Ukraine Macroeconomic Situation

October 2019

Oleg Ustenko, Julia Segura, Valentyn Povroznyuk
Edilberto L. Segura

Executive Summary

- During its first month, the new government made progress in advancing its reform agenda. It introduced draft laws to end parliamentary immunity from criminal prosecution; to enact the Concessions Law for the private operation of ports, airports, and roads; to seek a conservative fiscal budget with a low deficit of 2.1% of GDP; and to advance the de-shadowization of the Ukrainian economy by introducing mandatory cash registers for all entrepreneurs. Nevertheless, two developments lessened the progress made by the government. First, the country was involved in the controversy about the calls between Presidents Trump and Zelenskyy, which led to the ongoing impeachment inquire against President Trump. Second, the IMF mission that visited Ukraine in September to review the possibility of a new Extended Fund Facility left the country without signing a staff-level agreement, dealing the government a setback in efforts to obtain prompt financial support.
- In the second quarter of 2019, Ukraine's GDP grew by 4.6% yoy, compared to 2.5% yoy in the first quarter of the year. The mayor sources of GDP growth were gross capital formation (7.9% yoy growth rate), and household consumption (11.8% yoy). More frequent monthly output data show that economy recovery is still ongoing.
- The overall fiscal budget situation continues to be satisfactory, with a consolidated surplus of UAH 35.4 billion in January-August (about 1.4% of period GDP).
- Consumer inflation saw some deceleration in August, with the index dropping 0.3 percentage points to 8.8% yoy.
- In the banking sector, growth of Hryvnia bank deposits accelerated to 10.4% yoy, while foreign currency deposits grew by 10.5% yoy. Bank lending activities posted sluggish performance in August, with Hryvnia loans increasing only by 1.5% yoy and foreign currency loans declining.
- In September, the UAH/USD exchange rate appreciated by 3.2% to around 24.36 UAH/USD by the end of the month, thanks to foreign exchange inflows by non-residents to purchase government securities.
- In August 2019, Ukraine's current account deficit grew by 42.6% yoy to USD 512 million, compared to USD 359 million in August 2018. The deficit was fully covered by USD 639 million of financial inflows (principally from foreign direct investments and trade credits). The overall balance of payments had a surplus of USD 130 million, increasing international reserves to USD 21,437 million at the end of August 2019.

Main Macroeconomic Indicators	2013	2014	2015	2016	2017	2018	2019f
***GDP**, USD billion*	180	130	87	93.4	113	131	146
***Real GDP Growth**, % yoy*	0.0	-6.6	-9.9	2.4	2.5	3.3	3.3
***Fiscal Balance** (incl. Naftogaz/Pension Fund),% of GDP*	-6.5	-11.7	-2.1	-2.3	-1.4	-1.9	-2.1
***Public Debt, External and Domestic,** % of GDP*	40.4	69.4	79.1	80.9	71.8	60.9	59.0
***Consumer Inflation,** eop, % yoy*	0.5	24.9	43.3	12.4	13.7	9.8	8.0
***NBU Key Policy Interest Rate,** % eop*	6.5	14.0	22.0	14.0	14.5	18.0	16.0
***Hryvnia Exchange Rate per USD**, eop*	8.2	15.8	24.0	27.1	28.1	27.7	26.0
***Current Account Balance**, % of GDP*	-9.2	-3.5	1.8	-1.5	-2.2	-3.3	-3.4
***Merchandise Exports,** USD billons*	59	51	35	34	40	43	45
***Merchandise Imports,** USD billions*	81	58	39	40	49	56	58
***FDI,** Net Annual Inflow, USD billion*	4.5	0.4	3.0	3.3	2.3	2.4	2.0
***International Reserves**, USD billion*	20.4	7.5	13.3	15.5	18.8	20.8	20.0
***Public External Debt,** USD billion*	31.7	34.9	42.6	42.5	47.0	49.9	50.0
***Private External Debt,** USD billion*	110.3	91.2	76.0	69.9	70.0	71.0	72.0

Translator: Ieliena Segura
Editor: Rina Bleyzer O'Malley

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Political and Reform Developments

During its first month in office, the new Ukrainian government made progress in advancing its reform agenda. But it also faced some setbacks.

