CENTRE FOR ECONOMIC STRATEGY

GET German Economic Team

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Economy review in June.

London Conference: Will there be projects, and the funding?

WAR

WAR UPDATE

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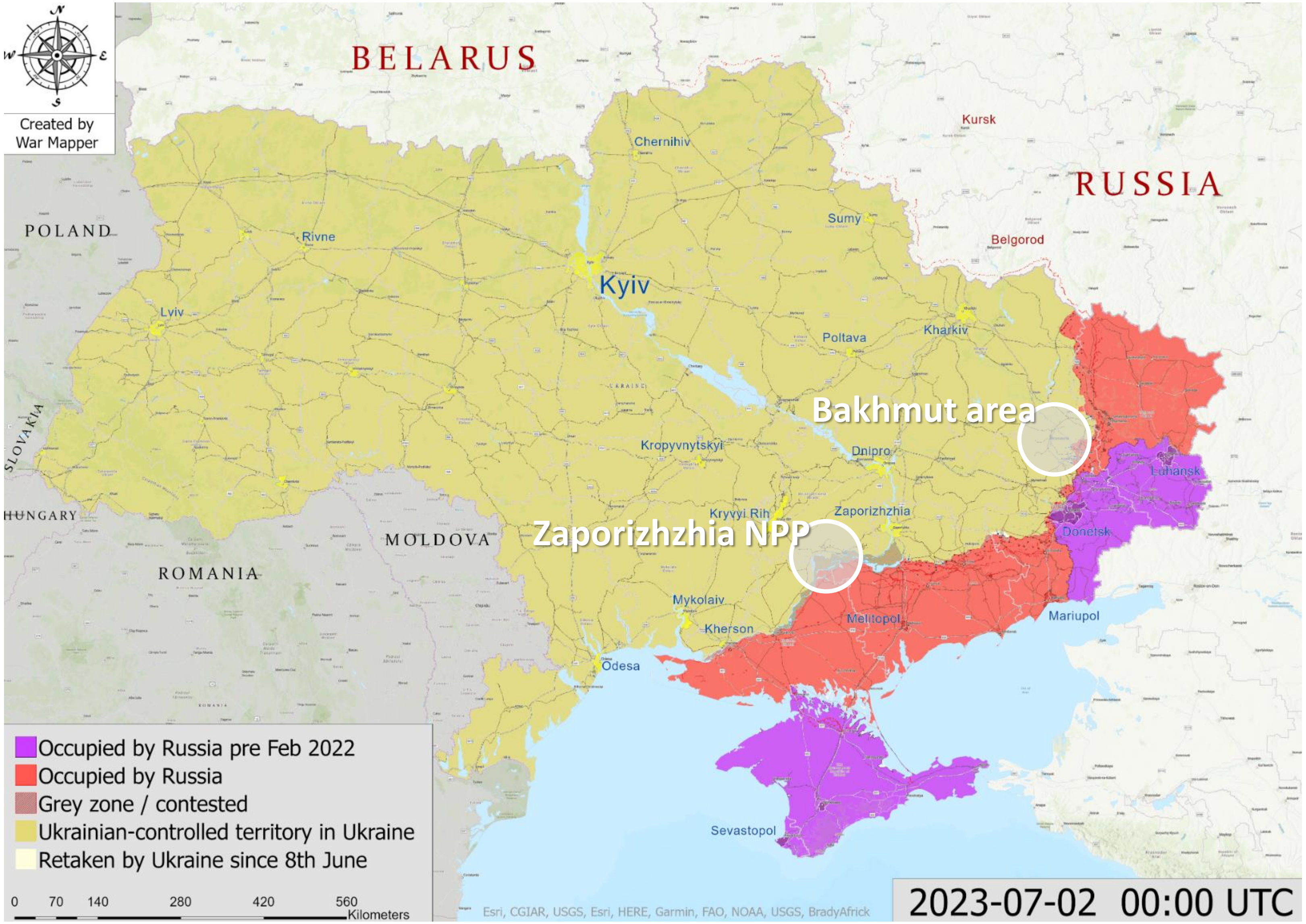

- In June, Ukraine commenced shaping operations on the Southern front. According to Ukrainian officials, the bulk of forces have not been yet deployed.
- Heavy fighting continues in Bakhmut area and elsewhere on the Eastern front.
- Zelenskyy and other Ukrainian officials have been warning the international community about the risk of destruction of Zaporizhzhia nuclear power plant by the Russian forces.
- A short-lived mutiny by Wagner Group, a terrorist organization led by Yevgeniy Prigozhyn and financed by the Russian government, occurred in Russia.

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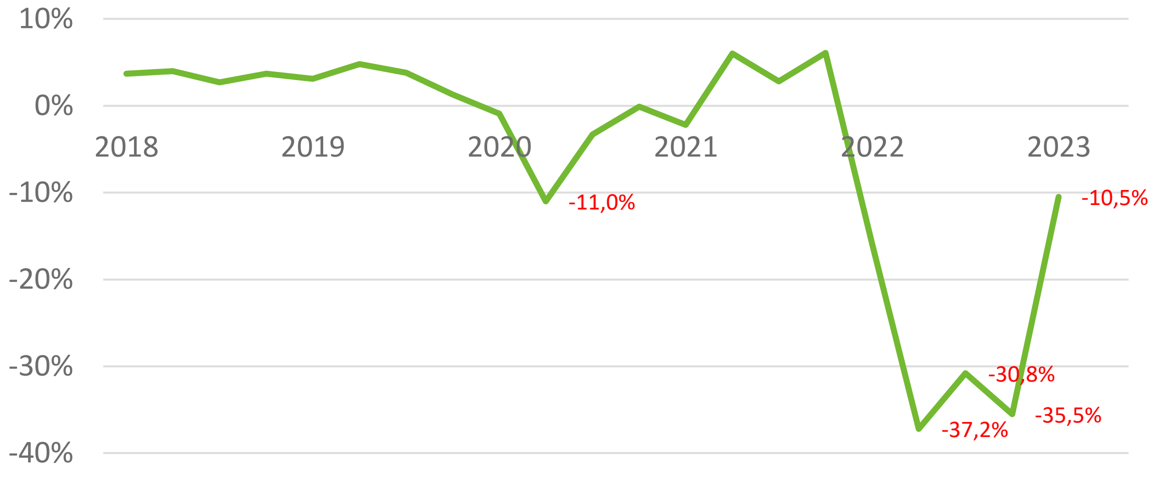
MACROECONOMIC TRENDS

MACRO

GDP down by 10.5% in Q1

- GDP decrease slowed down to 10.5% yoy in Q1 (not 13.5%, according to preliminary estimation by the National Bank), quarterly GDP grew by 2.4%;
- Several institutions improved their yearly forecasts (like IMF), although some of them (like Raiffaisen Bank) wanted to, but were stopped by effects of Kakhovka HPP destruction.

