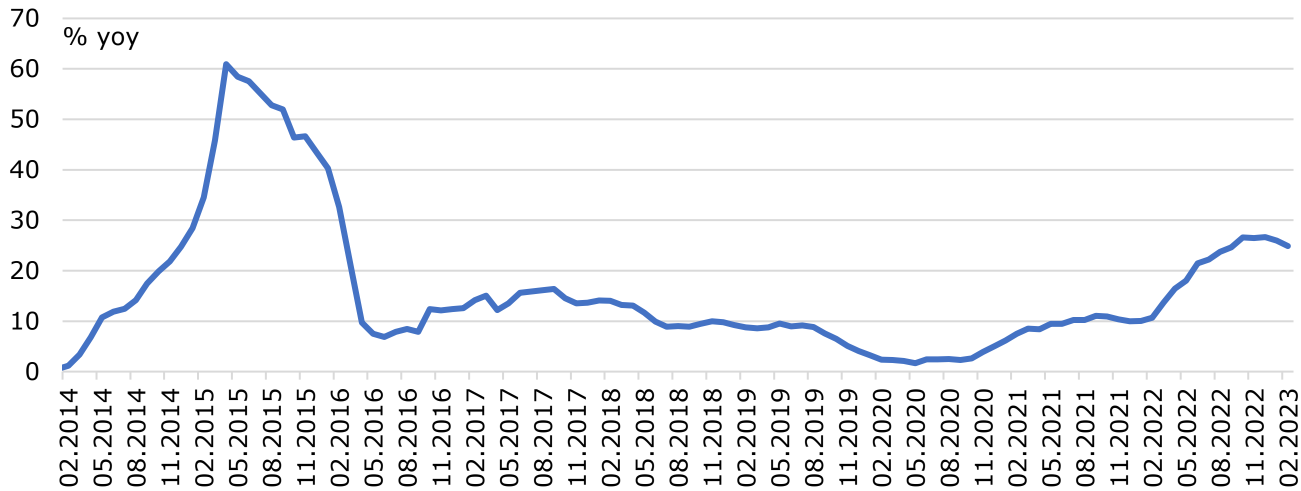
Changes to the budget. The first amendments to the Law on the State Budget for 2023 occurred. The main reason for adopting the changes was the need to change the funds' managers after the decision made at the end of 2022 on the merger of the Ministry for Communities and Territories Development and the Ministry of Infrastructure into a single Ministry. Accordingly, the new Ministry also received from the Ministry of Finance the budget program "Fund for the elimination of the consequences of armed aggression." At the same time, the use of expenditures from this budget program was expanded; it will now include compensation to citizens for damaged or destroyed housing due to hostilities, which is introduced in another draft law. At the same time, the Government and the Parliament have not revised budget revenues and expenditures, while deficit have slightly increased. In the near future, it is possible to expect changes in budget indicators, as the Ministry of Economy has revised its working version of the macroeconomic forecast: the real GDP estimate was revised downwards from a growth of 3.2% to 1% growth and the inflation forecast slowed to 24%. Thus, if approved by the Government, such a revision of the estimates may mean reducing the plan of tax revenues, all other things being equal.

However, on March 13, the Government adopted a draft law to increase spending on defense and security by UAH 518.2 billion. Higher expenditures should be financed mainly through more extensive domestic and external borrowings, increasing the need for funding.

Inflation: Four months of moderate price increases

In February, year-on-year inflation slowed to 24.9%. The monthly consumer price increases were below 1% for four months. Inflation stabilized at a relatively low level due to low consumer demand and decreased devaluation expectations. Lower or stable prices for the main items of Ukraine's foreign trade (primarily energy carriers and grains) also contained inflation. In February, vegetable prices rose sharply due to the limited capacity for their storage. At the same time, fuel prices fell due to significant stocks at gas stations, and the seasonal decline in prices for clothes and shoes continued. The State Statistics Service also reported reduced prices for some food products in February (lard, buckwheat, eggs). The stabilization of electricity supplies in February reduced the costs of producers and retail chains. However, inflation expectations remain elevated, and costs in the supply chain of consumer goods and services are still rising. These factors indicate the possibility of higher inflation in the coming months.