On the positive side, the new government introduced a number of draft laws to advance its reform program. These included (i) legislation to change the Constitution to end parliamentary immunity from criminal prosecution; (ii) the enactment of the Concessions Law for the private operation of ports, airports, and roads; (iii) the formal submission to Rada of a conservative fiscal budget with a low deficit of 2.1% of GDP; (iv) advance the de-shadowization of the Ukrainian economy by introducing mandatory cash registers for all entrepreneurs; and (v) the hiring of advisers for the privatization of state enterprises. The Rada also approval the first reading of several draft laws, including (i) a law to protect and encourage whistleblower for specific cases of corruption, (ii) introduction of a single EU standard customs declaration and a national electronic transit system, and (iii) abolition of the current list of state companies protected from privatization.

Nevertheless, several developments lessened the progress made by the government. First, the country was involved in the controversy in the US about the calls between President Trump and President Zelenskyy and the ongoing impeachment inquire as to whether President Trump abused his powers by asking President Zelenskyy for political favors against a potential electoral rival. Second, the IMF mission that visited Ukraine in September to review the possibility of a new Extended Fund Facility left the country without signing a staff-level agreement, dealing the government a setback in efforts to obtain prompt financial support from foreign donors and investors. The IMF praised the continuation of macroeconomic stability; but noted shortcomings in the legal framework, pervasive corruption, and large parts of the economy dominated by inefficient state-owned enterprises or by oligarchs. It also noted the need to make every effort to minimize the fiscal costs of bank resolutions, a reference to the potential cost of reversing the nationalization of Privatbank. International donors are now expecting the government to take credible measures to ensure that corruption at all levels will be promptly addresses and the rule of law and reform agenda will be implemented. President Zelenskyy has already made several statements that indicate that he has a zero tolerance to corruption, that the major corruption scandals, including the defense industry would be investigated, and that Privatbank will not be returned to the previous owners.

On the conflict in Donbass, there was some progress in Donbas in September. Although separatists continue violating the ceasefire, separation of forces in Stanitsa Luganska is expected to be finalized soon which will be followed by dismantling of fortifications. President Zelenskyy has also endorsed the Steinmeir formula to advance the peace process. This formula involves (i) troop withdrawals from the line of conflict, (ii) amnesty of those who did not commit crimes, and (iii) holding regional elections based on the Ukrainian legislation under the supervision of Organization for Security and Cooperation in Europe. However, there are now concerns that this formula may not help to bring peace to the eastern territories.

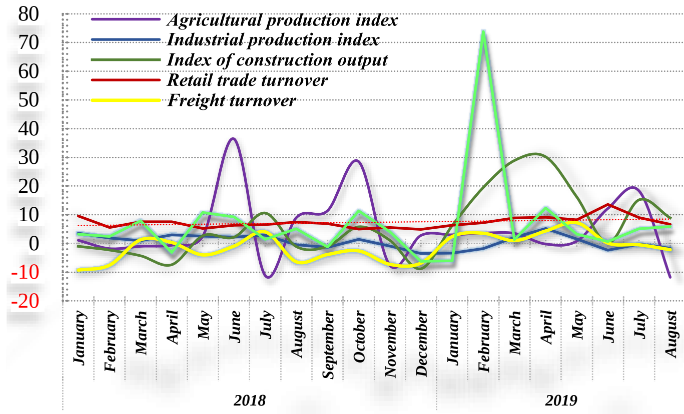
Economic Growth

According to the latest release of the State Statistics Committee, in the second quarter of 2019, real GDP grew by 4.6% yoy, compared to a 3.8% yoy in the second quarter of 2018. The mayor sources of GDP growth were gross capital formation, with a growth rate of 7.9% yoy, and household consumption, with a 11.8% yoy growth rate. On the other hand, Ukrainian general government expenditures showed a reduction of 6.4% yoy, as well as net foreign trade deficit expansion by 41% yoy, comparing to the 2nd quarter of 2018. The growth of GDP for the year is now expected to be 3.3%.