GDP growth, yoy



Sources: Ukrstat

MACRO

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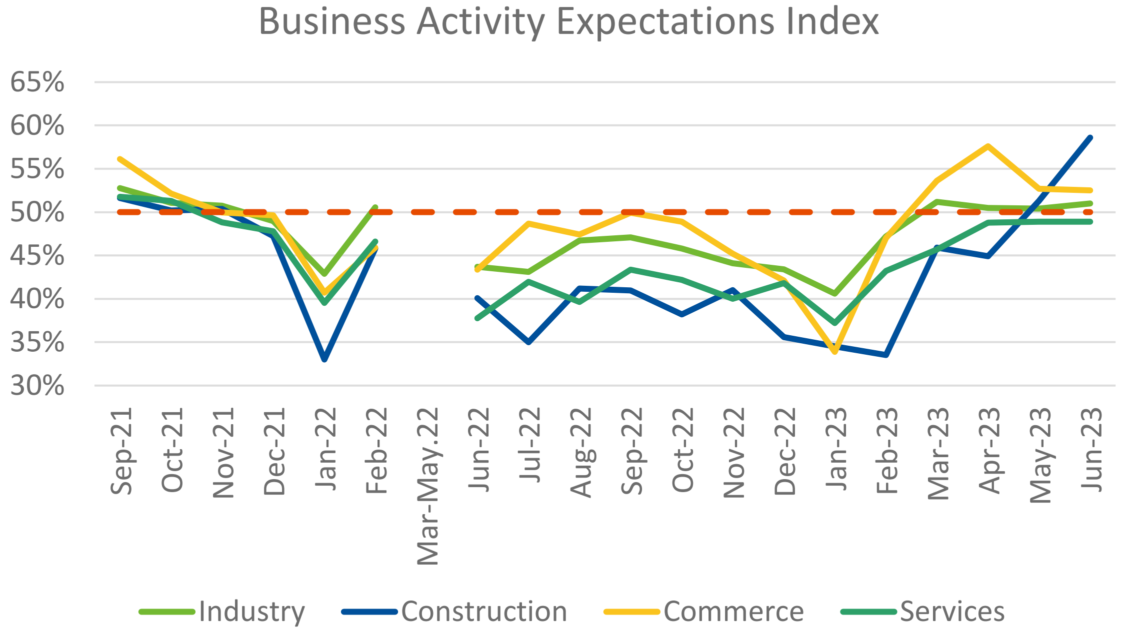
Business confidence: Most sectors are optimistic

- In June, the Business confidence index was 50.8, a small increase comparing to May;
- Composite index is above neutral level for the third month; subindices are too, except for services;
- Industry and construction improved expectations; services maintained previous level;
- Construction is now the leader of optimism, after long period of the worst expectations.



Source: National bank.
50% is neutral level (number of optimists equals the number of pessimists)

MACRO

War damage estimates increased by USD 0.2 billion

- Damage assessment increased by USD 0.2 billion during May, the smallest increase this year;
- Damages from Kakhovka HPP's destruction are estimated at USD2 billion;
- National bank downgraded credit risk forecast by 10 p.p., back to 20% (meaning USD2 billion less losses for banks).

Asset type	May'23	Apr'23	Change
Residential buildings	54.1	54.1	0.0
Transportation infrastructure	36.2	36.2	0.0
Industry	11.4	11.4	0.0
Education	9.7	9.7	0.0
Agriculture and land	8.7	8.9	-0.2
Energy infrastructure	8.3	8.3	0
Other assets	19.3	18.9	0.4
TOTAL	**147.7**	**147.5**	**0.2**

Source: KSE, Russia will pay project

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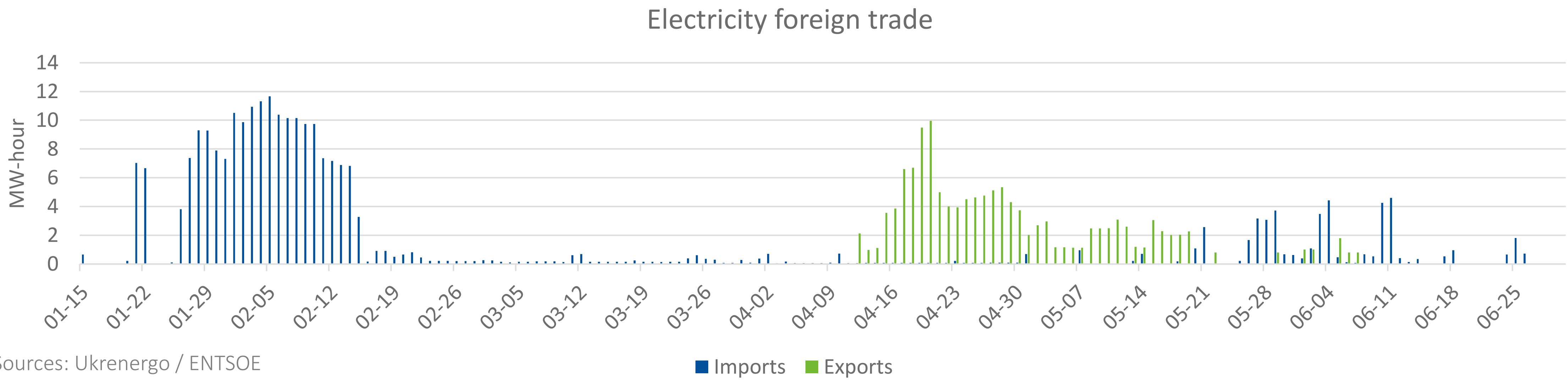
SECTORAL ANALYSIS

SECTORAL

Energy: Electricity surplus ended

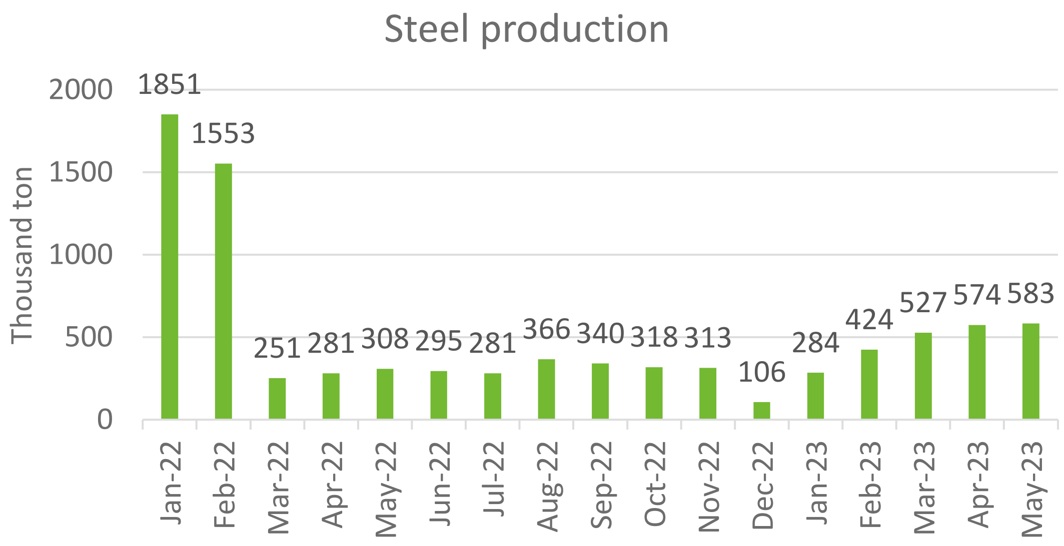
- Zaporizhzhia NPP is mined, reactors are in cold stop mode;
- The destruction of Kahkovka HPP led to decrease of hydro power generation up the stream;
- Renewable capacity down by 500 MW as a result of Kakhovka terrorist attack;
- Electricity exports are zero, imports increased, price was higher than in EU on some days;
- Russia attacked energy infrastructure again, but to much lower effect;
- Full-scale taxation (VAT and excise) of fuels restored, implying 12-24% growth of retail price.