Figure 6: Consumer price inflation

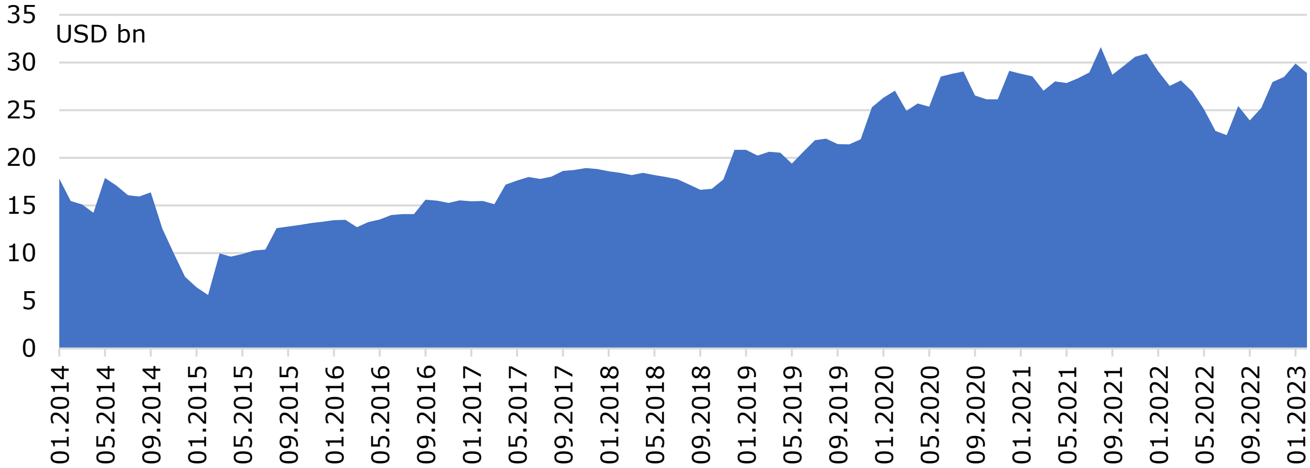


Source: State Statistics Service

Monetary policy: NBU actions begin to change interest rates on personal deposits

On March 11, another requirement to increase bank reserves came into force. Reserve requirements for the funds of individuals on demand reached 20% for the hryvnia accounts and 30% for the foreign currency accounts compared to 10% and 20% as of March 11. As a result, banks will be obliged to form additional reserves for approximately UAH 59 bn. For February 11-March 10, the mandatory reserves of banks have already reached almost UAH 221 billion, compared to UAH 70 bn until January 10. The NBU introduced new requirements to encourage banks to further align interest rates on deposits to the rate on NBU certificates of deposit (23% p.a.). In response, several large banks have reduced rates on demand deposits and raised rates on term deposits. However, the increases were moderate, and bank deposit rates remained significantly lower than the NBU rate.

Figure 7: International reserves



Source: NBU

The NBU's international reserves at the end of February were USD 28.9 bn compared to USD 29.5 bn at the end of January. This decrease reflected payments to the IMF and World Bank and reduced inflow of donor funds. According to the NBU, the Government has attracted USD 2.07 bn to international reserves, primarily from the US. At the same time, the World Bank and the IMF received USD 460 m in debt service on previous loans. Expenditures to maintain a fixed hryvnia exchange rate in February decreased to USD 2.45 bn. This decrease in expenditures probably reflected a reduction in the trade deficit in goods in February and the lower gap between the cash and non-cash exchange rates of the hryvnia to the US dollar.

Contacts:

Institute for Economic Research
and Policy Consulting
st. Reitarska 8/5-A, 01030 Kyiv
Tel. (+38044) 278-6342
E-mail: institute@ier.kyiv.ua
http://www.ier.com.ua

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