On the supply side of GDP, in the second quarter of 2016, the sectors that showed the highest recovery were construction (20.5% yoy); financial & insurance activities (17.9% yoy); agriculture, forestry & fishing (7.3% yoy); information & communication (4.9% yoy); real estate activities (4.8% yoy); administrative & support service activities (4.6% yoy); wholesale & retail trade (4.5% yoy); repair of motor vehicles and motorcycles (4.5% yoy); accommodation & food service activities (4.3% yoy); transportation and storage (4.2% yoy); mining & quarrying (3.5% yoy); professional, scientific & technical activities (3.3% yoy); public administration and defense; compulsory social security (3% yoy); arts, entertainment & recreation (3% yoy); electricity, gas, steam and air conditioning supply (1.7% yoy); manufacturing (0.8% yoy); and human health & social work activities (0.5% yoy). On the other hand, a few subsectors had negative rates of GDP growth in Q2 2019, in particular education (-1.1% yoy) and water supply, sewerage, waste management activities (-0.8% yoy).

Ukraine Economic Performance by Sector

(% yoy, to corresponding month of previous year)



Source: The Bleyzer Foundation

High-frequency data shows that Ukraine's economic activity has continued to improve. On August 2019, strong performance was shown by construction output (8.9% yoy), retail trade turnover (7% yoy) and passenger transportation turnover (5.9% yoy). Ukrainian domestic consumption was supported by higher level of nominal (17.4% yoy) and real (7.7% yoy) monthly wages growth. On the other hand, in August Ukrainian agriculture production showed a reduction by 11.8% yoy due to bad weather conditions. Ukrainian industrial production also fell down by -1.7% yoy in August 2019, following a reduction of 0.2% yoy in the previous month. The current reduction was partially due to complications of freight transportation, which showed a reduction of -2.2% yoy. Each manufacturing sector suffered from production declines as follow: textile industry (-9.6% yoy), wood products, paper & printing (-7.8% yoy), furniture (-6.7% yoy), pharmaceutical products (-5.6% yoy), machinery and equipment (-4.7% yoy), foodstuffs, beverages & tobacco (-3.6% yoy), metallurgy (-3.2% yoy), rubber and plastic products (-2.6% yoy), coke & refined petroleum products (-1.9% yoy), and chemicals goods (-0.2% yoy).

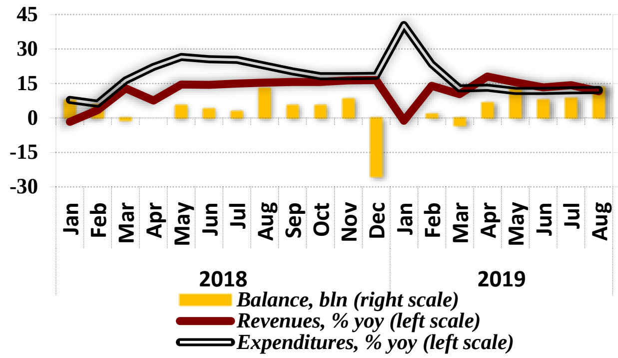
With regard to the geographical distribution of industrial output, the largest production growth was performed in the following oblasts: Vinnytsya (24.7% yoy), Odesa (15.6% yoy), Kirovohrad (14.5% yoy), Donetsk (10% yoy), Cherkasy (6.6% yoy), Dnipropetrovsk (3.6% yoy), Kyiv (2% yoy), and Volyn (1.6% yoy). On the other hand, in August 2019 negative rates of growth in of industrial production were experienced at the following oblasts: Zakarpattya (-32.7% yoy), Luhansk (-20% yoy), Khmelnytskiy (-19.1% yoy), Chernihiv (-16.4% yoy), Chernivtsi (-15.3% yoy), Rivne (-13.7% yoy), Sumy (-12.1% yoy), Ternopil (-10.5% yoy), Zhytomyr (-9.4% yoy), Kyiv city (-9% yoy), Ivano-Frankivsk (-4% yoy), Zaporizhzhya (-3.6%yoy), Kherson (-3.5% yoy), Kharkiv (-2.5% yoy), Lviv (-2.2% yoy), Poltava (-1.8% yoy), and Mikolayiv (-1.3% yoy).