Sources: Ukrenergo / ENTSOE

SECTORAL

Metals: Steel production set wartime record before contraction



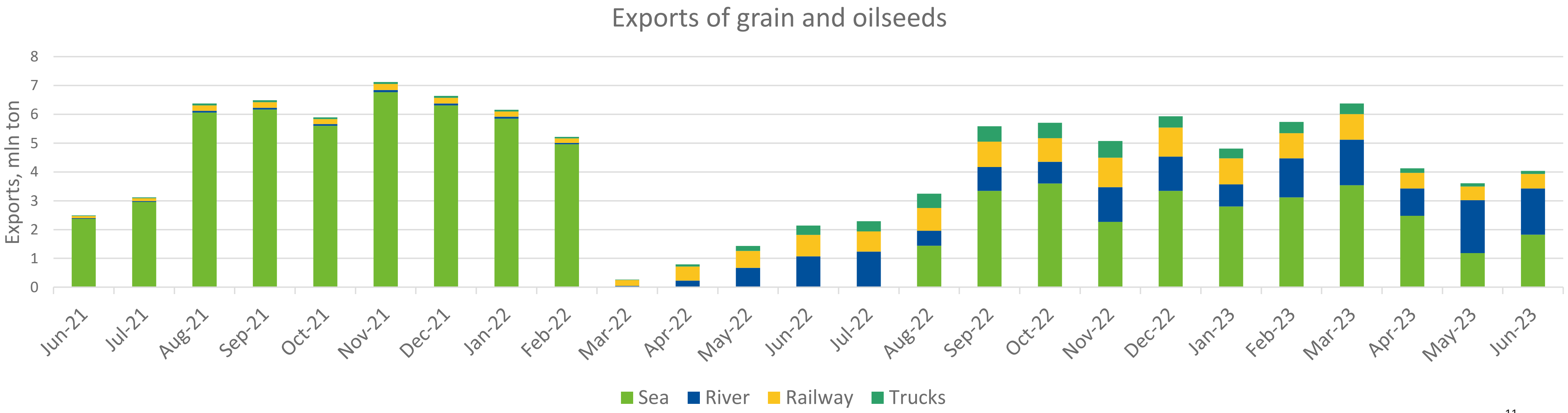
Source: Worldsteel

- In May, steel production doubled comparing to May 2022;
- The effects of Kakhovka HPP destruction are to be determined, but the production at ArcelorMittal Kryvyi Rig down by 50% in June comparing to previous months;
- Metinvest said that the situation on their plants is under control.

SECTORAL

Agriculture: Grain Deal is probably ending

- Grain Deal corridor operates at 20% capacity, not likely to be prolonged;
- Neighboring countries want both term and the list of Ukrainian products banned by EU to be extended;
- Ukrainian agrarian associations suggest taking the discussion of this ban to the WTO;
- Harvesting campaign started, the government improved harvest forecast;
- 127 thousand hectares of arable were demined, 25% of shortlisted plots;
- More agro holdings opted to develop further processing.



Sources: State Custom Service, Minagro, UN

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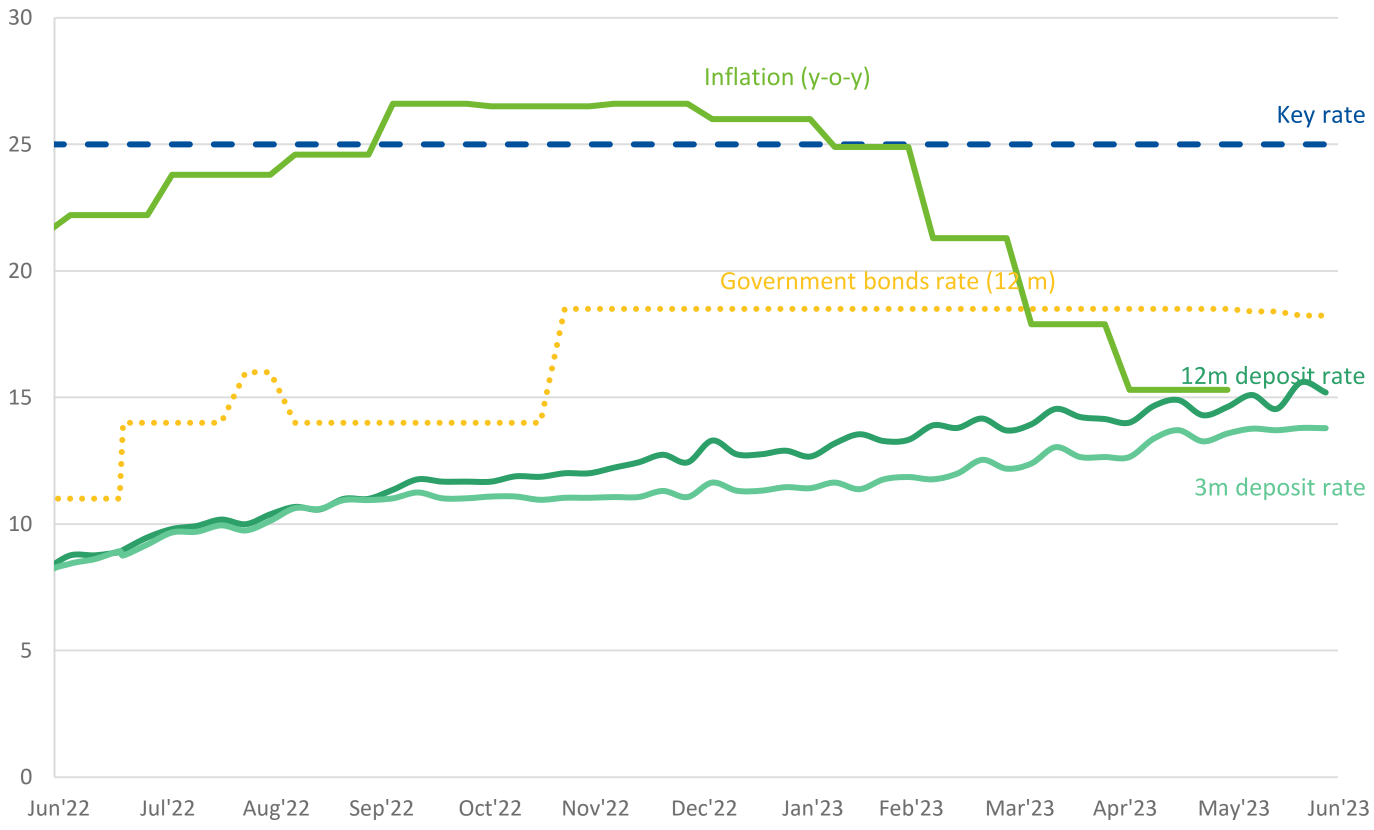
MONETARY AND FX POLICY