Fiscal Policy

The consolidated fiscal budget was in surplus again in August. The state budget surplus of UAH 5.2 billion was complemented by a surplus of local budgets of UAH 7.4 billion. In the course of budget execution, the government borrowed much less as comapred to the previous month. Moreover, it repaid previous loans even more. As a result, net repayments equalled to UAH 5.4 billion. Negative balance on active operations of the government (mainly changes in cash resources) totaled UAH 7.2 billion. Cumulative consolidated budget surplus from the beginning of the year further expanded to UAH 35.4 billion in January-August (about 1.4% of period GDP).

Consolidated budget revenues dropped 2.6% yoy in August. Different schedule of transferring profits to the fiscal budget by Naftogaz and NBU in 2019 as compared to 2018 led to a 39.7% yoy decline in nontax revenues. This decline in fiscal transfers more than offset a 4.2% yoy growth in tax revenues. But growth of tax revenues itself was three times lower than in July because of continued decline in production of tobacco products leading to a decline in receipts of excise taxes on domestic goods (7.8% yoy). Taxes on imports denominated in hryvnia also declined, including significant decline in taxes on natural gas. At the same time, fast growth of nominal wages and improvements in financial standing of businesses ensured high growth rates of receipts from both personal income tax and corporate profit tax (17.9% yoy and 13.5% yoy, respectively). VAT receipts posted the fastest growth at 36.1% yoy. The growth of cumulative consolidated budget revenues from the beginning of the year was 11.6% yoy in January-August.

Dynamics of Consolidated Budget Components (from the beginning of the year)



Source: The Ministry of Finance of Ukraine, The Bleyzer Foundation

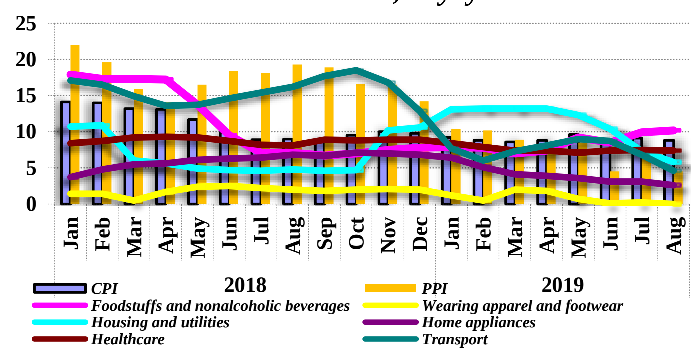
Growth of consolidated budget expenditures decelerated in August. Both current and capital expenditures grew at slightly slower pace (11.3% yoy and 19.1% yoy, respectively). Despite some deceleration, growth of current transfers was still the highest among major budget expenditures. Payroll expenditures, in contrast, saw their growth accelerating to 20.5% yoy, which was the second highest. Expenditures on goods and services and, especially, social security expenditures posted decelerated growth of 3.6% yoy and 3.9% yoy respectively. Expenditures on debt servicing returned to growth and expanded by 10.5% yoy. Growth of the cumulative consolidated budget expenditures from the beginning of the year remained almost unchanged at 12.1% yoy in January-August.

Foreign currency denominated state and guaranteed debt payments totaled USD 257 million in August. USD 89.7 million was paid to the IMF. Servicing payments on Eurobonds were equal to USD 33.7 million, while servicing payments on domestic sovereign bonds were at USD 23.0 million. Payments on other liabilities to foreign creditors and IFIs totaled USD 111.1 million. In the last quarter of 2019, Ukraine expects to pay USD 3.3 billion worth of debt according to the Finance Ministry. The figure is about 3% of Ukraine's 2018 GDP.

Monetary Policy

Inflation. Consumer inflation saw some deceleration in August. The all items index dropped 0.3 percentage points to 8.8% yoy. Slower growth in administratively regulated prices and core inflation more than offset the increase in prices of foodstuffs. Core inflation slowed by 0.2 percentage points to 7.2% yoy.