MONETARY POLICY

The rates are stable; inflation continues to decelerate

Inflation (y-o-y), NBU key rate, rates on hryvnia consumer deposits (12- and 3-month), and weighted average level of yield on 1-year hryvnia government bonds, %



Sources: NBU, State Statistics Service, UIRD

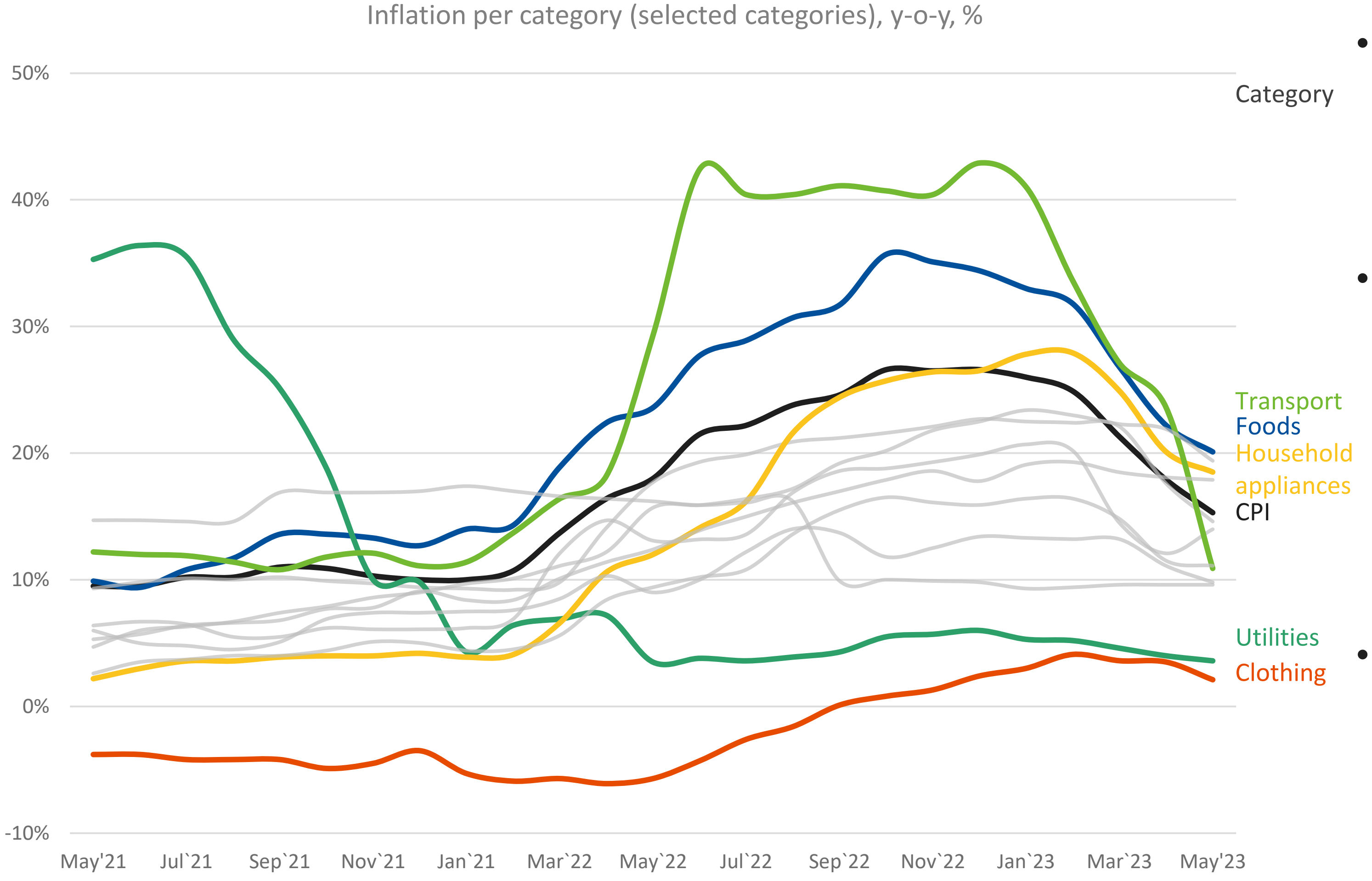
- The key policy rate remains unchanged at 25% p.a to maintain hryvnia instruments' appeal, sustain FX market stability, and reduce inflation since recent NBU MPC (Monetary Policy Committee). But there is a possibility that the NBU may launch a cycle of gradual key policy rate cuts either in July or September.

- The yield of one-year hryvnia military bonds decreased to 18.2% p.a. At the end of May, average rates on retail deposits (UIRD) continued to rise slowly. Interest rates on 12-month retail deposits rose to 15.2% p.a., and rates on 3-month deposits increased to 13.8% p.a.

- In May, inflation has been declining faster than expected, and the growth in consumer prices decelerated to 15.3% y-o-y. In monthly terms, prices grew by 0.5%.

CPI

Inflation slows down; CPI 15.3% y-o-y in May



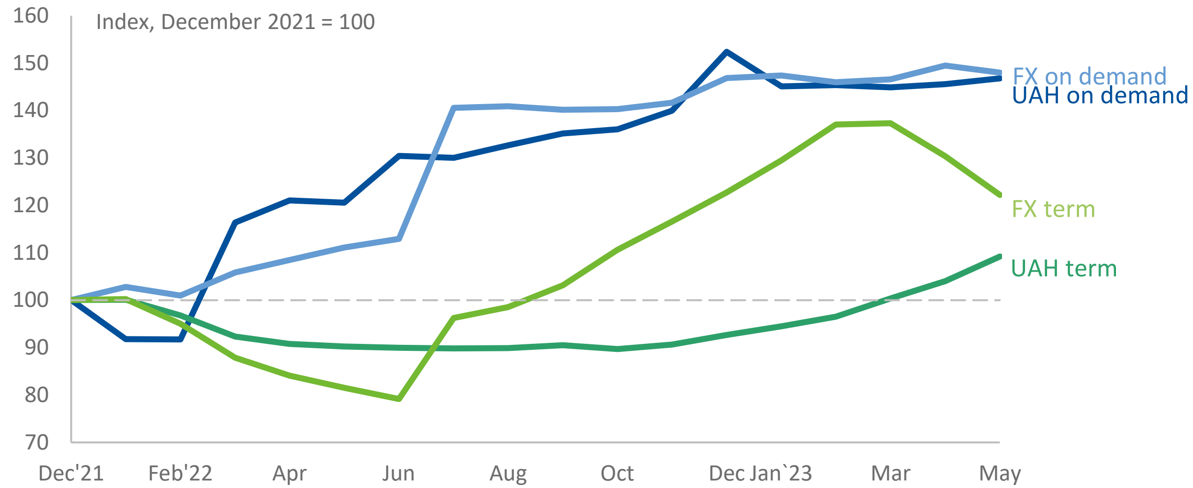
Source: State Statistics Service of Ukraine

- The decline in inflation is due to ample food and fuel supply, a stronger hryvnia in the cash market, improved inflation and exchange rate expectations, and the base effect.
- Core inflation decreased to 15.6% y-o-y in May, while growth in administered prices slowed to 9.3% y-o-y, mainly due to moderate demand and positive exchange rate expectations amid base effects. The moratorium on raising utility prices for households also curbed the increase in administered prices.
- NBU expects slower inflation decline due to reduced base effects, reintroduction of pre-war fuel taxes on July 1, and electricity market price adjustments. The recent terrorist attack on Kakhovka HPP by Russia will contribute about 0.3 pp to this year's inflation rate.

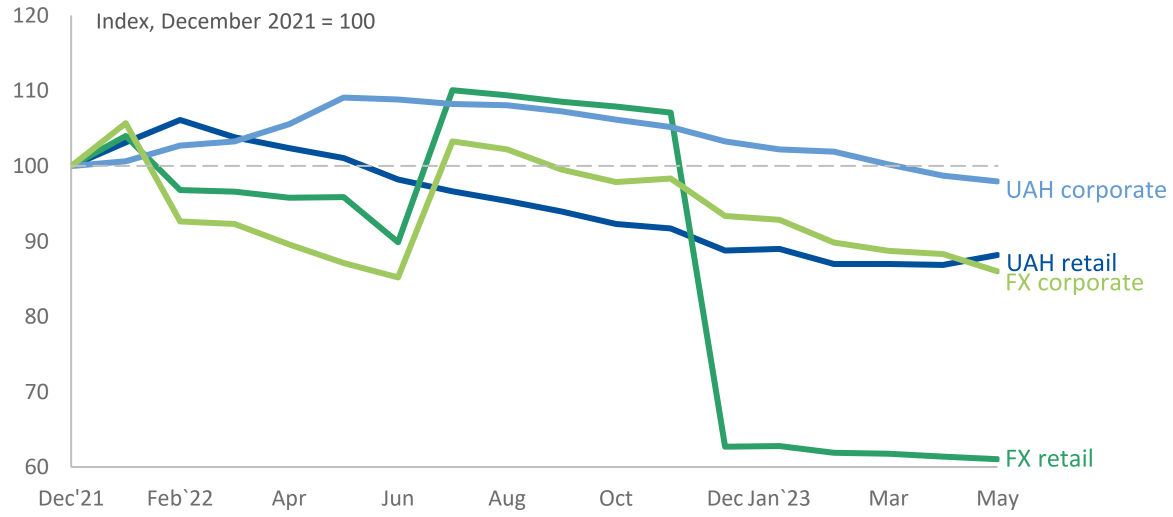
BANKING SECTOR

Loans continue to decrease; term deposits in hryvnia on the rise

Household deposits by currency and maturity, index, December 2021 = 100



Loans to residents by currency and sector, index, December 2021 = 100



NB: a sharp increase in FX loans and deposits in July 2022 is caused by change of official rate. Source: NBU

- The volume of household deposits continues to increase, primarily the term ones in hryvnia, due to higher interest rates compared to short-term deposits.
- However, both FX deposits on demand and term ones continue to decline due to hryvnia`s strengthening and allocation of funds into hryvnia deposits.
- Loans continue to decrease both for hryvnia and foreign currency loans. Volumes of new lending don`t cover repayments on earlier loans due to weak demand for them.
- The main driver for lending is the Affordable Loans 5-7-9% program – the main recipients are agriculture and wholesale enterprises. It is 1/3 of the net hrynia corporate loan portfolio.
- Banks continue to recognize loan losses. NPL stood at 39.1% as of the beginning of June.

FISCAL SECTOR

FISCAL SECTOR

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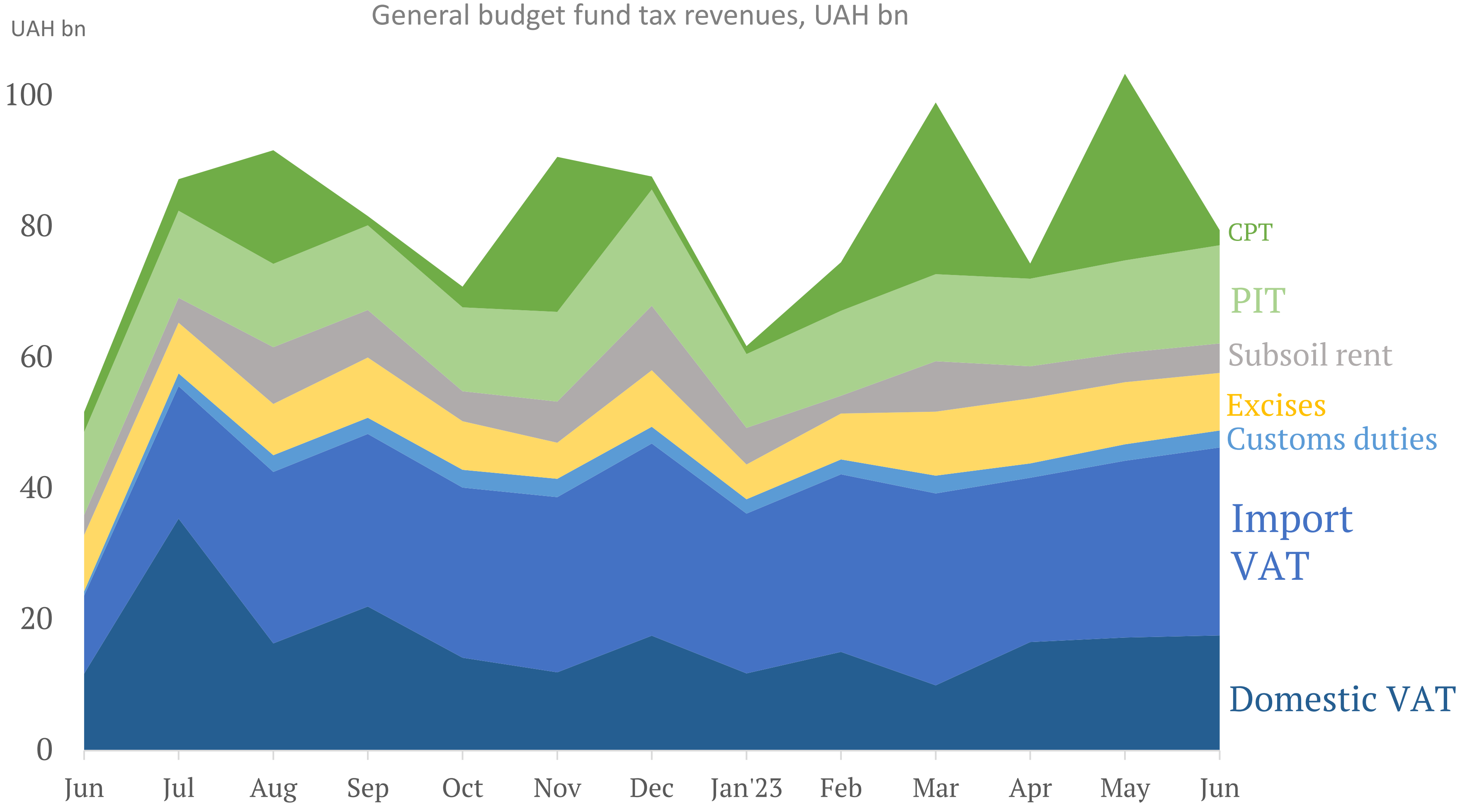
Tax revenues continue steady growth, driven by VAT



Source: Ministry of Finance

Tax revenues in June brought UAH 79.5 bn.