CPI, PPI, and Growth of Prices for Select Goods and Services, % yoy

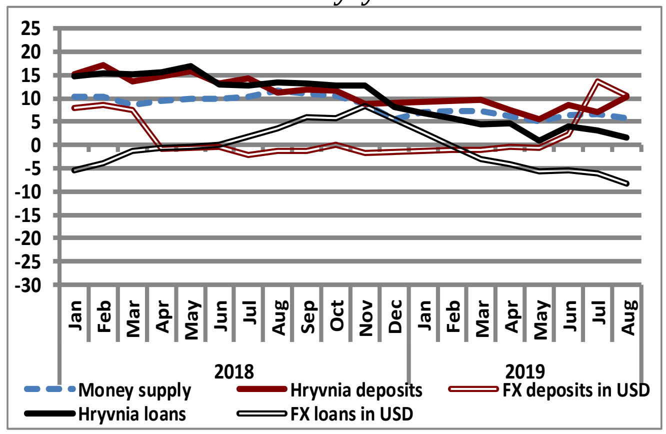


Source: State Statistical Service of Ukraine, The Bleyzer Foundation

Most of the major groups of goods and services reported deceleration in price growth. Transport services reported the largest deceleration in prices (by 2.2 percentage points to 4.6% yoy). This group was followed by housing and utilities (by 1.5 points to 5.8% yoy), culture and recreation (by 0.7 points to 2.5% yoy), and home appliances (by 0.5 points to 2.6% yoy). Based on recent price developments, we leave our forecast of consumer inflation unchanged at 8.0% yoy at the end of the year.

Banking Sector. There were mixed developments in banking deposits in August. Growth of the national currency bank deposits accelerated to 10.4% yoy, while growth of foreign currency deposits denominated in USD decelerated to 10.5% yoy. National currency deposits expanded thanks to continuous growth in wages and constant inflow of foreign currency with its further conversion into hryvnia. Household deposits grew by 14.7% yoy and corporate deposits increased by 8.4% yoy. As the effect of temporary factors (placement of Eurobonds of several big companies) is fading away, growth of foreign currency deposits denominated in USD decelerated. Growth of corporate deposits dropped 10.8 percentage points to 25.0% yoy which more than offset some accelerated in household deposits to 5.5% yoy.

Dynamics of Money Supply, Deposits, and Loans % yoy



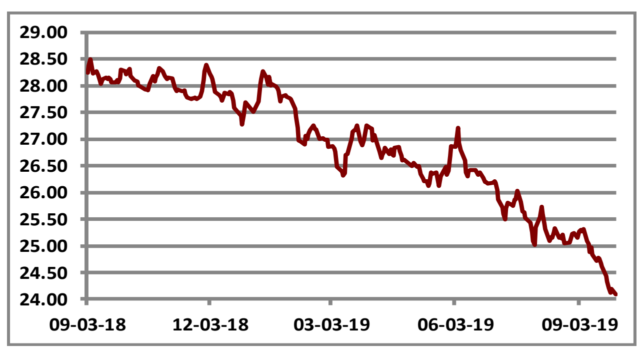
Source: The NBU, The Bleyzer Foundation

Bank lending activities posted rather sluggish performance again in August. Growth of national currency loans halved to 1.5% yoy. Household loans expanded fast at 25.5% yoy thanks to consumer loans but this growth was significantly compensated for by a 5.0% yoy decline in corporate loans. The decline in foreign currency loans denominated in USD accelerated because of faster decline in both corporate (5.7% yoy) and household (23.0% yoy) sector.

The monetary base and money supply moved in opposite directions in August. The former expanded by 2.2% mom. This led to acceleration of over-year growth to 5.7%. In contrast, money supply decreased by 0.7% mom leading to deceleration in its year-over-year growth by 1.0 percentage point to 5.7%.

Hryvnia Exchange Rate. The UAH/USD exchange rate followed an appreciatory trend during September except for the last two trading sessions. Appreciation of the exchange rate was supported by additional sales of dollar from non-residents and exporters. But on September 27th, the IMF mission left Ukraine without a staff-agreement, sending a negative signal to businesses and investors. In addition, the Ministry of Finance announced that it will cease placing 5-year bonds, which are of major interest among non-residents. As a result, the exchange rate depreciated during the last two trading sessions of September. Overall, the exchange rate appreciated by 3.2% to around 24.36 UAH/USD.

Official UAH/USD Exchange Rate (based on the Average Weighted Rate at the Interbank Forex Market)



Source: The NBU, The Bleyzer Foundation

In line with its program of currency exchange liberalization, the NBU lifted the monthly limit of EUR 5 million on repatriation of funds received from sales of securities and equity rights limitations. The limit was also lifted for funds received by foreign investors from lowering statutory assets of legal entities and exit from partnerships. The regulator also expanded the list of operations with accounts of non-residents.