Without CPT, the tax revenues increased 3% MoM and 59% YoY (low base due to import tax reliefs in 2022).

Import VAT was the largest revenue source (**UAH 28.7 bn**), and it grows faster than **domestic VAT** revenues (**UAH 17.6 bn**). Combined, VAT made 58% of total tax revenues in June.

Both Tax Service and Customs Service have exceeded the monthly revenue plans, by UAH 2.6 bn in total.

Note: the detailed breakdown by sources is not available as only preliminary June figures were released as of the current date

FISCAL SECTOR

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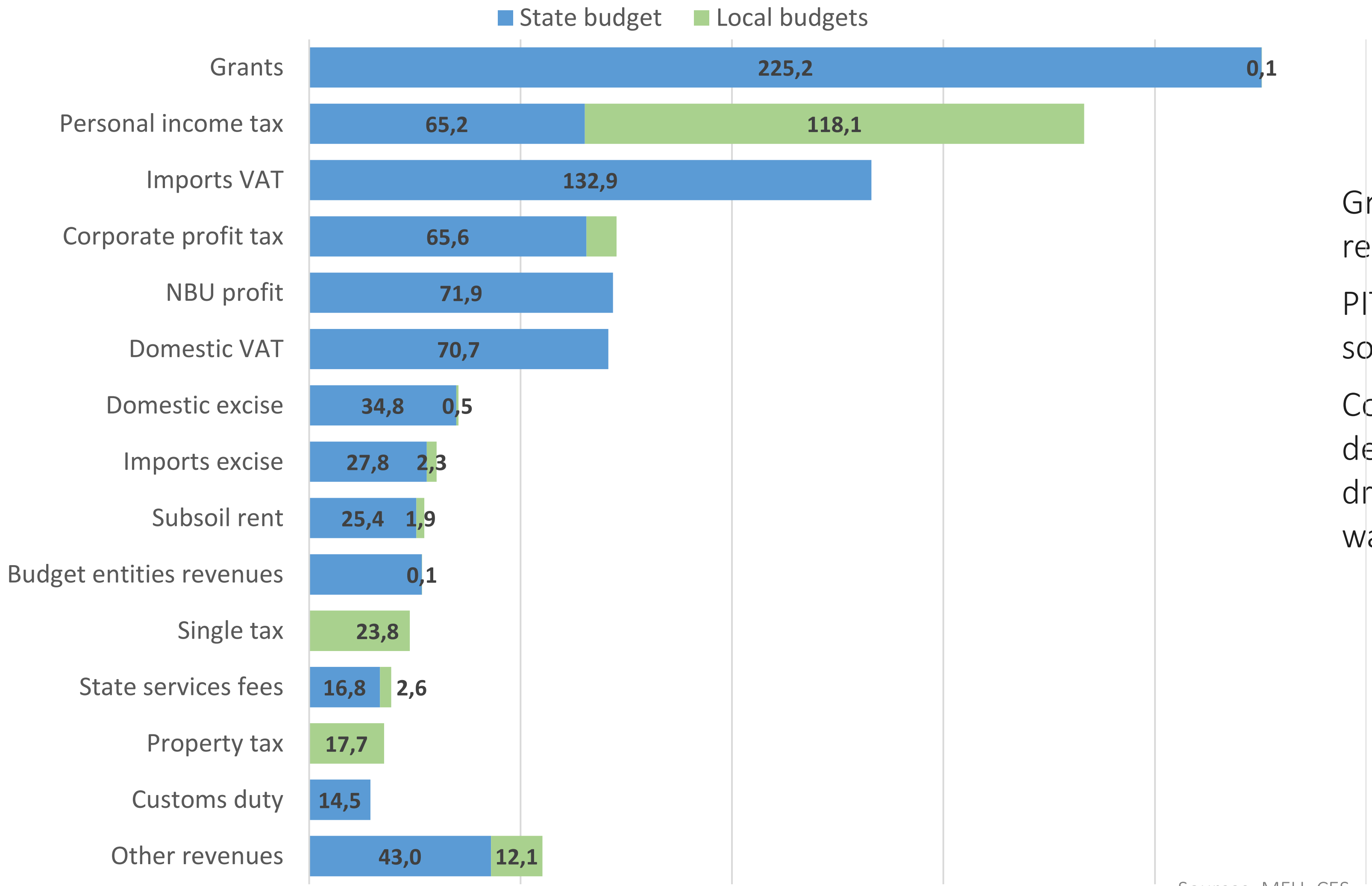
Grants remain the major revenue source for state budget, PIT – for the local budgets

Consolidated budget revenue sources excluding internal transfers for Jan-May 2023, UAH bn



Grants remain the largest source of revenue for the consolidated budget.

PIT(including military tax) is the largest source of revenue for local budgets.

Compared with 2022, domestic VAT decreased relative to imports VAT and dropped a few places down the list, giving way to CPT and NBU profit.

Sources: MFU, CES

FISCAL SECTOR

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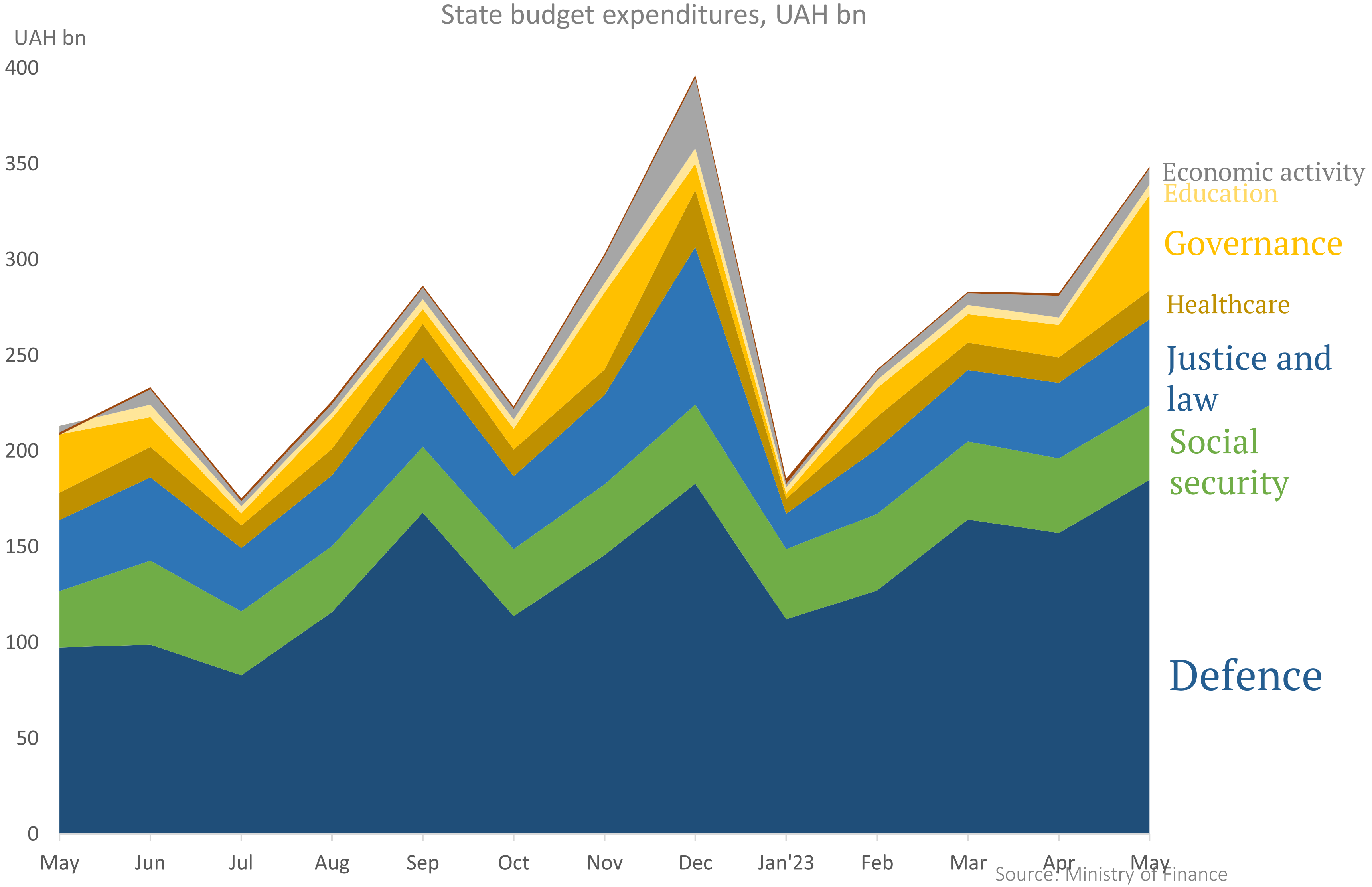
State budget spending expands further



Source: Ministry of Finance

Monthly state budget expenses in May reached UAH 349 bn – the second largest monthly spending after Dec'22 (+24% MoM and +67% YoY).

Defense expenses for 5m2023 amounted to **UAH 745 bn**, 56% of total expenses, with **UAH 174 bn** spent on **Justice and law** (13%).

May saw a sharp increase in spending on Governance – up to UAH 50 bn, thus exceeding Social security and Justice. Out of these 50 bn, 45.6 bn were spent on debt service.

FISCAL SECTOR

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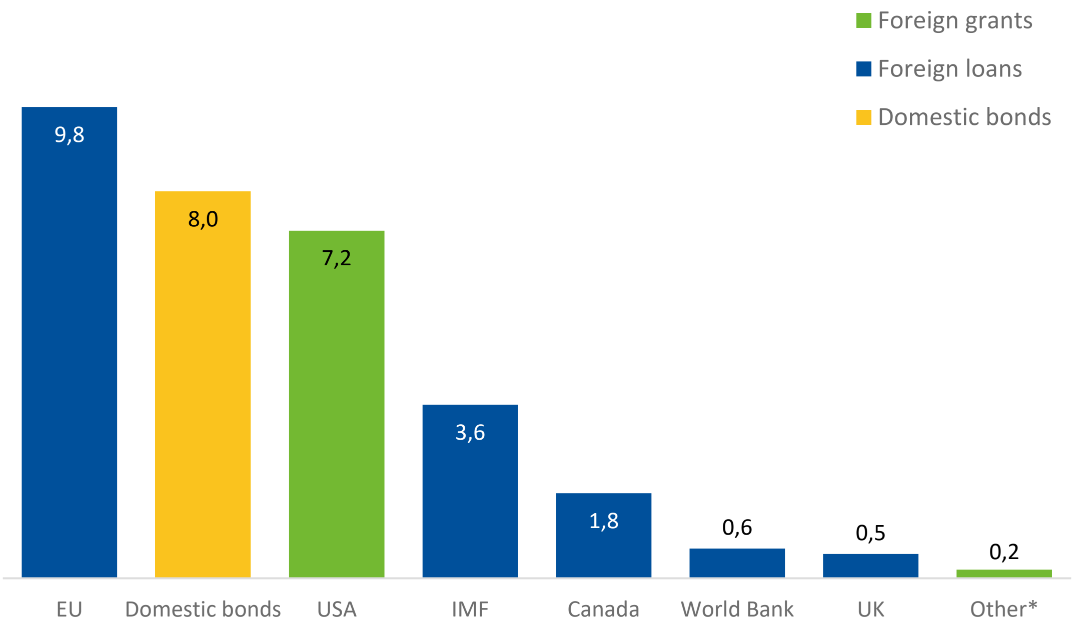
USD 3.8 bn of foreign financing in June

In June, Ukraine received a USD 1.64 bn loan from the EU and a USD 1.2 bn grant from the US. The IMF disbursed the second loan tranche of USD 890 m. Additionally, Ukraine received a USD 68 m loan from the World Bank and a USD 15 m grant from Finland.

In the first half of 2023, Ukraine's state budget deficit and debt repayment needs amounted to USD 27.1 bn while the foreign financing amounted to USD 23.7 bn. Monetary financing has been absent for 6 months already. According to Serhii Marchenko, the Minister of finance, Ukraine's budget needs in 2023 will be fully covered.

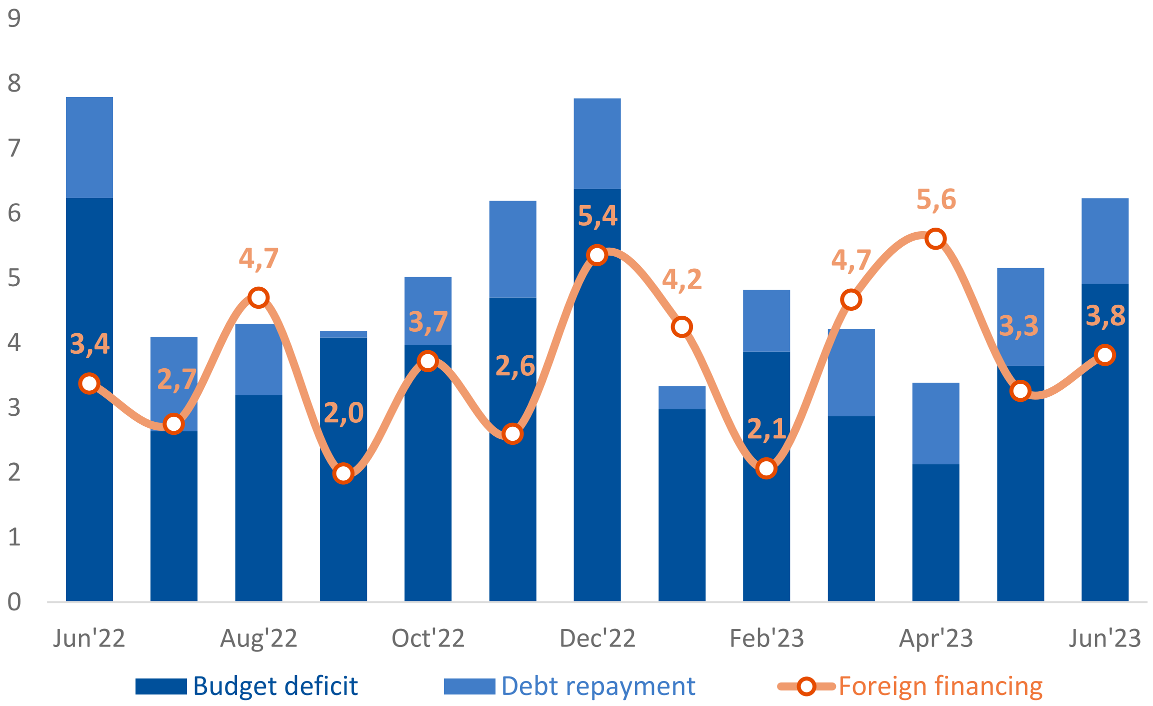
2023 additional financing of Ukraine's state budget as of July 4, USD bn