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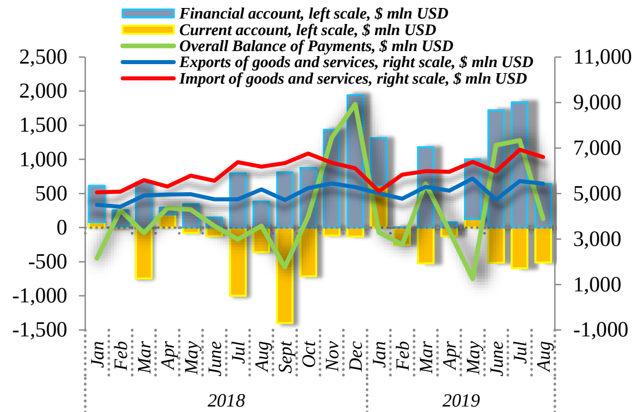
International Trade and Capital

In August 2019, Ukraine's current account deficit grew by 42.6% yoy to USD 512 million, compared to USD 359 million in August 2018. The recent deficit was due to a higher rate of growth of merchandised import (8.2% yoy, USD 3,933 million) relative to export increase (5.6% yoy, USD 5,229 million). Similarly, in August 2019 the net trade deficit of goods and services grew by 17.7% yoy to USD 7,188 million, due to higher import growth (7% yoy) relative to export expansion (4.9% yoy). On the other hand, net primary income strengthened the current account by (USD 3,248 million, 57.7% yoy). In particularly, employee's compensation raised by 8.6% yoy (USD 7,951 million).

Ukraine's External Balance of Payments



Source: NBU, the Bleyzer Foundation

With regard to merchandised exports only agricultural goods (19.7% yoy) and mineral products (38% yoy) showed positive growth in August 2019. Other sectors experienced export reductions ranging as follows: timber and wood products (-21%yoy), informal trade (-18.8%yoy), ferrous and nonferrous metals (-16%yoy), chemicals (-12.5%yoy), industrial goods (-1.8%yoy), machinery and equipment (-0.8%yoy).

On the goods import account, the largest imported products took place in four sectors: machinery and equipment (24.8% yoy), industrial goods (17% yoy), chemicals products (6.1% yoy), and agriculture products (5.1% yoy), in August 2019. On the other hand, Ukrainian merchandised import that achieved negative results were as follows: timber and wood products (-10% yoy), informal trade (-8.4% yoy), ferrous and nonferrous metals (-7.5% yoy), and mineral products (-0.8% yoy).

On a geographical distribution basis, in January-August 2019 Ukraine merchandised trade deficit of USD 8,291 million was distributed as follow: trade deficit with CIS countries: 50.4% share of the total amount; and other countries: 49.6% of the total. About 73% of the CIS deficit (USD 4,181 million) related to the Russian Federation (USD 3,041 million). On the export side, exports to Europe grew by 11.1% yoy to USD 11,847 million (with a share of 39%) on January-August 2019. Exports to Asia increased by 8.9% yoy and reached USD 9,721 million (32% share). While Ukrainian goods exports to CIS countries fell by 5.5% yoy to USD 4,382 million (a share of 14.4%) including the Russian Federation with exports of USD 1,761 million (-5.2% yoy, 5.8% share). From the point of view of Ukrainian imports of goods, the largest amount of imported goods were received from Europe with an amount of USD 15,881 million (10.6% yoy, 41.1% of the total imports share), Asia reached USD 9,295 million (22.8% yoy, 24% a share) and America imported goods of USD 2,587 million (7.6% yoy, 6.7% of the total amount of imports share), including USA with USD 2,017 million (11.8% yoy, 5.2% a share) in January-August 2019.

In August 2019, Ukrainian financial account of the balance of payments had financial inflows in the amount of USD 639 million (an increase of 66.8% yoy). The largest financial inflows were provided by foreign direct investments with USD 294 million (58.9% yoy) as well as trade credits in the amount of USD 715 million (131.4% yoy). Given that these financial inflows exceeded the current account deficit, the overall balance of payments reached a surplus of USD 130 million, which allowed the NBU to accumulate international reserves of USD 21,437 million at the end of August 2019.