Germany, Spain, Finland, Ireland, Switzerland, Belgium, Iceland, Estonia*

Source: Ministry of Finance

Foreign financing, budget deficit and debt repayment in 2022-23, USD bn



Source: Ministry of Finance, NBU, CES calculations

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LONDON CONFERENCE RESULTS

UKRAINE RECOVERY CONFERENCE 2023 RESULTS

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Financial aid: more pledges are needed to cover reconstruction and mid-term budget needs

✅ 2023 state budget needs will be covered

'We are fully funded for this year'
- Serhii Marchenko

⚠️ 2024 and beyond - uncertainty

'What is your position? Where is your support?'
- Serhii Marchenko to G7 nations commenting on the EU pledge of EUR 50 bn

The European Commission proposed EUR 50 bn of grants and loans that should cover 45% of Ukraine's state budget and immediate reconstruction needs in the years 2024-2027. **This financing will be tied to specific reforms that are meant to push Ukraine closer to the EU membership. No pledges from the U.S. yet.**

⚠️ 2023 immediate reconstruction needs are not fully covered

Ukraine's needs for immediate reconstruction are estimated at USD 14 bn. Before the URC 2023, Ukraine lacked USD 6.5 bn of pledges to cover the gap. However, **new pledges announced at the London conference are still not enough** to fully cover the immediate reconstruction needs in 2023.

⚠️ No clear plan to finance longer-term reconstruction needs

The issue of post-war reconstruction of Ukraine is still hanging in the air. Costs of rebuilding are already estimated at USD 411 bn and will only grow as the Russian invasion continues and new damages and losses occur every day. **The Western taxpayers are not ready to pay for the damages inflicted by Russia**; the primary source of financing should be the frozen Russian assets.

UKRAINE RECOVERY CONFERENCE 2023 RESULTS

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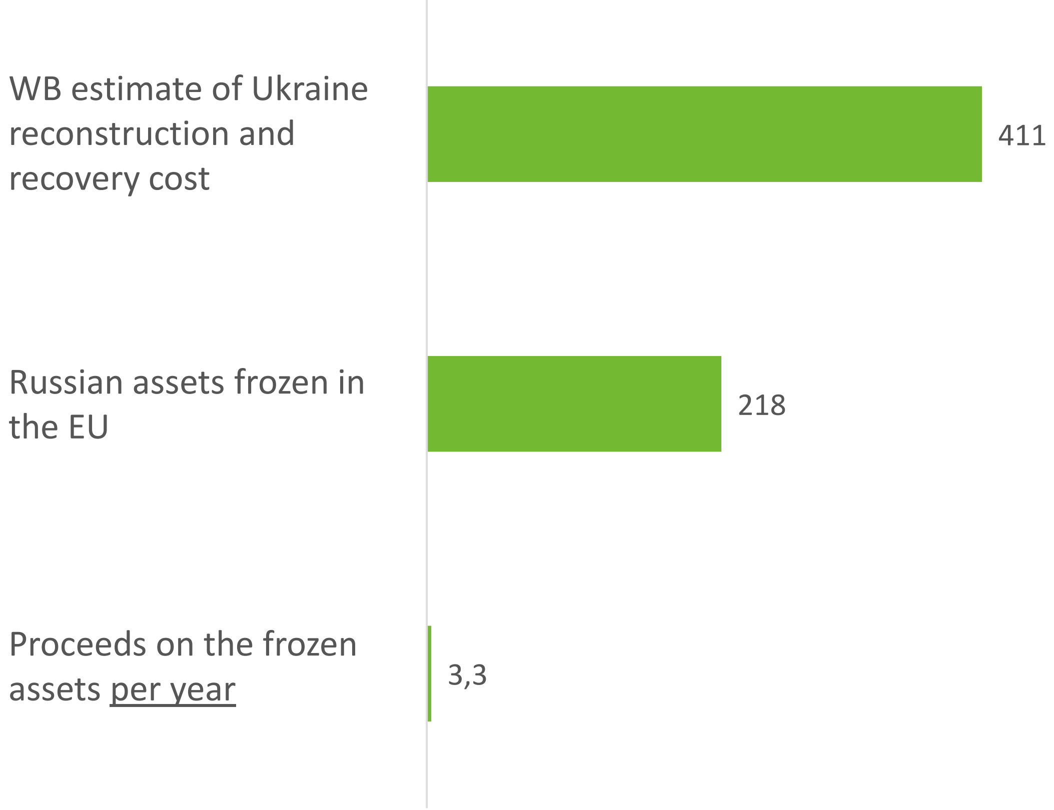
Around EUR 3 bn per year can be raised from the proceeds on the frozen Russian assets

- During her speech in London, president of the European Commission (EC) Ursula von der Leyen **announced the proposal to use the proceeds on the frozen Russian assets** to pay for Ukraine reconstruction.
- On a later summit, EU leaders supported cautiously exploring the option.
- This option would raise **around EUR 3 bn per year.**
- Some European leaders and the ECB are unwilling to use the Russian money to pay for the reconstruction of Ukraine.

Comparison of Ukraine reconstruction needs and the frozen Russian assets, USD bn



Source: World Bank, the European Commission, Anders Ahnlid

UKRAINE RECOVERY CONFERENCE 2023 RESULTS

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Important updates on war risk insurance

- Marsh McLennan will work with Ukrainian government to analyze the real levels of risks related to Russian missile attacks.
- Development Finance Corporation of the U.S. plans to cooperate with MIGA on insuring Ukrainian risks.
- EBRD also intends to relaunch the private insurance market in Ukraine in cooperation with the EC, Switzerland, Norway, and the EIB.

UKRAINE RECOVERY CONFERENCE 2023 RESULTS

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Ukraine now has a DREAM to improve recovery transparency

- Ukraine presented the DREAM system, which will ensure transparency and accountability of recovery projects.
- DREAM stands for Digital Restoration Ecosystem for Accountable Management.
- DREAM will collect, organize, and publish open data across all stages of reconstruction projects in real time.
- Transparency and support for communities working with open data is a prerequisite for donor funding for reconstruction.
- The system will be fully operational in December 2023.

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THANK YOU.

This text reflects the opinion of the authors and does not necessarily represent the views of the German Economic Team.